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Testimony of

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Subcommittee on Capital Markets, Insurance and GSEs**

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Chairman Baker and Ranking Member Kanjorski, thank you for this opportunity to discuss NASDAQ's views on the re-proposed version of Regulation NMS.¹

I. Summary Position on Proposed Regulation NMS

NASDAQ supports the goals of proposed Regulation NMS -- investor protection, enhanced competition, and transparency. And, we feel the proposal makes major strides towards achieving these goals. Moreover, NASDAQ commends the Securities and Exchange Commission (the "Commission" or the "SEC") for its focus on intermarket access standards, sub-penny trading, data revenue distribution, and reform of the trade-through rule.

In fact, NASDAQ supports much of proposed Regulation NMS, including the restrictions on sub-penny trading, the proposed access standards, and restrictions on access fees. While we are cautious about government imposed limits on fees, we think the current direction Reg. NMS takes in requiring participants to access certain quotes, demands such a limitation to protect investors. Most importantly, we applaud the impact the SEC's access standards will have on speeding the demise of the outmoded anticompetitive ITS system.

With regard to the SEC's proposal on market data, we support the SEC's liberalization of proprietary market data and the likely enhanced competitive environment that will result from this liberalization. We support the SEC's desire to change the way market data revenue is distributed by the various market data plans. However, we, along with the majority of

¹ Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) ("Second Regulation NMS Proposing Release").

commenters, believe that one element of the proposed formula that governs how market data revenue is distributed, the element known as the "Quote Credit" is seriously flawed and will be gamed by market participants.

Finally, with respect to the much debated topic of the trade-through rule, our position remains unchanged. NASDAQ opposes the trade-through rule because it is not needed, it is costly and, ultimately, it will not serve the best interest of investors. We are proud of the market quality experienced by investors every day on the Nasdaq Stock Market. We achieve that high quality without the anticompetitive effects of a trade-through rule. Investors have been, and will continue to be, protected from inferior executions by the strict application of, and surveillance for, broker-dealer best execution obligations and by competition. On the NASDAQ market, trade-through rates are minimal. We do not believe that extending the trade-through rule to NASDAQ is supported by the facts and may indeed be harmful to investors.

Philosophically, NASDAQ believes that no government decision maker, no matter how well-intentioned, is equipped to make the minute, technical judgments that are now handled by technology and competition in routing and executing millions of trades and billions of shares every day. Simply put, NASDAQ's primary concerns with Regulation NMS, as currently proposed, reflect our belief that market forces and best execution must serve as the bedrock principles to serve public purposes in the securities markets.

Nevertheless, we recognize that the SEC has moved forward with its market structure thinking. Allowing investors to make distinctions between fast and slow markets will help modernize our overall market structure. While repealing the trade-through rule would be a simpler way to achieve a competitive, pro-investor national market system, the advances proposed by the Commission with regard to floor-based markets are groundbreaking. Its proposal is driving floor-based markets to automate today. This proposal will enable electronic markets to compete and will offer investors a better opportunity for best execution than they currently have today. This contribution to the national market system is significant and worthy of praise.

II. Exempting "slow" quotes from the trade-through rule is a good step towards bringing competition to floor-based markets but the trade-through rule should not be extended to NASDAQ.

The Commission's work on the trade-through rule, reflected in the incentive given for markets to adopt electronic quotes, is a step forward and represents a competitive improvement within the NYSE listed space. Although NASDAQ prefers repeal of the trade-through rule, the fast-slow quote designation will have a dramatically positive effect. Inexplicably, however, Regulation NMS has evolved from an endeavor to bring competition to the NYSE space into an effort to impose a trade-through rule on the competitive, pro-investor NASDAQ market.

Application of the trade-through rule to Nasdaq-listed securities would be harmful to investors. The NASDAQ market is already a quality market. We are not convinced that the rule would even achieve the SEC's desired goal of increasing the use of limit orders. In contrast, we know that the rule will impose financial and technical costs and deprive millions of investors of the ability to determine for themselves what is best for them. Furthermore, the Commission studies used to justify extending the rule to NASDAQ significantly overstate the current extent of trade-throughs in the NASDAQ market and makes faulty assumptions about the functioning of the market.

A. Proposed Regulation NMS replaces investor choice with regulatory mandate.

Promoting transparency, disclosure, competition and investor has been the Commission's guiding principle when regulating secondary market trading of equity securities. Soon after being given the statutory mandate to foster a national market system, the SEC adopted rules to require the collection and dissemination of quotes and trade reports of certain over-the-counter ("OTC") equity securities. With access to this information investors could now determine whether the prices they were paying were fair. The SEC exposed OTC trading to some sunlight and in effect deputized millions of investors to protect themselves.

This empowerment of investors leverages the SEC's assets and is facilitated by a broker's duty of best execution – brokers must place the interests of their customers ahead of their own and seek the most advantageous terms reasonably available under the circumstances. This rule provides a legal foundation that ensures each investor – big or small – will hold the broker accountable for achieving what that investor believes is the best price for that investor's circumstances.

To further empower both the investor and regulator, the SEC recently required brokers and markets to disclose order execution quality statistics and descriptions of how they handle customer orders, again applying the information and disclosure principle. Throughout its years of study and review of secondary market trading, the SEC has not created a bright-line test for determining what constitutes best price or best execution. Instead, it has used this well accepted legal concept that keeps brokers and markets vigilant in performing the best they can for their customers.

Competition has also played an important role in ensuring that investors receive quality service and executions. Nowhere is the power of competition more evident than in the trading of Nasdaq-listed securities. – where competition fostered by the SEC and its policies has driven

phenomenal advancement in technological innovation and customer choice.² It is by no means inconsequential that all of these innovations and benefits developed only in the market that was free from the competitive distortions of a trade-through rule.

The combination of informed choice, competition, and regulatory oversight has served investors and the national market system well. Despite the quality and efficiency demonstrated by the NASDAQ market, the Commission is proposing to impose the trade-through rule on NASDAQ.

The Commission relies on two economic studies conducted by its staff to support application of the trade-through rule to Nasdaq-listed securities. NASDAQ respectfully disagrees with the Commission staff studies. NASDAQ is responding to these studies in detail. Our full analysis is attached as Exhibit 1 to my testimony.³ In general, however, the Commission staff studies significantly overstate the current extent of trade-throughs in Nasdaq-listed securities and erroneously conclude that differential fill rates for large marketable limit orders in Nasdaq-listed and NYSE-listed stocks are evidence of a defect in NASDAQ's market structure. Surprisingly, the Commission staff's conclusion with respect to fill rates for large marketable limit orders fails to consider a widely used order routing technique of intentionally sending oversized orders at displayed quotes searching (also known as "pinging") for reserves within the many limit order books trading Nasdaq-listed securities. Thus, this trading device produces orders that are never fully expected to be completely filled. The SEC study ignored these orders when compiling our fill rate, which would be much higher otherwise.

In proposing to retain a modified trade-through rule for exchange-listed securities and expanding it to include Nasdaq-listed securities, the Commission will be transforming its role from that of a referee of the national market system – acting when necessary to ensure the protection of investors – to an active, moment to moment player in the national market system, controlling nearly all aspects of interaction in the system (*e.g.*, recording response times, judging access standards, and setting access fees). This transformation is an unavoidable corollary to the Commission's underlying decision on the trade-through rule. This allows the trade-through rule to grant millions of momentary monopolies. A momentary monopoly is created because the rule distorts the competitive balance by, for the most part, requiring investors to interact with whomever is displaying a protected quote. These momentary monopolies are wholly unnecessary for the NASDAQ. With respect to NYSE-listed securities, the lack of competition and innovation in

² Competition has also led to innovation and greater responsiveness to investor needs. Examples include NASDAQ's opening and closing crosses, anonymous trading, routing, and the multitude of order types that NASDAQ and other markets provide.

³ See Exhibit 1. *Re-Proposed Regulation NMS; File No. (S7-10-04), Nasdaq Comments on SEC Staff Studies*, Nasdaq Economic Research, The Nasdaq Stock Market, Inc., January 25, 2005.

the market for NYSE-listed securities is the direct result of the competitive distortions that the current trade-through rule causes. Therefore, modification of the current trade-through rule to allow differentiation between automated and non-automated will introduce some needed competition into the NYSE market.

B. Choosing between the "Market BBO" and "Depth of Book" trade-through rule alternatives ignores the optimal policy choice of whether a trade-through rule should be applied at all.

Many in Congress have asked NASDAQ what we think of the two alternatives in the latest NMS proposal. Just to be clear – neither a top of book or depth of book version of the trade-through rule seems better than the NASDAQ open competitive model without the trade-through rule. The real question is: Has the trade-through rule outlived its usefulness and should it be repealed?

For those who do support a trade-through rule, however, we have found it interesting that the arguments relied upon conveniently evaporated from their advocacy when the depth of book alternative was proposed by the Commission. In fact, some seem to be taking intellectually inconsistent positions. This was evident when NYSE last testified before you on February 20th at the New York Field Hearing. You will remember Mr. Thain's "best price rule" arguments. He said:

"The principle behind the trade-through rule is, in my view, critical to protecting investor interests. Why should investors ever receive anything other than the best price? There is talk of the importance of speed, anonymity, and other factors. But in a commoditized market like that which exists for equities, if displayed prices across all markets are available immediately, there is absolutely no reason to allow agents to buy and sell on behalf of their clients for anything other than the best price."⁴

However, by January 12 of this year, the NYSE seems to have had a change of heart. In a letter to the SEC, the NYSE was praising the virtues of "promoting investors' ability to choose among alternative trading venues" and decrying that "mandatory Depth of Book routing eliminates intermarket competition by giving any limit order, regardless of where it was placed, the same protection."

If you really worship at the altar of best price, the depth of book alternative fulfills that objective better and more completely than the Market

Testimony of John A. Thain, Chief Executive Officer, New York Stock Exchange, Inc.. Capital Markets Subcommittee of the House Financial Services Committee held February 20, 2004. Field Hearing entitled "Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace."

BBO alternative. If someone supports a trade-through protection for one price, how can one logically argue against protection of an order as little as one penny away from that price? That is saying that the first investor in line deserves to have his or her spot protected but the second person in line, and any subsequent people in line, do not.

Those who oppose the depth of book alternative have cited the importance of competing market fill rates, competition and factors other than price as important investor casualties of a depth of book alternative. Of course, these are the very same public policy rationales upon which opponents of the trade-through rule rely.

Moving from the theoretical to the practical, however, we must mention that the practical implications of a depth-of-book trade-through rule would be extremely complex to implement and fraught with the potential for unintended consequences. Therefore, while we empathize with the philosophical rationale for full-book trade-through protection, the practical implications are overwhelming and the rule would create tremendous market structure complexity without accomplishing any tangible investor benefits that trade-through repeal would not.

C. Reforming the trade-through rule and the NYSE's hybrid market proposal

With respect to exchange-listed securities, the re-proposed Regulation NMS would be a definite improvement over the status quo, because the proposal acknowledges the value of speed and certainty of execution and allows electronic markets to compete at electronic speeds. By forcing the NYSE and other manual markets to automate, Regulation NMS would advance the goals of the national market system by enhancing competition in these markets. Manual markets will no longer be the weak link in the national market system, slowing down faster markets while humans – some with a distinct time and place advantage on the floor – attempt to execute orders. The “Fast vs. Slow” quote distinction has guided behavior in the NASDAQ market for some time, absent any guidance from the Commission.

In response to the Commission's proposed Regulation NMS, the NYSE has also proposed a substantial change to its own market structure rules. A side by side comparison of the NYSE's hybrid market proposal and Regulation NMS creates some uncertainty as to how these two fundamental market structure proposals will work together, and whether the NYSE's proposal allows even the limited competitive benefits of Regulation NMS in the listed market to be achieved.

For example, NASDAQ understands that the exception from the trade-through rule for market re-openings will include re-openings after a market has halted trading due to an order imbalance. As discussed below, this will provide the halted market an advantage over markets that continue to trade.

Furthermore, it is unclear what will be considered a re-opening under the NYSE's hybrid market proposal. For example, is trading on the NYSE considered halted each time a liquidity replenishment point is reached or when the specialist gaps the quotes in a security? If so, the NYSE will be able to ignore the quotes of other markets each time it returns from these halted states.

Furthermore, if re-openings are limited to an order imbalance, what kind of discretion does a market have to declare an "imbalance." In addition, is the NYSE free to change its rules concerning what types of orders create an imbalance? Is NASDAQ permitted to propose similar imbalance rules for market makers faced with large order imbalances on their desks? To provide market participants an opportunity to fully review and comment on both the NYSE hybrid proposal and re-proposed Regulation NMS, the proposals must be considered serially. Because the NYSE proposal is intended as a response to Regulation NMS, if the Commission adopts Regulation NMS, it should require the NYSE to resubmit the hybrid rule filing with a detailed explanation as to how it will operate and comply with the new regulation.

As mentioned above, the interpretation of what constitutes a market re-opening may provide halted markets an unfair competitive advantage. By allowing markets to trade-through other valid quotes during a re-opening after an imbalance or other market-specific non-regulatory halt ("non-regulatory halts"), the Commission creates a significant loophole in its own rule that works singularly to the advantage of manual markets. Once a market has declared a halt, market participants know they can execute orders on the re-opening market without regard to trade-through restrictions. Market participants electing to send orders to the halted market will in effect be electing to opt-out of trade-through protection, to the detriment of those displaying quotes and orders on other markets. This creates a disincentive to posting quotes and sending orders to other markets that continue to trade. Accordingly, if the trade-through proposal is adopted, markets re-opening after non-regulatory halts must be required to provide trade-through protection to the protected quotes of other markets.

III. Market data rules should be simplified to embrace competition, end gaming by market participants, and reduce costs to investors.

NASDAQ supports much of the Commission's pro-competitive liberalization of the rules governing distribution, consolidation and display of core and non-core market data by self-regulatory organizations ("SROs") and other market participants. However, the Commission has failed to extend that pro-competitive principle to the government-mandated market data plans, which stifle competition and raise the cost of market data for all investors. If the Commission is content simply to tinker with the Plan Allocation Formula, Nasdaq suggests that it adopt a simpler formula based entirely on proportionate dollar volume or proportionate share volume, and

forego its Quoting Share proposal, which makes the formula needlessly complex and more vulnerable to manipulation.

A primary objective of the national market system is to provide investors with accurate and timely market data with which to make informed investment decisions in a cost-effective manner.⁵ The Commission's paramount mission should be to safeguard the integrity of this "core" market data while striking a balance between competition and regulation to ensure a vibrant, accessible market for additional "non-core" market data. To the extent re-proposed Regulation NMS embodies such an approach, NASDAQ is in full support. NASDAQ welcomes the Commission's attempts to increase investor choice and market competition by proposing to reduce the data that vendors are required to display and the instances in which they must display it ("Display Amendment"), and by liberalizing the current restrictions on independent distribution of data outside of the national market system plans. The added competition will inevitably lower average investors' market data costs.

NASDAQ opposes, however, the proposal to re-engineer the Plan Allocation Formula in its current form. While elements of the proposal are consistent with the Commission's mandate to ensure data integrity, an over-emphasis on re-allocating revenue among SROs would place investors at risk of higher-cost and lower-quality data. In particular, the inclusion of a "Quote Share" component in the formula still leaves ample opportunities for manipulation that could cost investors even more than current practices. Adopting the proposed Quote Share element will motivate market participants to adopt artificial trading practices that distort core market data and increase investor costs by forcing national market system plans and vendors to purchase added distribution capacity.

The Commission's Quote Share proposal would lead to increased quotation activity as market participants chase valuable quotation credits in SRO member revenue sharing programs. For example, the Commission can expect innovative competitors to do some of the following:

- ***Flickering Quotes***: displaying quotations just long enough to earn quotation credits but not long enough to risk execution;
- ***Security Targeting***: generating quotations in securities where each quotation credit is proportionately more valuable;
- ***Market Targeting***: generating quotations on markets with little or no resident liquidity to minimize the risk of order interaction;
- ***Shredding Quotes***: generating multiple quotations in a single market, single quotations in multiple markets, or multiple quotations in multiple markets to slow the pace of executions

⁵ See, e.g., Exchange Act §11A(a)(1)(C)(iii), (D).

and thereby prolong the period in which quotation credits are earned; and

- ***Shifting Quotes***: moving quotations from one market to another to lengthen the chase by potential contra parties and thereby earn additional quotation credits.

The Commission must simplify the formula further to neutralize the potential for harmful economic incentives that the Allocation Formula could create. The simplest, fairest and most transparent Plan Allocation Formula would be based solely on share or dollar volume of trading activity, a metric the Commission has already endorsed by incorporating it into the square-root dollar volume Security Income Allocation method. Share volume and dollar volume are simple and transparent to calculate, would not motivate market participants to alter their quoting or trading behavior, and cannot be inexpensively manipulated by market participants to maximize their draw on member revenue sharing programs.

IV. We Need a Consensus Rule to Modernize Our Nation's Market Structure.

NASDAQ respects the efforts of the Commission to deal with this tough and complex issue. Let me reiterate that NASDAQ supports a great number of the proposals contained in Regulation NMS. We have seen some thoughtful comments from market participants on the proposed rule and are hopeful that Commissioners are still evaluating all the information placed on the record. We also sincerely appreciate this Subcommittee's interest in market structure issues and believe that this hearing will reinforce the notion that this major undertaking requires thoughtful deliberation

In the end, NASDAQ is hopeful that Reg. NMS is completed in a timely manner. It is important to move competition forward in the trading of NYSE issues, and the current rule process seems to be heading in the right policy direction. Again, we hope the Commission will reject the imposition of any trade-through rule on NASDAQ. The Commission's market structure rules are critical to maintaining U.S. superiority in the global equity markets, and will impact the way Americans and all investors view the quality and fairness of our equity markets. Finally, we would urge consensus decision-making, which is an indicator of a fair process and will yield the best rules.

In conclusion, I would like to take this opportunity to address another issue that relates to the national market system. I would like to compliment the Commission on working with NASDAQ on our exchange registration application. Commission staff publicly stated at the SEC December 15 open meeting that a solution is at hand on the NASDAQ application, and that the application could be considered expeditiously. The Commission has worked hard and in good faith with NASDAQ, and we appreciate their commitment to finding a solution that would enable NASDAQ to register as an exchange. I also would like to thank many of you for expressing support for NASDAQ's

exchange registration in the past. Approval of the application will separate our regulator from our market, strengthening integrity of our market.

Thank you for holding this hearing and considering NASDAQ's views.