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Before the
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
of the
House Financial Services Committee

Hearing on
"The SEC's Market Structure Proposal: Will It Enhance Competition?"

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Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee, thank you for the opportunity to participate in this important hearing regarding the Securities and Exchange Commission's market structure proposal, Regulation NMS. I commend the Subcommittee for its interest in ensuring that the U.S. capital markets remain competitive and innovative.

Knight Trading Group, through its affiliates, makes markets in equity securities listed on Nasdaq, the OTC Bulletin Board, the New York Stock Exchange, and American Stock Exchange, both in the United States and Europe.[1] On active days, Knight executes in excess of one million trades with volume exceeding one billion shares.

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[1] Knight is the parent company of Knight Equity Markets, L.P., Knight Capital Markets, Inc., and Knight Equity Markets International, Ltd., all of whom are registered broker-dealers. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary. Knight is a major liquidity center for the Nasdaq and listed markets. As a dealer, we make markets in nearly all equity securities. Knight's clients include more than 850 broker-dealers and 600 institutional clients. Currently, Knight employs nearly 700 people.

Congress amended the Securities Exchange Act in 1975 to establish the goals of a national market system. Since then the U.S. equity markets have dramatically changed. Rapidly advancing technology continues to improve trading efficiencies and increase competition, all positive developments helping to bring down trading costs for investors. However, for several years Knight has called on the SEC to address several problems in the equity markets, namely the lack of market linkages and efficient access to quotes, the privileged ability of ECNs to charge access fees to non-subscribers, and the negative impact of sub-penny quotations.

Although the SEC, through the re-proposed Regulation NMS (the "Reproposal"), addresses access fees and sub-penny quotations, we have very serious concerns about the SEC's proposal to extend the trade-through rule to all markets. Due to competitive forces and the lack of data supporting such a rule, there is no need to extend the trade-through rule.

The solution is simple: require linkages that efficiently connect all markets and ensure that all displayed quotations can be accessible and executable. This requirement alone could solve many of the market structure problems faced today. If there are efficient linkages, then the need for a trade-through rule on any market is greatly diminished, if not eliminated. Rules should be put in place to benefit investors and the markets. However, the best way to benefit investors is not by imposing a trade-through rule, but to instead require linkages so investors' trades can receive best execution.

Additional regulation should not be imposed simply for the sake of regulation. There must be a clear and unambiguous purpose for additional laws or regulations, and they must have

a material and demonstrable positive impact upon investors. We respectfully submit that no such purpose and no such benefit has been articulated which would justify the massive restructuring of the U.S. capital markets called for by the proposed trade-through rule.

There is no evidence to support extension of the trade-through rule. Many market constituencies do not believe that an extension of the trade-through rule is needed. In justifying a trade-through rule, the Commission referenced its data suggesting that 7.9% of the volume, or about 2.5% of trades executed on the Nasdaq (which currently has no trade-through rule) are traded-through. This compares with 7.2% of the volume, or about 2.5% of trades executed on the New York Stock Exchange, which does have a trade-through rule. The SEC's data on trade-through rates is nearly the same for a market that currently has a trade-through rule and one that does not, so it is unclear what is to be gained by instituting a trade-through rule across all markets. This suggests that the stated benefits to a trade-through rule may prove to be highly elusive.

In addition, as with any far reaching regulation, it may result in serious unintended consequences. Government mandated paths of trading could have a substantial negative impact on the technological innovations that have served to benefit greatly the U.S. investor over the last decade. Indeed, the technology timeline has been so compressed, that we are now experiencing technological innovations in the market almost daily.

The driver of this innovation can be summed up in a single word: "competition." Nowhere is competition greater and fiercer than in the securities markets. Profit margins have

been cut to razor thin levels, and technological advancements are staggering. Today, the typical U.S. investor experience can best be described as: ***blinding speed at the best price***. By forcing all trades to take a similar route and be handled in a similar manner, we will undermine the very foundation of competition – that is, ***the distinctions in execution offerings that motivate the investor***.

Indeed it is those very distinctions which, in turn, drive the markets to improve. If every investor wanted a trade handled in exactly the same manner, then we could simply centralize the markets and create a labyrinth-type utility for trade executions. However, the U.S. investor would never stand for that. They want fast trades, complete fills, minimal impact, superior pricing, minimal costs, and the list goes on. These investor demands move the markets to create, innovate, and operate in a highly efficient manner. Too many unnecessary rules create hurdles and roadblocks, and take competition away. As a consequence, market innovation may be stymied to such an extent that the investor experience ceases to improve and, worse yet, degrades.

In the Reproposal, the SEC makes a preliminary determination that a trade-through rule would encourage the posting of limit orders. We do not believe this to be the case. In fact, we firmly believe that many investors will not want to grant "free options" on their orders by placing additional limit orders of size in the market. If an investor wants to buy 10,000 shares of a security, he is not likely to want that openly displayed. In a decimal environment with compressed spreads at a penny, orders can simply step in front of him for one cent and receive execution priority. Rather, he prefers anonymity, and looks for his order to be worked into the

market, creating as little impact and volatility as possible. Thus, since we do not believe the Commission's data supports the need for any trade-through rule, we firmly believe that ***neither*** of the two alternative trade-through rules – Market BBO alternative (also referred to as "top-of-book") and voluntary display alternative (also referred to as "depth-of-book") – are warranted.

The Reproposal significantly underestimates the costs of instituting a trade-through rule for all markets. No trade-through rule has ever existed in the Nasdaq market, so firms like Knight will face a significant technology cost burden. They will be required to adjust their trading system technology, as well as develop compliance systems and add personnel, to monitor compliance with the rules. The costs of these technology and personnel changes will be significant, yet the benefits of a trade-through rule are minimal. The costs to the investor will be great, as investors will inevitably suffer from reduced market efficiencies brought about by a centralized, mandated trading protocol – which looks to handle all orders, regardless of size or investor preferences, in exactly the same manner.

The technology costs would include expenses relating to what we expect to be an exponential increase in message traffic due in part to chasing quotes in stocks where prices are flickering. Most trade-throughs occur at one penny, which the Commission has already indicated would be acceptable for stocks, such as Exchange Traded Funds ("ETFs"), with flickering quotes. In particular, the depth of book alternative, or what is sometimes referred to as a virtual Central Limit Order Book ("CLOB"), would impose the greatest technology costs as message traffic would increase even more.

<u>Competition, rather than regulatory mandates, should drive market participants</u>.

Unlike a trade-through rule mandate, the SEC's Rule 11Ac1-5 ("Rule 5") is a shining example of regulation that increases competition by promoting transparency and comparability. The rule requires market participants to post their execution statistics in accordance with standardized reporting metrics. As a result, Rule 5 has provided transparency and comparability of execution statistics, which order routing firms can and do use to make more informed routing decisions to meet their clients' needs. This has increased competition and pressured markets to continue to improve the execution of customer orders, as well as dramatically reduce costs for investors. An individual can now pay brokerage fees as low as about $5 per trade, while only a little over a year ago $15 trades were on the low end of the cost scale. Only a few short years ago, a 60-second execution in a Nasdaq-100 stock was considered a good execution. Today, most marketable executions are measured in sub-second increments. We believe this is due to competitive forces, not regulatory fiat.

We do not know what future, technological innovations are on the horizon. However, we do know for certain that those innovations and increased efficiencies may never come to fruition if we do not encourage and foster a competitive market environment, ***rather than*** pursuing and expanding antiquated, command and control methods of trading. A regulatory approach such as Rule 5, based upon the principle of promoting competition through full disclosure (as opposed to mandated paths of trading), provides a far less invasive and less costly way to achieve the goals of a trade-through rule.

<u>There is no evidence to suggest that a trade-through rule will increase limit orders</u>. As noted above, we do not believe that a trade-through rule would encourage the posting of large limit orders. In addition, we do not believe that small investors would benefit by a trade-through rule. In a penny trading environment, there is little incentive to post limit orders. In fact, Charles Schwab data indicates that its customers "tend to use limit orders approximately twice as often for Nasdaq-listed stocks… as for exchange-listed stocks."[2] If a trade-through rule is to encourage limit orders, it will not accomplish that goal since retail investors appear to use limit orders on Nasdaq-listed stocks (with no trade-through rule) much more often than on exchange-listed stocks (with a trade-through rule). We believe that the typical U.S. retail investor prefers the use of market orders, as opposed to limit orders, as it provides them the opportunity to immediately gain access to the displayed price and size they see in the market. For example, another large retail brokerage firm, Ameritrade, noted the results of a Gallup Organization poll which showed evidence that investors want the price they are quoted and they want fast execution of their trades.[3]

Indeed, we believe that limit orders tend to be used more frequently by professional traders. They use oversized limit orders to probe for undisplayed liquidity, knowing full well their order will only be partially completed. In fact, we believe that this trading strategy contributed to the "unfulfilled" limit order rate referenced in the SEC Staff study. Thus, it is not the typical investor order which is not being filled, rather the professional arbitrageur who is fishing for orders. If it were the U.S. investor order being unfulfilled, you could rest assured that

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[2] *See* letter from Jeffrey T. Brown, Senior Vice President, Charles Schwab, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, February 1, 2005, at 3.
[3] *See,* letter from John S. Markle, Associate General Counsel, Ameritrade Holding Corporation, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, October 13, 2004, attachment.

investors would be screaming for their brokers to advocate for a trade-through rule. Indeed, we have seen the exact opposite. Large retail-based brokers (such as Ameritrade and Charles Schwab) have argued that there is absolutely no need to extend the rule at all, particularly into Nasdaq.

In short, investors will not benefit from an extension of the trade-through rule to Nasdaq. Instead, investors have benefited by lower trading costs which are the result of increased competition and innovation. Extending the trade-through rule would inhibit further innovations and competition – the very factors that have driven costs dramatically lower over recent years.

Rather than imposing a trade-through rule at this time, a phased approach to addressing market structure issues should be implemented. Mandating effective connectivity and access between markets and participants, including elimination of access fees and sub-penny quotations, would be the necessary first step or phase to address most of the current market inefficiencies. Although it addresses access fees and sub-penny quotations, the Reproposal does not adequately address the need for improved connectivity to ensure that all markets are linked and can be accessed immediately.

Requiring connectivity would go a long ways toward ensuring that investors receive best execution of their orders. Non-automated markets force an automated market to wait for execution and deal with inaccessible quotes. The inability to automatically access displayed liquidity may also place brokers unfairly at risk for best execution liability when they are unable to obtain a better price for a customer because that price was inaccessible. Requiring

connectivity and access would address these market inefficiencies. Once connectivity and access are established, the Commission would be in a better position to examine data and determine whether there is a need for further investor protection rules or best execution guidance. If necessary, a pilot program covering select stocks could then be implemented to examine the impact of imposing a trade-through rule on those stocks.

Knight supports the Commission's proposals relating to limiting access fees, banning sub-penny quotations, and locked and crossed markets. Knight still believes that all non-subscriber access fees should be eliminated in order to establish integrity of the quote and to address the market distortions such fees cause. ECN access fees and rebates provide an economic incentive of certain market participants to lock and cross, which can lead to confusion in the marketplace. If the SEC chooses not to abolish access fees, Knight supports efforts to limit access fees to minimize these impacts.

Knight also continues to support a ban on sub-penny quotations. Sub-penny quotations diminish liquidity at each price point and make it easy for professionals to jump ahead of limit orders. In addition, Knight supports the adoption of a rule prohibiting locking the quotation of an automated market.

Conclusion. Knight reiterates its view that competition fosters innovation and efficiencies, ultimately benefiting the markets and investors. Connected markets and efficient and fair access will do more to benefit investors than a costly, unproven command and control trade-through rule. Knight recommends that the SEC minimize unintended consequences by

taking a market oriented approach that requires connectivity, efficient and fair access, and later considers whether a trade-through rule is necessary.

I greatly appreciate the Subcommittee's interest in examining the issues relating to Regulation NMS. Thank you for the opportunity to contribute to this important dialogue.