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BEFORE THE FINANCIAL SERVICES SUBCOMMITTEE
ON CAPITAL MARKETS, INSURANCE
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Chairman Baker, Chairman Oxley, Congressman LaFalce, and distinguished members of the subcommittee: My name is Carrie Dwyer, and I am General Counsel and Executive Vice President of The Charles Schwab Corporation, one of the nation's largest financial services firms. Schwab was founded more than 25 years ago as a pioneer in discount brokerage. With the acquisition last year of U.S. Trust, Schwab became the first firm to form a financial holding company under the provisions of Gramm-Leach-Bliley. Today, we have more than 7.6 million active accounts with more than $845 billion in client assets. About 4.3 million of those accounts are online accounts, making Schwab by far the largest online brokerage in the world. I would like to thank you for the opportunity to present Schwab's views on one of the most important issues facing the U.S. capital markets today: the cost and availability of market data.

As you may be aware, in many ways Schwab launched the discussion of this issue in June 1999 when we submitted a formal rulemaking petition to the SEC to review and correct what we believed to be the unreasonable and discriminatory market-data fee structure. In December 1999, the SEC issued a "concept release" requesting comments on several approaches to reforming the market data structure. The Commission received numerous comments that reflected divided views. In September 2000, the Commission formed an Advisory Committee on Market Information, chaired by Dean Joel Seligman of the Washington University School of Law, to examine the issue in depth and make recommendations to the Commission. I sit on that Advisory Committee, along with 24 other members representing a wide variety of companies and organizations. While consensus is emerging among the participants that the current system is flawed, deep divisions exist over what the appropriate solution should be. For that reason, I am pleased that Congress -- this subcommittee in particular -- is taking an active interest in monitoring this issue.

<u>Historical Background: What is Market Data?</u>

Market data is industry jargon for the prices at which investors are willing to buy and sell securities, and the prices of completed transactions. Real-time market data -- that is, data that shows transactions and quotations as they are occurring -- is collected from the broker-dealer members of the stock markets by registered securities information processors, like the Consolidated Tape Association. These processors package and distribute the market data to information vendors, like Bloomberg, and also to broker-dealers. Investors rely on this information to evaluate potential investments and to determine the best prices available in the market.

What we so blandly call "market data" is the lifeblood of our markets, the oxygen that they breathe, the most important component of what we call transparency. "Transparency" is industry jargon for fairness – the ability of investors large and small to really see where the market is at a given moment in time. The widespread availability of accurate market data is not only the reason for the unparalleled strength of our markets, but the key to democratizing our markets – allowing all market participants from the largest institutional investor to the single mom saving whatever she can save each month for her daughter's college education to make informed investment decisions. Of course, it wasn't always that way. Prior to Congress' adoption in 1975 of amendments to the Securities Exchange Act, individuals could not see for themselves accurate, timely market information. They had to obtain market information from an intermediary, such as their broker, or they could look in the next day's newspaper to see what happened. Individual investors also had little hope of finding the best price, or even knowing whether the price they received was fair.

In 1975, Congress created a national market system for securities and identified the democratization of quote and transaction information as a core principle for that system. The system linked all stock exchanges and over-the-counter markets to make information widely available and to allow investors to enter orders in one market yet still benefit from better prices available on another market. Congress required the various markets to enter into joint plans for collection and distribution of market information to ensure that all those who trade securities could have "accurate, up-to-the-second information as to the prices at which transactions in particular securities are taking place."[1] Congress envisioned that a consortium of exchanges would collect and disseminate the information in an "absolutely neutral" manner.[2] The consolidation process was organized in such a way that it gave the exchanges monopolistic power over the distribution of the information. In the 26 years since passage of the Amendments, the exchanges have used that monopoly to control every aspect of market information: the format, the speed, who can receive it, when they can receive it and how much it costs. These consortia of exchanges sell the quote and sale information to every market user, and split the proceeds among themselves, on a volume-based formula. The creation of a monopoly system may have been necessary in 1975, but computer and communications technology has advanced so significantly in the years since, that it no longer makes sense. The irony is that the system created to widely disseminate market information now functions as a barrier to cheaper more innovative use of data.

Schwab, like most brokerage firms, purchases market data from the registered securities information processors. Schwab then distributes real-time quotes and transaction prices to our customers, either online, over the phone or in person at a branch office. For the privilege of distributing this fundamental information to our customers, Schwab paid approximately $19 million to the exchanges in 1999. The New York Stock Exchange, the American Stock Exchange and the NASDAQ together collected more than $400 million in market data fees in 1999. That represents more than a third of the Amex's revenue; nearly 18 percent of the NYSE's

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[1] Senate Report 94-75.
[2] Ibid., p. 189.

revenue. Market data fees represent such a significant amount of money that discussions about opening the system to competition become very difficult.

Impact of Online Investing on Market Data Use

One of the most important factors in the market data controversy is the growth of interest in the markets – and in market data. Information on revenue is scarce, but in its 1999 Annual Report, the National Association of Securities Dealers, Inc., the parent of both the NASDAQ and the American Stock Exchange, noted an 18 percent increase in its revenue from market information services – to more than $276 million in 1999. It attributed that growth in part to "a significant increase in the amount of non-professional quote inquiries."[3] The New York Stock Exchange reported a 9 percent increase in market data revenue from 1998 to 1999 – totaling more than $125 million in 1999.

The simple fact is that more Americans have invested in the stock market than ever before, and more people check their portfolios more often. The Internet has facilitated this process. No longer required to have a conversation with a broker, an individual can hit the "refresh" button on his computer 10, 20, 50 times a day to see the latest information. With automated access to brokerage firms by wireless Internet, a customer can check her IRA while walking down the street if she chooses. Our own internal research found that in the days when our customers relied primarily on telephone orders, they asked for (and the firm bought) about 10 quotes for every trade. With online trading, Schwab buys in the range of 75 quotes per trade. While we encourage this trend, because it gives investors more knowledge, it is also clear that online investing has had a radical impact on market data revenue. If investors can have better information, they will make use of it.

When investors go online to check their stock positions or account balances, they reasonably expect to see the most up-to-date pricing information. Unfortunately, it is cost prohibitive for Schwab to offer real-time quotes to every customer. As a result, for some functions, we offer customers quotes that are delayed 20 minutes – which in today's market might as well be 20 days old, given their usefulness to investors. At a customer's request, we provide a limited number of real-time quotes free of charge, usually with a monthly limit; for customers who want real-time, unlimited, streaming quotes, we charge an additional fee. The technology exists today to make real-time streaming quotes available to every individual investor, but cost prevents us and most other major brokers from doing so.

Schwab's Petition for Rulemaking with Regard to Market Data Fees

We believe strongly that the current fee structure discriminates against individual investors. For example, online retail investors must either pay a per quote fee ranging from a half-penny to a penny, or a fixed monthly fee of $4.00 for Level I quotes. To see the real depth of the market, Nasdaq's Level II quotes, an additional $10 fee is charged. Firms like Schwab absorb the majority of these fees, but the reality is that they are passed on to customers, either directly or indirectly – they are built into the fee we charge customers for making a trade. The bottom line is that the fees are unreasonable –we paid more than $1.6 million for market data in

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[3] National Association of Securities Dealers, Inc., *1999 Annual Report*, p. 35.

January of this year, a 30 percent increase over the monthly average for fees in 2000. Brokerage firms that deliver market data to their customers the old-fashioned way – via a broker– pay a fixed monthly fee per terminal, no matter how many quotations they deliver. We think this fee structure penalizes investors using Internet technology, hinders direct investor access to market data, and has resulted in online brokers and their retail customers paying grossly excessive market data fees.

As a result, in June 1999, Schwab filed a petition with the SEC requesting that it institute rulemaking to govern the terms of access to market data. We requested that the rules ensure that market data fees are allocated in a fair, reasonable and non-discriminatory manner consistent with section 11A of the Exchange Act. We asked for more public disclosure of the fees, costs, contracts and policies relating to the collection and dissemination of market data. We believe it is impossible to determine whether the market data system is operated in a fair and non-discriminatory fashion if its terms are not fully open to public view. The current system is not transparent. For example, the processors have in the past avoided public and regulatory scrutiny in a number of instances by instituting fee changes through "pilot" programs that were not filed with the SEC for review, approval and, importantly, public notice and comment.

Schwab believed that SEC intervention into this matter was critical for a fair and prompt resolution of these issues for several reasons, many of which are relevant to this subcommittee's work. For example, although the processors are directed by the Exchange Act to distribute market data in a fair, reasonable and non-discriminatory manner, the processors are operated by joint action of the existing securities markets, and those markets share in the processors' revenues. Combined with the absence of public and industry representation on the processors' boards, it could be only natural for the processors' operations to favor the interests of the individual stock markets, rather than the interests of all market participants. This is exemplified by the recent programs offered by several markets to rebate a portion of the fees paid by certain market participants based on their volume of trades in that market, for the purpose of capturing order flow. These programs help the markets involved to compete, but do not foster the goals of widespread and fair dissemination of market data to all investors.

The SEC Concept Release on the Regulation of Market Information Fees and Revenues, issued in December 1999, represented the Commission's first step toward addressing the problem. Finding a lack of consensus on a rate-making approach, the SEC in September 2000 formed the Advisory Commission on Market Information to address this complex issue in more detail. That panel's report and recommendations are expected early this fall. The first meetings have shown areas of consensus – most notably around the general notion that the system is flawed – but broad agreement on a solution seems likely to be elusive, and it has been a glacially slow process. Several members, including Schwab, have offered various frameworks for possible reform.

Core Principles of Reform

The need for reform of the market data system is driven by the simple change in the end user over the last 25 years. The investing public has become the American public; more than half of all American households are invested in the stock market, either directly through securities or mutual funds, or indirectly through pension plans or other vehicles. And those investors are watching their portfolios very carefully, particularly in the volatile market in which we have found ourselves in the last year. There is an unquenchable appetite for information, accessible anytime, from anywhere, via television, the Internet, through handheld devices, even on cellular telephones. Investors are demanding these and other options, and companies like Schwab are striving to meet that demand with ever-more innovative products and services. The biggest hurdle is the cost and inflexibility of the current market data structure.

We at Schwab have long advocated more efficient and fair processing and dissemination of market data by talking about the fundamental principles that should govern the process. We believe there are several ways to achieve the national market system goals set forth by Congress. Rather than propose a specific legislative or regulatory solution, let me instead sketch some broad principles that should be the core of any reform plan:

First, reform must promote competition. To introduce market discipline and foster innovation, third-party vendors should be offered the opportunity to disseminate unconsolidated market data (including multiple levels of price and depth information) independently. Competition at all levels of the market data system will foster innovation to take advantage of electronic technologies, leading to the creation of market data products that better serve the needs of today's investors. Under the current system the exchanges have no particular incentive to continue to develop improved market data products that benefit investors, since they have no competition – market data comes in the manner and quality decreed by the exchanges. Let's let the exchanges compete with other market data vendors based on price and quality of service. Anyone wishing to compete to provide market data should ensure that access to market data is on fair, reasonable and non-discriminatory terms, as required by Section 11A of the Exchange Act.

Second, reform must ensure that no one has ownership over market data. For the last several years, the exchanges have been advocating database protection legislation on Capitol Hill that would give them an historical property right over market data. But market information is a set of facts, plain and simple: bids, offers, limit order prices, last sale prices. No one can own these facts. Investors and broker-dealers, not exchanges, create these "facts." Granting market data ownership or copyright protection to any one party would be antithetical to the very purposes of the national market system and to longstanding principles of intellectual property law.

Third, the market data system must become more transparent. Market data fees should be set in the sunshine. Greater transparency of the fees, costs, contracts and policies relative to the collection and dissemination of market data is essential to creating a fair and open system. One of the ongoing frustrations broker-dealers and individual investors have had with the market data issue is the secrecy that cloaks the process. Each entity works out its own contracts with the exchanges, meaning there may be side agreements, specially negotiated rates and "pilot programs" of reduced rates that are outside of the SEC's full oversight. Market data reform should require that fee schedules and all contract terms are made publicly available. There should also be an end to pilot programs that treat investors with one firm differently from investors using a competing firm. Transparency is the hallmark of our markets – so should it be the hallmark of our market information.

Fourth, reform must result in a level playing field. Ensuring the broadest possible access to market data is essential to the protection of investors and the fairness of our markets for everyone. Schwab believes that access to this data on fair and equitable terms is critical to ensuring that all investors, no matter where or how they trade, have the information that is essential to making fully informed investment decisions. All retail customers at all firms depend on this. Individual investors must be able to access critical market information at the same time and on the same terms as large institutional investors and other market participants.

In addition, the playing field must be level for online brokers and traditional brokers. For the most, online brokers continue to pay fees either by the quote or by the customer. Traditional brokers, on the other hand, are more likely to pay a flat monthly fee, regardless of the numbers of quotes they and their customers request. Investors who use online brokerages should not be penalized by a different fee system for the same information. While recent fee cuts by the major exchanges have helped close the gap, too many fee reductions are part of "pilot programs" that expire, often without the investor even being aware of the changing rates. The by-quote and by-customer quote prices fluctuate – they shouldn't.

Ironically, both the NYSE and the NASDAQ announced in the last several months that they plan to make real-time quotes available to the public on their Web sites for free. We applaud the sentiment behind this gesture. Without question, it is good for investors. But the exchanges plan to continue to force Schwab and other market participants to pay fees to offer the exact same information to customers. It is a baldly anti-competitive position. Customers should have the same access to the same information for the same price, regardless of where and how they access that information.

If competition is not brought into the market data arena, it will be necessary for the SEC to separate the vending of market data from the self-regulatory functions of the exchanges. The exchanges have asserted that the excess market-data revenues are used to fund their self-regulatory obligations -- to surveil the markets for fraud, abuse and other violations of the securities laws. We don't believe the Exchange Act permits this, but perhaps more important, the exchanges have not shown this to be the case. As important as self-regulation is, it should not be allowed to act as a shield to protect an unfair market data system. The costs of self-regulation should be borne by exchange members directly, as we believe they are through existing fees and dues, and not transferred to retail investors seeking access to market data.

Moreover, the exchanges recently proposed a rule change to implement a new "trading floor regulatory fee," which, according to the proposal, is being used to "partially" offset the cost of market surveillance. Although the exact amount of revenue that the exchanges will realize from this proposed fee is unknown, we estimate it to be in excess of $30 million. In making the proposal, the exchanges want it both ways – they want to retain the hundreds of millions of dollars they collect for surveillance via market data fees <u>and</u> impose a new fee to generate $30 million of additional income for the same purpose. All of this without revealing in either context exactly how much it costs to surveil the markets. Schwab has petitioned the SEC to reject the proposed new fees until the exchanges make a corresponding reduction in market data fees and provide adequate justification for the amount and allocation of the fee.

The 1975 Amendments to the Exchange Act were designed to open more fully the national securities markets to the free play of competition and to prevent unreasonable restraints on access to services and market information. Through the 1975 Amendments, Congress gave the SEC the authority to intervene in those situations where competition would not be sufficient to protect these interests. We are faced with such a situation. Technological advances, changes in the market and the rise of the individual investor have combined to radically transform the way market data is used today. It is time for the SEC to re-evaluate the entire framework by which market information is made available to investors, end the monopoly, and create a new system whose hallmarks are fairness, non-discrimination and competition.

Thank you very much for the opportunity to offer Schwab's views on this important issue.