Testimony of

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Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, thank you for inviting me to appear today to discuss the SEC's reproposed version of Regulation NMS. This subcommittee has held hearings throughout the formulation of the proposed rule, and I greatly appreciate the time and effort you have taken to understand the complexity of the issue and to remain involved in the process. In particular, I want to thank you, Chairman Baker, for your leadership on this issue.

Today, thanks to your interest and hearings like this one, almost everyone agrees that the old rules need to be reformed in order to promote greater competition. As SEC Chairman William Donaldson said last December, "the existing trade-through rule is not working as intended." Even such fierce rivals as the NYSE, Instinet and NASDAQ are now debating <u>what</u> reform is needed, not <u>if</u> reform is needed: a much healthier debate.

This afternoon, I would like to spend a few minutes reviewing Instinet's position on the portion of Regulation NMS that has been receiving the most attention – the issue of the trade-through rule.

When the SEC reproposed Reg NMS last December, Commissioner Cynthia Glassman encouraged those submitting comments not just to consider what type of trade-through rule they preferred, but if any trade-through rule is even necessary. We have taken Commissioner Glassman's words to heart and continue to advocate for the elimination of the trade through rule. Its repeal would foster competition without favoring one market model or another.

I must say that I was surprised by elements of the reproposed rule, since even at this late point in the process the case for retaining <u>any</u> trade-through has not been made. Sure, that case has been made rhetorically over and over by the NYSE and its allies. But today, most of us are understandably skeptical of the arguments put forward by any business that actually lobbies for MORE government regulation. We have rightly learned to discount such lofty rhetoric unless it is accompanied by facts. Sound economic principles, solid data and real world experience must be our guides when implementing rules that will impact our nation's capital markets, not rhetoric. Let's look at whether the trade-through debate can survive an analysis based on facts.

There are two main arguments that are used to support the trade-through rule.

First, it is said that a rule is necessary to protect investors from unscrupulous brokers that may execute customer orders at inferior prices. However, when the SEC proposed an opt-out provision so that those who did not believe that they were being taken advantage of could waive the unwanted protection in exchange for greater flexibility and control over their order, there was an uproar of opposition from the defenders of the status quo. Once it became apparent that the inclusion of an opt-out provision could have addressed the stated concerns of both sides – by protecting small investors but giving flexibility to sophisticated investors – the advocates of regulation had to shift to a second rationale for preserving the rule.

The second defense of the trade-through rule is that it encourages limit orders. The simple example given by supporters is one of the virtuous retail investor that bravely posts a limit order only to watch in dismay as other markets trade at prices inferior to the retail investor's price. All of this causes the retail investor to lose confidence in the market and to stop posting limit orders. With fewer limit orders, spreads widen and market quality is compromised. It's a good story but with a significant flaw: there is no empirical evidence to show that it's true. Moreover, the absence of a trade-through rule in other markets has not resulted in such a loss of confidence. In fact, retail investors have shown a preference for placing limit orders on the NASDAQ – without any so-called "trade-through protection" – over the NYSE.

I am concerned that the SEC has adopted the position that the trade-through rule promotes limit orders based on research that, upon closer examination, seems to prove just the opposite. In a study by the SEC's own Office of Economic Analysis, the SEC examined just 4 days of trading in 2003. The entire reform that has been debated for years is based on just 4 days of empirical evidence. And what did it find? The trade through rate for NASDAQ-listed securities was just 2.5% of trades – and a mere 1.9% of volume when limited to displayed size. This finding can only mean that supporters of the trade through rule believe that even though more than 97.5% of the time a limit order is not traded through, the mere 2.5% risk of being traded through is enough to discourage limit orders.

I don't believe that this extremely small risk deters limit orders. In fact, some of the largest brokerage firms that represent individual investors – including Schwab, Ameritrade, Morgan Stanley, Scottrade and even Goldman Sachs – report that they receive more limit orders for NASDAQ stocks – where there is no trade-through rule – than for NYSE stocks, where one presently exists. Further, the SEC's own study also noted that there were more limit orders placed in NASDAQ stocks than NYSE stocks. So how can there be more limit orders in NASDAQ stocks than NYSE stocks when NASDAQ does not have a trade-through rule? I believe it is because there <u>is</u> full confidence in the marketplace as well as a competitive and innovative environment that has provided investors with the choices and flexibility they demand when investing in a modern market.

So based on its own internal numbers, shouldn't the SEC be proposing the elimination of the rule entirely – as Commissioner Glassman suggests? Unfortunately, the SEC instead has indicated that it will impose the regulation on both the NASDAQ and the NYSE and has only asked for public comment on its two ways to apply this expanded trade-through rule: top of book and voluntary depth of book.

We believe that this is a false choice. Neither is a step forward for individual or institutional investors. The top of book proposal is largely the existing rule, with some modernization, extended to the NASDAQ marketplace. It would retain all of the problems created by a trade-through rule – still limiting investor choice and competition between markets – without protecting the majority of limit orders. That's why I believe that if the trade-through rule is retained and even expanded to the NASDAQ using the justification that we must protect limit orders, <u>all</u> limit orders should be protected under the voluntary depth of book proposal.

Defenders of the trade-through rule have, in effect, been hoisted on their own petard. The NYSE circulated a letter from the Consumer Federation of America last summer defending the trade-through rule but the CFA's latest letter takes the logical next step and calls for adoption of the voluntary depth of book alternative. I do not see that letter with the NYSE's material today. After arguing for years that the rule is necessary to protect investors, they are now backtracking to oppose the logical conclusion of the argument – that the rule should be applied to all orders and not just a lucky few.

This difference of opinion is not surprising. In fact, public comment letters to the SEC make it clear that there are sharp divisions on this issue. The NYSE and some others are strong defenders of the regulation. Yet 37 Members of the House and Senate signed comment letters last year calling for the repeal of the trade-through rule or, at the minimum, the inclusion of an "opt-out" provision. They were joined by nearly a dozen statewide officials from coast to coast, ranging from California Controller Steve Westly to Florida Attorney General Charlie Crist. Also calling for repeal or opt-out were more than a dozen state pension funds and labor unions, including some of the largest like the California and Ohio Public Employees Retirement Systems, the Teachers' Retirement Systems of Louisiana, Indiana and California, and The College Retirement Equities Fund and its companion organization the Teachers Insurance and Annuity Association of America (collectively known as TIAA-CREF). Major financial institutions such as UBS, Morgan Stanley, JP Morgan, Merrill Lynch and Citigroup joined retail firms like Ameritrade, Fidelity and Schwab as they all called for the rule's repeal or an opt-out exception.

Nor is there consensus on the top of book or depth of book proposal. The Securities Traders Association calls for a phased approach that is completely different from the SEC's proposal while a diverse group that includes the Investment Company Institute, the Consumer Federation of America and Instinet Group all prefer the voluntary depth of book proposal if the trade-through rule is retained as currently proposed. The other side has its champions, too. But it is clear that there is no clear consensus for <u>any</u> of the proposals the SEC is currently considering.

Such sharp divisions should be taken very seriously. We are considering fundamental changes in how our markets operate and compete. While we should not expect full consensus across our industry, I would think the SEC would be wary of sweeping changes with their related costs to investors in the face of such a deep split and with so many questions still unanswered.

Keeping in mind these unanswered questions, let me summarize the key remaining issues and Instinet Group's position.

First: the trade-through rule is an unnecessary burden that hinders competition, ultimately harming rather than protecting investors.

Second: on no account should the trade-through rule be extended to the NASDAQ marketplace. The NASDAQ market is an example of a highly liquid and highly competitive market where the competition has reduced investor costs, narrowed spreads and improved performance for all investors.

Again, let me be perfectly clear on this point. Neither independent nor SEC research demonstrates the need for the trade-through rule on the NASDAQ marketplace. As Chairman Donaldson himself said when reproposing Reg NMS, "We ought not lose sight of the fact that the U.S. equity markets today work pretty well both for investors and for issuers. Spreads are thin. Volatility is manageable. There is no need for radical surgery in pursuit of a Platonic ideal." He went on to say, "We need to identify real problems, consider the practical consequences of the possible solutions, and then move pragmatically and incrementally towards the goals Congress staked out."

Applying the trade-through rule to the NASDAQ marketplace is not a pragmatic and incremental move. It should be taken only when it is clear that the market is failing and less drastic remedies are inadequate. As Hippocrites admonished millennia ago, "First, do no harm."

And Third: if the SEC still feels the overwhelming need to protect limit orders by strengthening the trade-through rule and imposing it on the NASDAQ marketplace, it should implement a consistent rule that protects all limit orders through its voluntary depth of book proposal and not one that only protects the lucky few. It is simply not logical to impose a rule to protect a few and leave the rest to fend for themselves.

I've commented in greater technical detail on our position in the documents accompanying my remarks today and ask they be included in the record.

In conclusion, Mr. Chairman, this is all about how consumers can get the greatest return on their investments for the lowest cost. Regulatory reforms in NASDAQ have fostered competition, lowered trading costs, and delivered tremendous value to all investors – and without a trade-through rule. In the absence of clear evidence of its value, the trade-through rule, or "ossified relic" as some have called it, should finally be retired.

I thank you for your time and effort and would happily answer any questions you might have.