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Concerning Proposed Regulation NMS

Before the U.S. Securities and Exchange Commission

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Good morning. I am Kurt Halvorson, Executive Vice President and Chief Administrative Officer of Ameritrade Holding Corporation.

It is a privilege and an honor to be provided the opportunity to testify before the Securities and Exchange Commission ("Commission") concerning proposed Regulation NMS. At the outset, I want to commend the Commission for undertaking to update our antiquated market structure; and in saying so, I recognize that the issues underlying this initiative are indeed complicated and not easily resolved. My testimony today will focus primarily on the Commission's trade through aspect of the proposal, and will include some brief thoughts on the remainder of the proposal.

I. AMERITRADE AND THE SELF-DIRECTED INVESTOR

Ameritrade Holding Corporation ("Ameritrade Holding") has a 28-year history of providing financial services to self-directed investors. Ameritrade Holding's wholly owned subsidiary, Ameritrade, Inc. ("Ameritrade" or "the Firm"), acts as a self-directed broker serving an investor base comprised of over 3 million client accounts. Ameritrade does not solicit orders, make discretionary investments on behalf of our clients, or provide proprietary research or advice regarding securities. Rather, Ameritrade empowers the individual investor by providing them with desired tools they need to make their own investment decisions. In exchange for a low commission, we accept and deliver the order to buy or sell securities to the appropriate exchange, market maker, electronic communications network ("ECN") or other alternative market for execution. In addition, Ameritrade provides our clients with the ability to route their orders to certain market destinations that they can choose. Ameritrade does not trade for its own account or make a market in any security.

Ameritrade brings a unique perspective to the current debate concerning market structure in that we are one of the largest broker-dealers, if not the largest retail broker-dealer, that does not internalize order flow. As a result, Ameritrade's position as a pure agency broker allows us to comment on the Commission's proposals without concern for how today's proposals may impact an affiliated market maker or ECN. We believe this business model positions Ameritrade as uniquely qualified to speak with unwavering dedication to the clients that we serve and retail investors as a whole.

Ameritrade is an advocate for the retail investor. In speaking with our clients, we know from experience that clients generally want the following: they want the order they submit to be filled in its entirety, as fast as possible, at the price they are quoted upon order entry, or better. Ameritrade, as their agent, demands the same on behalf of our clients.

II. TRADE THROUGH PROPOSAL

Ameritrade agrees with the Commission that the current national market structure is in need of reform and that maintaining the status quo is unacceptable. In particular, we strongly believe the current ITS trade through rule is antiquated and must be significantly revamped or repealed. Briefly, the ITS trade through rule is unfair in that it requires advanced electronic systems to compete with manual, floor-based exchanges on their terms – the speed at which orders can be handled with human intervention. The ITS trade through rule simply has no place in the modern national market system.

We believe that repeal of the trade through rule would lead to greater intermarket competition, increased connectivity and transparency, which would propel the listed market to greater efficiency, all to the benefit of the investing public. As with the Nasdaq market, we believe the markets can operate efficiently without the presence of a trade through rule.

Before commenting on the Commission's proposal, we believe it is important to point out that the debate over the trade through rule has wrongly been simplified as the choice between fast executions versus slower executions at better prices. Rather, the debate should focus on the fact that better prices may or may not be available by the time the order is filled. As a result, it does not necessarily follow that the slower execution always gets the better price, and the fast execution gets the worse price – the pursuit of fast executions is a means to achieve a higher degree of certainty of execution at a specific price.

That being said, Ameritrade does support Commission's effort to reform the trade through rule, with important caveats.

1. First, Ameritrade strongly supports the Commission's Automated Execution Alternative proposal that would require market centers to provide an automated response to electronic orders at their quote. Ameritrade believes that requiring market centers to provide automated trading access to their quotes will resolve many difficult issues such as the opt-out and *de minimis* exceptions, and will eliminate the necessity of defining what qualifies as a "fast" market. The Commission's goal should be to create a market system in which "quoting" is synonymous with "trading." In addition, access and protection should be expanded to the entire book, not just the best bid or offer.
2. Second, Ameritrade believes that the trade through proposal must preempt existing anti-competitive rules such as the ITS trade through rule, and clarify that SROs should not adopt varying standards.

3. Third, if the Commission decides not to adopt the Automated Execution Alternative, it should consider amending the opt-out exception and eliminating the *de minimis* exception of the trade through proposal.

4. Finally, Ameritrade believes that to promote a greater level of order interaction and transparency to the investor, the Commission should require the display of internalized orders before execution.

I will address each one of these positions in order.

1. **<u>Automated Execution Alternative</u>**

As part of the trade through proposal, the Commission requested comment on an Automated Execution Alternative, whereby "all market centers would be required to provide an automated response to electronic orders at their quote." Ameritrade strongly believes this Alternative is in the best interests of the investing public, and at the same time, resolves many difficult issues surrounding the trade through proposal. In the view of Ameritrade, an automatic execution should be defined as requiring a market center to fill an order at its quote immediately, or to route the order to another market center displaying the best price immediately.

As noted, our experience is that many investors demand the certainty of fast execution at the specified price, over the possibility of a delayed execution at a better price. Ameritrade believes that retail investors would be best served by a rule that requires market centers to provide automated execution of electronic orders at their quote. If the Commission adopts such an approach, market centers would be required to either execute an electronic order at its quote, or if the market center's quote is not at the best price, route the order to a market center that was displaying the best price. In this way, Ameritrade believes retail investors will be more likely to receive the price displayed at the time they submitted their order.

As the Commission notes, the Automated Execution Alternative also resolves potential flaws. First, requiring market centers to provide an automated execution facility would eliminate the necessity of having the "opt-out" and "*de minimis*" exceptions. That is, if a market center was required to fill an order at its quote, or route it to another market center displaying the best price, there would be no need for investors to opt-out. In addition, such a requirement would allow the Commission to avoid having to determine what qualifies as a "fast" versus a "slow" market, which could lead to definitional gamesmanship. In fact, market centers offering automated executions would be required to compete with each other on all measures of best execution, including, but not limited to, speed of execution, price and liquidity. It is Ameritrade's position that such a requirement would lead to greater inter-market competition, transparency and price discovery – all to the benefit of the investing public.

The Commission requested comment on whether it should promulgate performance standards to ensure that the quotes of all market participants are available for automatic execution. We agree that the Commission will need to establish specific performance standards with respect to response time. Although Ameritrade does not have a specific recommendation concerning such a standard, we note that whatever standard is developed should not disadvantage new technology and faster markets, as what may be a fast response time today (*e.g.*, one second), may be slow tomorrow.

The Commission also requested comment on whether the scope of the proposed trade through rule should include protection beyond the best displayed bid or offer. Given the post-decimalization world, there often is a lack of size quoted at the top-of-book, and we believe it also is in the best interests of investors to require access to the entire book.

2. **<u>Existing SRO Rules</u>**

The Commission's proposal would allow SROs to maintain more restrictive trade through plans, such as the current ITS plan. Ameritrade believes that the Commission should abrogate existing trade through rules in order to create a uniform rule in this area. Allowing different trade through rules, even if participants can withdraw from them, will result in uneven regulation and regulatory arbitrage. Moreover, the existence of different trade through rules will most certainly result in investor confusion over what standard applies. As it is proposing in Regulation SHO, Ameritrade believes that the Commission should consider promulgating a uniform rule and not allow SROs to adopt varying versions of the same rule.

3. **<u>Opt-Out and *De Minimis* Exceptions</u>**

As noted, Ameritrade believes that requiring market centers to provide automated execution of electronic orders will eliminate the need to have an opt-out. If the Commission, however, decides to adopt the trade through proposal as proposed, Ameritrade strongly opposes the Commission's current opt-out and *de minimis* exceptions.

Ameritrade opposes the opt-out, as proposed, because it is intended only for institutional investors, and not retail investors. We are proud of our business model of providing services to retail investors that historically were only available to institutional investors. We are concerned that the opt-out, as proposed, turns back toward the provision of services in the old two-tiered manner. Ameritrade believes it is inherently unfair to limit the opt-out in this way.

Ameritrade currently offers its clients the ability to directly route their trades to certain market destinations. "Direct access" routing, while utilized by only a small percentage of Ameritrade clients, is important to these investors.

Before an Ameritrade client may directly route orders to a market destination, the client must execute a standing consent to terms and conditions that already address the Commission's proposal, including disclosure that they might not receive the best possible price and that the speed of execution might be worse than they would otherwise experience if they used Ameritrade's auto-routing.

Once a client agrees to the terms and conditions of direct access routing, he or she then has the ability to use Ameritrade's electronic order ticket to send orders to certain market destinations. The Commission's proposal of imposing an order-by-order informed consent requirement on direct access clients would effectively emasculate such an offering. That is, requiring client consent on an order-by-order basis, and imposing on the broker that it "must be confident that the customer fully understands this disclosure and the nature of the consent," would unnecessarily complicate seamless electronic trading systems offered by brokers, and place an impossible standard on brokers to know whether a client actually understands the disclosure that he or she is reading. We respectfully encourage the Commission to clarify how, as a practical matter, the order-by-order decision-making process could be implemented to enable electronic retail investors to utilize the opt-out.

Ameritrade's experience with direct access trading is that such routing is often used by investors that want to see their limit orders displayed on ECNs. Ameritrade believes that our clients that use direct access understand the risks, and notes that direct access routing has not been the subject of customer complaints.

In addition, Ameritrade questions whether the benefits of requiring brokers to disclose the NBBO at the time of the execution for those clients who have opted-out justify the costs of the exception. The Commission estimates that the cost of requiring this disclosure at a one-time cost of $193 million, with an annual cost of $148 million. Given the size of these numbers, which may even be understated, we strongly encourage the Commission to carefully consider whether the benefits outweigh the significant costs to be incurred on the securities industry.

That being said, Ameritrade does not oppose the Commission imposing disclosure requirements concerning direct access routing by clients, along with a consent approach whereby clients would consent once before using direct access routing, as Ameritrade does today. If the Commission believes the same is necessary, it also could supplement this approach with a mandatory annual notice being sent to clients in much the same way Privacy Policy notices are annually required.

Similarly, if the Commission does not adopt the Automated Execution Alternative, Ameritrade opposes the Commission's proposed *de minimis* exception as it will result in artificial spreads and investor confusion. Ameritrade believes that the *de minimis* exception is harmful to investors in that it builds in an artificial spread. That is, if a "fast" market is allowed to trade through "slow" markets by one to five cents, these *de minimis* amounts will necessarily act to widen the spread. Moreover, as occurs today, professional traders will attempt to arbitrage by selling at a higher price, and buy to cover in a market displaying the best price – at the expense of retail investors.

As proposed, we also believe the *de minimis* exception will be unduly complicated and result in investor confusion. Retail investors demanding executions at specified prices generally do not appreciate rules that allow market centers to fill their orders as long as they are "close" to the best price. Moreover these investors may not be receiving the executions at the price they are quoted as demonstrated by published 11Ac1-5 data, which shows that since the *de minimis* program began, quoted spreads have narrowed while trading spreads have widened. The *de* *minimis* exception, as proposed by the Commission, adds a further layer of confusion by establishing a range of permissible trade throughs based on the price of the security. Overall, Ameritrade believes that the proposed *de minimis* exception will harm price transparency and discovery. As a result, the Commission should not adopt such an exception.

4. Internalization and Limit Order Display

Although not part of the Commission's set of proposals, Ameritrade strongly believes that true price transparency and discovery will not be achieved until the Commission requires internalized orders to be subject to public display and available for interaction prior to execution. Requiring firms that internalize order flow to publicly display those orders and to make them available for interaction with other orders prior to execution would increase transparency for all investors. The benefits would be twofold – investors using a broker that internalizes order flow will be ensured that these orders will interact with the market as a whole, and other investors will have the opportunity to interact with these orders. Ameritrade believes that extending limit order protection in this way will greatly increase order interaction, again, to the ultimate benefit of the investing public.

This principle has been used in the options markets for many years, and is easily applied in an electronic trading environment. For example, the newest approved exchange, the Boston Options Exchange, or BOX, requires the display of an order for 3 seconds prior to internalization. Ameritrade strongly encourages the Commission to consider adopting a similar rule in the equities markets.

III. NON-DISCRIMINATORY ACCESS AND FEES

Ameritrade supports the Commission's efforts to require market centers to provide non-discriminatory access to market participants. As noted earlier, Ameritrade strongly believes that the Commission should require all market centers to provide electronic access to allow participants to trade at the price they are being quoted. If a market center aggressively quotes, market participants must have the ability to access these quotes. A quote that is unavailable undermines the integrity of the marketplace and leads to investor confusion and frustration. In addition, market centers presumably will be less able to cherry-pick uninformed order flow, while avoiding aggressive limit orders. Requiring non-discriminatory access will further ensure that market participants are able to access these quotes.

Ameritrade also applauds the Commission's steps to standardize access fees that will act to remove barriers to competing markets. The marketplace has demonstrated that open competition concerning the use of access fees has not resulted in investor benefit. Ameritrade believes the standardization of access fees should lead to fewer locked and crossed markets by removing the temptation of rebate arbitrage.

IV. SUB-PENNY TRADING

Ameritrade previously commented to the Commission that the Firm ceased allowing clients to submit orders in sub-pennies in April 2003 because it had determined that clients were using sub-pennies to step ahead of resting limit orders and undermining the Manning provision. As a result, we applaud the Commission's proposal to prohibit market participants from accepting, ranking or displaying orders, quotes or indications of interest in increments less than a penny. Given the evidence that sub-penny trading is being used by professional traders at the expense of the investing public, we believe that the elimination of sub-penny quoting can help to further restore investor confidence in the market and result in increased transparency and higher liquidity.

As for the Commission's proposed exception for securities trading under $1.00, Ameritrade's experience is that most of the sub-penny trading occurs in those exact securities. We note that the answer to this problem is for the NYSE and Nasdaq markets to uniformly enforce listing standards, which generally require a security to trade above $1.00.

V. MARKET DATA

Four years have passed since the SEC issued its Concept Release concerning market data structure, and the Commission has not moved any closer to addressing the central issue – whether the costs imposed by the current system are justified. In this regard, Ameritrade is disappointed that: (1) the SEC did not use Regulation NMS to address market data and related revenues in a comprehensive fashion; and (2) the SEC has failed to take the step of requiring transparency by requiring SROs and securities information processors ("SIPs") to disclose publicly the cost of providing market data to the public. By comparative example, Rules 11Ac1-5 and 11Ac1-6 have contributed greatly to transparency and competition in the order flow arena. Similar market data transparency would increase competition and potentially reduce costs for end users. Accordingly, Ameritrade is not interested in debating the merits of the proposed allocation model, or the hybrid model for that matter.

Ameritrade is interested in first gaining an understanding of the costs associated with providing market data, and then determining the appropriate structure to allow for either a return of excess revenues back to investors, or a model in which market data revenues simply equal the costs to provide such information to the investing public.

Not only are market participants forced to pay the costs of the very data they provide, the participants do not know whether the fees are reasonable given that there is no transparency concerning the costs that the SROs incur in providing this vital service to investors.

Any broker or vendor who conducts business in the current environment will tell you that the structure is costly, complicated and burdensome. For retail brokers like Ameritrade, the administration of market data contracts is onerous and costly. SROs require detailed information about how a firm will use market data, the type of services the firm provides, the firm's use of technology and how a firm monitors its users. Ultimately, brokers must share confidential and competitively sensitive materials with the SROs.

SROs also require individual investors to consent to an agreement that requires the payment of discriminatory fees and is replete with legalese and confusing terms and conditions. Ameritrade spends an inordinate amount of time and money simply complying with the administrative burdens of tracking market data use by its customers, and maintaining two separate systems, one for real-time data and one for delayed data. The Commission's proposal does nothing to address these issues.

Under the current system, the SROs are granted monopoly powers, and wield these powers at will both in terms of the fees charged and the control over the dissemination of the data. Moreover, market data fees are imposed in an entirely discriminatory fashion. First and foremost, investors accessing real-time quotes through an account executive by telephone, from devices in branch offices, and from media distributors do not incur market data fees. If the same investor, however, uses an online brokerage account to access real-time quotes, market data fees are charged based on each instance a real-time quote is accessed. In this case, either the brokerage firm pays the fee on behalf of the client, or passes the cost onto the investor. Either way, costs to investors are higher.

Ameritrade also believes the current market data definitions around professional and non-professional users are inconsistent and costly to the retail investing public.

The Release notes that out of the $424 million in revenues derived from market data fees, $386 million was distributed to SRO participants. Unfortunately, although the Commission previously has said, "the total amount of market information revenues should remain reasonably related to the cost of market information," there is no transparency to determine whether it actually costs anywhere near $424 million to provide the data to investors.

This issue is vitally important to both Ameritrade and its retail clients. During the six-month period from September 2003 through February 2004, Ameritrade paid over $6 million in market data fees on behalf of its clients. These fees are paid by investors directly in the form of charges for quotes, or indirectly, in the form of commissions or other fees.

Ameritrade submits the only way to determine whether there has been an equitable and reasonable allocation of costs is to require each SRO or SIP to publicly provide audited financials regarding the costs of providing market data to end users, including the retail investing public. Ameritrade recommends these financial statements be made available to the investing public through the Commission's website. Given that investors ultimately pay these fees, either directly or indirectly, we clearly believe requiring the transparency of such information is in the public's best interest. Only then can such cost data be analyzed and act as the basis and direction for future market data reform, both in terms of pricing and ultimately, distribution of such revenues.

VI. CONCLUSION

In closing, we at Ameritrade applaud the Commission and its staff for taking the important step in proposing Regulation NMS. As noted above, Ameritrade is a strong advocate for the Automated Execution Alternative whereby all market centers would be required to provide an automated response to electronic orders at their quote. We believe the Alternative proposal will be a tremendous improvement in the current national market structure, with retail investors reaping the ultimate benefits.

Again, I appreciate the opportunity to appear before the Commission, not only on behalf of Ameritrade but, more importantly, on behalf of our clients, retail investors.

I would be pleased to answer your questions at the appropriate time.