

WRITTEN STATEMENT OF
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CONCERNING

**“REGULATION NMS AND DEVELOPMENTS IN MARKET
STRUCTURE”**

BEFORE

**COMMITTEE ON BANKING, HOUSING AND URBAN
AFFAIRS**

UNITED STATES SENATE
ONE HUNDRED EIGHTH CONGRESS

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Good morning Chairman Shelby, Ranking Member Sarbanes, and other distinguished members of the Committee. As Chairman and CEO of the Archipelago Exchange (“ArcaEx”), it is a high privilege and great honor to be provided the opportunity to submit a written statement to and testify before the Committee on proposed Regulation NMS and developments in market structure.

I. The History of ArcaEx

ArcaEx’s beginnings were sown in the immediate aftermath of the Nasdaq price-fixing scandal of the mid-1990s, which culminated in sanctions being brought by the Securities and Exchange (“SEC”) and the Department of Justice.¹ One of the chief reforms exacted on the OTC marketplace in response to the scandal was the introduction of the so-called Order Handling Rules in 1996.² These rules provided me with an opportunity to design a trade-execution business that, although seemingly very simple, was revolutionary for its time. It was “to do the right thing” by the customer by creating a level playing field for all investors in an industry traditionally filled with insiders and insider deals. With that, our credo has always been: no special(ist) handshakes, no “negative obligations,” no “jaywalking,” and no thirty-second free options; rather, all investors are given the

¹ See Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, SEC, August 8, 1996.

² Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (File No. S7-30-95).

opportunity to play on a level playing field. This has been and will continue to be one of our competitive advantages.

From day one, we branded our business as "best execution" by delivering to all of our customers: (1) access to full and timely market information; (2) fast electronic and anonymous executions; (3) sophisticated order types and other value-added functionality; and, (4) arguably our biggest contribution to market structure - algorithmic outbound routing to guarantee best price where that price did not reside in ArcaEx. This latter element was both a sizeable technological innovation and a manifestation of two primary goals articulated by Congress in the National Market System Amendments in 1975.³ By establishing proprietary linkages among marketplaces, we were able to create a large virtual pool of liquidity where customers were given electronic access to best price, not only within ArcaEx's own system, but also at other (competitor) electronic marketplaces. Unlike the listed market,⁴ the OTC market does not have a "trade-through" rule today. Thus, in lieu of government fiat such as the ITS trade-through rule, getting "best price" for our customers was driven by a business idea, newly created customer demand, and our fiduciary obligation to achieve "best execution" for our customers.

³ National Market System Amendments of 1975 to the Securities Exchange Act of 1934; Pub. L. No. 94-29, 89 Stat. 97 (1975).

⁴ The "listed marketplace" is defined as those national securities exchanges and self-regulatory organizations that trade NYSE- and AMEX-listed securities, as well as securities listed on their own markets, and include ArcaEx (as a facility of Pacific Stock Exchange), Boston Stock Exchange, Philadelphia Stock Exchange, National Stock Exchange, Chicago Stock Exchange, NASD (Nasdaq 3rd Market) and, of course, the NYSE and AMEX, themselves. These listed markets interface and interact with one another in accordance with intermarket regulations and rules governed by national market system committees – ITS and CQ/CTA – and by the SEC. In contrast, the "over-the-counter (OTC) marketplace" is defined as those national securities exchanges and self-regulatory organizations that trade Nasdaq securities and include many of the entities listed immediately above such as ArcaEx. The "OTC marketplace" is structured under a wholly different set of intermarket regulations, rules, and committees than the "listed market."

In late 2001, ArcaEx was unanimously approved by the SEC to operate a fully automated electronic stock exchange regulated by the Pacific Stock Exchange. ArcaEx became operational to trade listed stocks in 2002, and OTC shares in 2003. ArcaEx is now available to execute trades in over 8,000 exchange-listed and OTC securities.

From literally zero volume as an ECN in 1997, ArcaEx now handles over 25% of the trading volume in OTC securities, over 19% of total trading volume in Amex-listed securities and 1.6% of total trading volume in NYSE-listed securities.

II. Big Doings in Market Structure Debate

In the past, I have come before this Committee and other congressional subcommittees and expressed the significance and importance of the issues of that day. However, today's hearing is easily the most consequential since I first appeared before a congressional committee in 1999. The large number of executives from my industry and K-Street lobbyists walking these corridors over the last several months and the amount of letters generated by members of Congress and the public certainly bears out the politically-charged nature of Regulation NMS.

Regulation NMS is a big-impact proposal. As you know, it tackles weighty and sensitive issues – the “trade through” rule, access fees, and market data fees – and is the SEC's most ambitious architectural transformation of our markets since the SEC created the National Market System (“NMS”) in response to congressional direction as part of the 1975 amendments to the Securities Exchange Act of 1934. The implementation of Regulation NMS, in current or modified form, could have colossal effects on the economics of this industry and the trading of equities, and could redefine long-standing investment relationships.

Competition has served the investing public in the OTC market and could in the listed market as well. Generally speaking, the OTC market was (re)built from the “bottom up” by entrepreneurs, among others, after the implementation of the Order Handling Rules in 1997. Competitive forces have compelled every legitimate OTC market center to provide firm quotes that are accessible by automatic execution with no human intervention or intermediation. This is true for not only the best bid and best offer (“BBO”) of each OTC market center, but also for their entire depth of book. If limit order protection is sacrosanct, then why stop at the BBO? Competitive forces in the OTC market have essentially caused all market centers to respect **all** limit orders, not just the BBO.

The listed market, on the other hand, was built from the “top down” where lots of rules exist and bureaucracy, with all of its interpretive complexity, reigns. The listed market could stand a good dose of competition. Adherence to the findings of Congress in 1975 would “kick down the door of monopoly” and sweep in the fresh air of competition. In this manner, services will grow, and the investing public will benefit.

Since a trade-through rule already exists, and has existed for decades, in the listed market, we understand why the SEC would continue to press for its existence, but in a reformed manner to make sure that investors can **really** receive the best price for their orders, and not just the best price for the specialist. “Best price” vs. “speed” is a false dichotomy. If the NYSE were providing “best price” to its customers than why the SEC fines of NYSE specialists for \$250 million, public complaints by customers of the NYSE, and editorializing by leading newspapers for change at the NYSE?

III. Regulation NMS

In this winter and spring, the SEC proposed several market structure initiatives, including trade-through reform, new market access standards, and market data revenue-sharing reform. Although we have strong views on each of the SEC's proposals, and I will mention briefly the market data proposal, I will focus today, for the most part, on two of these items: the need for reform of the current trade-through rule and the no-need for government rate-making in our extremely competitive markets.

A. Trade-Through Reform

Without question, the operation of the trade-through rule has been one of the most highly debated issues in the securities markets over the last several years. In its current form, it thwarts competition and impedes efficient execution. We believe that the solution to trade-through reform is simple: allow markets with firm quotes to trade-through markets with non-firm quotes, but not to trade through markets with firm quotes.

The recent history of reform in the OTC market vividly displays the benefits of efficient market access and firm quotes. It is beyond question at this point that the business model of ArcaEx and our direct competitors has had a profoundly positive effect on the OTC marketplace that has benefited investors. Our early success in the OTC market was attributable to the ability of ArcaEx and its competitors to access firm quotes on other markets to assure that investors always receive best execution.

Today, in the NYSE-listed marketplace, however, non-firm quotes are rampant and preclude firm quotes from timely execution. The trade-through rule in NYSE-listed securities was designed to provide price protection and encourage display of aggressively priced limit orders. The rule sought to assure that better priced orders would not be circumvented by inferior executions in other markets. In an electronic environment,

however, this means that orders must be transmitted to any market center with the best price, whether a manual or electronic market, even though that best price may no longer exist by the time that the order is received. Thus, there are few, if any, commentators today that question the desperate need to modernize this rule.

The current ITS trade-through rule was designed for a 1970s market structure when all exchanges were slow and manual and specialist-based ones. In today's electronic world, however, the rule limits customer choice and dumbs-down best execution to the lowest common denominator of the slowest market. It compels fast electronic markets, and their customers, to play at glacial speed. A broader effect of the trade-through rule is to thwart competition between electronic markets and the NYSE.

A modern trade-through rule must protect published prices that are firm quotes and that are immediately accessible and responded to instantaneously without human intervention.⁵ If a market still wants to operate in a manual manner, however, then electronic markets should be able to trade-through those slow quotes.⁶ Moreover, the rule must apply to all markets trading NYSE-listed securities - including those that internalize without reflecting their interest in the consolidated quote. The end result is that only true prices are protected and afforded the ability to instantaneously execute when at the best price. This concept was the cornerstone of the "Three Amigos" Proposal of 2002, which ArcaEx still stands behind strongly.

⁵ It is important to stress that accessibility includes the ability to enter and to exit a market center. Otherwise, some market centers will become "sticky" in an anticompetitive sense and will suck a market participant in with no ability to cancel and exit without an execution.

⁶ ArcaEx supports the proposed rule for listed trade-throughs: markets representing firm quotes may not trade-through markets representing firm quotes but may trade-through markets representing non-firm quotes up to \$.03; non-firm quotes may not trade-through any other quote whether firm or non-firm.

The existing trade-through rule protects the NYSE's market share by requiring orders to be funneled to the specialists at the NYSE when they display the best price. This provides the specialist with a virtual put option on the order and ensures that they, the specialist, obtains the best price.⁷ The customer, on the other hand, may or may not get the best price and may have even lost the opportunity, through this process, to receive any execution at all, not only at the NYSE but across all market centers.

We also want to caution that the SEC may have a difficult challenge in defining the concept of "fast" and "slow" markets, or even "automated" and "non-automated" markets.⁸ Definitions too often result in unnecessary complexity. For this reason, as well as others, we believe that investors must have the ability to bypass market centers where quotes are not firm, and this ability is critically important both in terms of enhancing market competition and in terms of maintaining market discipline.

1. Trade-Through Reform Is Not Necessary in the OTC Market

While we support reform of the current trade-through rule, we believe that a new trade-through rule is unnecessary in the OTC marketplace because competition already has driven the market to develop its own means of price protection. Importantly, we believe

⁷ Earlier this year, the NYSE's five largest specialist firms agreed to pay a total of about \$240 million to settle SEC allegations that they short changed customers by trading for their own accounts. See "NYSE Traders Will Pay Fines Of \$240 Million", *Wall St. J.*, February 18, 2004. Some five months after these five large specialist firms paid nearly a quarter of a billion dollars to settle SEC trading ahead allegations, the NYSE's other two much smaller specialist firms paid roughly \$5 million to resolve similar SEC charges. See "NYSE Small Specialists to Pay \$5 Million in Cases on Trading", *Wall St. J.*, July 9, 2004.

⁸ ArcaEx is of the view that whether a quote is firm should not be determined on a quote-by-quote basis at the discretion of an intermediary, such as a specialist, because such a structure would represent a step backwards to a time when intermediaries, such as market makers and specialists, could exercise individual discretion on when to turn on and to turn off automated systems. The potential for customer abuse, as well as customer confusion, in that environment is obvious and was well documented as such in the OTC market pre-Order Handling Rules.

that a trade-through rule in OTC would damage a marketplace that has changed dramatically for the better since the implementation of the Order Handling Rules. It makes little sense to us to pursue additional reform of the OTC market because of the recent mishaps of the NYSE. Execution speeds in OTC stocks are generally sub-second and currently surpass quote update speeds. Accordingly, introducing a trade-through rule in OTC would result in holding up executions while awaiting dissemination of quote updates, or worse yet, in instigating increased cancellation of orders. From a practical perspective, in OTC stocks where speed and certainty of execution are critical, the customer sending the order in an environment with a trade-through rule is disadvantaged because not only will it take longer to execute the order, but he or she may receive a partial fill - or no fill at all. In other words, the OTC market is not broken so why fix it.

2. The SEC Must Monitor and Enforce the Trade-Through Rules

Our second proposal for trade-through reform is equally simple: the SEC must monitor and enforce whatever trade-through rules are in place. Industry insiders have known for years that the trade-through rule is the least enforced rule this side of the double nickel speed limit on America's highways. For example, despite the fact that there is a trade-through rule for NYSE-listed securities, ArcaEx quotes are traded through on average of over 2,000 times per day.⁹ In fact, trade-through violations have actually risen most recently despite the glare of the regulator spotlight on the NYSE. On any given day, ArcaEx has a billion shares on or near the national best bid or offer. Yet, the NYSE sends only two million shares to ArcaEx over ITS when we have the best price.

⁹ ArcaEx runs software (aptly named "whiner") that messages alerts when exchanges trade through an ArcaEx quote in violation of the ITS Plan. For the week of June 21st 2004, ArcaEx complained to other exchanges 11,816 times about being traded-through for an average of 2,363 complaints per day.

Clearly, today's trade-through rule is not effectively enforced, other than to ensure that the NYSE specialists receive the best price.¹⁰ Implementing a clear-cut rule with no exceptions will be essential to ensure that the rule is adhered to and enforced. Reform would enable investors to choose how they want their limit orders handled. They could then send them to electronic markets that provide instantaneous display and automatic executions against incoming orders. Or, investors could choose to send them to a manual market if they want to expose the orders to specialist and floor broker handling.

B. Market Access Proposal

A second important issue raised by the SEC relates to accessing quotations displayed through the National Market System ("Market Access Proposal"). The Proposal establishes general principles designed to ensure all participants in the market have fair access to quoted prices—regardless of whether or not they are a member of the entity displaying the price. The Market Access Proposal also sets forth more specific regulations establishing fee caps for market centers and restrictions on a broker's ability to lock/cross the NBBO.

Our success is based on a business model in the OTC market that requires fair access. We are 100% in favor of a framework by which competitive proprietary intermarket linkages also can develop in the marketplace for NYSE-listed securities.¹¹ In

¹⁰ It is difficult for a market participant to pursue enforcement of the current trade-through rule because it is an ITS rule and not an SEC rule. One has to go to the ITS Committee to complain before approaching the SEC. In addition, enforcement is after the fact so it is time-consuming and otherwise troublesome. Moreover, the existing rule is riddled with exceptions which has built up interpretive complexity over time.

¹¹ It also is worth noting that the establishment of a vibrant and dynamic competitive marketplace will positively impact our nation's risk management which was exposed by the events of September 11, 2001. Certainly, a competitive network of multiple competitive market centers linked by robust linkages would appear to assuage this risk and avoid any single point of failure. A system of linked competitors is identical to the Internet model, originally designed to provide redundancy and avert such a single point of failure. It

our view, all market centers and linkages should benefit by “most favored nation” status requiring not only fair access, but access on the same terms as afforded others.

At the same time, however, ArcaEx fervently opposes rash rulemaking proposed in the fee area that is designed to address problems that are either non-existent or resolvable through less intrusive methods. In this hypercompetitive marketplace, why the need for command economy price-fixing? The SEC provided no data to support the need for this part of the proposal.

As a result of the SEC’s Order Handling Rules that were designed to stimulate competition, the OTC marketplace has become fiercely competitive and highly efficient. Today, the OTC market consists of four major liquidity pools connected by hundreds of private linkages. Not only are broker/dealers able to freely become members of any of these liquidity centers, but should they not want to become members or establish connectivity to any one of the liquidity pools, hundreds of brokers stand ready to provide direct access to any or all markets for a small fee. All major liquidity pools in the OTC market utilize computer execution algorithms, meaning all participants attempting to interact with the liquidity pools receive equal execution treatment—members, non-members, and competitors. In addition, it is our understanding and experience that all members pay roughly equivalent transaction fees. This structure enables all market participants—brokers, institutions, and even retail investors—to directly access any published quote at the touch of a button regardless of whether they are direct members of the venue publishing the quote.

was precisely this decentralized model that proved unconditionally successful as a means of communication on September 11.

Standards of fair access are not commonplace, however, in the market for Amex- and NYSE-listed securities. As the Committee is well aware, markets are extremely efficient. Most ECNs were able to charge significant access fees only when participants were not technically able to avoid trading with them. Nasdaq—through SuperSOES and SuperMontage—did not provide members with the ability to avoid trading with auto-ex ECNs, even when they charged exorbitant access fees. However, with Nasdaq’s self-imposed cap on ECN access fees, such excessive fees are no longer a significant issue. Moreover, the problem will not recur so long as OTC market participants are provided with the ability to choose not to trade with a market center that charges unreasonable fees. By virtue of market competition, fees have dropped well in excess of 80% since 1997. Competitors that did not reduce fees as a result of market forces found their market share and profits eroded.

We are very concerned, however, about the role of government in regulating the amount of any fees. History has not been favorable to command economies, in which the government places its judgment above that of the free market. In essence, by setting maximum access fees, the SEC would engage in ratemaking, substituting its views for that of the markets. Assuming that the SEC had the authority to engage in such actions, which is not clear to us in light of the 1975 amendments, what would also prevent the SEC from regulating maximum advisory fees for mutual funds, setting the spreads for market makers, establishing fee caps for retail brokerage firms, or setting the maximum investment banking fees?

C. Market Data Proposal

Another aspect of Regulation NMS is a proposal to replace the existing market data revenue formula with a new allocation method that bases revenues on the data's theoretical information content. While we are not confident that we fully understand all of the ins and outs of this new proposed formula (read: it's really complicated!), we do see that it merely reconfigures the revenue for existing participants without injecting competition into the mix.

Any allocation formula maintained by plan cartels or by regulatory directives will always create unintended consequences and is suspect in our judgment. The better approach would be to let the marketplace make its own judgments about market data economics, and the best mechanism for doing so is a competitive consolidator model. Absent a competitive consolidator model which lets the market decide what the data is worth, the data plans should reflect the costs of producing the data; and they should also reflect the economic value of the data.

IV. Conclusion

ArcaEx believes that a light regulatory touch is better than a heavy one; that targeted rulemaking is better than broad policymaking; and that simple is always better than complicated. We already have learned that when government makes decisions that permit competition, the markets transform rapidly to increase efficiencies. This has clearly occurred on Nasdaq which causes us to question why the SEC desires to impose on the OTC marketplace a trade-through rule where there is none. However, we do agree with the SEC that the trade-through rule now existing in the listed area needs to be reformed

and enforced to eliminate its anticompetitive effects that weigh heavily in favor of manual markets like the NYSE. This rule ensures the best price, but, alas, only for the specialist and not for the customer.

It is critical to any reform to preserve innovation and investor choice by maintaining an opportunity for automated exchanges to bypass manual ones. It is just as critical that reform not stop with the BBO. Competitive forces have compelled every legitimate OTC market center to provide firm quotes that are accessible by automatic execution with no human intervention or intermediation. This is true for not only the BBO of each OTC market center, but also for their entire depth of book, and such should be the case for the listed market as well. If one of the objectives of Regulation NMS is to protect limit orders, then reform should not stop at the BBO. Again, competitive forces in the OTC market have essentially caused all market centers to respect **all** limit orders, not just the BBO, and that has to be the case in the listed market too for meaningful reform to be achieved.

While we also wholeheartedly endorse increased access as a means to encourage competition, we want to caution that rate setting in the form of caps on access fees does not represent sound policy. Markets should set rates, not government.

Thank you for providing me this opportunity to testify, and I look forward to responding to your questions at the appropriate time.