Testimony

Of

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President & Chief Executive Officer
The Cincinnati Stock Exchange

Before the

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

On the

Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related Issues

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The Cincinnati Stock Exchange ("CSE," "Cincinnati," or "the Exchange") welcomes the opportunity to offer comments to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises regarding the structure and operation of the U.S. capital markets. Early last year CSE grew to become the third largest stock market in the country. Last month we set a new daily record of 415 million shares and 900,000 trades. We now handle 20 percent of all trading in Nasdaq listed securities, 10 percent of all trading in American Stock Exchange ("AMEX") listed stocks, and 1 percent of all trading in New York Stock Exchange ("NYSE") listed securities. We have achieved this growth through a combination of technical and market structure innovation, aggressive cost competition, and effective regulation.

Cincinnati was the first exchange to eliminate its physical trading floor. We created an electronic trading system that now routinely processes 300 trades a second, and we established an open systems architecture that gives our members the choice of using exchange trading technology, their own technology, or technology provided by a third party vendor. We were also the first exchange to automate its interface with the Intermarket Trading System ("ITS"), thereby providing automatic executions for ITS orders from other market centers. Finally, the Exchange combined its innovative competing specialist system with a time priority rule modification called "preferencing" to create a trading environment that combined the advantages of the NYSE's unitary specialist system and Nasdaq's decentralized market structure.

On the cost side, CSE has established itself as the low-cost provider of exchange services. In 1997, when the broker-dealer community expressed concern about the high cost of trading and market data, CSE responded by becoming the first exchange to develop a program – called the Specialist Operating Revenue ("SOR") program – that significantly reduced these costs by committing the Exchange to share all of its excess trade and market data revenue with its members. Cincinnati was able to do so by combining the operating leverage that derived from its electronic trading model with a commitment to operate on a utility cost basis, just like a true mutual company. Other exchanges and Nasdaq have now followed our lead and begun offering similar revenue-sharing programs.

With regard to regulation, CSE takes pride in its record of providing effective oversight of CSE trading activity. Cincinnati was the first exchange to develop a complete electronic order audit trail that captures an electronic footprint of all exchange trading activity. In 1996, after Nasdaq was ordered by the Securities and Exchange Commission ("the SEC" or "the Commission") to develop an electronic audit trail, it was Cincinnati that Nasdaq came to for help with what became OATS.

All of this innovation has come in the face of enormous resistance to change. For too long, we have had to live with policies that protect monopolies rather than promote competition. For too long people have accepted the false belief that, if only all order flow could be directed to one physical location, then customer order interaction would be maximized and the public investor would always get the best price. Lip service was paid to the idea of competition between exchanges, but if any of the non-primary exchanges came up with too good an idea and began capturing order flow, this accomplishment was somehow viewed as a problem and labeled with the pejorative word "fragmentation."

Recent events have called these underlying beliefs and policies into question. Troubles at the NYSE are symptomatic of monopolistic business practices and highlight the need for prompt action by the SEC to address serious outstanding market structure issues. While we do not wish trouble on anyone, we are hopeful that the current problems NYSE is experiencing will translate into an opportunity to develop constructive modifications to the National Market System ("NMS") so that it can benefit from the interplay of true competition. In the end, it is public investors who will be the beneficiaries of a more transparent, freely competitive capital market structure.

We certainly do not seek to answer all the market structure questions today. There are two issues, however, that we believe deserve immediate scrutiny:

- The Commission should expeditiously approve CSE's Voluntary Book Filing or, in the alternative, impose price/time priority throughout Nasdaq and the NASD's Alternative Display Facility ("ADF"). Nasdaq and the ADF share a monopoly in that they are currently the only markets permitted to trade Nasdaq-listed and NYSE-listed securities without intra-market price/time priority. (Nasdaq now handles 12% of all the share volume traded in NYSE-listed securities.) For two years CSE has sought Commission approval of a rule change that would begin to level the playing field between CSE and these over-the-counter ("OTC") markets by eliminating price/time priority on CSE for Nasdaq-listed securities. If the Commission is unwilling to permit an exchange to operate without intra-exchange price/time priority because of perceived investor harm, then the Commission should act to equally protect investors in the OTC markets by requiring those markets to impose price/time priority when they trade Nasdaq-listed and NYSE-listed securities.

- ITS is in need of reform. No other market structure change would do as much to force NYSE to compete for order flow than the modification or

> elimination of the ITS trade-through and locked/crossed rules. ITS was created because of the need to enhance a broker-dealer's ability to provide best execution. Ironically, today ITS often is an impediment to best execution because of the requirement to wait for the slowest common denominator of manual market updates and manual executions. With the modification or elimination of the trade-through and locked/crossed market rules, investors could seek an execution that is best for them rather than what is best for a manual market specialist.

Best Execution, Voluntary Book, and Price/Time Priority

The principle of best execution bears significantly on how markets operate internally as well as how markets compete among each other. CSE believes that the competition it has injected into the marketplace has enhanced best execution and promoted the Congressional goals of protecting investors and maintaining a fair and orderly market.

Best execution is at law a broker-dealer obligation. Generally, best execution has been interpreted to require a broker-dealer to obtain the best available price, but other terms in addition to price are also relevant to the equation. For example, best execution is also defined by "the size of the order, the trading characteristics of the security involved, the availability of accurate information affecting choices as to the most favorable market in which execution might be sought, the availability of technological aids to process such data, the availability of economic access to the various market centers and the costs and difficulty associated with achieving an execution in a particular market center."[1] Moreover, with the advancement of data communication and processing technology and the advent of trading in decimals, speed and certainty of execution have assumed a place equal to price for many traders.

Because of the elusive nature of best execution, the Commission has never promulgated a separate best execution rule or explicitly defined best execution. In enforcing the obligation of best execution, therefore, self-regulatory organizations must be guided by the expectations of customers and whether broker-dealers have met these expectations. All customers are different from each other and no single market structure fulfills all customer expectations, expectations that define the parameters of best execution.[2] Only through diverse, competing market structures may all customers find the mechanisms that satisfy their expectations.

A broker-dealer can only maximize its best execution performance through a market structure that promotes the greatest flexibility in order execution. Flexibility in order execution must operate on two levels: within markets and across markets. Consistent with the protection of investors and maintenance of fair and orderly markets, exchanges should be free to implement rules that increase the opportunity for brokers to meet the execution expectations of their customers. By promoting broker-dealers', exchanges' and associations' use of advanced

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[1] Exchange Act Release No. 38672 (May 23, 1997), 62 FR 30485 (June 4, 1997).

[2] Larry Harris, *Trading and Exchanges – Market Microstructure for Practitioners,* Oxford University Press, 2003. "Markets fragment because traders are not all identical and because their trading problems differ considerably. Some market structures therefore better serve the needs of some traders than other market structures do." *Id.* at 530.

technology in execution and order routing systems coupled with efficient rule sets that refrain from imposing regulatory distortions of natural order interactions, the CSE believes that the Commission may enhance the interests of public investors and redirect the NMS towards the forward-looking goals expressed by Congress in Section 11A of the Act.

In attempting to offer the necessary order execution flexibility, CSE, two years ago, proposed to make order interaction on our market voluntary among CSE members.[3] Like that which already exists in the Nasdaq's and the NASD ADF's market structures, the CSE's Voluntary Book would alter price/time priority so that CSE members obtain increased flexibility to seek the best method of executing their customer orders. Equally important, however, the Voluntary Book would expand customer order execution opportunities while promoting, not harming, best execution principles. For example, CSE's proposal would not change its members' obligations with respect to "Manning" requirements, the firm quote rule, or the limit order display rule. By altering our price/time priority principles, CSE would merely be providing a broker-dealer with more flexibility to achieve its customers' goals. That a broker-dealer must still comply with best execution and other CSE and Exchange Act requirements ensures that a broker-dealer's decision to execute a trade in a given market at a given price is rooted in its customer's interest, not its own.

CSE's Voluntary Book Filing follows upon earlier CSE amendments to price/time priority. CSE's Preferencing Rule,[4] which modified time priority for professionals, has created a more competitive environment for exchange-listed securities. By adopting a rule that permits CSE dealers to execute customers orders without regard to the time priority of other CSE dealer orders, bids, and offers, the CSE introduced elements of a Nasdaq-like market structure into an exchange for the first time. In approving preferencing on CSE, the Commission recognized that, "the CSE combines the features of both exchange and over-the-counter markets."[5] While the Commission was cautious in supporting preferencing at its inception, CSE has proven that the quality of executions pursuant to a program that waives time priority is equal to, and often exceeds, the quality of executions on the auction markets for exchange-listed securities. As the data published pursuant to Rule 11Ac1-5 demonstrates, CSE execution quality under our preferencing model consistently exceeds that of the NYSE and the Amex, both manual specialist markets. For example, in trades up to 2000 shares, CSE outperforms the NYSE in effective spread (2.8 to 4.83), execution speed (14.7 to 20.5 secs.), and percentage of trades outside the quoted market, *i.e.*, disimproved (15% to 36.9%). Clearly, CSE customers have benefited from the elimination of time priority through better prices and faster service.

CSE is seeking to expand on the benefits of preferencing through its Voluntary Book Filing. Again, CSE believes that the Rule 11Ac1-5 statistics of markets without price/time priority demonstrate the merits of CSE's proposal. In transactions up to 2000 shares in exchange-listed securities, Nasdaq, a dealer market without price/time priority, consistently outperforms the NYSE in effective spread (3.16 to 4.83), execution time (16.4 to 20.5 secs.), and shares disimproved (17.4% to 36.9%). In Nasdaq-listed issues, Nasdaq's numbers are even

3 Exchange Act Release No. 45405 (February 6, 2002), 67 FR 6558 (February 12, 2002). ("Voluntary Book Filing").
4 CSE Rule 11.9(u).
5 Exchange Act Release No. 37046 (March 29, 1996), 61 FR 15322 (April 5, 1996).

better – effective spread (2.54), speed (4.6 secs), and shares disimproved (9.2%). Interestingly, the market without price/time priority (Nasdaq) executes outside the National Best Bid or Offer ("NBBO") four times less -- 9.2% compared with 36.9% -- than the market that trumpets the necessity of price and time priority (NYSE). If the absence of price/time priority were to harm customers, as NYSE claims, the data should show the opposite. CSE believes the facts speak plainly for the principal that efficient markets, even absent price/time priority, more effectively promote best execution.

CSE believes that the Voluntary Book Filing is the natural progression in market structure given decimalization and advances in data communication, order routing and order management systems. The Voluntary Book offers a flexible approach to order interaction coupled with the obligation of best execution. Under an effective regulatory oversight program, the CSE believes that such an open trading market structure is necessary for it to compete with other markets and attract liquidity. As the Rule 11Ac1-5 statistics demonstrate, price/time priority need not dictate the execution process. Rather, satisfying the expectations of customers through instantaneous execution systems offers a higher likelihood that customers will receive what they expect to receive: best execution.

The Commission, however, seems inclined to disagree. Our Voluntary Book Filing as well as Nasdaq's exchange application have languished at the Commission for over two years, largely because of the price/time priority issue. Apparently, in the Commission's view an exchange must provide price/time priority in order to properly handle customer orders because they would otherwise suffer a failure of best execution. If that is the case, what then will the Commission do for the millions of customer orders executed every day in Nasdaq-listed and NYSE-listed securities on the OTC markets, where price/time priority is not required? Are these investors being disserviced every day? Are they not entitled to the same duty of best execution?

CSE believes that customer orders traded in the OTC markets should be subject to the same standards that the Commission imposes on the exchanges. If price/time priority is an absolute – and CSE categorically disputes that is should be – then it is only fair that price-time priority be applied in all securities, regardless of where they trade. We find it hard to imagine that investors believe (1) that their orders in Microsoft, a Nasdaq-listed security, are subject to different and lesser protection than their orders in IBM, an NYSE-listed security; and (2) that their orders in IBM, if executed in the OTC markets, are subject to different and lesser protection than if their IBM orders were traded on an exchange. If price/time priority is as vital as the Commission seems to indicate, the fact that Microsoft is listed on Nasdaq and trades predominantly in the OTC market should not deprive investors of price/time priority, nor should investors be deprived of such protection when they trade NYSE-listed securities in the OTC markets.

In conclusion, CSE submitted the Voluntary Book Filing to enhance its members' execution opportunities and to seek a level competitive playing field with Nasdaq. We believe that investors are better served by providing greater flexibility in how their orders are executed. However, if the Commission is not inclined to agree, CSE respectfully requests that the Commission impose price/time priority across all securities, wherever listed and traded. CSE can compete as long as our competitors are subject to equal regulation, which in this case is comparable rules on price/time priority.

ITS Reform

In formulating the NMS in 1975, Congress and the Commission were reacting to the market structure as it existed in the early 1970s. In 1978, the Commission stated that: "the major problems to which the idea of a national market system is addressed are those arising from 'market fragmentation,' or the existence of multiple, geographically separated forums in which trading in the same security occurs. . . These problems include, among others: (1) the need to perfect existing mechanisms for the disclosure of information concerning all completed transactions in multiply-traded securities; (2) the absence of a comprehensive, composite quotation system displaying buying and selling interest in those securities from all markets; (3) the inadequacy of existing means available to brokers for routing orders to and among markets in pursuit of the most favorable execution opportunities; and (4) the lack of a mechanism to provide nationwide agency limit order protection affording time and price priority to such orders regardless of geographical location."[6]

Although subject to renewed debate, the exchanges and the NASD have addressed the last sale issue through the development of the Consolidated Tape Association ("CTA") and the quotation issue through the Consolidated Quotation System ("CQS").[7] The creation of the Intermarket Trading System was a partial response to the third and fourth issues identified in 1978. ITS permits the routing of orders from one market to another and imposes trade-through and locked/crossed quote liability to protect bids and offers in the ITS markets. However, ITS attempts to enhance best execution at the exchange level, not at the broker level identified by the Commission as the place where the problem and obligation exist.

At the time of its creation, the Commission believed that ITS was only a step toward the solution to the order routing issue. The Commission proposed in addition to ITS that the markets create a universally available message switch, permitting brokers and dealers to route orders for the purchase or sale of qualified securities from their offices to any qualified market trading in that security.[8] This system would have required brokers and dealers, *i.e.*, those with the duty of best execution, to assume control of their efforts to provide best execution to their customers rather than rely on secondary order routing at the point of execution on the exchange level. In other words, the burden of best execution would have clearly been on broker-dealers.

Because of resistance from the brokerage community as well as the NYSE, the Commission abandoned the universal message switch system. Brokers argued that a universal message switch would eliminate broker discretion by forcing automatic routing of all orders on the basis of machine-displayed quotations.[9] "The commentators noted that such a system would virtually eliminate differences in execution services and competitive opportunities created by

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6 Exchange Act Release No. 14416 (January 26, 1978), 43 FR 4354 (February 1 1978).

7 Among the markets trading Nasdaq-listed securities, Nasdaq acts as securities information processor and disseminates a consolidated trade and quote data stream.

8 *Id.* at 4358.

9 Exchange Act Release No. 15671 (March 22, 1979).

those differences. It was also argued that, in routing orders, brokers must consider factors other than price. . . ."[10] In abandoning the universal message switch, the Commission recognized that broker discretion to best fulfill its customer needs should be permitted to flourish.

Twenty-three years later, brokers still argue that best execution requires that they be permitted to route orders to the market of choice on the basis of factors other than price. Even with the development of sophisticated smart routing systems that can read the current NBBO and instantaneously ship orders to markets with the best prices, brokers and their customers insist on sending orders to other venues because of the overall quality of execution offered by faster, more certain systems. Execution efficiency and investor access to quote, trade, and execution quality data have effectively supplied the necessary ingredients of the NMS, but the antiquated structure of ITS now serves to frustrate the continued evolution of the system.

To further address the fourth problem (nationwide price and time priority for limit orders), the Commission originally proposed to implement a Central Limit Order File. However, even while proposing the Central Limit Order File, the Commission recognized: "the possibility that introduction of a system based upon the absolute time priority concept could have a radical and potentially disruptive impact on the trading process as it exists today."[11] Rather than impose the Central Limit Order File, the Commission allowed the markets to develop ITS to provide limit order protection. However, the Commission acknowledged that flaws in ITS would prevent it from providing such protection:

> [f]oremost among the necessary changes is a reduction in the length of time required to enter commitments to trade and receive execution or rejection reports. Currently, the complexity of order entry procedures and the two-minute time interval provided for execution or rejection appears to discourage brokers from using the system, particularly during periods of active trading. ***Although the ITS participants are experimenting with a one-minute time period, this enhancement would appear to be insufficient if ITS is to be used for the purpose of ensuring nation-wide public limit order protection***. Ultimately, the exigencies of active trading in multiple locations probably will require systems enhancements which reduce response times to significantly less than one minute.[12]

With all the technological advancements of the last twenty-plus years, ITS has only been able to agree to reduce the order commitment time period for execution or cancellation to thirty seconds. In today's fast paced market environment, this is unacceptably slow for brokers trying to meet their obligation to provide best execution.

As competition from electronic markets like CSE developed in the late 1990s, the Commission again considered a CLOB as a potential means of solving what it perceived as a

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[10] *Id.* at 9.
[11] *Id.* at 5.
[12] *Id.* (emphasis added).

problem of market fragmentation.[13] Repeating history, however, the securities industry largely rejected the Commission's CLOB proposal because a CLOB would impair the ability of market centers to compete. The Commission again recognized the potentially deleterious effects of mandating price/time priority (such as the elimination of any incentive to enhance technology or to reduce cost) and concluded instead that enhanced disclosure of order execution data, while not imposing nationwide limit order protection, would create standardized terms for measuring execution quality.[14] Based on this data, investors and order-routing brokers could make informed decisions when choosing an execution venue.

CSE agrees with the disclosure approach and, as discussed below, believes the available data highlights the quality of execution occurring away from the auction-based manual markets. Moreover, CSE believes that today's technology, combined with disclosure, eliminates the harmful consequences of market fragmentation. Other market microstructure analysts agree. Larry Harris, Chief Economist for the SEC, writes:

> All traders therefore want all other traders to trade in the market structure they prefer. Differences among traders, however, cause them to prefer diverse market structures. . . . The resulting fragmentation suggests that some of the cost-reducing benefits of market consolidation may be lost . . . These concerns would be well-founded if traders in various market fragments did not know - - and respond to - - market conditions in other fragments. . . . Market diversity, however, does not necessarily imply inferior price formation and high transaction costs. ***Traders can obtain the benefits of consolidation in fragmented markets when information flows freely between market fragments, and when some traders can choose which fragment in which to trade***. These two conditions are sufficient to coalesce a fragmented market into a unified complex of diverse segments."[15]

With market data from all execution venues readily available in real time as well as order routing systems that can instantly send orders to the best market, the conditions for a "unified complex of diverse segments" exists today. For this reason, CSE believes it is time to reevaluate the ITS rules which impose anti-competitive costs on executions in ITS eligible securities.

The Commission recognized in 1979, and reiterated just a year ago, that ITS is not functioning as an efficient order routing system or a nationwide system for public limit order protection. The then-Chairman of the SEC confronted the individual ITS Participants with the results of studies conducted by the Commission's Office of Economic Analysis ("OEA") and the Office of Compliance Inspections and Examinations ("OCIE").[16] OEA found that during a five-day period, 39.5% of the executions in the QQQs traded-through a better-priced quote of another

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[13] Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 ("Fragmentation Release").

[14] *See* Exchange Act Rule 11Ac1-5.

[15] Larry Harris, *Trading and Exchanges – Market Microstructure for Practitioners*, *supra* note 2, at 533 (emphasis added).

[16] *See, e.g.*, letter from Harvey L. Pitt, Chairman, Commission, to David Colker, President & Chief Executive Officer, CSE, of October 1, 2002.

ITS Participant.[17] While the Commission stated that the ITS trade-through provisions were designed to help ensure best execution, it recognized that "these rules and the ITS itself were designed at a time when the order routing and execution facilities of the markets were much slower, intermarket competition less keen, and the minimum quote increment for exchange-listed securities was 1/8 of a dollar ($0.125)."[18]

CSE believes that the extraordinary number of trade-throughs demonstrate two things:

- Best execution can no longer suffer the delays inherent in ITS. In active markets with decimal pricing, brokers require immediate execution at current market prices, not at prices subject to the delays of manual specialists. Market participants migrate to models that produce the most efficiency unless regulatory restraints are applied. In this context, that means a market model that provides instant, certain execution at the price desired without regard to the trade-through rule.
- ITS fails as an intermarket linkage because of embedded option values both in the commitment time period as well as in the trade-through complaint process. Specialists in manual floor-based markets routinely ignore or delay execution of ITS commitments through selective use of Firm Quote Rule[19] exceptions, gaining option value over the sending party. Moreover, trade-throughs are only challenged when the option value held by the party traded-through exceeds the differential between the price traded-through and the then current price of the security. These options have nothing to do with the efficient routing of orders to seek best execution but rather with the protection of market models that may provide acceptable efficiency for select members but clearly fail to meet the needs of all investors.

The Commission acted over a year ago to provide some relief from the burdens of ITS.[20] The Commission stated that "with the introduction of decimal pricing and technology changes that have enabled vastly reduced execution times, the trade-through provisions of the ITS Plan have increasingly limited the ability of a Participant or ITS/CAES Market Maker to provide an automated execution when a better price is displayed by another Participant that does not offer automated execution."[21]

The Commission acted on this problem by granting a *de minimis* exemption from the trade-through provisions of the ITS Plan for certain exchange-traded funds ("ETFs"), which the Commission believed were particularly restricted by the ITS Plan. The *de minimis* exemption permits transactions in ETFs that are effected at a price not more than three cents away from the best bid and offer quoted in the NMS. The Commission settled on a three-cent standard in order to "avoid compelling broker-dealers to use ITS unless the expected price improvement is greater

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17 *Id.*
18 *Id.* at 2.
19 17 CFR 240.11Ac1-1.
20 Exchange Act Release No. 46428 (August 28, 2002), 67 FR 56607 (September 4, 2002).
21 *Id.*

than the de facto cost of using ITS. The de facto cost of using ITS is largely due to the option value of the commitments that broker-dealers give to dealers in other markets when trying to obtain better execution prices."[22]

CSE applauds the Commission for acknowledging and seeking to neutralize the inherent option costs of ITS. In removing the constraints of the ITS trade-through rule, the Commission stated goal is to "provide investors increased liquidity and increased choice of execution venues while limiting the possibility that investors will receive significantly inferior prices."[23] CSE supports the three-cent *de minimis* modification to ITS. That modification, however, did not go far enough. CSE believes that the Commission should expand the *de minimis* relief to all ITS eligible securities. In this manner, the Commission will expand the opportunities for brokers to satisfy their customers best execution expectations while protecting customers from receiving execution prices that may not reflect the best available price at any given time.

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The above comments reflect CSE's views on just two of the market structure issues confronting the capital markets. Naturally, others will have different views. What is important, however, is that the government recognize that the troubles being focused on by the press today are symptomatic of deep market structure issues that have gone unattended for too long. We urge members of the Subcommittee to ask questions of the Commission as well as of the market participants in order to sharpen the focus on these matters. The need is real. Whether it is Nasdaq's exchange application, CSE's Voluntary Book proposal, ITS reform, or other concerns, market structure issues must be addressed now if we are to enhance the efficiency and preserve the credibility of our capital markets.

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22 *Id.* at 56608.
23 *Id.*