Testimony Concerning
Equity Market Structure: A Review of SEC Regulation NMS

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and Government Sponsored Enterprises

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Chairman Garrett, Ranking Member Maloney, and Members of the Committee:

Thank you for inviting me to testify today concerning the important developments in the equity markets and Regulation NMS.

I am a former Commissioner of the Securities and Exchange Commission (SEC), having been confirmed twice by the U.S. Senate, serving from 2002 – 2007. I was one of the three out of five votes cast by the SEC Commissioners in favor of passing Regulation NMS. I am a now a partner with the international law firm of Locke Lord LLP, where I am head of the Securities Enforcement and Regulation Practice.

Reflecting on landmark regulations of our equities markets over the years – from the Securities Exchange Act of 1934, to the Maloney Act of 1938, to the 1975 Acts Amendments, the Order Handling Rules, to new types of markets, to the initiation of trading in penny increments, and to Regulation NMS – I am reminded that, indeed, change is constant.

The very difficult concerns that existed when we considered the adoption of Regulation NMS exist today, although the issues may be manifested differently. For example, today just like in 2005, our equity markets experienced sweeping changes driven in large measure by developments in technology and globalization. As such, I commend the Subcommittee on Capital Markets and Government Sponsored Enterprises for recognizing the ever-present need for a regulatory structure that accounts for developments in our markets. Certainly, all major regulations need periodic review to assess suitability to the changing landscape.

Amid the ever-present evolution of our equity markets, the guiding principle for the SEC as formulated by Congress has remained constant: to provide fair and efficient capital markets. Embedded in that principle is the theme that small and retail investors not be disadvantaged in a meaningful way by the professional class of traders and institutional investors. The U.S. markets are unique in the world in having an active participating retail class of investors, which add substantial liquidity and in turn attract investors from all corners of the globe. The concepts in our securities markets endure – the various trading venues are places that bring together the orders for securities of multiple buyers and sellers and use established, non-discretionary methods under which such orders interact with each other. As a Commissioner, I held steadfast on one overriding objective – the protection of all investors. As the head of one of the largest sovereign wealth funds once told me, "We buy equities in the U.S. markets because they are fair, efficient, and transparent, and I know that if something goes wrong, we have the protection of American law that will treat us fairly."

When originally considering Regulation NMS, I realized that it was foolish to predict the future and also that it would be impossible to determine in theory what would be the best business model for the markets. Instead, the objective became to establish a framework for the U.S. markets in which fair competition and not regulators would determine the winners and losers and the ultimate market structure. Indeed, the U.S. markets are also unique in that competition exists in both among trading centers (exchanges and other platforms such as ATS's) and separately among orders as well.

These principles have served our equities markets well. Our securities markets continue to be the envy of the world: we have the deepest most liquid markets, and most studies conclude that the U.S. markets provide the lowest costs to trade.

Today, there is criticism in some quarters that Regulation NMS is a principal force driving the capital markets toward a complex, fragmented market structure where priority is given to speed over liquidity and technology over human judgment. The equity markets constantly evolve, as does the regulatory structure. Rather than a "which came first" debate, the SEC's oversight has focused on the appropriate regulation for the evolving equity market structure. And, it should continue to do so.

With Regulation NMS, we dealt with a decades-long trend in which market structure was evolving from manual trading to a market structure dominated by automated trading. Nostalgia for a simpler world should not be a factor. There were many problems and unfairness to investors in the prior market world that was largely concentrated in one exchange.

Prior to Regulation NMS, the lack of consistent inter-market trading rules for all NMS stocks had divided the equity markets into halves: a market for exchange-listed stocks and a market for Nasdaq stocks. For historical reasons, including the history of the NYSE as an auction market and Nasdaq as a dealer market, these stocks traded in quite different regulatory structures. Exchange-listed stocks were subject to the Intermarket Trading System, or ITS, rules. With Regulation NMS, the Commission took a critical step forward in adopting a comprehensive set of reforms designed to strengthen and modernize our national market system.

Today, manual trading has gone the way of the horse and buggy. While the U.S. market share in *trading* is no longer concentrated in one market, our markets are linked as one *national market system.* The fact that executions can occur in any of over 60 platforms and exchanges does not mean that the markets are fragmented. After all, these platforms are linked and connected electronically – creating what Congress intended: a national market system, where the best price can be found for investors in fractions of a second among all the trading centers. That has been a good result. Assuring consistent inter-market trading rules was the right decision then, as it is now. Of course, particular decisions in Regulation NMS, such as the access fee and others, deserve a reevaluation.

In my view, Regulation NMS has had largely positive effects on equity market structure. Reviewing market structure is appropriate, but the old adage "Do no harm" comes to mind. Accordingly, in any review of markets, Congress and the SEC must be guided by accurate and comprehensive data. As I learned in my service as a Commissioner, the SEC and Congress must always consider the source of information and remember that existing businesses will seek primarily to justify their business model and to disadvantage competitors. Some have suggested negative unintended consequences from Regulation NMS, which certainly require careful study and consideration by Congress and the SEC.

Such a study should carefully isolate engineering problems, as distinct from issues with regulatory policy. For example, while my computer crashes more often than I like, I have not abandoned my PC in favor of the typewriter I used earlier in my professional career. We should work to resolve engineering problems imposed by new technology (flash crash and other technology failures), and mitigate potential damages with appropriately tailored regulatory policy.

I also advise caution in assuming that trading systems known as "dark pools" are per say a bad thing. Remember that the competitive markets, not regulators, have determined that such platform systems provide valuable services. First of all, there has always existed so called internalization – where brokers use their in house inventory to fill orders from their customers in their back offices outside exchanges. Regulation NMS reflected reality and the demand by large investors to lower their execution costs and not to reveal large unexecuted orders to the market – where front running could occur and the share price be disadvantaged. Regulation NMS required that internalization and ATS's reflect the last best price and then report executions to the Consolidated Tape. Therefore, today these executions are not really dark.

ATS's and dark pools offer many benefits that investors desire: the ability to trade large block orders without moving the market and offering in many cases price improvement. One particular ATS model regularly executes at the mid-point between bid and offer, providing substantial price improvement. Remember that institutional investors that use so called dark pools capture lower costs and price improvement for pensioners and beneficiaries, assisting in achieving retirement dreams.

Again, I am certain this Committee and its distinguished members will study carefully the new challenges for the U.S. markets, while keeping in mind the many advantages and benefits that today's markets convey to investors.

Thank you again for inviting me to speak to you and provide my views.