

Testimony Before the Senate Banking Committee
Proposed Regulation NMS
New York Stock Exchange, Inc.
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Introduction

Mr. Chairman, Members of the Committee, thank you for inviting me to present our views on proposed Regulation NMS. We appreciate your initiative as we collaborate on how best to modernize our National Market System, (NMS). We applaud the SEC for its leadership in advancing a comprehensive proposal that serves as the basis for our discussions. The issues before us are complex in a time of rapidly advancing technologies and evolving market models. That is all the more reason to stay focused on our primary mission.

Our goal is not a victory for one market over another, but, rather, competition among markets to create the best possible national market system for all investors, with one deep pool of liquidity. This policy is both the fairest for all, and the surest way to keep the United States in the forefront of global competition. A fractured market that betrays the interests of investors and that puts our capital market leadership at risk would be a pyrrhic victory at best, and a major loss for America.

Long before I joined the New York Stock Exchange, I considered the NYSE a great American institution. Already, my brief tenure at the Exchange has reaffirmed that belief. However, after months of debate over the issues of market structure, I've also come to realize that our national market system is also a great American institution.

As we move forward, let us be guided by the principles that were designed to protect the public good, and that have enabled our national market system to become the world's best. Technology has changed since the national market system was created, and the trading choices available to investors are different. But these principles are every bit as valid, and as vital, today as they were at the origins of the NMS.

- **The Customer Comes First.** Our national market structure should require intermediaries to place their customers' interests ahead of their own;
- **Best Price.** Every order, regardless of the market to which it is sent, should have the opportunity to receive the best price available;
- **Protection of Limit Orders.** Limit orders provide liquidity to the market and accessible limit orders must be assured an execution before a trade occurs at an inferior price;
- **Choice.** Investors are best served when markets are free to compete and offer an array of execution options, including the opportunity for price improvement;
- **Reduced Volatility.** Greater intraday volatility raises the cost of capital for listed companies;

- **Speed.** Speed should be an option for those customers who want it, but not at a price of damaging the integrity of markets or introducing excessive volatility;
- **Transparency.** Investors should have widespread access to the market data of their choosing on an uninterrupted basis; and
- **Competition.** Commission ratemaking should always be a last resort. Competition typically does a better job than government ratemaking in providing fairly priced services to investors.

These principles have served the nation well. As Chairman Donaldson stated at the SEC's hearings in April, "Our markets are among the world's most competitive and efficient. Competition among markets has fostered technological innovation and the creation of trading platforms... that address the needs of all types of investors, regardless of size and sophistication. Investor participation in the markets has exploded in the last decade."

When individual markets have competed within the NMS to uphold these principles and add value for investors, their businesses have been rewarded. When markets have not done so, their customers have taken their business elsewhere. We are pleased that, for the most part, proposed Regulation NMS strives to defend those principles and to end practices that are contrary to them. However, certain proposals are inconsistent with our goal of protecting investors, and we believe they must be improved.

1. TRADE-THROUGH RULE

The best way to characterize the trade-through rule is to consider it the "best-price" rule, for that is what it guarantees to each investor. Approved by the SEC in 1981, its purpose is to ensure price protection for investors who post limit orders in any market participating in our national market system. The system envisioned a structure that would enable investors in any region to see the prices being bid and offered for listed stocks in all markets. The trade-through rule ensures that their limit orders will be protected at the best price.

The trade-through rule is the essence of good public policy for our markets. It is the heart of an honest market. And it is the beginning of a virtuous circle for investors. When investors are assured their orders will receive the best price, and that small investors can compete with large institutions, their confidence in the fairness and integrity of that market is bolstered. As investor confidence rises, they are more willing to maintain, or increase, their limit orders, and thus, liquidity is enhanced. A larger, deeper pool of liquidity serves, in turn, to decrease market volatility and to promote fair and orderly markets.

Nevertheless, the many virtues of best price are no guarantee of success. Today, the NYSE posts the best price in our listed securities over 90% of the time, yet nothing prevents investors from sending their orders elsewhere.

We compete tenaciously and tirelessly, and evidence of that competition can be seen in the price spread between bids and offers. Over the past year, the average spread of the National Best Bids and Offers on the 93 NYSE-listed stocks in the S&P 100 Index has narrowed from about 5 cents to 2 cents. A 2-cent spread is a fraction of the historic spread and illustrates that every market maker in NYSE shares competes aggressively for orders. Clearly, there is no monopoly in the financial marketplace.

As the trade-through rule serves the interests of individual investors, its role in reducing volatility is equally significant for listed companies. When the New York Stock Exchange surveyed chief executives and senior officers of some 400 of our listed companies, their most important factor in choosing a trading venue was market quality. And, by far, the most important determinant of market quality was reduced volatility. That preference is also borne out by reality. Over the past two years, 51 companies moved their listings from the Nasdaq, where no trade-through rule is in effect, to the New York Stock Exchange. The intra-day volatility of those companies fell, on average, by 50 percent – a substantial decline.

The dynamics of best price that strengthen competition, reduce volatility and narrow spreads create real dollars-and-cents-benefits. Companies benefit from reductions in their cost of capital. And, billions of dollars in savings flow through to investors to their individual investments, or investment accounts, such as 401K's, pension funds, and college education accounts.

The Congress, the Commission and industry all understood the central importance of the trade-through rule. They considered its protections and advantages to be the foundation of good public policy. And, they embraced price-protection and best-price execution as the organizing principles of the NMS. Recognizing both benefits and beneficiaries, let us also be clear that bypassing, or trading through, a market's best price quotations creates four victims:

- The investor who buys or sells shares at a price inferior to the best price;
- The investor whose better-priced limit order is ignored;
- Market transparency and price discovery, since a stock is priced at something other than its true value; and,
- Liquidity and capital formation, since investors will lose confidence in the fairness of the market and will be less willing to submit limit orders knowing that they may be bypassed.

While price-protection and best-price execution must remain guiding principles, we recognize that speed is important to certain customers in the 21st Century marketplace. Some of our customers have told us they can better serve investors by taking a price that is available immediately by automated execution, rather than exposing an order to the floor auction for potential price improvement. Our data shows that orders executed on our floor in the auction often receive better prices than orders that simply hit our quote.

Nevertheless, we understand why our customers have raised this issue. We are continuing to listen to our customers. We will continue to be responsive to them. And, we are determined to be competitive across the national market system.

Our commitment is to offer customers the ability to trade electronically, quickly, with certainty and anonymity. At the same time, we want to retain the advantages of the auction market, where floor brokers and specialists are adding value and competing to improve prices, moment-to-moment, on the floor of the New York Stock Exchange. As one who spent 25 years at the crossroads of technology and finance, I enthusiastically embrace opportunities to enhance the speed and efficiency of trading. However, there are many occasions, such as during an earnings surprise or outside event that disrupts the market, when the judgment and abilities embodied by the human factor are invaluable, if not indispensable. This is why we believe that the solution is to marry the best of both worlds by creating a hybrid market.

Last week, the New York Stock Exchange completed a draft of a filing to the SEC which represents a major step to leverage technology and offer more choices to investors and to all constituents of the Exchange. The filing will expand application of our electronic platform, known as Direct+. The hybrid platform will provide customers sub-second, automatic execution, as well as broader choice than any other market center, and the most flexible access to the world's deepest pool of equity liquidity. We are reviewing that draft with our various constituents who will be affected, and anticipate a formal filing with the SEC within the next few weeks.

2. OPT-OUT EXCEPTION

Proposed Regulation NMS acknowledges that nationwide price protection is a core feature of the national market system. As a result, the Commission is recommending extension of the application of the trade-through rule to Nasdaq stocks. Given this fact, we are concerned that the Commission has included a provision that would allow certain institutions to forego giving their customers the best price by simply ignoring – or, opting-out – of the trade-through rule.

Permission to opt-out would undermine the basic objectives of Regulation NMS, compromise the integrity of the marketplace and risk grave consequences to our national market system. The opt-out provision amounts to nothing less than sanctioning the deliberate overcharging of millions of investors. In addition, by encouraging other harmful practices, such as internalization – where orders are never exposed to the market – the opt-out provision would permit intermediaries to profit in other instances at the expense of unsuspecting investors.

Associations representing millions of investors have completed their due diligence on Regulation NMS and come out strongly opposed to the opt-out provision. To cite three:

- The AARP has noted that its members, by more than two to one, believe that the “best available price” should be the “top priority” when engaging in a market transaction.
- CFA (Consumer Federation of America), states that the opt-out provision would undermine the trade-through rule’s objectives and would take away with one hand the benefits that it has given with another.
- CIEBA (Committee on Investment of Employee Benefit Assets) observes that its constituency is concerned with long-term growth and market stability, and that the ability to opt-out could place those investors at a disadvantage, creating one set of rules for the small investor and another for large institutions.

These associations are keenly aware that their members would be the first casualties of best-price violations. But they would not be the last. As losses from patently bad public policy rippled through the NMS, they would trigger other negative repercussions. Seeing their orders bypassed, investors’ confidence in the fairness and integrity of the market would be shaken. They would no longer be willing to maintain limit orders, which would result in reduced liquidity, wider spreads and increased volatility. And, as intermediaries used the loophole of an opt-out to create their own, private trading market, the NMS would become fragmented and less competitive – an unquestionable loss for investors, U.S. markets and U.S. competitiveness.

The operating rule should be, “Let the best price win.”

To those who refuse to compete on the basis of best price, important questions need to be asked: why do proponents of an opt-out exception call for elimination of the requirement in the NMS proposal that investors be advised how much they lost by not receiving the best price?

Why do proponents of an opt-out exception, who premise their lobbying on the concern about missing quotes because of a delay in execution, still insist on that premise when the SEC proposes to allow fast quotes to trade through slow quotes?

The answer is economic self-interest. At whose expense? The unsophisticated investor. That’s what these associations know, that is why they are gravely concerned about an opt-out exemption – and we believe you should be concerned, as well.

We strongly urge the SEC to eliminate the “opt-out” provision in the final rule.

3. MARKET ACCESS

The Commission has proposed a series of related rules to accomplish universal access to markets.

We support the Commission's proposal to require all market centers to permit access to their quotes on terms that are not "unfairly discriminatory," as well as broader alternatives for intermarket access than the Intermarket Trading System currently provides.

Access Fees

We understand the Commission's desire to address hidden access fees charged when an ECN's quote is accessed through SuperMontage. However, we believe that the Commission's proposal to regulate by Commission rule the transaction charges imposed by every market in the U.S. is not an efficient way of dealing with what we consider an isolated problem.

Unfortunately, the Commission's proposal would deprive markets of the flexibility envisioned by the Exchange Act, thus forcing them to charge a standard fee to all users. We believe a more sensible solution would be to amend Regulation ATS and the Commission's quote rule, so that no market could publish a quotation that would include an additional fee not expressly agreed to by its members or subscribers. Thus, exchange and association member fees, and ECN subscriber fees – all agreed to in advance – would be permitted, but fees that are charged to the contra party to the trade without consent would be prohibited. In this way, quotations at stated prices would all have the same meaning and members of exchanges and associations, and subscribers to ECNs, can factor in those charges when making routing decisions.

4. MARKET DATA

We recognize the Commission's need to address a number of objectionable practices that have arisen over the past decade, including the use of exchanges as print facilities, payment for order flow, wash sales and tape shredding. We agree that these are serious issues, but we would prefer an approach that deals with them directly, rather than through market data revenue. For example, using markets as print facilities for transactions that occur elsewhere, thereby distorting perceptions of market liquidity and undermining price transparency, is a much bigger issue than is the market data revenue allocation. The commission should simply ban the undesirable practices, and disband the CTA consortium at the heart of the economic inefficiencies producing such behavior.

Conclusion

In conclusion, we appreciate this opportunity to appear before your Committee. Regulation NMS represents the most far-reaching reform of the national market system since its creation 30 years ago. This is a pivotal moment. Investors across America are looking to their leaders, and trusting their leaders, to do the right thing. We should not let them down.

This is no time to put personal interests ahead of investor interests, to put the interests of individual markets ahead of market principles. It is important the government do the right thing by not allowing the best interests of investors to be ignored.

At a time when the Nation is tightening rules on mutual funds, late trading, market timing and raising standards for corporate governance, it should not allow intermediaries to run roughshod over long-standing rules that ensure fair and honest markets.

To do so will be an invitation to future problems – to improper trading that harms investors, harms the competitiveness of our markets, and harms the health and wellbeing of our economy.

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