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The SEC Proposal on Market Structure

Thank you Chairman Baker, Ranking Member Kanjorski, and members of the Committee for the opportunity to present to you this afternoon my views on reform of US market-structure regulation.

Although the SEC's proposed "Regulation NMS" covers a wide range of important issues related to market linkages, access fees, and market data, I will confine my brief, prepared remarks to the specific matter of the "trade-through rule," changes in which have the greatest potential to improve the ability of our securities markets to service investors.

Although the idea of having a simple, market-wide rule to ensure that investors always have access to the "best price" is an attractive one, in practice the trade-through rule has operated to force investor orders down to the floor of the New York Stock Exchange, irrespective of investors' wishes. The rule therefore operates to discourage free and open competition among marketplaces and market structures; the type of free and open competition which has in Europe produced a new global standard for best-practice both in trading technology and exchange governance. The trade-through rule should therefore be eliminated, as it serves neither to protect investors nor to encourage vital innovation in our marketplace.

Those who support the maintenance of some form of trade-through rule, most notably the New York Stock Exchange, have raised five main arguments in its defense. The most effective way to illustrate why the rule is undesirable is to address each of these directly.

1. "Why should *speed* be more important than *price*?"

According to this view, the whole debate is about whether traders should be allowed to sacrifice best-price in the pursuit of speed. But the notion that investors would ever sacrifice price for "speed" is nonsensical. In the marketplace, it is *always* about price. It is about the *price for the number of shares the trader wants to trade*, not just the 100 shares advertised on the floor of the NYSE, and it is about the *price that is really there when the trader wants to trade*. Statistics from competing marketplaces about fill rates, response times, and the like make very nice input into a trader's decision, but they are not substitutes for a decision.

2. ". . . but the rule is necessary to protect market orders!"

The normal fiduciary principle says that "the agent must act in the customer's interests." But the trade-through rule says that "the agent must *ignore* the customer's interests." In other words, to eliminate any possibility that a broker may abuse his discretion, regulators should forbid not only his discretion but his *customer's*. This cannot be sensible.

To illustrate, an investor may wish to buy 10,000 shares at $20 a share, done at a key stroke on market *x*. The trade-through rule, however, would oblige that investor instead to buy 100 shares at $19.99 at the New York Stock Exchange and then submit to a floor auction there, so that Exchange members on the floor may profit from knowledge of his desire to buy many more shares.

Tellingly, the same people who insist that brokers will abuse discretion, or that their customers should not be entitled to it, will defend to the death the right of *specialists* to use discretion. This view, curiously, is entirely unburdened by knowledge of the $241.8 million in fines paid by five of the seven NYSE specialist firms for improper discretionary trading.

3. ". . . but the rule is necessary to protect limit orders!"

According to this argument, it is not the market orders that have to be protected, but rather 100-share limit orders. But this is a strange principle for the NYSE to defend, given that the floor could not even *exist* were it not for the ability of specialists and floor brokers to trade in front of limit orders. Indeed, the most frequent complaint of institutional investors about trading on the floor is precisely the fact that limit orders are revealed to the crowd, who are then allowed to use that information to trade in front of them.

In a marketplace, Mr. Chairman, it takes *two* to trade. The fellow who puts down a limit order in market *x* has no moral standing over the gal who sees a better package deal in market *y*. Appeals to "fairness" favor neither one over the other.

4. " . . . but if limit orders are traded through, no one will place them!"

If limit orders are traded through on market *x*, they just won't be placed *on market x*. They will move to market *y*, where they won't get traded through.

5. ". . . but a fair compromise is to have a trade-through rule among 'fast' markets."

The NYSE has stated repeatedly that in the "fast" Exchange of the future there *must* be a role for the floor auction. To be clear, this means that the NYSE will only be "fast" for as few shares as the SEC will let them get away with.

So to go back to the example of an investor wanting to buy 10,000 shares available on market *x* at $20 a share, if the NYSE is designated a "fast" market it means only that the NYSE might sell him a fast few hundred shares at $19.99, but then – just like old times, Mr. Chairman – the Exchange will force him into a floor auction.

More fundamentally, do we really want the government to be in the business of determining which markets are "fast" enough for all investors, now and in the future, and doling out protection from competition on that basis? My judgment is that we do not.

To conclude, I do not believe that any of these arguments for a trade-through rule are compelling. Moreover, the rule is not even enforced at present against its leading supporter and only systematic violator, the New York Stock Exchange, which trades through other markets hundreds, even thousands of times a day. Since the SEC is silent on the question of how the rule will actually be enforced in the future, it must be assumed that if perpetuated it will continue to operate solely to force investors to trade on the New York Stock Exchange even if they desire to do otherwise.

The SEC should, of course, be concerned to see that intermediaries do not abuse their discretion in handling investor orders. But given that the focus of recent SEC disciplinary action has been improper discretionary trading by *specialists*, it cannot be in the interests of investors to oblige them to trade with specialists if they do not wish to. After all, the SEC emphasizes in its proposal that a trade-through rule "in no way alters or lessens a broker-dealer's duty to achieve best execution for its customers' orders." If this is truly the case, Mr. Chairman, then a trade-through rule is neither necessary nor desirable.

I thank you again for the opportunity to testify this afternoon, and I look forward to assisting your deliberations in any way possible.