Testimony of
Robert Greifeld
CEO and President
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Reviewing US Capital Market Structure: The New York Stock Exchange and Related Issues

Principles of Market Structure Reform: Investor Choice, Competition and Fairness

Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee,

Thank you for inviting me to testify before you today. As you may know, I became the CEO and President of the NASDAQ Stock Market some 5 months ago. I consider NASDAQ to be a unique asset of the U.S. economy whose success is driven by how well it serves the individual investor. Although technology, regulation and complex market structure issues are a part of my daily life, most major decisions affecting NASDAQ's future can be and should be viewed from the perspective of the individual investor. My premise today is that the individual investor is best served by free choice, competition and fundamental fairness.

Of course, every aspect of this country's capital markets is affected by the decisions of public policy makers. In this regard, we are fortunate to be served by an institution like the SEC with its expertise and tradition of excellence.

I have learned that the SEC can say "yes," and can say "no." And for a manager in a fiercely competitive market, when they don't say anything, this means "no" as well. So as we examine the issue of capital market structure, I urge you to encourage the SEC to be deliberative and cautious, but also expeditious. Their actions or inactions have a direct effect on the investor experience and the continued viability of America's capital markets which create the jobs and economic growth we all seek.

With respect to the debate about securities market structure, the Securities and Exchange Commission is faced with critical decisions at a unique time in our economic history. Now is the time to face these decisions. At the top of the list I would put three issues: reform of the trade through rule, the need to separate the securities regulator from the securities market, which in our case means approving NASDAQ's Exchange application, and, the need to ensure uniform regulation of the marketplace by addressing the emergence of trading in sub-pennies.

The SEC should keep in mind three fundamental principles as it seeks to solve the emerging issues of market structure: promoting investor choice, promoting competition and ensuring the competitiveness of U.S. capital markets.

Principles of Market Structure Reform

With regard to competition, NASDAQ competes for every listing, every quote, every execution, and every trade report, and we feel other markets should do so as well. Competition has always been good for NASDAQ. Our open architecture has facilitated competition. We have nearly 300 market makers who are willing to commit capital to help with the execution of buy and sell orders. NASDAQ's market structure promotes efficiency, and market quality statistics mandated by the SEC bear this out. At NASDAQ, the speed of execution is faster than ever and the spreads are tighter than ever.

Many argue that a floor-based monopoly can produce short-term benefits. But history and economics show that monopoly power is corrupting and is bad for citizens, markets and investors. In a decimalized environment, the monopoly enjoyed by floor-based markets fails to deliver the degree of price improvement needed to justify departing from the principles of competition and fairness. Competition forces market participants to focus on how best to serve the customer and the investor. Rapid technological strides, as well as decimal pricing, have helped to promote the spread of electronic markets and should lead to a reappraisal of market structure.

Reform of the Trade Through Rule

With regard to the most important market structure issue, it is important to understand that there are "haves" and "have- nots." There are markets that have electronic, competitive models and there are markets that are stuck with closed, specialist based monopoly models. The issue here is fair competition and the fact that one market model currently dictates how the others operate. Electronic trading has revolutionized trading on NASDAQ, but the listed arena is frozen in time. When electronic orders try to move in the listed environment, they are held up for an "eternity of seconds" because of the trade through rule. Trading in NYSE-listed stocks is slowed to the pace of the slowest market. Speed is the critical consideration for many market participants.

The trade through rule is a twenty-year-old provision of an SEC-approved plan for trading NYSE and Amex listed securities. It forces investors to send their orders to floor-based markets through an antiquated linkage, instead of allowing investors to decide for themselves whether they wish to route their orders to faster, more transparent, electronic markets.

In the era before fully electronic markets and lightning-fast private linkages, the SEC mandated that the trade through rule was needed to ensure that investors' orders were executed fairly. Because only floor-based markets existed at the time, the SEC premised the rule on the physical limits of floor-based trading.

Decimalization has starkly highlighted the benefits of electronic trading. Before share prices were decimalized, bid-asked spreads were often 25 cents or more.   If I could cut the spread by a nickel, there was much to be gained by spending the time looking for such savings. But share prices are now decimalized. Actively traded stocks have a one-penny or two-penny spread. The effective spread for Microsoft is only eight tenths of a penny

Consumers often prefer to pay extra for a gallon of milk at the convenience store round the corner than to travel a couple of miles for cheaper milk at the supermarket. The same is true for investors. Many want to be able to choose to trade quickly, sometimes forgoing a penny or two in order to ensure they have their order filled rapidly. But they can't because of trade through. They have to trade at the pace of the slowest market – the floor-based exchange. Clearly, now is the time for reform of the trade-through rule.

The trade through rule is an anachronism. Investors are no longer homogenous. Investors have different needs. Investors want the freedom to choose faster markets or anonymous executions or markets with lower costs. The trade through rule stifles investor choice by forcing investors to use slow, manual markets. It stifles competition and innovation by protecting the monopoly of a single specialist. If investors could send their orders to faster, more transparent electronic markets, it would force specialists to compete for orders by, among other things, narrowing their spreads and executing trades faster.

Investor orders subject to the trade through rule actually receive slower, more costly executions than orders that are free of it. The SEC's own execution quality statistics -- the 11Ac1-5 or "Dash 5" statistics – show that NYSE stocks subject to the trade through rule have wider spreads. And trades are executed more slowly and expensively.
The trade through rule should be repealed as quickly as possible. As SEC commissioner Paul Atkins said in a recent speech, the trade-through rule may actually "prevent individual investors and professional traders from obtaining an execution that meets their needs." The SEC has already acknowledged the failure of the trade through rule by exempting the trading of the QQQ, Spiders and Diamonds – among the most heavily traded stocks in the world – from the strict requirements of the rule. The SEC should let investors decide what they need, avoid the appearance that they favor one market over others, and promote competition.

Separating the Regulator from the Market

Much is being written these days about corporate governance within the exchange itself. America's exchanges rely on the trust of investors. At the moment NASDAQ is in the process of separating from its regulator, the NASD, based on the belief that separation is the only structure that works for our market. As CEO and President of NASDAQ, I can't imagine explaining to Congress that my regulator hat was on one day and off the next.

This is why we contract with NASD to provide our market with unsurpassed regulation. NASD regulators are on the case 24 hours a day, seven days a week. It is untenable to combine a market center with a regulator in one corporate parent. It would be as if the FDA had an ownership interest in Merck.

NASDAQ does not simply list public companies; it is itself part of the environment of public companies. No NASDAQ CEO has ever sat on the board of a listed company. NASDAQ is subject to Sarbanes-Oxley and adheres to the same listing requirements that we impose upon our listed companies. This list includes standards such as Sarbanes-Oxley 404 and Regulation FD.

NASDAQ will not complete the task of separating from the NASD until it becomes an exchange. Until then, although we are in different companies, the NASD still has voting control over NASDAQ. Neither the NASD nor NASDAQ wants to continue in this limbo with the NASD and NASDAQ in the same corporate family.

NASDAQ filed its application with the SEC on November 9, 2000, to become a national securities exchange. Exchange status for NASDAQ removes even the hint of a possible conflict of interest in the application of regulations by separating NASDAQ as an exchange with voluntary membership from the NASD and its compulsory membership requirements. Exchange status streamlines the governance of NASDAQ to eliminate the need to obtain the approval of two organizations and two boards for decisions that improve the market and deal with such things as market disruptions.

The SEC has already stated that NASDAQ is an exchange. For example, in December 1998, the Commission stated that "NASDAQ performs what today is generally understood to be the functions commonly performed by a stock exchange," and that "NASDAQ's use of established, non-discretionary methods bring it within the revised interpretation of 'exchange'." After a multi-year process, in 1999 the Commission laid out a detailed policy for the application of a broad definition of what constitutes an exchange. There is no basis in policy or fact for abandoning this broad definition. In fact, the Exchange Act goals of protecting investors and promoting competition "among exchange markets and between exchange markets and markets other than exchange markets" would be harmed, if a narrow approach was adopted and the past ignored.

One of the stumbling blocks to our exchange registration is that we do not mandate time/price priority. Some have suggested that the Commission should dictate a rigid concept of an "exchange" based on the floor-based, auction market model, for which the price/time priority is a key organizing principle. But it's worth noting that we do not mandate against price/time priority; in fact a large portion of the NASDAQ marketplace today actually trades with price/time priority. Compared with traditional exchanges that direct orders to floor-based, specialists, NASDAQ's decentralized structure of multiple dealers competing for orders gives investors faster execution speeds, superior quoted spreads, and lower transaction costs.

Uniformity in Regulation: Trading in Sub-Pennies is Harmful

There should be uniform rules across all markets that trade NASDAQ stocks. That is not always true. Let me give you one example. NASDAQ has alerted the SEC to an alarming trend in the trading of some stocks. Some ECNs are allowing market participants to quote and trade in sub-penny increments. The danger here is that some investors have the ability to quote and trade in these increments and some do not. Furthermore, sub-penny quotes threaten to erode the National Best Bid/Offer (NBBO) as a source of accuracy and investor protection – the NBBO does not show sub-penny quotes to ordinary investors.

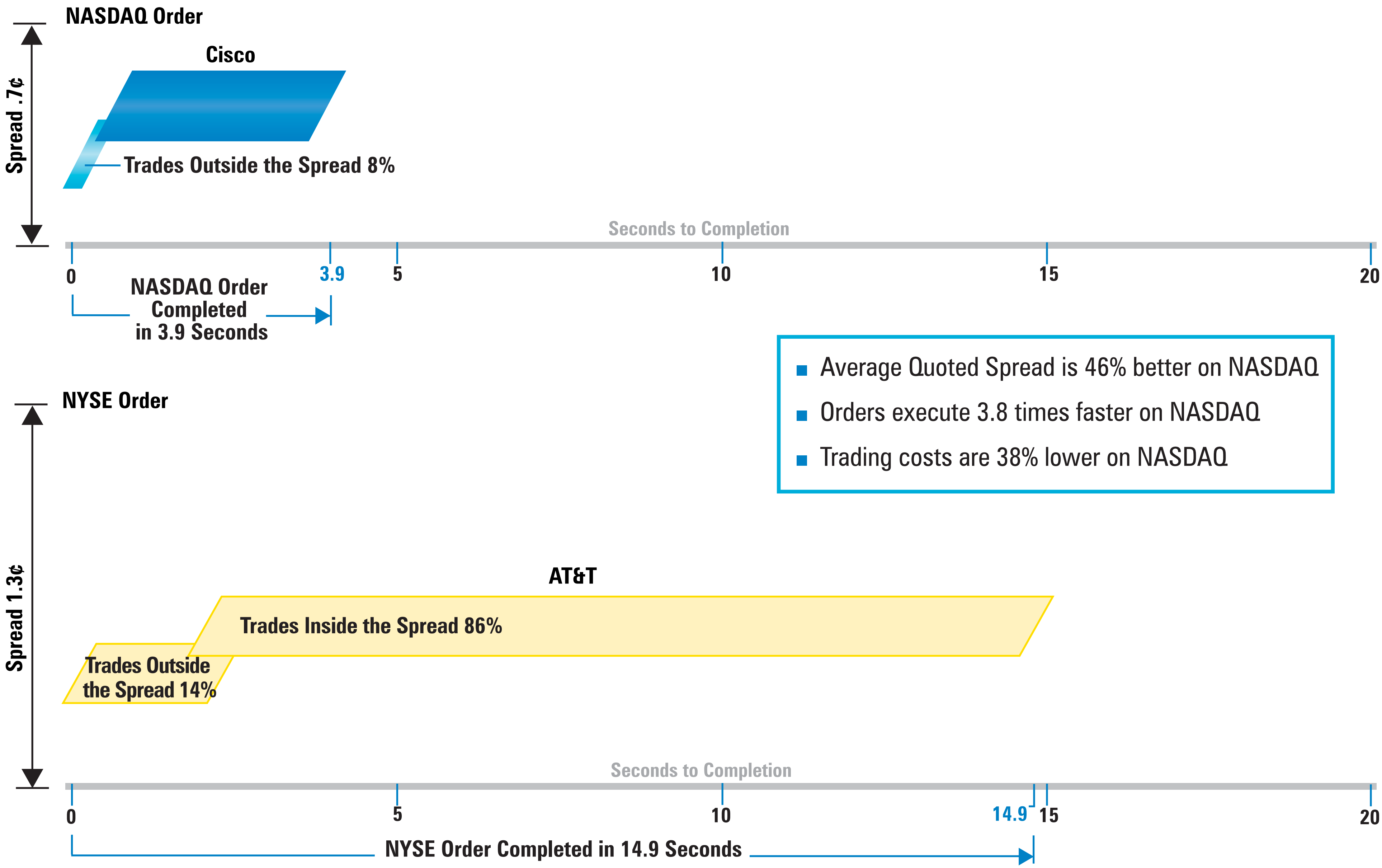
Most ordinary investors could not conceive of trading in hundredths of a penny. We fear that this creates two markets, one for sophisticated traders and one for other investors. Sub-penny quotes imply the re-emergence of hidden markets, which the SEC strove to eliminate through the Order Handling Rules. Such hidden markets facilitate and encourage the practice of "stepping ahead" of customer orders by economically insignificant amounts. Sub-penny trading has reached significant levels, accounting for 16 percent of NASDAQ trading. We think it is harmful and could erode investor confidence in the belief that "Main Street" and "Wall Street" play by the same rules. But if the SEC does not act quickly, we will be forced to accept no action as a policy decision endorsing sub-penny trading.

Should the SEC decide to allow sub-penny trading for all markets -- thereby avoiding a two-tier market -- then we must embark upon an educational campaign to equip the individual investor for the sub-penny trading environment. He or she should know that they can choose to buy or sell at sub-decimal prices. Everyone should play by the same rules and be afforded the same opportunities.

While we recognize the complexity of these market structure issues, we hope that action on them will not be delayed. As long as the Commission is guided by the need to preserve investor choice and to promote free and fair competition, investors will be protected.

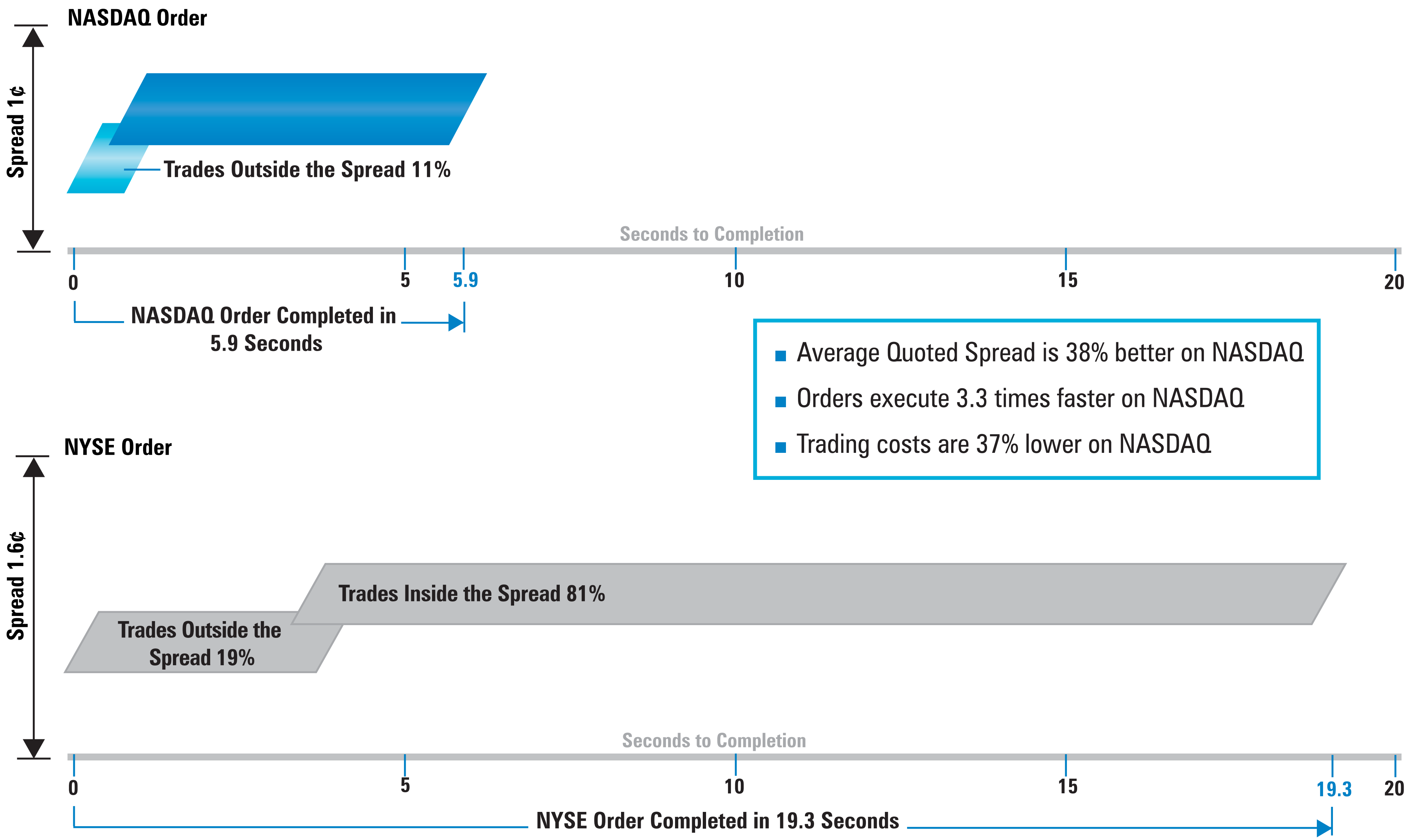
I would be happy to answer your questions.

NASDAQ Trading of Cisco Systems Compared to NYSE Trading of AT&T



Source: Market Systems Inc. Data as of August 2003

Trading S&P 500 Stocks – NASDAQ Trading Compared to NYSE Trading



Source: Market Systems Inc. Data as of August 2003