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CONCERNING

"MARKET STRUCTURE III: THE ROLE OF THE SPECIALIST

IN THE EVOLVING MODERN MARKETPLACE"

BEFORE

COMMITTEE ON FINANCIAL SERVICES –

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND

GOVERNMENT SPONSORED ENTERPRISES

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Good morning Chairman Baker, Ranking Member Kanjorski, and other distinguished members of the Subcommittee. I am Jerry Putnam, Chairman and Chief Executive Officer of The Archipelago Exchange or "ArcaEx." It is high privilege and a great honor to be provided the opportunity again to submit a written statement to and testify before the Subcommittee on issues of market structure. If I may say, is there any more suitable setting for this hearing than, here, in New York City, the financial capital of the world, and in this historical place, the custom house named after Alexander Hamilton, our first Secretary of the Treasury and the founding father of American banking and finance.

I. The ArcaEx Story

The seeds of ArcaEx's beginning were sown in the immediate aftermath of the Nasdaq price-fixing scandal of the mid-1990s, which culminated in sanctions being brought by the Securities and Exchange Commission ("SEC") and the Department of Justice. [1] One of the chief reforms exacted on the OTC marketplace in response to the scandal was the introduction of the so-called Order Handling Rules in 1996. [2] These rules provided me an opportunity to design a trade-execution business that, although seemingly very simple, was revolutionary for its time. It was "to do the right thing" by the customer by creating a level playing field for all investors in an industry traditionally filled with insiders and insider deals. I reasoned that any business model

[1] *See* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, SEC, August 8, 1996.

[2] Securities Exchange Act Release No. 37619A (September 6,1996), 61 FR 48290 (September 12, 1996) (File No. S7-30-95).

that focused on the needs of its customers (investors) would be a profitable one. With that, our credo has always been: no special(ist) handshakes, no “negative obligations,” no “jaywalking,” and no thirty-second free options; rather, all investors are given the opportunity to play on a level playing field. This has been and will continue to be one of our competitive advantages.

From day one, we branded our business as "best execution" by delivering to *all* of our customers: (1) access to full and timely market information; (2) fast electronic and anonymous executions; (3) sophisticated order types and other value-added functionality; and, arguably our biggest contribution to market structure, (4) algorithmic outbound routing to guarantee best price where that price did not reside in Archipelago. This fourth prong was both a sizeable technological innovation and a manifestation of two primary goals articulated by Congress in the National Market System Amendments in 1975.[3] By establishing proprietary ***linkages*** among marketplaces, we were able to create a large virtual pool of liquidity where customers were given electronic access to ***best price*** not only within Archipelago’s own system but also at other (competitor) electronic marketplaces. Unlike the listed market, [4] the OTC market does not have a “trade through” rule today. Thus, in lieu of government fiat such as the ITS trade through rule, getting “best price” for our customers was driven by a business idea, newly created customer demand, and our fiduciary obligation to achieve “best execution” for our customers.

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[3] National Market System (NMS) Amendments of 1975 to the Securities Exchange Act of 1934; Pub. L. No. 94-29, 89 Stat. 97 (1975).

[4] The “listed marketplace” is defined as those national securities exchanges and self-regulatory organizations that trade NYSE- and AMEX-listed securities, as well as securities listed on their own markets, and include ArcaEx (as a facility of Pacific Stock Exchange), Boston Stock Exchange, Philadelphia Stock Exchange, National Stock Exchange, Chicago Stock Exchange, NASD (Nasdaq 3rd Market) and, of course, the NYSE and AMEX, themselves. These listed markets interface and interact with one and other in accordance with inter-market regulations and rules governed by national market system committees – ITS and CQ/CTA –and by the SEC. In contrast, the “over-the-counter (OTC) marketplace” is defined as those national securities exchanges and self-regulatory organizations that trade Nasdaq securities and include many of the entities listed immediately above such as ArcaEx. The “OTC marketplace” is structured under a wholly different set of inter-market regulations, rules, and committees than the “listed market.”

In late 2001, after working with the staff of the SEC for two years, ArcaEx was unanimously approved by the SEC Commissioners to operate the first totally open electronic stock exchange. ArcaEx became operational to trade listed stocks in 2002 and OTC shares in 2003. Today, ArcaEx is ***the largest electronic stock exchange in the world*** (based on dollar volume) and is the ***second largest exchange in the United States*** (based on trading volume). From literally zero volume as an ECN in 1997, ArcaEx now handles about 26% of the trade volume in the OTC marketplace and 3% in the listed-marketplace, and is the largest marketplace for Exchange Traded Funds ("ETFs"), including QQQ, the most actively traded equity product in the world. ArcaEx handles about 600 million shares a day with our record day of over 800 million shares. In addition to ArcaEx's execution business, we have developed a listings business, which competes with NYSE and Nasdaq for both primary and dual listings. Like the execution business, more competition among listings venues provides issuers with better products and services at a more efficient price.

We believe our business success as an exchange is matched by our success as a regulated entity. In the same spirit of "doing the right thing" for investors by operating an open and un-conflicted trading platform, ArcaEx consciously organized its marketplace to eschew the legal and regulatory conflicts that accompany the traditional Self-Regulatory Organization ("SRO") structure where the regulatory arm is tightly wrapped around and integrally interwoven with the business marketplace. It is just that traditional SRO structure that contributed mightily to the Nasdaq price-fixing scandal of the mid-1990s and the bountiful NYSE scandals of 2003-present. To the contrary, ArcaEx is regulated by the independently owned and operated Pacific Stock Exchange ("PCX"), where the lines between business – which is operated by ArcaEx – and regulation – which is operated by PCX – are bright and distinct and fireproof. As CEO of

ArcaEx, I am responsible for the business and all ArcaEx employees ultimately report to me. No employees of PCX report to me; rather they all report ultimately to the Chairman and CEO of PCX. Further, PCX has its own board of directors to which its directors owe fiduciary and regulatory obligations. The upshot: by outsourcing our regulation to PCX, our model allows us to avoid conflicts and focus exclusively on building and operating our business and serving our customers.

II. <u>The Cure-All : Dynamic Competition</u>

Nasdaq's price-fixing scandal in the mid-1990s principally involved conflicts of interest between the NASD regulator and its commingled Nasdaq marketplace, and investor execution quality being substantially compromised by inside players (market makers; alias competing specialists) for the direct benefit of those inside players at the expense of investors. The SEC imposed the Order Handling Rules, which benefited investors by lowering entry and competitive barriers in the OTC marketplace. Not surprisingly, these lower barriers cultivated an environment – primarily driven by upstart Electronic Communication Networks ("ECNs") and Alternative Trading Systems ("ATSs") – which introduced rapid technological innovation, unprecedented cost efficiencies, and an "investor comes first" attitude. What once was a Byzantine playground for insiders doling out legally dubious execution quality to investors, today's OTC marketplace – which consists of competitors like ArcaEx, Nasdaq, Instinet, and the National Stock Exchange – provides more choice, functionality, speed, efficiency, and, yes, *better execution quality* than the NYSE.

Today, the NYSE evidences all the lethargic and inefficient symptoms of anti-competitive and monopolistic pathology. A group as diverse and esteemed as John Bogle, [5] the editorial page of **The Wall Street Journal**, [6] Benn Steil, [7] Fidelity, [8] the American Enterprise Institute, [9] CalPERS, [10] and AIG Chairman Hank Greenberg [11] have been highly critical of the NYSE and its rules of inter-market and intra-market operation. It is this pathology, I may suggest, that is a leading cause of why the NYSE is suffering through its current panoply of scandals.

A. <u>Trade Through Rule: Enforce It</u>

As was the cure for the OTC marketplace, we respectfully submit that a large dose of competition would serve as a proper antidote to cure the ills of the listed-marketplace. Over the years, NYSE anti-competitive initiatives have taken on several shapes and forms. For example, NYSE Rules 390 & 394 (repealed under pressure) imprisoned investor trade execution on the floor of the NYSE. NYSE Rule 500 (repealed under pressure) imprisoned issuer listings on the NYSE and erected colossal barriers for issuers to list on alternative listing exchanges. Today, the manifestation of NYSE anti-competitive barriers is the Inter-Market Trading System ("ITS") Plan, its "trade through" rule, and the ITS Operating Committee that "administers" the ITS Plan.

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[5] John C. Bogle, "SpecialistMan," *Wall St. J.*, September. 19, 2003.

[6] "Can We Trade Through?" *Wall St. J.*, October 30, 2003; "A Better Big Board," *Wall St. J.*, February 4, 2004.

[7] Benn Steil, "The 'Neanderfloor,'" *Wall St. J.*, October 31, 2003.

[8] John Hechinger, "Big Board Under Fire," *Wall St. J.*, October 14, 2003.

[9] James Glassman, Testimony before House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, October 16, 2003.

[10] "Calpers Sues Big Board and Specialist Firms," *Wall St. J.*, December 17, 2003.

[11] M.R. Greenberg, "Lose the Specialists," *Wall St. J.*, December 18, 2003.

Industry insiders have known for years that the trade through rule is the least enforced rule this side of the double nickel speed limit on America's highways. And what may come as great surprise to those outside the industry is that the biggest recidivist and serial violator of the trade through rule is none other than the NYSE. Empirical data shows that the NYSE trots out the trade through rule when it suits its competitive purposes, but ignores it when it does not. Here are some facts: ArcaEx runs software (aptly named "whiner") that messages alerts when exchanges trade through an ArcaEx quote in violation of the ITS plan. The whiner database reflects that ArcaEx customers have suffered up to 7,500 trade-through violations in a single week by the NYSE. In fact, trade-through violations have actually risen most recently despite the glare of the regulator spotlight on the NYSE. Since just this last the fall (2003), the annualized cost to investors of the NYSE specialists trading through ArcaEx's quotes has increased 3-fold from approximately $1.5 million to $5 million. On any given day, ArcaEx has a billion shares on or near the national best bid or offer. Yet on any given day, the NYSE sends only 2 million shares to ArcaEx over ITS when we have the best price.

We have confronted the NYSE with our voluminous data but to no avail. If, in the NYSE's own words, the trade through rule "serves to protect investors," the NYSE has some "splaining" to do and needs to take corrective action forthwith to enforce and comply with the trade through rule in its own marketplace.

B. Trade Through Rule: Reform It

The ITS trade through rule was designed for a 1970s market structure when all exchanges were slow and manual and specialist-based ones. In today's electronic world, it limits customer choice and dumbs-down best execution to the lowest common denominator of the slowest market, which just happens to be the NYSE. It compels fast electronic markets, and their customers, to play at the glacial speed of the NYSE.

The effect of the trade through rule is to prevent electronic markets from competing with the NYSE. As a result, the NYSE can protect its mother load of 80% market share. The most effective long-term means to address specialist misconduct is to remove the anti-competitive stranglehold of the trade through rule. One way to reform the rule would be to limit application of the trade through restriction to the quotes of markets providing automatic execution against their best quotes. If a market still wants to operate in a manual manner, however, then electronic markets should be able to trade through those slow quotes. [12]

Reforming the trade through rule in this manner would free up competition between markets and enhance best execution. The SEC's pilot program begun in September 2002 proves this point. Since then, the SEC has permitted trade throughs of up to three cents in the most actively traded equity product in the world, the QQQ, SPY, and DIA. The pilot has been a smashing success for investors and best execution. QQQ maintains a one-cent spread and deep, liquid markets. Electronic markets now account for almost 60% of the volume in QQQs, while the NYSE executes a mere 5%. No wonder the NYSE has fought reform of the true trade through rule.

Reform would enable investors to choose how they want their limit orders handled. They could then send them to electronic markets that provide instantaneous display and automatic

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[12] The distinction between automatic execution markets and manual ones is often misleadingly described as "speed vs. price." This is a complete mischaracterization. If institutions and other customers of the NYSE were really getting "best price," why all the complaints and scandals and public criticism by John Bogle, CalPERS, Fidelity, *et al*.? In fact, the "best price" dichotomy foisted on the industry and the investing public by the NYSE is one of the great spins of our time. The data more and more is showing that the only entities that consistently get "best price" are the NYSE specialists. For the rest of the investing public, it's a "maybe price" as part of a free option for the specialist.

executions against incoming orders. Or, investors could choose to send them to a manual market if they want to expose the orders to specialist and floor broker handling.

Beware, however, of attempts by the NYSE to masquerade a transition to automated execution as "reform." In recent press releases (the rule proposals have not been filed at the time of this hearing), the NYSE announced that it is expanding Direct +, which is an automated execution service. That notwithstanding, the NYSE has just reconfirmed only days ago at an ITS Operating Committee meeting that Direct+ will not interface with inter-market linkage, but instead is for NYSE members only. Additionally, the NYSE refuses to commit to any timeline (2005 or 2006?) on when it will automate its inter-market interface linkage. Do not be lured into believing this fools gold; there are extremely important distinctions between NYSE intra-market and inter-market linkages. It appears that the NYSE may be attempting to proclaim that they are reformists when, in fact, everything remains status quo.

Alternatively, if the trade through rule is not reformed, then the SEC should either get rid of it or enforce it to the letter. As discussed earlier, the NYSE trumpets the importance of the rule as its specialists routinely violate it. Our whiner databases are stuffed with examples of NYSE specialists violating the trade through rule by ignoring better prices on ArcaEx. Perhaps if there were a zero tolerance policy on violations of the trade through rule, the NYSE may decide that they do not want it after all.

III. The 21st Century Specialist: Adaptation or Extinction?

At first blush, a rational response to the query "what will be the role of the Specialist in the evolving modern marketplace" would be simply to cite the law of supply and demand and its related corollaries. The role, or lack thereof, of the 21st century specialist will (should) be determined by the marketplace of competition (subject to regulatory oversight and compliance with SRO rules and federal regulations approved by the Securities and Exchange Commission ("SEC")). If specialists – in whatever shape or form they may take – provide a valuable service to investors and traders and institutions, they will (should) in deed have a material role in the execution of securities in our marketplaces. The corollary of that statement, of course, is also true; if specialists provide little to no value, or even extract value, from investors and traders and institutions, their role will (should) be immaterial and marginal. Like any other business, these observations are only common sense.

The problem with the above analysis is that its methodology does not include the "externality," in economist jargon, of anticompetitive rules and policies. Whether it be NYSE Rules 390 or 500 or the ITS trade through rule and the lack of enforcement thereof (or Nasdaq's newly adopted "Rule 500," discussed below), this Subcommittee and the SEC, among others, need to be vigilant in preventing and rooting out anti-competitive rule-making and policies. Certainly, each marketplace should be able to establish its own business model and rule set (subject to SEC approval and oversight), whether it be with or without specialists, or whether it be vanilla, chocolate, peach or rocky road. At ArcaEx, for instance, we have no specialists. Every ArcaEx customer competes on price with the same market information. However, the days of the NYSE or Nasdaq pressing their thumb down on the scales of competition should be over. And, the rest should be left to competition.

IV. Nasdaq's "Rule 500": What's Good For The Goose Is Not For The Gander

The NYSE certainly does not have an exclusive franchise on anti-competitive reflex. Under the cover of darkness and, apparently at the time, unbeknownst to the SEC, Nasdaq in

January 2004 installed its own anti-competitive version of Rule 500. Like its now defunct NYSE stepfather, the purpose and effect of Nasdaq's Rule 500 is to imprison issuers and maroon them on the Nasdaq listings island. Nasdaq seeks to accomplish these ends by severely penalizing any Nasdaq-listed issuer who is also part of the Nasdaq-100 Index – for instance, Microsoft, Cisco, Intel, Dell, Sun Microsystems – that dare contemplate ***dually listing*** on another competing exchange. The punishment for the crime of dually listing on another exchange is ignominiously being thrown out of the Nasdaq-100 Index Trust (alias "QQQ") and having hundreds of millions or even billions of dollars in the offending issuer's stock (depending on market capitalization) summarily sold overnight by the trust.

Mind you, this is the same Nasdaq who for years valiantly fought against NYSE Rule 500, whose purpose was to maroon issuers on the NYSE. During the course of that fight, Nasdaq argued that NYSE Rule 500 "impedes issuers in selecting the marketplace best suited to their needs" and is "antithetical to the free and open competition that the Commission has consistently advanced and that is the bedrock of the U.S. capital markets system." Mind you further, this is the same Nasdaq that only a month ago embarked on a media campaign that sang the high praises of listings competition when Nasdaq successfully attracted a handful of NYSE-listed issuers to ***dually list*** on Nasdaq. During that media blitz, Nasdaq advertised that "a dual listing … not only serves to improve the quality of trading in your company's stock – it can generate added visibility for your company and raise awareness and interest with the investing public." Nasdaq exclaimed that "with a dual listing, investors have greater access to liquidity and more opportunity for best execution." Nasdaq's summed up the dual listing value proposition as "the power of choice." What these advertisements failed to disclose in the fine print was that the "power of choice" belongs exclusively to issuers that currently list on the

NYSE and who Nasdaq is marketing to for a dual listing on its market. Apparently Nasdaq issuers should not be interested in "greater access to liquidity and more opportunity for best execution" that a dual listing on another exchange may offer. [13] In other words, Nasdaq issuers "need not apply."

A. <u>NYSE Rule 500</u>

Nasdaq led the fight to overturn the anti-competitive NYSE Rule 500, and Archipelago was completely supportive of Nasdaq in that fight Much like Nasdaq's own "Rule 500," the NYSE once erected enormous corporate governance barriers for NYSE issuers who attempted to leave the NYSE and list on another exchange. In its own rulemaking petition to eliminate NYSE Rule 500, Nasdaq aggressively and correctly argued that Rule 500 impeded competition, was antithetical to investor protection, and inhibited openness and responsiveness. [14] Among other things, Nasdaq supported its argument by citing the NYSE's front-running scandal in the 1990s and, at the time, increases in listing fee. Nasdaq concluded that "Rule 500 gives the NYSE a grip on its listed companies that companies cannot break free of, even when faced with an archaic and unfair trading system, extremely onerous fee increases or other anticompetitive burdens that under normal competitive circumstances would drive at least some companies to consider voting with their feet and listing on another market." In the end, Nasdaq's petition was ultimately granted, and rightly so from our vantage point; NYSE Rule 500 was repealed in October 2003.

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13 Nasdaq dual listing brochure: "Nasdaq Dual Listing Guide" and subtitled "The Power of Choice" (copyrighted 2003).

14 "Petition for a Rulemaking to Repeal Rule 500 of the New York Stock Exchange (Corrected Copy)" dated May 13, 2003, from Edward S. Knight, Executive Vice President, Nasdaq, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission.

B. The Devil Is In The Details

Fast Forward to January 2004: Nasdaq cleverly amends its eligibility requirements in connection with the Nasdaq-100 Index. Prior to January 1, 2004, those rules read that for an issuer to be eligible to join the Nasdaq-100 Index, it had to be "listed" on Nasdaq. Fair enough. This structure required an issuer who sought to be eligible for the Nasdaq-100 Index to list on Nasdaq, but, at the same time, afforded that same issuer the "choice" of dually listing on another exchange. In January 2004, however, Nasdaq amended this language – and apparently without consulting with or making the appropriate regulatory filing with the Division of Market Regulation of the SEC – to require an issuer to be ***exclusively*** listed on Nasdaq in order to be eligible for the Nasdaq-100 Index (except where an issuer had been dually listed on another exchange prior to January 1, 2004.) Like the now repealed NYSE Rule 500, Nasdaq's Rule 500 consciously and purposefully erects a huge barrier for those issuers who would like the choice of dually listing at another exchange, but who also would like to remain eligible for the Nasdaq-100 Index and not have potentially billions of dollars of their stock wantonly sold because of an anti-competitive tying arrangement.

Note that I do not use the words "consciously" and "purposefully" loosely. Out of abundance of caution, and believing that we were in error in our understanding of the amendment, we contacted Nasdaq senior officials and made inquiry. We suggested to those officials that in lieu of an eligibility requirement of "exclusively" listed on Nasdaq, that Nasdaq could accomplish their branding goals through a less onerous "primary listing" requirement. Unlike an "exclusively listed" requirement, the "primary listing" requirement would give an issuer the "choice" that Nasdaq so eloquently articulated in its fight to eliminate NYSE Rule 500 and its own dual listing campaign. The "primary listing" would also protect Nasdaq's own brand identity and identity of its index.

Nasdaq politely listed to our position but firmly rejected them out of hand: the amendment language was in deed accurately drafted and the "exclusively listed" requirement would stand. Further, they argued that the amended eligibility rules were not anti-competitive and that the SEC had no jurisdictional role in reviewing their eligibility amendment.

We beg to differ. We believe that this "sleight of hand" amendment is anti-competitive, harms issuer choice and investor "best execution," and is hypocritical, to say the least. Further, we respectfully believe that this Subcommittee should be interested in its policy implications and, moreover, submit that the SEC and the Department of Justice have statutory authority to investigate this matter. [15] Like the mutual fund investors who have suffered the pain of oppressively high back-end loaded fees, Nasdaq's Rule 500 is the mother of all back-end loaded fees for issuers seeking listings choice.

V. The Lessons of 9/11 and Competitive Marketplaces

Before closing, it is worth touching on how the issues discussed above, especially the ones involving the establishment of a vibrant and dynamic competitive marketplace, impact on our nation's risk management exposed by the events of September 11, 2001. Certainly, a competitive network of multiple competitive market centers linked by robust linkages would

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[15] This type of restraint may violate Section 11A provisions of the Exchange Act on fair competition among markets and Section 15A provisions of the Exchange Act that the NASD rules not impose any unnecessary burden on competition. Further, Section 19g of the Exchange Act requires SROs to comply with the federal securities laws. Such an anti-competitive action by Nasdaq may not be consistent with the federal securities laws. Finally, both the SEC and DOJ brought actions against the five options exchanges for conspiring to keep the listing and trading of options to only one exchange. While Nasdaq's Rule 500 is not a conspiracy among competitors, but rather a unilateral action, the harm to competition is still just as real.

appear to assuage these risks. Some markets will offer a floor-based solution, with the advantages of "high touch" order handling, while others will offer screen-based and anonymous access, perhaps as a means to mitigate geographic risk. A system of linked competitors is identical to the Internet model, originally designed to provide redundancy and avert a single point of failure. It was precisely this decentralized model that proved unconditionally successful as a means of communication on September 11.

In 1975, Congress laid out the roadmap for a National Market System of informationally-linked competing exchanges. As part of this roadmap, we embrace a less centralized, though linked, marketplace, which we believe will thereby eliminate the risk of shutting our markets down in the face of the unthinkable.

VI. Conclusion

Like the execution business, the role of the 21st century specialist should be determined through competition (subject to regulatory oversight and compliance with SRO rules and federal regulations approved by the SEC). Anti-competitive rules and policies should be repealed and eliminated as was the case with NYSE Rules 390 and 500. Similarly, the trade through rule needs to be reformed and enforced to eliminate its anti-competitive effects that weigh heavily in favor of manual markets like the NYSE. Beware of NYSE's recent announcement concerning Direct + and automating its marketplace. Direct + does not affect inter-market linkage, and the NYSE is noncommittal on when it will establish an inter-market interface that will provide automated execution. It appears that NYSE is attempting to masquerade as a reformist when nothing in fact has changed. Finally, Nasdaq's newly implemented "Rule 500" must be repealed because its purpose and effect is clearly designed to eliminate issuer choice and competition among listing venues.

Thank you again for providing me this opportunity to testify, and I look forward to responding to your questions at the appropriate time.