

## **Outline of Testimony**

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### **Concerning Proposed Regulation NMS Before the US Securities and Exchange Commission**

**April 21, 2004**

#### **1. General Opening Statement.**

Given the magnitude and complexity of the Commission's proposals, I believe a bit of synthesis will help to define the debate. Ultimately, the underpinnings of many of the Commission's proposals concern the value and uses of quotation information, in particular, the NBBO. The past several years have seen a dramatic rise in market centers either refusing to trade with each other or being rendered unable to trade with each other. The alarming rise in locked and crossed markets in Nasdaq stocks and the continuing incidents of trade-throughs in listed stocks provides the Commission with compelling reasons to address the standards, rules and protocols around access to the quotations of competing market centers.

Although the Commission has articulated many factors that a broker can consider when seeking best execution, Knight maintains that proximity to the NBBO (as measured by Rule 11Ac1-5, SRO execution reports cards and similar information) has, in practice, become the primary factor used to measure execution quality in the marketplace. We believe that market forces through appropriate disclosures, including those measured by Rule 11Ac1-5, rather than regulation, is the best determinant of execution quality. We contend that the consolidated NBBO, which includes quotations from ATSS that charge widely differing fees for access and UTP exchanges with floor based models that are simply inaccessible from off the floor, is misleading and not a realistic benchmark for judging best execution. Since current rules and interpretations do not distinguish between quotes that are accessible quickly and cheaply from those quotes that are not, broker-

dealers are forced to deal with market centers that exploit the current situation, bringing the entire market-place to the lowest common denominator.

In order to address these issues and restore the NBBO as a realistic benchmark for assessing execution quality, we feel the Commission must address two core issues: (i) access fees charged by quoting market centers, quoting market participants, broker-dealers with attributed quotes, and (ii) inadequate access to posted quotations. Only after addressing these baseline structural impediments should the Commission assess the need for a market wide application of the trade-through rule to the Nasdaq marketplace.

## **2. Access Fees -- Why not simply eliminate them.**

Historically, ECNs were allowed to charge access fees by regulatory fiat, through a footnote in the Order Handling Rules. Although access fees were initially intended to permit ECNs to, “impose charges...similar to the communications and systems charges imposed by various markets...,” they quickly became a revenue stream for many ECNs. Indeed, they became the sole source of profit generation for many ECNs. However, following decimalization, market-makers ability to profit by capturing spread was diminished substantially. In addition, the SEC staff is now challenging whether market-makers should be able to capture spread under a number of typical trading scenarios. These changes to market conditions have lead Knight to further question the viability of access fees altogether, and to unevenness of the playing field between ECNs and market makers.

Knight supports the Commission’s efforts to address the distortions that access fees cause in the market. However, our preferred solution to the problem would be different. It is important to distinguish between access fees charged by a market to its members and subscribers from access fees charged to “non-subscribers.” When a firm determines to send an order to a market of which it is a member or subscriber, it has made an affirmative determination to route the order to that market and pay the relevant access fee. In reality, many of these markets are simply buying order flow by paying firms to place limit orders in their market and then charging others excessive “non-subscribers” access fees when they are forced to access those quotes.

ECNs have long argued that eliminating interdealer access fees will destroy their economic model. That argument does not bear out under close scrutiny. Exchanges have for years permitted their specialists to charge members when the specialist is given a limit order to represent on the book. The specialist is performing a brokerage function and is entitled to be paid for it. Members that seek to access that quotation are not charged by the specialist because it is not performing any brokerage function with respect to that order. Moreover, an access fee imposed on a person lifting a quote distorts the accuracy of quotations. The same is true of ECNs. There is no reason why they cannot survive with that model. If their economic model is to buy order flow and then impose exorbitant access fees through a contract of adhesion, then perhaps they should rethink that model.

#### **SEC Access Fee Proposal.**

We would prefer to eliminate access fees entirely. If the Commission is unwilling to take that step, Knight believes that the Commission's proposal is a positive first step in addressing this issue. Under current SEC interpretations, ECNs are permitted to impose access fees and market makers are not. This creates an uneven playing field. The Commission's proposal would end this inequality by permitting all market participants to charge a very small access fee of one tenth of a cent. The proposal also attempts to rationalize and allocate permissibility of charging access fees based on quote interaction by market centers, market participants, and broker-dealers as stated. Knight applauds the Commission's initial efforts to develop a comprehensive solution to the issues we have identified.

The current proposal has a number of technical inconsistencies which Knight will more specifically address in our formal comment letter.

## **TOM JOYCE TESTIMONY ON SUB-PENNY PRICING**

### **1. General Opening Statement.**

Within the last six years our industry has gone through a wholesale transition, moving first from trading in eighths to sixteenths and then from sixteenths to pennies. Now there are cries from some market participants to move to even smaller increments. Knight believes it is time to assess the situation and determine who has benefited from these changes and who has been hurt, and whether the markets as a whole are better. Let us remember that the individual investor, not the speculator, arbitrageur or day trader, is the core that makes our markets strong and liquid and must at all costs be protected.

Knight believes that the change from eighths to sixteenths dramatically reduced spreads and increased competition. Customers clearly benefited from this change although market makers such as Knight saw their spreads and profitability narrow. The change to pennies is far less clear. Although pennies have caused spreads to narrow further in some stocks, there have been a variety of negative affects. First, sub-penny quoting fails to promote the fair and orderly functioning of markets that the Securities Act Amendments of 1975 encourages. The result is proliferation of price points and diminished depth of market. This has resulted in more transactions required to complete an order. Consequently, processing and technology costs are rapidly increasing. As a result, these costs will ultimately be passed on to the investor. The NBBO has far less depth than before and is less useful as a tool for determining real price. It is now necessary to view prices several levels away from the NBBO to get a true picture of the market. Second, penny pricing has created an environment where quotes may exist for only a second or two and cannot therefore be readily accessed. Third, sub-penny pricing will cause another round of capital investment in order to accommodate the increased quote traffic that has resulted. Fourth, and most importantly, penny pricing has made it economically easier for market professionals to step ahead of customer orders, disadvantaging the investing public. Research by the SEC's Office of Economic Analyses (OEA) concludes that sub-penny trades often cluster around the \$0.01 and \$0.009 price points, indicating that some participants use sub-penny quoting in order to

step ahead of limit orders.<sup>1</sup> This is not the type of market behavior that should be encouraged. This activity instead serves to erode investor confidence, particularly when orders remain unexecuted due to executions occurring within sub-pennies of their desired price. Bill Christie, the economist who first identified quote anomalies in Nasdaq and who has historically been a supporter of penny pricing, recently wrote an editorial arguing for a return to nickel pricing. His theory is simple. Customers are harmed by penny pricing because the fundamental tenet of time priority has been nullified by market professionals stepping ahead of customer orders.

While it might be perceived as self serving for Knight to argue for a move to nickels, we certainly believe that a move to sub-pennies would be counterproductive.

## **2. Sub-Pennies in ETFs**

Although we believe there is general agreement that a move to sub-pennies would do more harm than good, certain commentators have suggested that the market for actively traded ETFs should move to sub-pennies. Knight disagrees. First, these ETFs are hardly low priced stocks. The S&P ETFs trades at over \$110 and the Nasdaq ETFs trades at over \$35. Secondly, let us remember who would benefit from this change. Surely not the investor. We see the move to include ETFs as no more than an intent to appease market professionals that arbitrage positions using sub-penny increments. We do not believe that this marginal benefit outweighs the negatives associated with sub-penny pricing. Allowing sub-penny quoting of ETF's does nothing to improve quality, efficiency or retail consumer's access to the product.

## **3. Securities Trading below \$1.00**

The Commission specifically requests comment on whether it is desirable to exclude those stocks trading below \$1.00 from the sub-penny quoting ban.

Knight believes that such delineation for low-priced securities may be appropriate to facilitate the execution of trades in these securities, if the exception is limited to securities trading at less that \$1.00. However, in such instances quotes should be limited to four decimal places to enhance efficiency.

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<sup>1</sup> Securities and Exchange Commission Release No. 34-49325 (February 26, 2004), 69 *Federal Register* 11170 (March 9, 2004).