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Statement No. 205

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Statement of the Shadow Financial Regulatory Committee

On

Regulation NMS and Securities Market Structure

May 24, 2004

The Securities and Exchange Commission's proposed Regulation NMS (National Market System) consists of four different and somewhat inter-related proposals that would: (1) modify the application of the so-called "trade-through" rule in the trading of both New York Stock Exchange listed securities and Nasdaq securities; (2) impose a ceiling on the market access fees used by electronic communications networks (ECNs); (3) prohibit sub-penny bids and offers; and (4) change the method for the sharing of revenue from the sale of market data. The SEC's proposed modification of the trade-through rule is the most consequential proposal for the question of market structure, and this statement is directed solely to that issue.

The trade-through rule currently provides that no transaction can be executed on any registered exchange that is subject to the rule at a price that is inferior to (i.e., purchased for more than or sold for less than) a price posted on any other exchange where the securities are traded. For historical reasons, and because Nasdaq is not formally an exchange, the rule applies only to trading in securities listed on regulated exchanges such as the NYSE and The American Stock Exchange (Amex), and not to Nasdaq securities. ECNs that do not post their bid and ask prices in the Consolidated Quotation System—which contains the current bid and ask prices in securities listed on the NYSE and Amex—are not currently required to comply with the trade-through rule, but they argue that the inability to advertise their prices in this way impedes their ability to gain market share from the NYSE and Amex.

The SEC's new trade-through proposal in Regulation NMS has three parts: it would (1) allow investors, on a trade-by-trade basis, to opt out of the trade-through rule, (2) allow traders on automated, fast markets to trade through the prices on non-automated markets, and (3) apply the trade-through rule for the first time to the trading in all Nasdaq securities.

Those who favor the current trade-through rule argue that it is fair to investors because it assures that they will get the best price available in the market when they buy or sell, and that it tends to increase liquidity and thus reduce spreads. Those who oppose the trade-through rule argue that it prevents the development of competing and thus more innovative markets, like the ECNs, and in particular prevents fast electronic markets from trading NYSE securities, which are traded in the slower human-mediated NYSE. Some have argued that the trade-through rule is responsible for the large market share of the NYSE in the trading of NYSE securities, and that its absence is responsible for the decentralized trading that characterizes the market for Nasdaq securities.

The basic issue is whether investors and the economy are best served by a centralized market place or a marketplace characterized by competing trading venues. A centralized marketplace might enhance liquidity and thereby reduce trading costs and the costs to corporations of raising capital. A competitive marketplace may lead to innovation that would be stymied by centralization.

The Shadow Financial Regulatory Committee has concluded that the SEC's proposal on the trade-through rule fails to address this central issue—whether investors and the economy generally would be better served by a market structure that features one centralized trading venue like the NYSE or by the competing trading venues that characterize the trading of Nasdaq securities.

As things stand today, there are two entirely different market structures in place, and the SEC has failed to indicate which it thinks would be best for our securities markets. If the SEC believes that the centralized model is best—because it provides benefits such as fairness, higher liquidity and better pricing—it should apply the trade-through rule everywhere, without permitting an opt-out by investors. An opt-out will threaten to diminish or eliminate these benefits. On the other hand, if the SEC believes that allowing an investor opt-out will improve pricing in the market for NYSE and Amex securities by enabling these securities to be traded on ECNs, then it should completely eliminate the trade-through rule.

The compromise proposal advanced by the SEC in Regulation NMS serves no purpose that the Committee can discern, and certainly does not amount to desirable market structure reform. Accordingly, the

Committee believes that the SEC should withdraw the rule and conduct the analysis necessary for a proposal that fully considers the central issues of market structure.