FINAL VERSION

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Good Afternoon. I am delighted to be back at AEI and pleased to have the chance to talk with you today about our Nation's market structure. Looking across this full room, I recall those early and lonely days – only some five years ago – when Instinet and a firm it subsequently purchased - Island, tried to meet with almost anyone in Washington to talk about these market structure issues. Our enthusiasm and persistence drew blank stares. I fondly recall seeing one of my colleagues speaking enthusiastically to a senior Republican member of the Senate Banking Committee, and until at last the Senator interrupted him by saying, "Oh, you are the President of Island, I thought you said President of Ireland," at which point the conversation abruptly ended. Hopefully, we've come a long way since then.

More seriously, I believe that the work AEI has done over the past few years on the issues covered by Regulation NMS has been a valuable service to investors. Under Chris DeMuth's leadership, AEI has continued its critical role in defining and shaping strong public-policy recommendations, informed by serious academic study and practical experience. In particular, I applaud Peter Wallison's efforts to articulate how much is at stake in this debate and to lay out – in his usual clear and persuasive fashion – the right road to reform. I suppose it's not exactly a newsflash to confess that Peter and I are in violent agreement on most aspects of the Reg NMS debate. Peter, Jim Glassman, and others have reminded us of a core and central proposition: that is, unless there is compelling data showing a market failure, the most efficient results are achieved through competition rather than regulatory mandates.

This afternoon, I would like to spend a few minutes reviewing Instinet Group's position on the portion of Regulation NMS that has been receiving the most attention – the issue of the trade-through rule.

The basic philosophy behind our position then and now is that nobody knows what the best market structure is. Modesty in such circumstances is not only good public-policy, but the only way to proceed. Nobody knows how the markets should or actually will evolve. As a result, we need an equity market structure that allows different market models to compete and innovate. To get there, though, we must have a regulatory structure that promotes competition and innovation, not a structure that inhibits them. Over time, the marketplace itself will determine the most efficient market model and investors will reap the benefits.

One of the difficult things about this debate is that the costs of over-regulating and harming competition are impossible to calculate. Are our equity markets so successful because of, or in spite of, our current regulatory structure? I believe there are hidden costs to investors due to the current trade through rule. For example, when comparing NYSE and NASDAQ market volumes, the NYSE has companies with total market capitalizations approximately 4 times greater than the NASDAQ market. 93 of the S&P 100 stocks are NYSE companies. In short, the NYSE lists most of the companies that are household names. Yet on a share basis, the NASDAQ market

trades more shares nearly every day. And when you compare the dollar value of shares traded per day, the NYSE is only approximately 20% larger despite being four times the size of NASDAQ.* My belief is that NYSE volume is artificially low and that trading costs are unnecessarily high, due to regulatory barriers and operational inefficiencies caused by a lack of competition. How much does this cost investors every year? Nobody knows.

Over the course of five years coming to Washington to talk about the proper regulatory structure for our markets, I'm proud of the fact that Instinet has never asked anyone – from legislators, to regulators, to public policy experts -- to change how any other market operates. Instead, we've simply asked for the ability to compete on equal terms against all different types of market models. Given this basic premise, we have advocated the elimination of the trade through rule because it dictates how markets must operate and how investors must trade, inhibiting innovation and imposing hidden but possibly substantial costs on investors.

I find the debate regarding the trade-through rule to be very instructive as to how difficult it is to eliminate regulations that may be counter-productive. In looking at the SEC's most recent re-publication of Regulation NMS and comparing it to the original defenses of the trade through rule we heard a few years ago, there has been a shift in the debate. Initially, the chief rationale in defense of the trade through rule was that it was necessary to protect investors from inferior executions. In other words, without a trade through prohibition, unscrupulous brokers would execute investor orders at prices other than the best available price.

But when we said, "fine, let investors only knowingly opt-out of the trade through protections," the rationale for preserving the trade-through rule shifted. The latest rationale for continuation of the trade through prohibition is that it is necessary to encourage limit orders. So even if the person trading through does so knowingly, the act of trading through does harm to the market generally by discouraging limit orders. Limit orders, it is said, are the building blocks of our markets so the more protection there is for limit orders, the greater the liquidity in the marketplace.

I agree with the SEC and others who say that limit orders are critical to a strong marketplace. That is one reason why INET, the electronic marketplace part of my business, pays broker-dealers who post limit orders while charging customers who access this liquidity. In contrast, the NYSE actually charges for many types of limit orders and does not charge for market orders. Thus, while the NYSE proclaims the sanctity of limit orders, its very policies -- as reflected in its actions rather than rhetoric --undermine its own position.

But while I agree that limit orders are important, I don't believe that the adoption of a trade-through rule is going to lead to greater liquidity in the marketplace. Not only do I believe that liquidity will not be improved materially, but I believe that there will be substantial costs to innovation and competition that will far outweigh the benefits, if any, of a trade-through prohibition. While I or anyone else are certainly free to speculate on different outcomes, we actually do have real-life, ongoing evidence to test whether a trade through rule is necessary to promote the display of limit orders—it's called the market for NASDAQ-listed stocks.

Three major markets, INET, ARCA and NASDAQ all trade the same securities without a trade through rule. How often do they ignore better prices in each other's markets? Let's turn to the very study the SEC itself is using to justify KEEPING and EXPANDING the trade through rule. The SEC's Office of Economic Analysis examined 4 trading days in late 2003 and found that NASDAQ share volumes identified as trade-throughs were 1.9% of the volume if trade through volume is limited to displayed depth. In other words, only about 2% of the volume executed on

the NASDAQ market was executed at prices inferior to the quoted price when the depth of the market is taken into account. Since, as I mentioned above, the key rationale for preserving and extending the trade-though prohibition is now that trade-throughs discourage the posting of limit orders, the most relevant statistic is the volume of shares displayed in the quote that are traded through—which according to the SEC's study is less than 2%.

To make this point more clearly, let's assume that 2 people were waiting in line for a movie. Now assume that 5 people arrive, bypassing the 2 people in line and going directly into the theater. Now, if we want to know how many people were disadvantaged by line skipping we would say 2. We would not reference the 5 people that by-passed the line. To carry through our example, what the SEC study shows is that 98 out of 100 people waiting in line entered when it was their turn. Further, the remaining 2 people may very well have entered despite being by-passed. The question is, does that 2% risk, assuming it is even an accurate measure, reduce the number of people willing to stand in line?

I don't think so. I don't think it's even close. And I certainly don't think it warrants costly regulation.

Now, let me be clear. I believe that institutions and other market participants certainly do have concerns about posting limit orders. But the root of their concern is not the 1.9% of their displayed size that is traded through, but market impact. In short, they don't want other market participants to know their intentions because disclosure of their limit orders ultimately raises their trading costs. Indeed, one of the main business propositions of the other part of my business, Instinet, our agency brokerage business, is that we reduce implicit and explicit trading costs resulting from, among other things, market impact. Every day I deal with market participants who tell me that their priority is minimizing costs from market impact. So contrary to the SEC's claims in proposing Regulation NMS, I don't believe there will be any material increase in displayed size due to a new trade-through regime.

Unfortunately, I understand that the current conventional wisdom in this town is that the final regulations will not include elimination of the trade-through rule nor is an effective opt-out provision part of the reproposal. Rather, as the re-published Regulation NMS makes clear, the only key remaining question is whether the trade-through rule should apply to only the best priced quotes or the full depth of book. This is a fascinating turn of events.

Let's recall what supporters of the trade through rule originally said about protecting limit orders. Phrases like "bedrock of our markets" were being thrown out at every turn to describe any and all limit orders. Well, be careful what you ask for, my friends. It turns out that supporters of the trade-through rule were so convincing in their arguments that the SEC basically said, "If you like top of book limit order protection, then you are going to love limit order protection for the full depth of book!"

Then began a ferocious backpedaling. The very people who were preaching about the sanctity of limit orders now said they really meant ONLY THE BEST PRICED limit orders should be protected. In other words, they make the unconvincing argument that while trading through the best price discourages limit orders, trade-throughs of orders at less than the best price don't similarly discourage limit orders. Or, to go back to our movie-line analogy, they are essentially saying that the rules should ensure that nobody cuts in front of the first person in line, but that it's quite alright to cut in front of everyone else in line.

I remember a hearing where Senator Schumer gave a simple yet compelling example. He said if his father posted a limit order and yet saw transactions being executed at inferior prices that his father would feel disadvantaged and lose confidence in the market. But, apparently, according to the NYSE, Senator's Schumer's father may feel disadvantaged if he is traded through when his price is the best price but not when it is only the second best price available.

Not surprisingly, I fail to see any logical consistency in this position, since either limit orders should be protected or they shouldn't. But I'd like to assert today that what's driving the most recent NYSE position is not necessarily intellectual consistency, as much as plain and simple business survival. The NYSE got caught in seeing its articulated position carried to its natural conclusion, and now realizes that it would be impossible for it to live under such a regime. Not surprisingly, the NYSE has to shovel some of the toothpaste back in the tube. The NYSE realizes that its key competitive advantage -- the informational monopoly enjoyed by members on the floor that effectively forces everyone to come to the floor for price discovery -- will be compromised by a depth of book trade-through rule. Its most cherished asset – the volume on the floor – would become fair game for other market centers. That must be protected at all costs.

As a result, the NYSE had to launch a mini-campaign to reposition its arguments. Recently, the NYSE's John Thain wrote in the Wall Street Journal-and I quote:

> "Such a proposal (HE IS REFERRING TO DEPTH OF BOOK) would transform our market system into a virtual Consolidated Limit Order Book or CLOB. The CLOB has been proposed in the past, debated at length, and wisely and repeatedly rejected by previous SEC chairmen and commissioners for a number of reasons; foremost among them, it would convert our dynamic, diverse, and internationally competitive markets into a government-mandated, one-size-fits-all monolith."

Interestingly, that has been Instinet's argument against ANY trade though rule from the start. But like the circus contortionist, the NYSE must explain why they support top of book trade-through but not depth of book. Again, although basic logic tells us that depth of book trade-through would do far more to protect limit orders, the NYSE must unearth some value in just a top-of-book trade through:.

> Here is Mr. Thain's attempt in the same article:
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> "In an electronic-only environment, where exchanges must break up orders to attempt to chase displayed quotes from market-to-market, large orders of stock will be difficult to execute. Instead, these large orders may go elsewhere, to be traded in private markets or overseas."

Notice how the NYSE has redefined the terms of the debate. The old rallying cry had been that a trade-through rule is necessary to protect and thereby encourage the display of limit orders. Now the NYSE is saying in effect, "if we have to really protect <u>all</u> limit orders then it will hurt our floor-based market." And that "big investors need to be able to ignore better prices in order to get trades done." But what about that individual investor's limit order the NYSE once felt so compelled to protect? Will that investor feel better because although he was traded through, he facilitated a negotiation on the floor of the NYSE?

To be fair, I see nothing wrong about a business advancing a public-policy position based on its ability to prosper under such a regime. But let's at least be honest about it, my friends, and not

dress it up in our Sunday best and call it serving individual investors. More importantly, when it comes to making public-policy, it should never be based on the needs of the NYSE or any other market center for that matter. If we believe that limit orders should be protected, then let that principle truly guide our actions in a logically consistent manner by protecting as many limit orders as possible with the full depth of book alternative.

In closing, then, let me return to where I started. As AEI and others have reminded us in many contexts over the years, any initiative for new regulation must be based on clear, compelling evidence of market failure. That's the only way to justify the additional costs of further regulation versus a reliance on market competition to drive innovation. I don't believe a 1.9% trade-through rate represents a market failure.

While the NYSE and its allies still insist on some sort of tortured trade-through rule that simply furthers their own business model, the rest of us should insist on regulations based on coherent policy arguments and sound economics. The case for the trade-through rule fails on both accounts.

Thank you.

*Data from the SEC's proposal of Reg NMS Exchange Act Release #50870, December 16, 2004.

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