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Government Sponsored Enterprises

of the

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Hearing on "Reviewing U.S. Capital Market Structure:

Promoting Competition in a Challenging Trading Environment"

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Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee, thank you for inviting me to participate in this hearing regarding the structure of the U.S. equities markets. I commend you for your efforts to examine the rules governing our markets to ensure that such policies and regulations remain relevant and adaptable to market developments. We also commend the SEC for its continued efforts to insure that the proper regulatory framework is in place to preserve the integrity of our capital markets, and make them the most vibrant, competitive and transparent in the entire world.

Knight Trading Group, Inc. is the parent company of Knight Equity Markets, L.P., Knight Capital Markets LLC, Knight Execution Partners LLC, Knight Financial Products LLC, and Knight Securities International Ltd., all of whom are registered broker-dealers. Knight and its affiliates make markets in equity securities listed on Nasdaq, the New York Stock Exchange, the American Stock Exchange, the OTC Bulletin Board and in options on individual equities and equity indices. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary.

Knight is a major liquidity center for the Nasdaq and listed markets. As a dealer we make markets in nearly all equity securities and are specialists in option classes that constitute approximately 70% of all equity option volume executed in the United States. On active days, Knight executes in excess of one million trades, with volume exceeding one billion shares. Knight's institutional sales business offers comprehensive yet unbundled trade execution services covering the depth and breadth of the market. As a market maker, we facilitate large and complex trades by committing our capital. We are consistently the number one SuperMontage liquidity provider in the Nasdaq marketplace. Using our connectivity to various market centers, we commit capital to facilitate investor trading. Knight has the expertise to execute institutional orders according to client needs. Knight's clients include more than 850 broker-dealers and 600 institutional clients. Currently, the eight year old, publicly traded company employs nearly 1,000 people.

Importance and Role Market Makers Play in the Securities Markets

Knight and other market makers serve a central role in the securities markets. Knight commits capital. Basically, Knight uses its own money to facilitate executions. If someone wants to sell stock, we stand ready to buy it – using our own money if necessary in many instances. By doing so, Knight, and other marker makers, provide stability in volatile markets, and speed and certainty in less liquid issues; such as, securities below the top one hundred in volume, Nasdaq mid-cap stocks, certain listed stocks, the Small Caps, the Over the Counter Bulletin Board (OTCBB) stocks, and the Pink Sheets securities. We are able to ensure that trades are executed in a manner consistent with articulated preferences, based on the unique trading requirements of individual and institutional investors. We offer superior executions, a majority of which are automatically executed, with enhanced liquidity to other broker dealers including many of the online trading firms that have become household names. There is a fundamental difference between market makers and ECNs; while ECNs simply match buyers and sellers electronically, when there is no natural match between a buyer and seller, an order can sit on the books of an ECN for several seconds, minutes or hours if someone does not come along and is willing to trade with that order. A market maker, however, will many times use their own money to provide an execution to that order. By doing so, market makers provide liquidity by committing capital and taking risk to execute the trade as principal. These are functions, I submit, that are vital to the efficiency and depth of our capital markets.

If not for market makers, many stocks would be far less liquid, with increased transaction costs for the investor in the form of wider spreads. At Knight, we commit substantial capital every day, so that whether the investor wants to trade shares of Cisco or a relatively unknown over-the-counter stock, buy and sell orders are executed quickly at a low cost and at the best available price. In other words, the market maker's ability to commit its own capital to execute trades allows investors to efficiently get into and out of their investments. If market makers did not exist to add liquidity, the market's slogan might be "trade by appointment only." Importantly, what makes our capital markets so strong is that we continue to embrace different trading mechanisms (from specialists to market makers to ECNs) that provide different benefits for different types of stocks and different types of investors. Competition and transparency are cornerstones of our capital markets. We are not here to find fault with one market model over the other; rather, we believe that all models should be given the opportunity to compete fairly. To do so, the rules across venues need to be reasonably and consistently applied to all market participants, so that competition and innovation can thrive – which ultimately inures to the benefit of the public investor.

Deep, liquid capital markets offer an increased capacity for the growth of the economy. Market makers take on the necessary risk to facilitate the efficient trading of securities. In his book on market microstructure, Larry Harris, now Chief Economist at the SEC provides an excellent discussion of the nature of liquidity in capital markets.[i] He also notes the function of market makers to "primarily supply liquidity in the form of immediacy."[ii] Market makers support the capital formation process by providing capital and liquidity to the markets.[iii] Given recent market conditions including a dearth of initial public offerings, smaller firms are very dependent on these venues to continue to raise capital and attract investors.

In the United States, the small business sector is the key to job growth and innovation. If a business is able to access capital and attract investors, it is able to invest in technology, create jobs, and make the capital improvements necessary for sustained growth. The resultant increase in investment by our large and small business sector not only benefits the U.S. economy and creates additional jobs for Americans, but also helps to provide the capital necessary for development of innovations and new technologies. In other words, by providing investors with liquidity in the market place, market makers serve as an integral part of our nation's economic growth.

State of the Equity Securities Industry

Although the U.S. equity markets remain the most vibrant, efficient and liquid markets in the world, they are currently facing several serious problems. The conversion to decimals has narrowed spreads, and has also created a variety of issues that must be addressed. The interaction between floor based markets and electronic markets is straining our ability to achieve the goals of the National Market System. The existence of certain rules that are applied in unfair or inconsistent ways is hampering effective competition. These problems are acute, systemic and have reached a point that causes harm to the efficient functioning of the markets and ultimately, to investors. I will address what we see as the most significant market structure issues below.

Unfulfilled Goals of the Securities Acts Amendments of 1975

Fortunately, the Congress anticipated many of these issues when it adopted the Securities Act Amendments of 1975, which directed the SEC to facilitate the establishment of a National Market System.[iv] At Knight, we take these goals seriously and want to fulfill our obligations as established in the 1975 Amendments. Doing so puts the investor first. We reaffirm the goals of the Amendments, which are to provide for the “maintenance of fair and orderly markets to assure:”

1) “economically efficient execution” of transactions;

2) “fair competition” among and between market centers, including exchange markets;

3) availability of quotations;

4) “executing investors' orders in the best market”;

5) “an opportunity… for investors' orders to be executed without the participation of a dealer”; and

6) “the linking of all markets… [to] contribute to best execution.”

The important thing for us to remember is that these six goals are interdependent. For example, it doesn’t make sense to try to link all markets if there are inconsistent rules that do not permit fair competition between markets. Similarly, although the 1975 Amendments talk about finding ways to allow “investors’ orders to be executed without the participation of a dealer”, this was in no way a mandate to eliminate dealer markets, especially in less liquid stocks where orders typically cannot be executed without dealer participation. And, in a post-decimal, one-penny MPV (minimum price variation) trading environment, this directive does not have the same meaning it did when it was adopted nearly 30 years ago. Throughout my testimony I will expand upon specific examples of rules, or lack thereof, which overlook several of the goals of the 1975 Amendments.

I want to commend Chairman Donaldson and other Commissioners and SEC staff for consistently stating the need to expeditiously address market structure issues. The SEC has already developed a significant body of knowledge and sponsored a number of initiatives that have examined all aspects of market structure in considerable detail, including the Market Data Advisory Commission formed by former Chairman Arthur Levitt, and the market structure hearings conducted by the SEC late last year. Unfortunately, after years of study, given the distractions caused by issues relating to accounting fraud, corporate governance, and now mutual fund investigations, the SEC has yet to formally take action. All of these are very important issues and deserve serious attention, but it is important that market structure issues be promptly acted upon or we risk a continued degradation of the efficient functioning of the American equity markets, and ultimately the capital formation process.

I must admit it is somewhat disconcerting to hear from several commentators that the only way to resolve market structure issues is by acting in a "holistic" fashion. As the saying goes, "perfection is the enemy of the good." Unfortunately a holistic approach, one where the Commission would address every market structure issue at the same time, is a recipe for further delay and inaction. Instead, incremental steps can, and must, be taken to address specific issues that are impacting the efficiency of our markets. If we wait on implementing sensible changes until every issue is ferreted out, then it is very possible that no action will result.

Delay will Only Create Further Inefficiencies in the Market

It is interesting to note that only a year ago 97% of all trading volume in Nasdaq stocks was reflected in the Nasdaq market. Today, just one year later, that number has dropped to approximately 50%. The reasons for this vary. For example, the failure to deal with the market data issues raised several years ago has contributed to the decision of certain market participants to leave Nasdaq. These market participants have instead chosen to print their volume on regional exchanges who have adopted a "shared economic approach" to revenues generated by those exchanges. Thus, we believe that the consequences of waiting for the perfect solution or taking a holistic approach are immense. Market developments such as the Standard & Poor's recent announcement that it will initiate a pilot program using the American Stock Exchange's ("Amex") closing prices of 12 Nasdaq securities for calculating the S&P 500 Index will continue to challenge the market. For the first time, these 12 securities will have two "official" closing prices. Clearly, this will lead to more dislocation of liquidity (for example, the Amex currently accounts for less than 1% of the volume in these 12 stocks), as well as confusion among public investors as to what closing price they are entitled.

Let me be clear that fragmentation is not harmful so long as there are fair rules that allow for a level playing field between competitors. Fragmentation without these essential characteristics does not fulfill the National Market System goal of linking all markets to achieve the best execution of orders. Knight is linked to virtually every market to ensure that it can serve its clients' best interests. These linkages, however, have come at an increased cost. For instance, an NYSE or Amex "commitment to trade" through the Intermarket Trading System ("ITS")[v] with Knight's system is given instant automatic execution. But the NYSE and Amex do not provide automatic execution for an ITS order coming from Knight, resulting in an ineffective linkage. Thus, true bilateral linkages, equal access and fairly applied rules are needed for markets to effectively and efficiently interact with each other.

Best Execution for Investors

The starting (and ending) point for any discussion on market structure is the concept of best execution. On the surface, it seems to be a simple concept. But what may be best execution for one investor could be very different for another, making it very difficult to define. Thus, we must let the individual investors decide. Today, investors make suitability determinations when opening their securities accounts at brokerage firms. They decide if their investing goals are "long-term growth" or "income" or "speculation" to name a few. They decide whether they want to receive dividends or have them reinvested. They should also be permitted to decide ***how*** they want their orders executed – speed, liquidity (fill-rate), and price. Trade execution requirements are simply an extension of the investor decision. An investor's right to choose should be sacrosanct. To decide otherwise is simply incompatible with a free market society. Commissioner Atkins concisely illustrated this point in a speech he gave earlier this year.[vi] He used the example of a time when his wife was pregnant with their first child. She wanted a particular type of ice cream. The local deli store a few blocks away had the favored brand, but it charged a high price. One of the other options was to go to a supermarket on the other side of town where the ice cream was cheaper. Of course, getting to the supermarket would be inconvenient and could fail to satisfy the cravings in a timely fashion. Consequently, Commissioner Atkins chose the local deli to meet his needs at that particular time. As you can see, he adapted his execution standards to meet his immediate needs.

When it comes to Best Execution, we reiterate -- let the investor decide. Best execution can and should vary by investor and can be different for various trades by the same investor. One investor may place importance on speed of execution to lock in a certain price. A different investor may place primary importance on price, while yet another may be most concerned with maintaining anonymity and liquidity. The different investor needs reflect varied best execution standards, as defined by the investor. As such, relationships with clients are the most important determinant of their best execution needs. A market participant that "knows the customer" will know the needs and objectives of the investor, thus ensuring best execution. Former Chairman Arthur Levitt affirmed this investor-centered concept of best execution in 1999 by stating, "[T]he quality of execution must always be viewed from the customer's perspective, not the firm's."[vii]

It is significant to note that today investors have many more tools and information available to help them assess the execution quality of a broker-dealer. For example, the SEC adoption of Rule 11Ac1-5 improved the disclosure of broker-dealer order execution quality.[viii] The rule requires market centers to make monthly reports of statistical information regarding their order executions, most notably statistics of price and speed of execution. The SEC also adopted Rule 11Ac1-6, which requires all broker-dealers to make available quarterly reports of their routing practices.[ix] These disclosures help all investors, whether they execute one trade per month or several trades per day, to determine which market centers provide the best execution of orders, and whether their brokers route their orders according to the investor's best interests.

The concept of best execution surrounds other market structure issues, such as consistency of rules across trading venues and sub-penny trading. Consistent rules across markets are needed to ensure a level playing field for all market participants and the best execution of investors' orders. Sub-penny trading dramatically increases the number of quoted price points, meaning liquidity is further dispersed, thus reducing transparency and liquidity. I will describe these issues more fully below.

The Need for Consistent Rules Across Markets

As baseball fans are well aware, the American League and the National League have different rules relating to the use of a designated hitter. As a result, the first time a team from the National League played a team from the American League, the problem of which rules to use arose. The compromise was that the rules of the home team be applied. Today, different market participants have different rules. A harmonization of rules across market venues is necessary for a level playing field so that the industry can better ensure best execution for investors regardless of where the security is traded. Uniform rules that are transparent and vigorous are necessary to serve the best interests of investors.

Increase of Nasdaq Stocks Traded under the Unlisted Trading Privileges Plan

Several inconsistencies encountered in the market result, in part, from the dramatic increase in the trading of Nasdaq/National Market securities (NNM) on regional exchanges pursuant to the Unlisted Trading Privileges Plan (UTP Plan). When the Congress passed the Securities Act Amendments of 1975, it properly envisioned markets where listed securities could freely be traded over-the-counter and unlisted securities could be freely traded on exchanges.[x] The Nasdaq/UTP Plan was established as one component of the National Market System to provide transparency for NNM securities, thereby enabling members of the regional exchanges to trade securities listed on Nasdaq. Although the Nasdaq/UTP Plan governs the collection, consolidation and dissemination of quotations, its scope is limited to market data and does not require any meaningful type of market linkage nor does it impose any common set of rules other than for trading halts.

Some markets have evolved and advanced their technologies significantly while others have not kept up with such developments. This has caused a collapse in the ability to efficiently execute trades and provide best execution – each being important goals of the National Market System. For example, there are few requirements for a market to update its rules or technology if it is seeking the right to trade Nasdaq securities under the UTP Plan. One of the requirements to gain UTP status is to allow access to the quote. The problem is that this requirement does not go far enough – it does not indicate how market participants can access the quote (e.g., manually or automatic execution).

When the over-the-counter market for listed stocks (the so-called third market) was integrated with the listed market through a linkage called ITS/CAES, third-market market makers were required to adjust certain of their practices to the practices of exchanges in order to assure some comparability of regulation. For example, third-market market makers were required to change the way they reported trades to the way exchanges reported trades. Similarly, although there were many third-market market makers, their quotes were consolidated into a single quote to mimic the way exchange quotations are presented. Finally, third-market market makers were required to agree to the terms of the ITS Plan which provides a uniform (albeit inefficient) linkage among markets trading listed stocks.

When the UTP Plan was implemented, none of these steps were taken. As a result, inconsistent trading environments and access mechanisms have become more common, which directly hinders the ability to efficiently execute trades. The most glaring example has to do with access. The Nasdaq is a screen based electronic dealer market which provides automatic execution in most instances, while most regional exchanges are floor-based auction markets without automated execution. This difference means that regional exchanges can easily access Nasdaq quotes whereas Nasdaq market makers cannot easily access regional exchange quotes. These consequences cause disruptions and do not further the goals of the National Market System to provide for the maintenance of fair and orderly markets. Thus, depending upon the investors' needs, the inefficient linkages may hinder best execution. As such, we believe the UTP plan needs to be revised to properly address these issues.

Short-Sale Rule

The short-sale rule is another rule with differing treatment across venues, although the SEC is proposing[xi] a "bid test" short-sale rule[xii] that will apply to every U.S. equity market, rather than the current inconsistent application of the rule. We support the SEC's attempt to unify the differing rules by applying one rule across all markets. It has been reported, however, that the SEC may not renew the short-sale exemption for market-making activity. We question why this exemption should be taken away as it has served the markets well. As with any law or rule, isolated abuses of the rule can and should be swiftly dealt with. However, we should not throw the baby out with the bathwater. There are very important reasons why market makers need this exemption (e.g.,, the ability to execute investor buy and sell orders in declining markets). The proposed rule would eliminate the short-selling behavior that has been of concern to issuing companies, but there is no rationale for eliminating the market-maker exemption.

Trade-Through Rule

Briefly, the trade through rule prohibits ITS participants from trading a stock at an inferior price if there is a better price available in another participating market. On May 30, 2003, the SEC granted an additional temporary nine-month *de minimis* exemption to the ITS trade-through rule for transactions in three exchange-traded funds ("ETFs"), the Nasdaq-100 Index ("QQQ"), the Dow Jones Industrial Average ("DIA") and the Standard and & Poor's 500 Index ("SPY"). The rule exempts such transactions from the trade-through rule if they are executed at or within three cents of the best bid and offer.

While the *de minimis* exemption is a step in the right direction, the exemption should be extended across the market to all other intermarket securities. In the meantime, the utility and relevance of the trade-through rule should be further examined due to the rapid technological advancements in the industry that make price priority less relevant. Because decimalization has significantly lowered spreads, and as mentioned earlier, because investors' execution needs vary with some preferring speed over price, the trade-through rule no longer provides the same safeguards as it did when enacted 20 years ago. The market now provides a number of its own protections, including the one-penny MPV, as well as faster and more complete fills, rendering the trade through rule virtually obsolete. Indeed, the trade-through rule may hinder certain investors from implementing their execution strategies. So, we believe that the SEC should permit investors to decide what is important to them, as it appears the SEC has already done in granting exemptions for certain ETFs.

Efficient Linkages are Key to a Competitive National Market System

The Securities Act Amendments of 1975 envisioned intermarket linkages for the trading of securities to “foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.”[xiii] The lack of efficient linkages is yet another shortcoming of efforts to achieve the goals of the National Market System.

As mentioned earlier, in the listed markets there has been a linkage in place since the Intermarket Trading System (ITS) was introduced in 1978. Unfortunately, this system still uses the technology developed in 1978 and is out of date. For example, some participants still do not allow for automatic execution, instead they require up to 30 seconds to respond to a quote. In markets where executions are measured in milliseconds, 30 seconds is an eternity. Thus, in an ITS setting, executions are not necessarily defined by the best market price, but can be defined by the slowest link in the chain. The linkages that do not provide access to automatic executions do not fulfill the National Market System goals of “fostering efficiency” and “best execution”. Therefore, we call for significant improvements to the ITS to ensure more efficient executions of trades. For this to occur, the technology should be updated to allow for automatic execution capabilities, and it should allow direct access for market makers.

For Nasdaq stocks, the situation is much different. There is no common linkage like ITS and the dispersion of liquidity is far greater than for listed stocks. On one level this is good. Competition fosters better pricing and efficiency. However, on another level, the lack of standard rules which define access and trading practices among the different venues has led to a degradation in execution quality.

With requirements of best execution appropriately falling upon various market participants, it has become extremely difficult (and costly) to efficiently and effectively access simultaneously all points of liquidity. And, with quotes flickering at staggering rates, there is no single way to sequentially access pockets of liquidity at any one point in time. Many times, it is “now you see it, and now you don’t.” As such, it is imperative for the SEC and other regulators to apply realistic notions of what constitutes best execution, and to use the National Best Bid or Offer (NBBO) as a guide – not an absolute measurement.

Unfortunately, the UTP Plan simply does not deal with these issues. Although the Plan does require each market to make its quotations available by telephone, given the way Nasdaq stocks trade, this type of access is useless. It is essential that the SEC step in and require some form of automatic execution of inbound orders. Currently, some markets such as the Amex do not provide for any type of automated execution of orders. Thus to access their quotations, it is necessary to send an order through the Amex order delivery system and wait, quite often for several seconds or even minutes for an execution. What was true for the over-the-counter markets when they started to trade listed stocks is true for exchanges that wish to trade Nasdaq stocks – they must conform to the trading conventions of the market. In the case of Nasdaq stocks that means instantaneous execution.

The concept of best execution and price-time priority also goes to a proposal now before the SEC. The Cincinnati Stock Exchange ("CSE") submitted a proposal to the SEC last year that would, if implemented, establish a "Voluntary Book" for orders. The proposal would subject both the CSE and the Nasdaq to similar regulatory treatment by allowing the exchange to move away from the price priority rules to which it is currently subjected. The Voluntary Book would include only Nasdaq securities traded through the Nasdaq/UTP Plan. It would do away with price time priority, thus allowing market participants to provide best execution for investors according to their specific needs or requirements. Again, best execution should be from the investor's perspective, meaning the investors could value speed over price. If implemented, the proposal would allow market makers to execute an order based upon the investor's best execution needs.

As with market participants, we believe that competition should be permitted to flourish among market centers. Adoption of this rule will permit the CSE to complete more fairly with other market centers.

ECN Access Fees[xiv] Inhibit Transparency and Promote an Unlevel Playing Field

The National Market System goals encourage fair competition among and between markets. Vigorous competition between market centers ensure that the best ideas flourish and develop. If rules are fairly applied, healthy competition and the free market system will reward the best ideas. Such competition will further reduce transaction costs and cause firms to offer other value-added services to the benefit of investors. However, if rules treat some market participants differently than others, distortions in the market and unfairness result.

The privileged ability of ECNs to charge access fees is another case of an unlevel playing field in the securities industry. ECNs are allowed, due to a footnote in the Order Handling Rules,[xv] to charge fees for accessing the liquidity in their systems. In contrast, Knight and other dealers are prohibited from charging such fees. By allowing only one segment of the market to charge a fee, competition is hampered and investors lose out.

The National Market System also encourages best execution of orders. A market maker is faced with best execution obligations, which may require it to take liquidity from an ECN's system to provide the "best" price for the investor. The fees charged by ECNs are priced in sub-pennies and typically range from about $0.0025 to $0.009 per share, resulting in significant costs for market participants that must access the quote. This means that if an investor were to purchase a security quoted at $10.95, the actual price of that security if purchased by a market maker would be $10.95, but if purchased through an ECN's system, the actual price of the security may be anywhere from $10.9525 to $10.959.

There is one positive development in regard to ECN access fees. The Nasdaq recently filed a proposed rule change that would establish a maximum ECN access fee in its SuperMontage system.[xvi] As mentioned earlier, the level of ECN fees can vary significantly, making it difficult for a market maker to know the costs they will incur when interacting with an ECN quote. The Nasdaq proposal is a good first step and would help to reduce the disparity in the level of ECN access fees; however, this is only a partial solution to the problem. The issues of fairness and transparency of prices still remain. In addition, other market centers have not placed limits on these fees, thus maintaining an inconsistency of rules across markets relating to the fee levels.

We believe in competition. Competition among the various liquidity pools has in the past and, we believe, will continue to assure that access fees charged to firms that determine to route orders to them are reasonable. The same cannot be said of ECN access fees charged through Nasdaq's SuperMontage precisely because no competition with respect to access fees is permitted. The only competition permitted within SuperMontage is with the price, time and size of quotations. Access fees do not fit into the equation. An appropriate analogy would be if a broker on an exchange floor who had the best bid in the crowd charged another broker who traded with him an access fee. The exchange auction could not operate effectively in this way, nor can Nasdaq.

Sub-penny Quotations

The implementation of decimals has significantly impacted the market. For example, academic studies have shown that individual investors may have benefited from the narrowing of spreads,[xvii] but some studies have also shown that trading costs for mutual funds – in which the majority of Americans are invested – have actually increased.[xviii] This is the result of liquidity dispersed across 100 price points rather than sixteen or eight, thus making sourcing of liquidity difficult.

I strongly urge the Commission and Congress to hold the line on sub-penny quoting and go back to pennies . Here is what I mean.

We are now seeing a shift from decimals to sub-decimals. Securities, particularly Nasdaq, are currently being traded not in 100 increments, but in 1000 price points per dollar, or sub-pennies. The effect is greater diffusion of quotes, resulting in less liquidity and transparency for investors. This reduces the efficiency of our capital markets and renders some rules, such as the short sale more complicated. As I mentioned earlier, liquidity is absolutely necessary for well-functioning markets. Sub-penny trading quite simply degrades the ability to access liquidity for our investor clients. Additionally, it allows some market participants to “step ahead” of investor orders by fractions of a penny. This clearly serves to erode investor confidence, particularly when their orders remain unexecuted in the face of executions occurring within “mils” of their desired price.

Sub-penny increments have also greatly increased quote traffic, straining the technological systems of the market and its participants. A recent study shows that when compared to a pre-decimal period (March/April 2001), Nasdaq quote traffic in the same post-decimal period (April 2003) jumped about two hundred-sixty (260%) percent, during a period when trade volumes were declining. This means that the number of quotes per trade dramatically increased due to the move to 100 price points, thereby resulting in substantial strain on the technological systems. Sub-penny quoting will further degrade the market and increase quoting activity across a thousand price points.

Let me be very clear – we are not talking about going to nickels. We are instead talking about going back to pennies. In its July 23, 2001, request for comments, the SEC staff acknowledged, "there may be a point at which the incremental costs of reducing the MPV exceed the incremental benefits."[xix] I respectfully submit that the negative effects of sub-penny trading has far exceeded any possible associated benefit. We should not further erode the usefulness of the NBBO by permitting the infestation of sub-penny trading. Rather, the SEC should continue its efforts to insure that we maintain the highest possible standards of execution quality, and that individual investors have complete access to the market.

Locked and Crossed Markets Impact Best Execution and Cause Inefficient Trade Executions

Access fees, a lack of adequate intermarket linkages and the increase in trading of Nasdaq stocks pursuant to UTPs have contributed to a raft of locked and crossed markets, particularly during the open and closing markets. Locked and crossed markets cause substantial confusion in the marketplace because these conditions give the appearance of irrationality. A locked market is one where the bid and ask are equal. In a crossed market, the bid is higher than the offer, making it appear that buyers are willing to pay more for the security than they are willing to sell. In a locked market situation, the best bid and ask are the same; so a trade should occur. But because of ECN access fees or inefficient ITS linkages the trades do not occur, and investors miss out on an opportunity to buy or sell securities.

Locked and crossed markets used to be unusual but are now common occurrences. While lowering spreads for investors is positive, locked or crossed markets result in confusion and slower execution of investor orders. If trade executions are delayed for an investor, the market may move in an adverse direction for the investor after the market is unlocked. Regardless of market moves, slowing executions hampers best execution.

The SEC does not have rules applying to all markets that would address locked and crossed markets. NASD Rule 4613(e) governs such market events for trades on the Nasdaq Stock Market. However, other markets that quote Nasdaq securities pursuant to UTPs do not have rules that address the situation, resulting in further inconsistencies in the marketplace even when trading the same stock.

Again, we believe that there needs to be consistently applied rules across all exchanges to deal with this market structure issue. For example, the SEC should require all market participants to first attempt to trade with posted quotes and displayed orders before locking the market. By doing so, we believe that the incidents of locked markets will be substantially reduced.

Conclusion

Knight has always believed competition is best for the markets and investors. Competition fosters creativity and innovation. But a lack of clarity for rules can lead to less appetite for innovation and technological development due to regulatory uncertainty. At times we have been caught between inconsistent rules, resulting in confusion, wasted time and energy. At Knight we believe in our team and technologies. We have no doubt in our ability to compete with others in the marketplace. But for us to make proper business decisions, we need certainty and fairness in the rules.

It is important to emphasize that market structure is not merely an esoteric issue that only affects Wall Street firms. These issues impact the costs investors must incur and ultimately the capital formation process critical for the growth and development of large and small companies. Vibrant US equity markets will ensure that successful companies of all sizes are provided with the necessary liquidity and access to capital necessary for their growth. Sub-penny pricing, ECN access fees and inconsistently applied rules and the resultant locked and crossed markets should be addressed to ensure liquidity does not dry up, which would have a particularly negative impact on small- and mid-cap companies.

Chairman Donaldson, Commissioner Atkins, Commissioner Glassman, Commissioner Goldschmid, Commissioner Campos, as well as former Chairmen Levitt and Pitt, have all made statements about the importance of addressing market structure. This demonstrates that market structure issues have been lingering for years, only to now reach a critical point. I applaud Chairman Donaldson for his recent comments before the Senate Subcommittee on Securities and Investment regarding his desire to move the process forward. Spending additional months and years examining the issues would only serve to hinder the capital formation process and the maintenance of fair and orderly markets.

I ask the Congress, in exercising its oversight responsibilities, to ensure that that the Commission acts swiftly to address these critical market structure issues. Inaction is a decision to do nothing. Instead, the SEC must act by beginning a rulemaking process for each issue. Promptly addressing these issues will serve to support the capital formation process and ultimately benefit investors.

Endnotes

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[i] Harris, Larry, Trading & Exchanges: Market Microstructure for Practitioners, Oxford University Press, 2003, pg. 394. He states, "Liquidity is the ability to trade large size quickly, at low cost, when you want to trade. It is the most important characteristic of well-functioning markets. Everyone likes liquidity. Traders like liquidity because it allows them to implement their trading strategies cheaply. Exchanges like liquidity because it attracts traders to their markets. Regulators like liquidity because liquid markets are often less volatile than illiquid ones… impatient traders take liquidity. Dealers, limit order traders, and some speculators offer liquidity. Brokers and exchanges organize liquidity."

[ii] Ibid, pg. 401.

[iii] Ibid, pg. 400. Mr. Harris identifies liquidity-offering traders as market makers, block dealers, buy-side institutions, or individual investors.

[iv] Securities Exchange Act of 1934:

> Section 11A(a)(1) The Congress finds that –
>
> (A) The securities markets are an important national asset which must be preserved and strengthened
>
> (B) New data processing and communications techniques create the opportunity for more efficient and effective market operations.
>
> (C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure-
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> > i) Economically efficient execution of securities transactions;
> >
> > ii) Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
> >
> > iii) The availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
> >
> > iv) The practicability of brokers executing investors' orders in the best market; and
> >
> > v) An opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.
>
> (D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

(2) The Commission is directed, therefore, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under this title to facilitate the establishment of a national market system for securities (which may include subsystems for particular types of securities with unique trading characteristics) in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection. The Commission, by rule, shall designate the securities or classes of securities qualified for trading in the national market system from among securities other than exempted securities. (Securities or classes of securities so designated [are] hereinafter in this section referred to as "qualified securities".)"

[v] The Intermarket Trading System ("ITS") was developed pursuant to Section 11A of the Securities Act Amendments of 1975, which mandated the SEC to oversee the development of a national market system. The ITS is an order routing system that links all eight US exchanges and Nasdaq in order to assist in the intermarket trading of exchange-listed securities. One significant problem with ITS operations is the

inability of some participants to allow for automatic execution, diminishing the value of the intermarket linkage system for those with auto-ex capabilities.

[vi] Speech by SEC Commissioner Paul Atkins before the American Enterprise Institute, Washington, DC, May 7, 2003.

[vii] Speech by SEC Chairman Arthur Levitt, "Best Execution: Promise of Integrity, Guardian of Competition," before the Securities Industry Association, Boca Raton, Florida, November 4, 1999.

[viii] Securities Exchange Act Release No. 34-43590 (November 17, 2000), 65 FR 75414 ("Adopting Release).

[ix] Ibid.

[x] Pub.L. 94-29 (Section 11A, Securities Exchange Act of 1934).

[xi] http://www.sec.gov/news/press/2003-140.htm

[xii] The "bid test" prohibits selling a stock short if bid for the stock is lower than the previous inside bid. Currently the Nasdaq has a bid test short-sale rule, while the "tick test" applies to the New York Stock Exchange and the American Stock Exchange, while another exchange does not have rules governing short sales.

[xiii] Securities Exchange Act of 1934, Section 11A(a)(1)(D)

[xiv] Electronic communication network (ECN) access fees are fees paid to the ECN when interacting with orders placed on its system. Other market participants are currently not permitted to impose fees for similar access to orders on their systems. Footnote number 272 of the Order Handling Rules adopted by the SEC on September 12, 1996, allow ECNs (but not broker-dealers) to impose fees to access the liquidity in their systems. The footnote reads in its entirety:

> "For access to be "equivalent", the ECN must enable non-subscribing broker-dealers to execute against the ECN's published best price to the same extent as would be possible had that best price been reflected in the public quote of a specialist or market maker. The ECN, however, may impose charges for access to its system, similar to the communications and systems charges imposed by various markets, if not structured to discourage access by non-subscriber broker-dealers."

[xv] Securities Exchange Commission Release No. 34-37619A (September 6, 1996), Federal Register 48290 (September 12, 1996) ("Order Handling Rules").

[xvi] Securities and Exchange Commission Release No. 34-48501, File No. SR-NASD-2003-128, "Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by the National Association of Securities Dealers, Inc. Relating to Establishing a Maximum ECN Access Fees in SuperMontage and Elimination of SuperMontage's Price/Time With Fee Consideration and Price/Size Execution Algorithms," Federal Register 56358 (September 17, 2003).

[xvii] Goldstein, Michael A. and Kavajecz, Kenneth A., "Eighths, Sixteenths and Market Depth: Changes in Tick Size and Liquidity Provision on the NYSE, " September 16, 1998; Jones, Charles M., and Lipson,

Marc L., "Sixteenths: direct evidence on institutional execution costs," February 2000; Sugato Chakravarty, Venkatesh Panchapagesan, and Robert A Wood, " Institutional Trading Patters and Price Impact Around Decimalization," December 2001; Sugato Chakravarty, Robert A Wood, and Stephen P. Harris, "Decimal Trading and Market Impact," January 10, 2002; Bourghelle, David and Declerck, Fany, "Why Markets should not Necessarily Reduce the Tick Size," October 2002.

[xviii] Bollen, Nicolas P.B. and Busse, Jeffrey A., "Common Cents" Tick Size, Trading Costs, and Mutual Fund Performance," May 2003. The study examined mutual fund trading cost changes after reductions in tick sizes in the US equity markets. It compared trading costs before and after the switch to sixteenths and decimals. The authors estimated the change in trading costs of mutual funds by inferring trading activity from changes in quarterly-reported portfolio holdings, adjusting this benchmark to account for the actual cash holdings and expense ratios of the funds. The report focused on individual funds invested predominantly in US stocks with at least 90% of their assets in equities. The findings concluded that the average change in trading costs after the switch to sixteenths was not statistically significant. However, the study finds trading cost increases of 1.367% of fund assets after the switch to decimals. Additionally, it reported no evidence of reduced trading costs after the first half of the period following decimalization.

[xix] Securities Exchange Commission Concept Release No. 34-44568, File No. S7-14-01, "Request for Comment on the Effects of Decimal Trading in Subpennies," July 18, 2001.