TESTIMONY
of
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before the

FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT-SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES

"THE SEC'S MARKET STRUCTURE PROPOSAL: WILL IT ENHANCE COMPETITION?"

February 15, 2005

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee, my name is Carrie Dwyer, and I am general counsel of The Charles Schwab Corporation. I am pleased to be here today to represent our perspective on an issue that has direct consequences for the individual investors we serve.

Charles Schwab is one of the nation's largest financial services firms and for more than three decades, our focus has been serving individual investors. We provide them with convenient and efficient access to the markets, and the information and tools with which to make informed investment decisions. Today we serve more than 7.3 million client accounts with nearly $1.1 trillion in client assets. Our customers can trade by phone, through automated voice channels, at a branch, and, of course, online through the Internet. During the fourth quarter of 2004, our clients made an average of 177,000 equity trades a day, as well as about 70,000 mutual fund trades each day. On an average day, our customers trade about 3.5 million shares on the

NYSE and Nasdaq combined. Whether investing in the stock market directly, or investing indirectly through investment advisors and mutual funds, our customers' investment returns are dependent on efficient executions. Our customers demand ever greater efficiency, better service, and lower prices. We believe a regulatory structure that promotes vigorous competition between markets will generate the innovation that will deliver those benefits to them.

The National Market System as a concept was created by the 1975 Amendments to the Exchange Act. Those amendments were the result of a 10-year study and debate here in Congress about the principles which should govern a National Market System. The historic conclusion then was to reject a government-designed central market. Congress determined that the National Market System should evolve through the interplay of competitive forces, and that the SEC's role would be limited to "facilitating" the objectives of the Act where competitive forces were determined to be insufficient. The people sitting in your seats then knew that they could not foresee all of the ways in which technology and investing would evolve, or choose which competitors should succeed and which should fail. They did not believe that a government agency would be in the best position to make those choices either. The decision to allow markets to evolve and adjust through competition has served us well over the years, fostering the highly efficient and technologically advanced markets we enjoy today.

Nevertheless, finding that balance has never been easy; we seem to come together every five years or so to debate centralization and uniformity versus competition and innovation. Removing entrenched anticompetitive barriers has not been easy either. Before the trade through rule, there was the infamous off-board trading rule, which took the SEC over 20 years to remove from the books.

Regulation NMS and the proposals for expansion of the trade-through rule, whether top-of-book or depth-of-book, represent a fundamental redesign of the equity markets. In this proposal, the Commission seeks to substitute its own algorithm for the interaction of competitive market forces: Regulation NMS specifies the order routing algorithm for every broker and every type of customer, specifies new order types to be used on every market, and specifies linkages, response rates, quote volatility tolerances, and a myriad of other details for order routing. This is design, not facilitation.

By specifying a single order routing algorithm, the Commission has in effect designed a central market system that extinguishes the present and future benefits of competition and innovation. Brokers will be forced to route to markets that may not necessarily get the customer the best overall price, and which they would otherwise seek to avoid because of old-fashioned order handling procedures, cumbersome technology or capacity and reliability concerns. Should this design be adopted, there will be no incentive for markets to compete on how orders are executed or how they discover prices or depth because exchanges are guaranteed to receive orders no matter how moribund their technology. Without an incentive to innovate, technological and operational efficiency will be the inevitable casualties.

As numerous buy-side and sell-side firms have pointed out, with every broker forced to route to the same market to take out the same quote when they trade, there is also a serious risk of market gridlock. With the advent of efficient trades over the Internet, our customers have grown used to getting the price they see on the screen within seconds of entering the order. What will we say to them when their orders start taking longer to execute, and at worse prices?

What is the basis for such radical change? It is hard to find a solid empirical basis in the Commission's release. Many of the commenters on the Commission's release have cast doubt on the thoroughness of the Commission's analysis and conclusions.

Is the rationale for a trade through rule the quality of effective and quoted spreads? Our experience with our own order flow has shown us market quality improvements in the transfer just last fall of the QQQQs from the listed markets, which have a trade through rule, to NASDAQ, which does not.

Is the rationale high rates of trade-throughs? The Commission's own reported rate of trade-throughs (about 2%) seems too small to justify changing how the other 98% of orders are handled. And other commenters have found that the actual incidence of trade-throughs is significantly lower. In any case, the Commission reports that the trade-through rate is about the same for NYSE and NASDAQ, despite their differences in market structure.

Is the rationale to encourage greater use of limit orders? The SEC offers no evidence that will be the result. Our own customers choose to enter limit orders on NASDAQ, which has no trade through rule, at twice the rate they do on the NYSE.

Don't be misled by those who will argue that a trade-through rule is merely about requiring that customers get the best price. That is a stalking horse. From the customer's perspective, the issue is not whether the first part of their order is being executed at the best quote; the issue is whether they are getting the best price overall, for their whole order. There are so many more factors that go into that analysis, such as speed and ability to discover additional liquidity for an order. Regardless of which variation of the trade-through rule it adopts, the SEC's proposal will result in situations in which individual investors do not receive the best price for their trades. This stands in direct contrast to both the current regulatory requirement for best execution, and the commitment that Schwab has made to its customers. Indeed, the trade-through rule now in effect on the exchanges predates all of the best execution rules, tools, execution quality data and other resources that have been developed over the past nine years to ensure customers are getting best execution. The bigger question is whether we should trust the formula for what is best execution to a single, government designed, one-size-fits-all algorithm, rather than to brokers and markets all competing to offer state-of-the-art execution protocols tailored to the unique needs of individual and institutional customers.

The SEC's experimentation with a new design for our equity markets stands in striking contrast to its slow response to a well-documented structural problem that has continued to disadvantage investors.

Under current SEC rules, the securities exchanges operate as a cartel to fix the price of market data and restrict access to data – to the detriment of investors, but especially individual investors who cannot afford the hundreds of dollars a year that the exchanges charge for access to quote services that display market depth information. Right now, individual investors generally only have access to what's called the National Best Bid and Offer, just the two best quotes among all the markets. But these prices are often good for only a few hundred shares. The professionals, on the other hand, can see the level of trading interest at each price level.

Without access to information about market depth, how are individuals going to gauge the prices they will likely get, how and when they should enter their orders, and whether they received best execution? Needless to say, access to quality market data is vital to the functioning and fairness of our markets. Congress, in establishing the National Market System, noted that the market data system operated as a public utility, and said it should be regulated as such. Yet despite five years of study, comment, re-study, re-comment, and debate, the Commission proposes only a "first step" that merely reapportions the pool of money and does not address the root cause of the problem and the inequities it creates.

Mr. Chairman and Members of the Committee: Facilitating competition means eliminating barriers to competition (such as the trade-through rule) that guarantee a market will receive business even if it refuses to evolve. And it means facing up to cartels that place individual investors at a disadvantage. Regulation NMS represents a step that requires reconsideration by the Commission with the thoughtful input of this Committee. While Congress has traditionally respected the SEC's historic role in terms of market oversight, it has consistently reaffirmed that competitive market forces should shape market structure – and it should do so again.

Thank you for allowing me to share our views – I look forward to answering any questions.

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