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

Hearing on
"The SEC Proposal on Market Structure: How will Investors Fare?"

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Good afternoon Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. I am John Giesea, President and Chief Executive Officer of the Security Traders Association ("STA"). Thank you for the opportunity to testify on behalf of the STA to discuss the important issues relating to the structure of the US equities markets, specifically as they relate to the Securities and Exchange Commission's ("SEC") proposed Regulation NMS.

The STA is composed of approximately 6,000 individuals engaged in the purchase, sale and trading of securities for individuals and institutions.

Proposed changes to market structure will ultimately impact investors and the capital formation process. That is why these deliberations are so important. But as we consider such changes, we must also realize that the needs of all investors are not always the same.

My testimony will highlight the major points of which the STA has achieved consensus on proposed Regulation NMS. The STA has consistently called for SEC action to address several structural anomalies, so it is encouraged by the release of proposed Regulation NMS. The STA's White Paper[1] released last year provided three major recommendations that if implemented, would make the markets more efficient and serve to benefit investors:

1. Improve intermarket linkages and trading rules.
2. Require consistent rules across markets.
3. Eliminate ECN access fees.

<u>Proposed Regulation NMS</u>

The STA is currently in the process of completing its formal comment on proposed Regulation NMS. The process has involved input from more than 60 traders, including those from the buy-side and sell-side, to undertake a very comprehensive review. Since the STA's traders represent all market segments, the organization provides a unique perspective of the impacts of market structure proposals.

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[1] *Fulfilling the Promise of the National Market System: STA's Perspective on US Market Structure*, August 2003.

Proposed Regulation NMS includes four new rules or changes to existing rules that address the following issues:

- A uniform rule for the prevention of trade-through across all market centers, subject to certain exceptions.

- A uniform rule that would permit all market participants to access other markets on a non-discriminatory basis with a *de minimis* charge of $0.001 per share for such access.

- A ban on sub-penny quotations.

- A modification of the formula used for allocating market data revenues.

I will highlight the four proposals in Regulation NMS and the major points where the STA has largely reached consensus on these issues.

Trade-Through Rule

Since the publication of our White Paper, the STA has taken the position that a fully linked market with automatic execution will substantially diminish the need for a trade-through rule.

The SEC's proposal would create a uniform trade-through rule, with exceptions for: 1) an opt-out on an order-by-order basis, and 2) an automated market executing orders without regard to a better price in a non-automated market. The automated market would be able to trade through slower markets by a *de minimis* amount, varying from $0.01 to $0.05, depending on the price of the stock.

STA suggests one way to address the trade-through proposal would be to execute it in a phased approach, thereby significantly reducing the potential unintended consequences. Each phase would be implemented after a comment period provides opportunity for review. The first phase should clearly define "automated" and "non-automated" markets. Step two would oversee the creation of linkages to ensure true connectivity and access among the markets. Halfway measures are not sufficient if there is not an accompanying high degree of connectivity. Phase three would be a reexamination of the need for a trade-through rule, as such a rule may be impossible to enforce as well as unnecessary given the competitive forces driving best execution standards. The end result of this phase-in approach would be a major step toward the envisioned National Market System and beneficial for all market participants and investors.

Although the STA views the proposal as a very positive approach to drive markets toward more automation, and economic and efficient access, I make a few points for consideration.

The proposal would extend the trade-through rule to the Nasdaq market. We question why, when there have not been problems regarding price protection, the rule should be imposed on the Nasdaq market. Adoption of an intermarket trade through rule should be made following implementation of the steps discussed above. It would be incorrect to impose this rule at the onset.

Although there may be some practical and other drawbacks to an opt-out, we would support an opt-out exception on an interim basis for the purpose of driving greater automation in, or access to, markets. However, if automatic execution and efficient and economic access to quotes were achieved, an opt-out provision would become unnecessary. Therefore, an opt-out exemption should be specifically designed as an interim tool to achieve near-term execution objectives necessary in today's market conditions, while continuing to provide an incentive for change.

A key determination is the definition of an automated market. STA believes that a market must provide for automatic execution coupled with immediate refresh capability. Less stringent criteria would neutralize the gains sought in an updated national market system.

The varying *de minimis* amounts at which a trade-through can occur, depending on the price of the stock, are overly complex. Instead a flat $0.03 increment rather than the proposed tiered structure would be less burdensome and expensive to administer.

Access Fees and Locked and Crossed Markets

The Commission has correctly identified access fees as a critical component of any discussion regarding best execution. The SEC's proposal to cap access fees at $0.001 per share is a very positive step toward reducing the current problems in the marketplace; however, we continue to believe the preferred action is complete elimination.

The STA has long held that access fees, since they are not included in the quotes of an ECN's system, complicate best execution obligations and undermine transparency of prices. Broker-dealers that do not subscribe to ECNs may sometimes be required to interact with a quote on an ECN's system if it is the best bid or offer ("BBO"). If a broker-dealer accesses the ECN's quote in order to fulfill its best execution obligations, then it is charged an access fee even if it is not aware of the existence or amount of the fee. Access fees also create market inefficiencies by imposing economic disincentives to seeking out the best price and by creating incentives to lock and cross markets.

Rather than allow all markets, in addition to ECNs, to charge access fees as the SEC proposes, the STA believes simply eliminating such fees would provide more benefits to investors. However, the SEC's proposed *de minimis* cap of $0.001 per share will create more consistency of such fees and seems an equitable approach.

The SEC's proposal appropriately calls upon markets to create and enforce rules eliminating locked and crossed markets. The best way to eliminate the economic incentives causing locked and crossed markets would be to simply ban access fees. The STA strongly supports a uniform intermarket rule that assists in preventing locked and crossed markets. Locked and crossed markets impact the execution of investors' trades, causing delays in getting customer orders filled. Such market conditions may actually result in a trade being executed at an unfavorable price due to the market changing after the market is unlocked.

Sub-penny Quotes

Sub-penny quotations create a number of problems in the market, including a decrease in market depth at the BBO and the facilitation of stepping ahead of limit orders by some market participants. A move to sub-penny quoting would result in a decrease in the amount of liquidity at each price point, which does not benefit the investor. Proposed Regulation NMS cites an SEC staff study that finds sub-penny trades cluster at the $0.001 and $0.009 price points, suggesting stepping ahead behavior. The SEC's proposal to ban sub-penny quoting, which is strongly endorsed by the STA, recognizes such troubling results of sub-penny quoting.

I want to intentionally draw a distinction between sub-penny quoting and sub-penny trading. There are certain instances where sub-penny trading, such as volume weighted average pricing (VWAP) and other averaging mechanisms, are used to facilitate certain executions. Such instances actually increase efficiencies and ultimately benefit investors.

Of all issues embedded in Regulation NMS, this is one that appears to have gained near universal acceptance. STA, since 2001, has actively supported the elimination of sub-penny quotations.

Market Data

The STA is not is a position to comment on the precise formula to be used for the distribution of market data revenues. We are, however, supportive of market data allocation proposals that lead to rewarding quality quotes, and at the same time eliminate the print factory and other practices designed only to game the revenue stream.

Liquidity Providers

I also note the importance of liquidity providers to the capital formation process and the efficient functioning of the markets. Just as not all investors are alike, not all stocks trade alike. Liquidity providers such as specialists and market makers are especially important for the trading of less active stocks where natural buyers and sellers are not always available at a specific price point. A lack of liquidity in such stocks diminishes the ability of those companies to raise capital, thus adversely impacting the US economy and ultimately, job creation for these smaller businesses.

The trend in rulemaking has been to encourage the matching of buyers and sellers without an intermediary. There would likely be consensus that some highly liquid stocks such as Intel (Nasdaq: INTC) do not, under normal circumstances, require a liquidity provider to facilitate the execution of trades. However, the need for specialists and market makers becomes ever more important in stress situations, whether they be stock specific or general market conditions. Where liquidity providers add significant value is in the trading of less active stocks where natural buyers and sellers are not always immediately available.

Conclusion

I thank the Members of the Subcommittee for your continued interest in ensuring that the US markets are efficient and liquid. Such characteristics are important to a robust capital formation process, benefit the US economy, and ultimately benefit all investors. For it is the investor who drives the markets; therefore, the investor should be the focus of any changes made to the structure of our markets.

The STA views the National Market System principles established in the Securities Exchange Act of 1934, namely the maintenance of efficient, competitive and fair markets, as both a measure and a goal. The SEC's proposed Regulation NMS is a step towards the goal of a more national market system. However, such a system could be further facilitated by a connectivity-based approach, or one in which the various markets are connected and quotes between such markets can be quickly and efficiently accessed. Such an approach will encourage the facilitation of automatic execution of orders and best serve the interests of investors.