OUTLINE OF INTENDED TESTIMONY
David A. Herron
Chief Executive Officer, Chicago Stock Exchange

The Chicago Stock Exchange welcomes the Commission's willingness to consider possible changes to the current state of the national market system. The system has evolved quickly over the past several years – markets have developed widely disparate trading models that rely on an unprecedented level of automation in handling the orders they receive. Seen in isolation, these changes appear to add value to investors, proving that unfettered competition can lead to important order handling enhancements. These technological changes, however, have been accompanied by a substantial increase in fragmentation, with a decreasing level of interaction among market centers. This fragmentation – and the further fragmentation that would result from some of the proposals in Regulation NMS – poses a potentially significant harm to investors. The CHX believes that the Commission should follow a course that both recognizes the benefits of technology and protects the integrity of the national market system.

A. The Trade-Through Rule

The CHX believes in the important protection given customer orders by the trade-through rule.

1. The trade-through rule provides important protections for investors.

The trade-through rule, and the linkages required by the ITS Plan, unify the markets that trade listed securities. In their simplest form, the ITS provisions are designed to ensure that, if a customer order to buy stock is displayed at the Chicago Stock Exchange and it is the best price in the national market, that order will be executed when another customer wants to sell stock.

If the trade-through rule and the linkages that are part of the ITS Plan disappear, however, the same customer order to buy stock could remain unexecuted, even while worse-priced customer orders in other market centers are filled. This fragmentation of the national market system moves back in time – to an unconnected system that only benefits the sophisticated trader, without protection for the ordinary investor.

2. The automated market proposal set out in Regulation NMS maintains trade-through protections but modernizes the rule to accommodate new technologies and trading models.

While trade-through protection is important, it is also important to recognize that markets have developed using different models. The Exchange believes that the automated market proposal allows investors who want quick, certain executions to get them, while at the same time ensuring that customer orders in other automated markets do not remain unexecuted. In implementing this proposal, however, the Exchange strongly encourages the Commission to tackle the difficult question of identifying the automated and non-automated markets – it is imperative that there be clear and verifiable standards for determining whether a market truly qualifies as an automated one before allowing that market to trade through non-automated markets.

3. Allowing customers to "opt-out" of the trade-through rule unfairly harms the individual investors whose displayed, better-priced orders are ignored.

Regulation NMS's opt-out proposal has the potential to completely undermine the protections otherwise given by the modified trade-through rule. As an initial matter, the opt-out proposal, which allows a customer to decide whether or not he or she should be allowed to trade through an order in another market, allows the wrong person to make the decision – we believe that it's a little like allowing a burglar to determine whether or not the laws against breaking and entering apply to his conduct. Moreover, a customer's need for an immediate fill can be satisfied through the automated markets proposal – customers should not have the additional ability to ignore better prices at will, particularly when they are available immediately, through an automated execution.

B. The Market Access Rules

The proposed market access rules set out one possible way for trying to ensure that a participant in one marketplace can access, at least indirectly, an order or quote displayed by another marketplace. These indirect access standards, however, should not be read to take the place of any direct linkages that markets may want to continue or put in place – and may not go far enough to ensure that an effective trade-through rule can be implemented. Additionally, the proposal on access fees is somewhat confusing; we believe that it should not jeopardize the ability of exchanges to charge transaction fees. As a final matter, however, the Exchange recognizes that other issues complicate the question of market access, including the value associated with marketplace memberships.

C. The Market Data Proposal

For better or worse, markets currently fund a portion of their operating costs from the receipt of market data revenue. As a result, all markets likely are interested in the impact that this proposal will have on their bottom lines. The CHX believes that, in some respects, the proposal has hit on key ideas – that markets should be rewarded for their trades and their quotes. As we have additional time to evaluate the proposal, we likely will have comments on a variety of specific issues, including the highly complex revenue formula, and will work to highlight any unintended consequences that might result from the new formula, including the potential for a market's participants to "game" the system.

One aspect of the proposal, however, seems odd right off the bat – the notion that a trade must have a dollar value of $5000 or higher to be counted in determining a market center's trading share. Although this idea may serve to ensure that a market center does not get credit for "shredded" trades, it completely (and we believe inappropriately) devalues the information provided by the execution of small orders, particularly in lower-priced stocks. While a large institutional customer may not find much "price discovery value" in the execution of a 200-share order in a $24 stock, a small retail investor, hoping to sell 200 shares of the same stock, might find that pricing information to be quite important. This aspect of the proposal, along with the opt-out portion of the trade-through proposal, reflects a bias toward large institutional participants that inappropriately devalues the role of retail investors and smaller institutions in the securities markets.

D. Subpenny Pricing Proposal

The CHX welcomes the Commission's proposal to end the practice of subpenny pricing. The Exchange agrees that subpennies should have no priority standing in the securities markets and wonders whether the Commission should end subpenny trading altogether, with a possible exception for certain average-priced trades.

E. Conclusion

Ultimately, the Commission must decide whether it believes in an integrated national market system or not. The CHX believes that a system of linked, but competing, markets provides investors with the best of all worlds – opportunities for fast, automated executions, at the best available prices.