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Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
Of the House Financial Services Committee

Field Hearing:
Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace

Chairman Baker, Ranking member Kanjorski and members of the Subcommittee, thank you for inviting me to testify before you today in New York. As a New York-based company, The NASDAQ Stock Market is proud to be an integral part of the capital market system in the financial capital of the world.

The purpose of this hearing is to explore what the role of the specialist should be in the evolving modern marketplace. I would argue that the market is already answering that question today, as witnessed by the evolution of NASDAQ, the growth of electronic communication networks (ECNs), and by the fact that my colleague at the New York Stock Exchange (NYSE) is contemplating major structural changes designed to inject some electronic trading into the NYSE's market.

The role of the specialist is diminishing today because investors are demanding faster executions, they are demanding to trade more efficiently and with greater certainty and, consequently, they are achieving better results for themselves and their clients. These investors include many more Americans than was the case even a generation ago. Today, even Americans with limited incomes have 401k accounts at Fidelity, open Individual Retirement Accounts, or receive stock options at work. As more Americans invest their money in the market, American markets are becoming open to greater scrutiny and therefore must be transparent and demonstrate better results. Electronic markets offer these qualities; today's specialist system is based upon an 18th century model that cannot serve today's investor.

Moreover, listed companies are increasingly seeing the benefits of added liquidity which come from electronic trading. Many major corporations have chosen to list their stocks on NASDAQ, and others are beginning to reconsider their market choice in order to take advantage of greater electronic trading.

Specialists in a floor-based system trade slower than electronic markets, they deny investors access to critical market data, and they maintain a monopoly in the trading of individual stocks. It is no wonder that all other major markets worldwide (except of course the NYSE and the American Stock Exchange) have abandoned floor-based systems for electronic markets.

At NASDAQ, we are offering an alternative to the specialists by encouraging competition in the listed company marketplace through our dual listing program and by competing for transactions of NYSE-listed stocks. If you really want to see what the role of the specialists should be in the marketplace, support NASDAQ's dual listing program and repeal the Trade Through rule. These steps will inject competition into the specialist's marketplace, and will enable markets and investors, not monopolists and regulators, to answer that question.

But to offer my opinion, the answer to the question posed for this hearing is that the role of the specialist, as it now exists, will come to an end; it is inevitable as sure as cars replaced horse-drawn carriages.

How NASDAQ operates versus how specialists at the NYSE operate

The evolutionary track of the American capital markets can be seen today at NASDAQ. NASDAQ is not a market floor; it exists in cyberspace. NASDAQ does not grant a specialist a monopoly to trade a company's stock; NASDAQ employs competing specialists, called market makers, electronic order routing technologies called ECNs and direct access brokerage firms to vie with one another for executions by electronically entering customer orders. Every stock has at least three market makers who commit their own capital and maintain a market by providing buy and sell orders, and some stocks may have forty or more market makers. Buying and selling takes place in milliseconds.

NASDAQ offers a dynamic and competitive environment where all market participants view quotes and transactions simultaneously in real-time. NASDAQ ties together all interested market participants; it does not limit trading to an elite few. NASDAQ is the democratization of the marketplace.

NASDAQ is the embodiment of competition and free markets. NASDAQ participants compete for every listing, every quote, every execution, and every trade report, and we feel other markets should do so as well. 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. If our market makers are not needed to help with the execution of an order, we provide the electronic venue where buyers and sellers can meet at low cost, high speed, and without the knowledge of any unneeded intermediary. NASDAQ's market structure promotes efficiency, and market quality statistics mandated by the SEC bear this out.

This is in stark contrast to the current floor-based system at the NYSE. The floor-based private clubs hoard information. All orders flow to a single specialist for a stock. The only participants with real time views of buy and sell interest are the specialists. Other participants are relegated to less transparent, sometimes questionable, information streams. This lack of uniform transparency undermines investor confidence and is evidenced by investigations into specialists "stepping ahead" of customer orders and a host of other occurrences with equally disturbing names like "penny-jumping," "holding up cancel requests," and "matching the public." The shared flaw in all these manipulations is that the specialists have non-public material information about the trading characteristics of their assigned stock. Investors are at their mercy.

When trading does occur, a live auction can take 30 seconds or more. In that time, a stock may change price hundreds of times on an electronic market.

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 investors. 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 the Trade Through rule requires the orders to get routed to a specialist. But, in a decimalized environment, the specialist can no longer offer significant price improvement opportunities. A 30-second interruption of trading is not justified for the potential of a one-cent improvement in price.

In this regard, it is important to highlight that each price point in the equity market has a total number of shares that are available to trade. If Wal-Mart advertised that it was selling Coke at 99 cents but stated there were only five hundred bottles available at that price, recognizing how busy Wal-Mart is on a Saturday afternoon you would realize that by the time you traveled to Wal-Mart it would be unlikely that you would be able to purchase the Coke for 99 cents. The average trade size on the NYSE is five hundred shares.

What our colleagues from the NYSE are asking for is a continuation of a practice where their specialists have the ability to stop the advancement of the U.S. equity markets because their specialists might advertise, without a commitment to trade, at a certain price. If the specialist, in his discretion, is willing to trade at that advertised price, he can limit that commitment to one hundred shares. If at a point in time there were advantages to the monopolistic manual methods of the specialist system, they have no claim on our future.

Finally, some have raised a false dichotomy between the floor-based monopoly specialist model and electronic markets. For most enterprises, automation is used to improve operations, but it does not replace the value added by humans. The NASDAQ business model represents the best of man and machine. We use an electronic market when it offers a less expensive, faster, more transparent and more consistent forum for investors to trade stocks.

The NASDAQ market model utilizes market makers when people and capital can add true value to investors. In addition to market makers, our market employs hundreds, even thousands, of skilled professionals who engage in activities such as: innovating and improving the services offered to investors; constructing legal safeguards to protect investors and listed companies; and monitoring and interpreting trading data to ensure compliance with the rules. In the State of New York, NASDAQ and its corporate parent the NASD collectively employ 509 people, and an additional 2,500 people work directly in the NASDAQ listed trading community.

At NASDAQ, humans do what humans do best and machines do what machines do best.

Why Repeal the Trade Through Rule

The SEC is now considering changes to the Trade Through rule as part of its market structure reform effort. In the era before fully electronic markets and lightning-fast efficient linkages, the SEC mandated the Trade Through rule 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.

But the Trade Through rule is an anachronism today, and we believe that it should be repealed. NASDAQ has thrived without a Trade Through rule, and the SEC has already acknowledged the shortcomings of the Trade Through rule by exempting the trading of the largest Exchange Traded Funds (ETFs) QQQ, Spiders and Diamonds – among the most heavily traded stocks in the world – from the strict requirements of the rule. The pilot program has been successful.

This issue is relevant to today's hearing because repeal of the Trade Through rule will enable the marketplace to decide the role of the specialist by requiring them to compete. As CEO of NASDAQ, I know that the structure and operation of the NASDAQ Stock Market is the best in the world. I support the pro-competition policies in place at NASDAQ, and I yearn for the opportunity to compete on a fair and even playing field with the NYSE and the American Stock Exchange. The SEC does not need to outlaw specialists for competition to bloom, but specialists should be stripped of their exclusive trading privileges and forced to compete with alternative models. By abolishing the Trade Through rule, the specialist would be forced to compete just like NASDAQ, the ECNs and market makers.

Therefore, the repeal of the Trade Through rule would inject competition into the specialist's world; it would not eliminate the specialist. Specialists will continue to operate at the NYSE so long as they can add value. If so, as they so ardently claim today, this policy change will not harm them, as investors would continue to send order flow to them. <u>Investors</u> will choose whether they add value or not and will use them accordingly.

This brings us to the most important aspect of Trade Through repeal – investors would benefit from having choice and from the innovation and improvements that competition will unleash, just as they have in the NASDAQ market space with tighter spreads, great liquidity, faster execution times and better fills rates.

Investors are no longer homogenous. Investors have different needs. Investors want the freedom to choose the certainty of faster markets or the minimal market impact of 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 or to market makers willing to compete with specialists, it would force specialists to compete for orders by, among other things, narrowing their spreads and executing trades faster.

There is no mystery to what happens to markets when Trade Through is eliminated. NASDAQ is the laboratory with documented superior results. 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 than NASDAQ listed stocks.

- According to the most recent Dash 5 data, the effective spreads for S&P 500 stocks traded on NASDAQ are 1.21 cents. For the NYSE, the effective spread is 1.76 cents.

- The average execution speed for S&P 500 stocks on NASDAQ is 6.7 seconds. For the NYSE the average execution speed is 18.4 seconds.

- The percentage of S&P 500 shares executed at or inside the quote at NASDAQ is 91.1%. That is far better than at the NYSE, where the percentage of shares executed at or inside the quote is only 82.4%.[1]

The move to decimalization has highlighted the benefits of electronic trading as detailed in the Dash-5 statistics. 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. Actively traded stocks today have a one-penny or two-penny spread. The effective spread for Microsoft is only seven-tenths of a penny. In such an environment, the only purpose of the auction on the NYSE floor is to provide the specialist the time to gain advantage from the information in the investors' orders.

To use a real world example, consumers sometimes prefer to pay a little extra for a gallon of milk at the convenience store around the corner rather than travel a couple of miles for cheaper milk at the supermarket. The same principle 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 at an acceptable price. But they can't do this today because of Trade Through. They have to trade at the pace of the slowest market – the floor-based exchange. If Trade Through were repealed, investors would still be able to choose the best advertised price. They get to choose whether they want to drive a little further for that gallon of milk.

Clearly, now is the time for reform of the Trade Through rule. 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

[1] Source for all data is SEC Rule 11Ac1-5 data, November 2003 marketable orders, provided by Market Systems, Inc. See SEC Release No. 34-43590; File No. S7-16-00 (November 17, 2000).

needs." The SEC should let investors decide what they need, avoid the appearance that they favor one market over others, and promote competition.

Dual Listing and Trade Through

While repeal of the Trade Through rule would enable competition for NYSE-listed stocks, NASDAQ already has embarked on a campaign to compete with the NYSE specialists for listings. On January 12, 2004 NASDAQ announced that six companies listed on the NYSE – Apache, Cadence Design Systems, Charles Schwab, Countrywide Financial, Hewlett-Packard, and Walgreens – have agreed to be dual listed on the NASDAQ market. This announcement represents an exciting and proper evolution for competition between primary market centers.

As many do not know, NASDAQ currently trades all NYSE listings through the intermarket trading system; and we have 13 percent share of NYSE volume. With dual listing, we hope to prove to these companies that the NASDAQ structure is better. As long as Trade Through stands as a barrier to trading, however, these outcomes could be limited.

As Sean Harrigan, President of the California Public Employees' Retirement System (CalPERS) Board of Administration said after the announcement of dual listing, "This is an excellent market response to the debate over the specialist system versus an automated system. I believe investors will benefit from this competition by seeing improved liquidity, better execution, and greater transparency. I would encourage other CEOs and their Boards to examine the option of dual listing on both exchanges. It is our hope that the regulatory authorities will further improve the efficiency of the markets by eliminating the trade-through rule."[2]

Languishing NASDAQ Exchange Status an Impediment to Competition

Finally, I want to discuss one unresolved issue critical to fair treatment and competition. For over three years NASDAQ has awaited word from the SEC on our application to become an exchange. As an exchange, NASDAQ would have a legal structure that companies considering their listing decision could not question. Currently, NASDAQ is frozen in a partially separated structure that does not remove all conflicting roles from our governance structure. Most importantly, our regulator the NASD would be completely separated from our market by approving exchange registration.

NASDAQ is not a startup entity. We trade more shares everyday than any market in the world. We diligently protect investors. Our rules are fair and unbiased – and SEC approved. We should be granted exchange status.

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[2] Press release, "CalPERS issues statement on dual NYSE/NASDAQ listing of companies," Sean Harrigan, President of the California Public Employees' Retirement System Board of Administration, January 14, 2004.

Of course, NASDAQ is committed to working with the SEC to ensure that the application fully reflects the intentions of Congress and the requirements of the securities laws.

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Thank you again for this opportunity to testify. I am happy to answer your questions.