PHLX
PHILADELPHIA
STOCK EXCHANGE

Statement of Meyer S. Frucher, Chairman and Chief Executive Officer,
The Philadelphia Stock Exchange,
Before the House Subcommittee on Capital Markets, Insurance and GSEs
October 16, 2003

On behalf of the Philadelphia Stock Exchange, Inc. (the "Phlx"), I appreciate the opportunity to participate in this hearing on market structure issues. The decisions made, or not made, by legislators and regulators on questions of market structure will have a direct impact on the U.S. capital markets and the ability of those markets to meet the needs of both issuers and investors. The Phlx believes that issuers and investors are best served by a market structure that promotes competition.

This statement will describe the Phlx's vision of the broadest possible competition, including between exchanges with different business models and between exchanges and dealer markets. It will summarize steps that the Phlx is taking to make itself more competitive and offer the Phlx's views on the competitive implications of certain specific market structure issues. To understand better the Phlx's perspective on all these topics, this statement first provides information about the regional securities exchanges in general and the Phlx in particular.

<u>Role of Regional Securities Exchanges</u>

The nation's regional securities exchanges – the Phlx, Chicago, Pacific, Boston and Cincinnati Stock Exchanges – collectively form an essential pillar of the national market system. They are the descendants of the more than 100 local exchanges that existed 100 years ago. While they differ in many respects and with regard to many aspects of their business models, the five regional stock exchanges share an important role: they all make markets in stocks listed by the New York Stock Exchange ("NYSE") and thereby provide needed competition to the Big Board. The NYSE's share of trading in the stocks it lists regularly exceeds 80%, a dominance that almost surely would invite government scrutiny in any other industry. The Phlx believes this dominance is unhealthy for investors.

Today's regional stock exchanges survive because the competitive environment in which they operate forces them to be innovators. The Phlx and a number of the other regional securities exchanges employ an electronic system of remote competing specialists, described below. On the regional exchanges, many stocks have three or four specialists competing to offer the best price, rather than a single specialist setting a price as on the Big Board. The regional securities exchanges were the first to adopt innovations as essential as the securities clearing house, continuous net settlement of trades and automated execution of small orders – all improvements that the NYSE adopted after the regionals had first paved the way.

<u>Background on the Philadelphia Stock Exchange</u>

The Phlx is the oldest securities exchange in the United States. The Phlx is both a stock and an options exchange. It trades over 2000 stocks listed on the NYSE and American Stock Exchange ("Amex"), over 1000 equity options, 13 industry sector options created by the Phlx, and 100 currency pairs. For the most recent month, September 2003, equity options volume on Phlx was over 10 million contracts. This represented roughly 14% of total U.S. options trading. Total equity trading on the Phlx in

2002 was a record 2.4 billion shares. Equity volume on the Phlx for September 2003 was over 277 million shares. This figure was up 43% over Phlx equity volume for September 2002 and represents approximately .5% of all trading in NYSE-listed stocks and 1.5% of all trading in Amex-listed stocks for the month.

While the Phlx is comparable to the NYSE in age and tradition, its method of equity trading differs from the NYSE's in an important respect. While both the NYSE and the Phlx use a floor-based specialist system, the Phlx employs competing specialists rather than a single specialist per stock. The Remote Competing Specialist System implemented by the Phlx in 2002 lets specialists make markets and trade from remote sites. This secure communication network expands trading beyond a fixed number of specialists to enable qualifying firms to operate from their offices. It means that more than one equity specialist can make a market in an eligible stock, so order flow providers can direct orders to the specialist of their choice. The result is a boundless market center permitting virtually unlimited access to qualified specialists and customers alike.

Need for Market Structure that Promotes Competition

The existing structure of the U.S. capital markets is fundamentally sound. U.S. capital markets remain the deepest, most liquid in the world. But policymakers and market participants alike should remember that competition, more than any other single factor, has created and characterized those markets. It is advisable periodically to review market structure, to evaluate whether it continues to promote competition to the greatest extent possible or whether developments in technology, market practices or other areas suggest that market structure has become outmoded. It would be both ironic and unfortunate if elements of market structure intended to promote competition had come to impede it instead.

Congress has already endorsed the view that market structure should promote the broadest possible competition. The Securities Acts Amendments of 1975 granted the Securities and Exchange Commission ("SEC") authority to "facilitate the establishment of a national market system for securities."[1] In so doing, Congress told the SEC to promote "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets."[2] Congress understood that greater competition produces greater protection for investors and more dynamic and fair markets.

To maximize competition, exchanges and dealer markets must be free to compete in terms of all the services they offer investors. The price at which different markets are willing to execute a trade, their best bid and offer, is the most obvious criterion on which markets compete. It is not the only one, however, and it may not even be the most important one for every investor and every trade. Markets compete on the basis of the fees they charge for execution; the speed of execution; the depth of their liquidity; the convenience of their technology; the advanced functionalities they may offer, such as "volume weighted average pricing" and block trading; and their trading and other rules.

The Phlx believes that exchanges should be free to compete on the basis of their business models. Since enactment of the Securities Exchange Act of 1934 (the "Exchange Act"), and indeed before that time as well, exchanges have been characterized by centralized auctions, including trading rules that govern the sequence of trading in a

---

1 Securities Exchange Act Sec. 11A(a)(2).
2 Securities Exchange Act Sec. 11A(a)(1)(C)(i).

particular security. Every exchange has rules of priority and precedence of bids and offers. The Exchange Act does not, however, mandate a single exchange business model.[3] The Exchange Act does not mandate the degree to which an exchange operates with a central limit order book, nor does it specify a required degree of order interaction or opportunity for price improvement. Should the SEC be inclined to try to promulgate a single standard to address these issues, the agency will quickly find it lacks a principled basis on which to do so. The statute gives scant guidance, for example, as to how much order interaction an exchange must provide, and whether that interaction must actually take place over some period of time or must only be theoretically possible under the exchange's rules. Further, the SEC would be hard-pressed to argue that the statute requires each and every facility of a national securities exchange must offer the same degree of interaction.

The Phlx believes investors will benefit more if exchanges are free to compete on such aspects of their business models as degree of order interaction and possibility for price improvement. The marketplace can decide the optimal level of interaction and price improvement; market participants would benefit from the opportunity to choose between different models. So long as the SEC allows all exchanges, and not just a select few, the chance to explore different modes of trading, this competition between marketplaces will translate directly into benefits for investors.

---

[3] Section 3(a)(1) of the Securities Exchange Act and Rule 3b-16 promulgated by the Commission set forth the definition of a national securities exchange. Section 3(a) defines an exchange as "a marketplace or facilities for bringing together purchasers and sellers of securities…" Rule 3b-16 expands on this concept by providing that an "organization, association or group of persons" constitutes an exchange if it provides a marketplace or facility that "(1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods…under which such orders interact with each other…"

While the Phlx supports the greatest possible competition on the basis of business models, competition between exchanges and broker-dealers known as electronic communication networks ("ECNs") must not be skewed by differential regulation. The SEC's Regulation ATS[4] enhanced the ability of ECNs to compete for liquidity. As noted above, the Phlx believes that ECNs benefit investors through lower costs and increased innovation. However, investors are denied potential benefits from innovation by exchanges if exchanges must compete with ECNs while inappropriately bearing greater regulatory burdens. To the extent ECNs look and act like exchanges, they should have the same obligations as exchanges regarding the handling of orders. The Phlx believes that creating greater opportunities for ECNs to operate cooperatively with and through regional exchanges would improve the balance among the goals of continued innovation; investor protection; and a level playing field.

Innovation at the Philadelphia Stock Exchange

The Phlx is determined to shape its future proactively through continued innovation. The Phlx intends to be a low cost, highly liquid, technologically advanced marketplace, while still retaining the advantages of a floor-based auction market. Projects underway at the Phlx that will help the exchange achieve this goal include demutualization; electronic trading of options; and electronic trading of Nasdaq-quoted stocks.

Demutualization

Last year the Phlx management proposed to its Board a plan to "demutualize" -- to transform the institution from a member-owned institution to shareholder ownership.

[4] SEC Release No. 34-40760 (December 2, 1998).

While still relatively new to the U.S. marketplace, the concept of an exchange as a shareholder-owned institution is now the prevailing model overseas. In London, Frankfurt, Tokyo, Hong Kong and elsewhere, stock exchanges have demutualized.

Demutualization will allow the Phlx to respond more quickly and more forcefully to the market forces that are reshaping the securities world. A shareholder-owned capital structure will allow the Phlx to maintain its competitive strength while making it easier for the exchange to enter relationships with strategic and financial partners and to access the capital markets. This can translate into significant new investment in the Phlx. Rather than membership, the Phlx intends to utilize trading permits, which will provide broader access and deeper liquidity to the exchange's core equity and options markets.

For these reasons, after nearly a year of review and discussion, the Phlx Board of Governors on October 1, 2003 approved a demutualization plan. The Phlx membership and seat owners will vote on this plan later this fall. If adopted by the membership, the Phlx will submit the plan for approval by the SEC, which approval would be expected in the first quarter of 2004.

Electronic trading of options

The Phlx is transitioning its options trading toward a more electronic trading environment, while maintaining the advantages of floor-based trading. The exchange is developing a series of enhancements that will increase liquidity, speed executions, and reduce the need for manual handling of options orders by specialists. By giving much greater electronic access to competing market makers, the enhancements will also promote greater quote competition. In particular, they will allow competing market makers to "stream" quotations from the options floor and ultimately from remote locations. The Phlx has filed the rules for the initial phases of this program with the SEC and expects to make further filings to implement the next phases.

Phlx Trading of Nasdaq Stocks

The Phlx has also submitted to the SEC proposed rule changes relating to trading Nasdaq stocks.[5] Under the Phlx's proposal, Phlx members and non-members could send orders in Nasdaq stocks to a Phlx floor broker, who could match customer orders and execute them on the Phlx. Alternatively, they could place orders on a limit order book maintained by the exchange.

In addition, the Phlx proposal is intended to provide a new venue for providing exchange services and regulation to ECNs. ECNs are electronic broker-dealers that typically match buy and sell orders on a pure agency basis. Competition from ECNs for execution of trades in Nasdaq stocks has benefited investors through lower costs and increased innovation. Under SEC rules, ECNs must report their matched orders through a self-regulatory organization, that is, through a securities exchange or the National Association of Securities Dealers ("NASD"). Their choices for doing so are limited. Only the NASD and the Cincinnati Stock Exchange currently offer viable programs for the reporting of matched orders in Nasdaq stocks.

Under the Phlx proposal, ECNs and other Phlx members could electronically submit to the Phlx for execution and trade reporting matched orders meeting certain eligibility requirements in Nasdaq stocks. The Phlx would use the market data revenues it would receive for reporting trades in Nasdaq stocks first to pay for operating and regulatory costs. The Phlx would then distribute a portion of the remainder to ECNs based on the number of Phlx executions of their trades in Nasdaq stocks. The Phlx

---

5 SR-Phlx-2002-73.

believes its proposal would increase competition, to the direct benefit of ECNs and the indirect benefit of the many individual and institutional investors who use them.

Need for Prompt Action by the SEC

For the Phlx and the other regional exchanges to survive, they must innovate. To innovate, they must receive prompt consideration of their proposals by the SEC. The Phlx hopes that its proposals described above will be considered in a timely manner. The Phlx has great respect for the dedicated and insightful staff of the SEC's Division of Market Regulation and will work cooperatively to resolve any concern.

Unfortunately, SEC consideration of innovative filings has not always been timely. In the absence of direction from the Commissioners, the staff is limited in the degree to which they can make decisions on filings. The Phlx hopes that the full complement of new Commissioners at the SEC will shortly be able to provide that direction. The SEC staff is working on market structure proposals for the Commissioners to consider.[6] The Phlx hopes these will be ready shortly and stands ready to work with Chairman Donaldson and his colleagues to fashion principles by which proposals by the Phlx and its competitors can be evaluated without undue delay.

Other Market Structure Issues

The Phlx would like to address certain additional market structure issues and their potential to enhance or inhibit competition. The Phlx believes that broader application of market data revenue sharing would benefit investors through greater competition. On the other hand, payment for order flow by exchanges inhibits competition by interfering with

[6] "Remarks before the American Enterprise Institute," Commissioner Paul S. Atkins, May 7, 2003.

market forces. Finally, the Phlx will share its views on decimalization and self-regulatory functions of exchanges.

Market Data Revenues and Revenue Sharing

Pursuant to the Exchange Act and SEC rules, exchanges must collect quotation and last sale information from their members and be members of National Market System plans that consolidate and disseminate that information. Exchanges must also enforce member quotation and trade reporting requirements and surveil for that compliance. In support of the goals of the National Market System, exchanges must maintain trading systems and communications networks.

Revenues from the sale of this market data helps exchanges defray the costs of meeting the statutory public policy objectives and serves as an important source of funding. This is particularly true for regional exchanges, which do not have issuer listing fees as a revenue source. The Phlx understands that the SEC is currently considering proposals that could have the effect of potentially reducing market data revenues available to exchanges. Any such proposal would severely limit the ability of the regional exchanges to fund their operations, attract participants to their markets, and provide competition to the NYSE.

Not only is distribution of market data revenues to exchanges important, but so is exchanges' freedom to use those revenues. Once received by an exchange, revenues are fungible. Sharing of market data revenues is but one financial incentive that an exchange may use to attract participants to its markets. Other methods currently used by exchanges include liquidity provider rebates; fee caps; volume discounts; temporary and permanent fee waiver; and payment for order flow programs. Numerous exchange programs for sharing market data revenues with exchange members are currently in effect for stocks listed on the NYSE and the American Stock Exchange. The Chicago Stock Exchange, Boston Stock Exchange, and Cincinnati Stock Exchange have all had programs that fund various types of member credits, at least in part, out of revenues from the consolidated market data tapes for NYSE- and Amex-listed stocks.

However, the SEC has taken a very different tack with respect to exchange programs to share revenues from market data in Nasdaq-quoted stocks. In the first half of 2002, Nasdaq, the Cincinnati Stock Exchange and the Pacific Exchange all adopted pilot programs for sharing of market data revenues they received with respect to Nasdaq stocks. On July 2, 2002, the SEC invalidated these programs by abrogating the respective filings filed by the three markets.[7] The SEC took no action against the programs described above for sharing market data revenues in NYSE- and Amex-listed stocks.

The Phlx feels that the inconsistent nature of the SEC's approach to market data revenue sharing by exchanges is inhibiting competition. There is no logical distinction between sharing market data revenues in respect of Nasdaq stocks and NYSE and Amex-listed stocks. Refusing to allow Phlx and other exchanges to share market data revenue in Nasdaq stocks entrenches Nasdaq's position in trading Nasdaq-quoted stocks and hinders competition by other venues.

The exchanges are in the best position to determine the implications of market data revenue sharing measures on their overall revenues and to ensure that their self-regulatory programs are sufficiently funded, from whatever source or combination of sources. The SEC's regular examinations, its authority to require exchanges to modify

[7] SEC Release No. 34-46159 (July 2, 2002).

their self-regulatory programs in areas needing improvement, and its authority to bring disciplinary actions ensure that the exchanges discharge their regulatory responsibilities. So long as they discharge their obligations, exchanges should have the opportunity to determine what is in their competitive interests and to implement those decisions. This competition would quickly translate into benefits for investors.

Payment for Order Flow by Exchanges

The Phlx believes strongly that exchange-sponsored programs to pay for order flow have a damaging effect on U.S. markets – particularly in the market for listed options. While these programs vary somewhat from exchange to exchange, they typically involve an assessment levied by an exchange on the specialist and market makers in the trading crowd. The specialist then uses the funds collected to attract orders, such as by paying broker-dealers for options orders they direct to the exchange.

Phlx believes that exchange-sponsored payment for order flow programs, which are prevalent in the listed options market, interfere with market forces, thereby reducing competition. Exchange-sponsored programs create a known and stable price point (the exchange-levied fee) that affects negotiations between specialists and order flow providers. They establish a rate at which the specialist's arrangements with order flow providers are subsidized. In this way, exchange-sponsored payment for order flow programs may cause distortions in the market, such as reduced quote competition and inferior customer service or research.

Exchange-sponsored payments for order flow may also create conflicts of interest in the exercise of exchanges' self-regulatory obligations. An exchange must enforce compliance by its members with the securities laws, including its members' obligation to achieve best execution for their customers. When an exchange sponsors and promotes a payment for order flow program, its regulatory objectivity may come into question.

In August 2001, the Phlx suspended its exchange-sponsored payment for order flow program in the options market. At that time, the Phlx Board of Governors reserved for the Chairman the authority to reintroduce the practice if competitive pressures so warranted. In November 2002, the Phlx reluctantly reinstituted a payment for order flow program in its options business. Despite its conviction that exchange-sponsored payment for order flow is unhealthy for U.S. markets, the Phlx felt compelled to respond to those exchanges that maintain the practice. To do otherwise would place the Phlx at an untenable competitive disadvantage. Because not all of the options exchanges are willing to eliminate their payment for order flow programs, the Phlx has petitioned the SEC to adopt a rule banning such programs.[8]

<u>Decimalization</u>

Decimalization is one of the most significant to U.S. securities markets change in the last 20 years. Where most participants in the U.S. securities markets had quoted and traded in fractions – in eighths or sixteenths of a dollar – decimalization requires participants to quote stocks in dollars and cents. Beginning in 2000 and continuing in 2001, the U.S. self-regulatory organizations have required their members to quote in Minimum Price Variations denominated in decimals -- $.01 for stocks and $.05 and $.10 for options.

---

8 Letter from Meyer S. Frucher to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, regarding “Options Exchange Payment for Order Flow Programs; Petition for Rulemaking,” February 3, 2003.

Members of Congress were among the strongest supporters of decimalization.[9] They deserve commendation for their focus on the potential benefits decimalization can bring to investors. For example, decimal pricing of securities may be easier for investors, particularly retail investors, to understand than pricing in fractions. Investors may also experience lower transaction costs to the extent pricing in decimals causes narrower trading spreads – the difference between the bids and the offers for particular securities.

Although decimal pricing may have produced benefits for investors, it has produced challenges as well. With the number of price increments increasing from 16 per dollar to 100 per dollar, less liquidity may be available at each price point. In turn, the price point representing the "national best bid and offer" may be a less revealing snapshot of trading interest. A recent study suggests decimalization has led to higher trading costs for actively managed mutual funds.[10] Some institutional investors believe that decimalization has led to increased instances of exchange specialists stepping ahead of customer orders by one penny.[11]

Decimal pricing is producing challenges for market intermediaries as well. To the extent decimalization has narrowed trading spreads and increased volatility, it increases risks for exchange specialists and market makers. They are discouraged from providing liquidity in certain securities. Specialists and market makers on regional exchanges have been particularly affected, with many firms ending or reducing their participation in the

---

[9] See, e.g., H.R. 1053, the "Common Cents Stock Pricing Act of 1997," introduced by Rep. Mike Oxley on March 13, 1997.

[10] "Common Cents? Tick Size, Trading Costs, and Mutual Fund Performance," by Professors Nicholas Bollen of Vanderbilt University's Owen Graduate School of Management and Jeffrey Busse of Emory University's Goizueta Business School.

[11] See, e.g., letter of Craig Tyle, General Counsel, Investment Company Institute, to Richard Grasso, Chairman, New York Stock Exchange, March 1, 2001.

markets. Withdrawal of specialists and market makers only hurts investors, through reduced competition and less available liquidity.

Given these factors, the Phlx believes at a minimum that the marketplace would benefit from an impartial review of the impact of decimalization on the trading environment. The Subcommittee might consider asking the General Accounting Office to study the effects of decimalization. Such a study could address issues such as whether decimalization has affected available liquidity for certain securities; investors' trading costs; and the usefulness of market data. The Phlx feels that the implications of decimalization should be well understood before any further reduction in minimum quoting and trading increments further, such as to pennies for options or sub-pennies for equities.

Self-Regulatory Function of Exchanges

Recent developments at the NYSE and elsewhere have focused attention on the self-regulatory obligations that the Exchange Act places on all national securities exchanges. Self-regulation has been a hallmark of the U.S. capital markets since the Exchange Act was enacted. While it is entirely appropriate to review this important element of the U.S. securities markets, no conclusions should be reached hastily or in response to isolated incidents.

The Phlx believes that self-regulation by individual exchanges has worked well overall. A single self-regulator might well develop into a centralized monolith, with an insular mentality and a lack of understanding of changes in technology, changes in the marketplace, and other emerging issues. Regulation by individual marketplaces involves better-informed regulation better suited to the individual exchange. Among the bases on which U.S. exchanges compete against each other is different methods of trading. These different methods are reflected in different technology and trading systems from exchange to exchange and accordingly in different trading rules as well. Each exchange is most knowledgeable about its own trading systems and trading rules, its own members, its members' trading strategies, and the dynamics of trading in its marketplace. Each exchange is therefore best situated to enforce its rules and detect violations involving such abuses as tape painting, wash trading, front running and the like. As in other contexts, in this situation "local authorities" are better situated to assess conditions and develop and enforce rules than is a distant authority located in Washington or New York.

The Phlx sees no advantage to a single market regulator with oversight across all markets trading any particular type of security.[12] To the contrary, such an approach would likely result in inefficient and inappropriate regulation of exchange members and quite possibly anticompetitive outcomes. Each market center, other than those that have "outsourced" a portion of their regulatory functions, currently uses its own methods to meet the level of surveillance, compliance and enforcement required by the Exchange Act. The exchanges strive to identify the most appropriate means of carrying out these responsibilities. Some exchanges use more automation, some more manpower, while some embed regulatory mandates into the algorithms used in their trading systems. Such algorithms make it impossible for certain rules to be violated or alert members and surveillance times to possible violations. At the same time, the SEC routinely inspects the adequacy of the self-regulatory organizations' regulatory programs, the competency of their staff; and their compliance with the Exchange Act and the SEC's rules.

---

[12] See Letter from Meyer S. Frucher to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, regarding "Request for Comment on Nasdaq Petition Relating to Regulation of Nasdaq-Listed Securities, Release No. 34-47849, File No. S7-11-03," June 17, 2003.

The Phlx sees particular disadvantages to a single-regulator concept if that regulator has authority over members that hold memberships on competing markets. Exercise of regulatory authority by such an entity might result in the imposition of anticompetitive policies or rules on competing exchanges. The Phlx would not support such a structure.

Recent events at the NYSE may create a perception in some minds that exchange regulatory functions do not have sufficient structural independence from inappropriate influence. Rather than complete separation of trading and regulatory functions, the Phlx believes the SEC and NYSE should look at overall governance issues. The Phlx reformed its governance extensively in the late 1990s. Since 1997, non-industry members have constituted a majority of the Phlx's Board.[13] The Phlx believes that members and member organizations have an important role to play in exchange governance, where their expertise on boards and committees is invaluable. However, to safeguard the independence of the regulatory function, an appropriate balance must be struck between public and member representation on exchange and other self-regulatory organization boards and on committees overseeing such key functions as audit, compensation and nominations.

* * *

The Phlx is thankful to have this opportunity to share its views with the Subcommittee. The Phlx looks forward to working with Members of Congress, the SEC, its fellow self-regulatory organizations and market participants to craft improvements to market structure that will benefit investors through increased competition.

---

13 See Letter from Meyer S. Frucher to The Honorable William H. Donaldson, October 3, 2003.