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## Remarks

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## REMARKS

ANNETTE L. NAZARETH†

Good morning. I'm delighted to be here to talk to you today. I plan to focus my remarks on some of the significant market structure issues the Commission is facing and the flexible regulatory approach we're taking to them. Before I begin, however, I must remind you that my remarks represent my own views, and not necessarily those of the Commission or my colleagues on the staff.<sup>1</sup>

During my time as the Director of the Division of Market Regulation, I have come to appreciate the experiences of Captain Kirk of the Star Ship Enterprise: exploring strange, new, and uncharted worlds and discovering new possibilities. Actually the only real differences between us are that Kirk's experiences were fictional and occurred once a week, while mine are real and occur daily. Changes in our marketplace are occurring at breathtaking speed, warp speed if you will, and while they pose no life and death dilemmas, questions concerning market structure have a real and immediate impact on the financial well being of our securities markets.

Fortunately for us, the Securities Exchange Act was drafted by people of vision, who understood that designing a securities market to meet their needs and their vision of the future would be too rigid.<sup>2</sup> Does anyone here believe that they would have

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<sup>1</sup> The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publications or statements by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or the author's colleagues on the staff of the Commission.

<sup>2</sup> See DANIEL C. ROPER, 73D CONG., LETTER OF SUBMITTAL TO PRESIDENT ROOSEVELT VI (Comm. Print 1934). "[I]t is . . . proposed to require the suggested administrative agency to engage in the full and adequate collection of statistics upon which to base its rules and regulations, with a flexible power to alter these from time to time as a fuller knowledge may require." *Id*; see also COMMITTEE ON STOCK EXCHANGE REGULATION, 73D CONG., REPORT TO SECRETARY OF COMMERCE 6 (Comm. Print 1934) (stating Committee's belief that a flexible mechanism should be

envisioned: electronic communications networks; on-line trading; after-hours trading; global trading; or the myriad of other changes that have occurred over the past 65 years? And even if they had, could they then have designed a market structure that addressed these technological changes and accommodated further innovation? To the contrary, Congress had the foresight to design a flexible regulatory structure that addressed the pressing need of the nation—investor confidence.<sup>3</sup> Let's face it, our markets are driven not by technology, but by investor confidence, and as Chairman Levitt has observed and as the Congress understood, once that confidence is lost it is not easily regained.<sup>4</sup> Investor confidence was the issue in 1934 and it is the issue today. Fortunately, Congress saw the issue clearly and mandated that the markets be allowed to develop on their own, provided they were fair, orderly, and protected investors.

As the debate over the market structure of the future continues, virtually every facet of our market structure is being called into question. I firmly believe that while technology makes it not only possible, but in many instances preferable, to alter the way we apply the National Market System principles, the principles themselves are as valid as ever. We simply cannot

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set up to allow for unknown future issues). "Stock Exchanges . . . do not present a static situation susceptible to fixed standards." *Id.*

<sup>3</sup> See H.R. REP. NO. 73-1383, at 5 (1934) ("If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance . . . the ordinary citizen . . . has to trust others and cannot personally watch the managers of all his interests . . .").

<sup>4</sup> See S. REP. No. 73-792, at 3-4 (1934) (discussing causes of the Great Depression and concluding that "it is essential that the Federal Government adopt measures which will enable it to stem the speculative tide whenever necessary"); Spencer Derek Klein, Note, *Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence*, 16 HOFSTRA L. REV. 665, 666 (1988) (stating that along with other events surrounding the crash of 1929, the "disintegration of investor confidence in the integrity of the securities markets provided the primary impetus for federal regulation of securities transactions"); see also BARRY ALEXANDER K. RIDER & H. LEIGH FRENCH, *THE REGULATION OF INSIDER TRADING* 6-7 (1979) (noting the importance of investor confidence in attracting capital from international investors in addition to domestic investors); John J. Phelan, Jr., *In Pursuit of Insider Traders*, BANKERS MAG., Nov.-Dec. 1986, at 51 ("Shareholders' participation is an act of faith in the system . . . . If that faith is lost or badly shaken, then the system is at risk."); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 264 (1968) ("A liquid stock market presupposes public confidence which creates willingness to purchase shares. Much of the difficulty in organizing capital markets in the less developed countries arises from public distrust and reluctance to invest funds in such markets.").

expect investors to remain confident in the inherent fairness of a marketplace that does not promote competition, transparency, price discovery, best execution, or efficiency. These principles are not only valid, they are the very foundation of the securities industry!<sup>5</sup>

Each of the five pillars is an integral element of a comprehensive regulatory approach. In implementing these objectives, the relevant issue for the Commission is never whether to choose one objective to the exclusion of another, but to facilitate the development of a market structure that adequately incorporates and advances each of the five objectives. The Commission's job is to promote a regulatory environment that allows industry and technology to develop on their own, consistent with the principles of the National Market System. Quite clearly, any market system dictated by the government would be obsolete before it was fully implemented.

The U.S. securities markets have developed remarkably well since 1934 using this regulatory approach. Today, investors have unprecedented access to information about securities and the markets, and enjoy narrower spreads, lower execution costs, and faster execution speeds.<sup>6</sup> As we face today's challenges, I believe there is consensus both at the Commission and in the industry that this flexible framework will continue to serve us well in the years ahead. There is no doubt that the securities industry stands at an historic crossroad. Technology continues to revolutionize our marketplace and much of our original "plumbing," if you will, established after the National Market System legislation, is in need of serious repair. The debate rages on: should we patch or should we tear down and start anew? Some major structural challenges that currently face us include: our model of self-regulation; the linkage between market centers; how market data is collected and disseminated; and fragmentation of the marketplace.<sup>7</sup> These structural questions

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<sup>5</sup> See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 10.13 (1985) (discussing Congress' 1975 mandate of a national market system).

<sup>6</sup> See *infra* note 9, at 70,845 ("Market participants have incorporated technology into their businesses to provide investors with an increasing array of services, and to furnish these services more efficiently, and often at lower prices."); see also *Electronic Traders Association Adopts Statement of Ethical Principles for Member Firms*, BUS. WIRE, July 29, 1999, at 321 (stating that "[c]hanges in technology allow individuals direct access to the securities markets").

<sup>7</sup> See Lan Cao, *Looking at Communities and Markets*, 74 NOTRE DAME L. REV.

clearly focus the debate—patch or tear down? Regardless of our decisions with respect to the future structure of our marketplace, the foundation of our market structure—the core principles enunciated by Congress in 1975<sup>8</sup>—have amply demonstrated their durability and merit in guiding the development of our securities markets.

As you'll see from several of the examples I'm about to discuss, the Commission recently has been experimenting with some novel—and very flexible—regulatory approaches to addressing some of the more complex market structure issues we face today. In some cases, the Commission simply is setting the regulatory goals, and then drawing upon industry expertise to devise the means of achieving those goals.

Let's look at some of ways the National Market System principles are now being tested.

### I. MARKET CENTER COMPETITION

I'll begin with market center competition. Much of the innovation in our marketplace today is due to competition. Indeed, much of the success of our securities markets has been achieved through the incentives created by multiple, competing market centers.

In 1998, to promote market competition while recognizing the role that electronic communications networks (ECNs) were playing as new market centers, the Commission adopted Regulation ATS.<sup>9</sup> Regulation ATS provides a streamlined regulatory structure for ECNs that choose to be regulated as alternative trading systems rather than national securities exchanges, and thereby enhances the opportunity for innovative market center competition.<sup>10</sup> Since the adoption of Regulation ATS, the competition generated by ECNs has continued to thrive, and we are making progress in integrating them into our National Market System. Through their successful creation of electronic agency trading venues, ECNs today account for

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841, 917 (1999) (discussing whether linkages “between the open market and the community market . . . should be introduced”).

<sup>8</sup> See HAZEN, *supra* note 5 (outlining the core principals and the purpose and goals of the 1975 Amendments).

<sup>9</sup> See Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 70,843F, 70,844 (Dec. 22, 1998) (to be codified at 17 C.F.R. §§ 202, 240, 242, 249).

<sup>10</sup> See *id.*

approximately 30% of the share volume and 40% of the dollar volume in NASDAQ stocks.<sup>11</sup>

A significant market structure challenge facing us today is how to level the playing field between ECNs and the SROs. SROs, unlike ECNs, serve a unique self-regulatory function. They have the power to discipline members.<sup>12</sup> They must provide fair access to members and they must submit most rules to the Commission for review. Many of the SROs argue that the latter process stifles competition by impairing the SROs' ability to respond to competitive pressures.<sup>13</sup> Because ECNs do not submit their trading rules to the Commission for approval, they may have a competitive advantage over registered securities exchanges. Thus, we are exploring ways to streamline our exchange regulation in a fashion that will allow market innovation, but at the same time not sacrifice market integrity or investor protection. Specifically, we are considering allowing most trading rules proposed by exchanges to become effective immediately upon filing with the Commission. This option would be conditioned on the exchange having established procedures for the effective surveillance and enforcement of these trading rules.

## II. ORDER INTERACTION

Despite the numerous beneficial effects of market center competition, problems such as excessively fragmented markets can result in reduced opportunity for order interaction. The

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<sup>11</sup> See Mara Der Hovanesian & Emily Thornton, *Tough Times in Electronic Trading*, BUS. WK., Oct. 23, 2000, at 142 (reporting that ECNs handle a third of NASDAQ trades).

<sup>12</sup> See 15 U.S.C. § 78 (1994); David A. Kessler, *Investor Casualties in the War for Market Efficiency*, 9 ADMIN. L.J. AM. U. 1307, 1322 (1996) (stating SROs may fine, suspend or expel members); *Sloan v. N.Y. Stock Exch., Inc.*, 489 F.2d 1, 4 (2d Cir. 1973) (concluding Congress clearly intended that the Exchange Act function as a self regulatory body and that appellants knowingly and intelligently subject themselves to SRO disciplinary procedures). SROs also reserve the right to inspect and examine the books and records of their members. See NAT'L ASSOC. OF SECURITIES DEALERS, INC., MANUAL 3142.

<sup>13</sup> See Richard G. Ketchum & Beth E. Weimer, *Symposium: Market 2000 and the NASDAQ Stock Market*, 19 IOWA J. CORP. L. 559, 573-74 (1994) (stating "record keeping requirements . . . continue to place the self-regulatory organizations at a tremendous disadvantage," and observing that while a proprietary trading system may make changes quickly in response to customer demands and market conditions, it takes SROs "operating through the rule filing process months or years to accomplish" the same thing).

Commission has taken action in the past to promote the opportunity for investor orders to interact without the participation of a dealer.<sup>14</sup> It may seem inconceivable today, but up through the early 1990s NASDAQ market makers routinely traded ahead of public limit orders.<sup>15</sup> As a result, it was nearly impossible for individual investors to use limit orders effectively in the NASDAQ market. Market makers accepted the limit orders of customers, but generally did not execute them until they had become marketable, and were therefore substantially equivalent to a market order. This effectively denied the opportunity for individual investor limit orders to compete with dealer quotations. To address this problem, and at the Commission's strong urging, the National Association of Securities Dealers ("NASD"), in 1995, changed its rules to prohibit a market maker from trading ahead of its customer limit orders.<sup>16</sup>

One year later, the Commission took the further step of adopting the Order Handling Rules.<sup>17</sup> Until then, the national best bid and offer ("NBBO") for NASDAQ securities generally reflected only market maker quotations. Such quotations did not reflect limit orders of any kind, whether submitted by investors to market makers or submitted by market makers or investors to ECN limit order books, even when these orders would improve the NBBO. In addition, the ECNs with the best prices did not make their prices publicly available in the consolidated quotation stream, but generally granted access only to their subscribers.

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<sup>14</sup> See Disclosure of Order Execution and Routing Practices, 65 Fed. Reg. 75,416 (Dec. 1, 2000).

<sup>15</sup> See Ketchum & Weimer, *supra* note 13, at 560. "The American Stock Exchange (AMEX) and the regional exchanges . . . criticiz[ed] a limited disclosure exception that permit[ed] market makers to trade ahead of customer limit orders." *Id.*; see also Self-Regulatory Organizations, 59 Fed. Reg. 10,842 (March 8, 1994) (proposing elimination of the disclosure safe harbor for firms that trade ahead of their customer limit orders); *In Re E.F. Hutton & Co.*, Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,326 (July 6, 1988).

<sup>16</sup> See NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., *supra* note 12, at 4121-22.

<sup>17</sup> See Order Execution Obligations, 61 Fed. Reg. 48,290 (Sept. 6, 1996) (to be codified at 17 C.F.R. Pt. 240) (requiring, inter alia, inclusion in the consolidated national best bid and offer (NBBO) of limit order prices and sizes that improved the market for a security by either improving the price of the NBBO or adding significant depth to the NBBO).

To remedy these practices, the Commission exercised its National Market System authority to require market makers to include in their quotes (or send to ECNs) customer limit orders that improve a market maker's published quotations.<sup>18</sup> The Commission also required market makers to publish their best-displayed prices either in their quote or through an ECN.<sup>19</sup>

This past February, the Commission issued its much-anticipated Concept Release on Market Fragmentation, which was published together with the notice of the NYSE's proposed rescission of Rule 390.<sup>20</sup> This provided an appropriate context for the Fragmentation Concept Release because of concerns about the potential for increased fragmentation of trading interest once NYSE members were permitted to conduct transactions in all listed securities off an exchange.

The Fragmentation Concept Release requested the public's views on whether fragmentation is now, or may become in the future, a problem that significantly detracts from the fairness and efficiency of the U.S. capital markets. For instance, certain broker-dealer practices—such as internalization and payment for order flow—may substantially reduce the opportunity for investor orders to interact, which is the effect of fragmentation. To assist commenters in formulating their views, the Commission briefly described six potential options to address fragmentation, ranging from increased disclosure of order routing and execution practices to the establishment of a national market linkage system to mandate price/time priority for all displayed trading interest.

While the comments reflected a wide range of views on these issues, many commenters expressed serious concern about market fragmentation in general, and internalization and payment for order flow practices in particular.<sup>21</sup> Most commenters expressed support for the idea of increased disclosure of order routing and execution practices, and the

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<sup>18</sup> *See id.*

<sup>19</sup> *See id.*

<sup>20</sup> *See* Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, 65 Fed. Reg. 10,577 (Feb. 28, 2000).

<sup>21</sup> *See* Disclosure of Order Execution and Routing Practices, 65 Fed. Reg. 48,347, at 48,407 (Aug. 8, 2000). "Many commenters [sic], especially institutional investors, expressed serious concern about market fragmentation in general and internalization and payment for order flow practices in particular." *Id.*

Commission agreed that there was a need for improved disclosure in this area.<sup>22</sup> Accordingly, the Commission proposed two rules to improve public disclosure of order routing and execution practices. Under the proposed Order Execution Quality Rule<sup>23</sup> (Rule 11Ac1-5), market centers that trade national market system securities would be required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis. These measures include price improvement and disimprovement, speed of execution, and limit order fill rates. Under the proposed Order Routing Disclosure Rule<sup>24</sup> (Rule 11Ac1-6), broker-dealers that route orders in equity and option securities on behalf of customers would be required to make publicly available quarterly reports that describe their order routing practices and disclose the venues to which customer orders are routed for execution. By enhancing disclosure of order routing and execution practices, the proposed rules are intended to promote fair and vigorous competition among broker-dealers and among market centers, and permit customers, other market participants, analysts, and academics to evaluate their performance in this critical, but previously opaque, area of customer service.

These proposed rules, admittedly, do not directly confront the issue of market fragmentation. As it turns out, the more aggressive options proposed in the Concept Release that would have dealt directly with fragmentation proved the most controversial. While many commenters supported a nationwide system of price/time priority,<sup>25</sup> many others believed that such a system would have an overall negative impact because it would impair the ability of market centers to compete.<sup>26</sup> After carefully considering the comments, the Commission elected not to take action at the time on the price/time priority alternatives described in the Fragmentation Concept Release. Among other things, the Commission was concerned about possible operational and technological problems that might arise if it were to mandate price/time priority at that time, as well as the

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<sup>22</sup> See *id.* at 48,409.

<sup>23</sup> See *supra*, note 17, at 48,291-93.

<sup>24</sup> See *supra*, note 22.

<sup>25</sup> See *id.*

<sup>26</sup> See *id.* at 48,407.

unpredictable impact decimalization and new technologies would have on market structure.

The Commission, for these reasons, elected to proceed in a measured way and gather additional evidence before proposing more sweeping changes. This should not be interpreted, however, as a broad retrenchment by the Commission on the issue of market fragmentation. The Commission remains deeply concerned about the potential for internalization and payment for order flow arrangements to interfere with order interaction and discourage the display of aggressively-priced quotations. To more fully evaluate these concerns, the Commission's Office of Economic Analysis is currently conducting an in-depth study of trading in NASDAQ and NYSE equities to assess order execution quality. The Commission intends to use the results of this study, as well as its experience with changing market conditions, to determine whether further steps are necessary to address internalization and payment for order flow.

Finally, the Commission is considering further ways to strengthen price competition and price priority within the existing market structures. With respect to strengthening price competition in the quote, the Commission intends to carefully consider and discuss with the SROs whether in a decimal trading environment market makers and similarly situated market participants should be able to step ahead of limit orders by as little as a penny without previously quoting at that price. It also is committed to resolving the remaining issues hindering the inclusion of all ECN prices in the public quote for listed equities, including the treatment of access fees charged by ECNs to their non-subscribers.

With respect to strengthening price priority, the Commission believes that it is important to encourage price priority across markets, particularly as new sources of quotes emerge and order routing technology improves. One possibility for doing so would be to adopt a rule for the equity markets requiring a broker-dealer to disclose to a customer whenever that customer's order traded at a worse price than the NBBO. A similar trade-through disclosure rule has been proposed for the options markets, which I'll discuss in a few minutes.

### III. PRICE TRANSPARENCY AND LINKAGES (EFFICIENT AND BEST EXECUTION)

Price transparency is another key pillar of the National Market System identified by Congress.<sup>27</sup> It formed the initial focus of Commission action in 1975. The wide availability to investors of an NBBO and a consolidated stream of transaction reports from all the market centers that trade a security is a minimum essential element of a truly National Market System. To achieve the price transparency objective, the Commission adopted rules requiring that all market centers make their basic quotation and transaction information publicly available, that such information be consolidated, and that it be made available to investors on a real-time basis.<sup>28</sup> As a result, investors have ready access to an NBBO and a consolidated transaction stream for each of the thousands of equity securities actively traded in the U.S. markets. Price transparency has become the hallmark of our securities markets, and many market participants credit it for much of their success over the last 25 years.

The fundamental objective of price transparency—assuring that investors have ready access to high-quality consolidated data—remains just as important today as it was 25 years ago. Some, however, have questioned whether the arrangements that have been set up to disseminate consolidated data are in need of updating.<sup>29</sup> For example, some suggest that greater competition could be introduced into the system if we abandoned the model where a single processor consolidates and distributes the data. They argue that advancing technology allows for new models for consolidating and disseminating data. In the months ahead, we intend to explore whether there are better, more efficient tools with which to achieve the National Market System objectives—and we will actively seek private sector input in this analysis.

For example, in July the Commission announced that it is establishing a federal advisory committee to assist it in evaluating the public availability of information in the equities and options markets.<sup>30</sup> The Advisory Committee on Market

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<sup>27</sup> See HAZEN, *supra* note 5.

<sup>28</sup> See *supra* note 21, at 48,408.

<sup>29</sup> See HAZEN, *supra* note 5.

<sup>30</sup> See *SEC to Establish Advisory Committee on Market Info*, SEC NEWS DIGEST, Issue 2000-141, at 1, available at 2000 SEC News LEXIS 1389 (July 25, 2000).

Information will have a broad mandate to explore fundamental matters, such as the benefits of price transparency and consolidated market information, and practical issues such as the most effective methods of consolidating market data. The Committee will be chaired by Dean Joel Seligman, a renowned scholar on securities regulation, and have approximately twenty-five members representing a wide range of perspectives, including investors, markets, broker-dealers, vendors, and other market participants, as well as the public at large. Our hope is that the Advisory Committee will be able to forge a consensus on a range of issues concerning market information, and issue a written report containing its recommendations to the Commission by September of next year. This is yet another example of the Commission thinking “outside the box” of traditional regulatory approaches. When confronted with difficult and technical issues, such as those surrounding market data, the Commission is actively utilizing private sector expertise to aid in developing possible solutions. We are optimistic that, with this “team” approach, we will be able to effectively promote the fundamental principle of price transparency.

Price transparency alone, however, is not sufficient to achieve the National Market System objectives. Providing access for executions against those prices, no matter where they may have originated in the National Market System, is also essential to address the objectives of efficiency and best execution.<sup>31</sup> Brokers provide the primary means of access to the markets. But once a broker has routed an order to a market, a better price may arise in another market. The Commission, therefore, has used its regulatory authority to prompt the securities industry to create intermarket linkages that provide access between market centers to the best-displayed prices.<sup>32</sup> These linkages include the Intermarket Trading System for listed equities and NASDAQ’s National Market Execution System for NASDAQ securities.

Another challenge is the integration of alternative trading systems into the quote and linkage mechanisms for listed securities. This past March, the Commission approved a

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<sup>31</sup> See *supra* note 22, at 48,409–10.

<sup>32</sup> See *id.* at 48,408–09.

proposed rule change by the NASD that will permit ECNs to link to the listed market through the ITS/CAES linkage.<sup>33</sup> Although additional ECN linkage issues remain, the NASD rule is a significant step in the right direction. We also expect the participants in the ITS plan to negotiate in good faith and work diligently to bring new exchanges into the ITS plan.

Some have suggested that advancing technology has made it possible for brokers to meet their best execution responsibilities through direct links with market centers, and intermarket linkages, such as ITS, are no longer necessary.<sup>34</sup> As with the arrangements for disseminating consolidated data, it is worth exploring whether there are better, more efficient tools with which to achieve the National Market System objectives. It is critically important, however, that the objectives themselves are not impaired in the process.

With respect to the options markets, only last year did they begin the multiple trading of options in earnest.<sup>35</sup> This allowed options investors, for the first time, to reap the benefits of a truly National Market System with competing market centers. But the multiple trading of options raised new best execution challenges for broker-dealers and significantly increased the likelihood of intermarket trade-throughs. To alleviate these concerns, the Commission, last October, ordered the options exchanges to file a linkage plan.<sup>36</sup> But the options exchanges were unable to agree on a single plan, so they filed three different linkage plans with the Commission.

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<sup>33</sup> Order Directing Options Exchanges to Submit an Inter-Market Linkage Plan, 64 Fed. Reg. 57,674, 57,675 (Oct. 26, 1999).

<sup>34</sup> See NEW YORK STOCK EXCHANGE SPECIAL COMMITTEE ON MARKET STRUCTURE, GOVERNANCE AND OWNERSHIP, MARKET STRUCTURE REPORT 41-44 (March 23, 2000), available at <http://www.nyse.com/pdfs/marketstructure.pdf> (last visited Feb. 22, 2001); *Hearing on the "Financial Marketplace of the Future" Before the Sen. Comm. on Banking, Hous. & Urban Affairs*, 106th Cong. (2000) (prepared testimony of Mr. Charles Schwab), available at <http://www.senate.gov/~banking/00-02hr/022900/schwab.htm> (last visited Feb. 22, 2001).

<sup>35</sup> *Hearing on "Maintaining Leadership in the Financial Marketplace of the Future" Before the Sen. Comm. on Banking, Hous. & Urban Affairs*, 106th Cong. (2000) (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission), available at <http://www.senate.gov/~banking/00-02hr/022900/levitt.htm> (last visited Feb. 22, 2001).

<sup>36</sup> See Press Release, SEC, Commissioner Orders Options Markets to Develop a Linkage Plan; Option Exchanges Meet at SEC to Discuss Linkage Plan Process (Oct. 19, 1999), available at <http://www.sec.gov/news/press/99-137.txt> (last visited Feb. 22, 2001).

This past July, after reviewing the comment letters submitted in response to the linkage plans—which reflected a wide range of views—the Commission took an approach to the problem of options market linkages that I believe is revolutionary in its flexibility.<sup>37</sup> The Commission refrained from mandating one single form of linkage, which might fail to adapt over time to changes in the markets or technological developments, and might impede the entry of new participants with different business models. Instead, it took a flexible, market-based approach to achieve its goal of reducing intermarket trade-throughs and encouraging effective linkages.

The Commission's approach consisted of three parts. First, it approved the linkage plan proposed by the AMEX, CBOE, and ISE but did not order the options exchanges to participate in it.<sup>38</sup> Second, to enable customers to better assess the quality of the executions that they receive, the Commission proposed a trade-through disclosure rule for the options markets.<sup>39</sup> That disclosure rule, however, would not apply to transactions in an options market that participates in a linkage plan approved by the Commission that contains provisions reasonably designed to limit trade-throughs. Finally, to ensure that quotes would be honored when orders are routed to them from other markets, the Commission proposed a rule that would require options markets' quotes to be firm up to their published quotation size.<sup>40</sup>

This flexible approach was designed to encourage access to, and linkage among, the competing options markets, without mandating the means to achieve this goal. The industry, as a result, should be able to readily improve the “plumbing”—the means of achieving the national market system goals—as technological developments and changing market conditions warrant.

## CONCLUSION

What general principles, then, can be extracted from these

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<sup>37</sup> See Press Release, SEC, SEC Approves Options Intermarket Linkage Plan (July 25, 2000), available at <http://www.sec.gov/news/press/2000-101.txt> (last visited Feb. 22, 2000).

<sup>38</sup> See Order Approving Options Intermarket Linkage Plan, 65 Fed. Reg. 48,023 (Aug. 4, 2000).

<sup>39</sup> See *id.* at 48,029.

<sup>40</sup> See *supra* note 33.

examples of Commission action to further National Market System objectives? First, the Commission has been reluctant to impose specific components for the facilities and systems of the National Market System. Instead, it has focused whenever possible on enhancing the opportunity for competition, particularly competition by innovative market centers and by investor limit orders. When required to act, the Commission has eliminated practices that detract from National Market System objectives, or set necessary market wide standards, while preserving maximum flexibility for the markets to design, implement, and govern any needed facilities or systems.

Second, the interests of investors are preeminent to those of any individual market center or its participants. The secondary securities markets exist to facilitate the transactions of investors. Investor interests should be protected; investor orders should receive best execution; and investor orders should have an opportunity to interact without the participation of a dealer. Any rules or practices that place the interests of intermediaries ahead of those of investors are incompatible with the National Market System mandated by Congress.

Third, the fact that a practice may further the competitive self-interest of any individual market center or type of market center is not determinative of whether that practice is consistent with the National Market System objectives. If such a practice hampers the efficient execution of transactions, damages price transparency, interferes with the best execution of investor orders, or isolates those orders from an opportunity for meaningful interaction, the practice warrants careful examination by the Commission to determine whether competitive forces alone will be sufficient to address its negative effects. In the past, for example, market centers with the best prices have attempted to restrict access to those prices, such as disseminating their quotations only to members or subscribers.<sup>41</sup> Even though this practice may be in the competitive self-interest of the individual market center, it is directly contrary to the price transparency objective of the National Market System, as well as efficient execution of transactions and best execution of investor orders.

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<sup>41</sup> See Order Approving Options Intermarket Linkage Plan, 65 Fed. Reg. 48,023 (Aug. 4, 2000).

Finally, there have been times when the collective result of individual market participants, acting in their own self-interest, has not been sufficient to address practices that are harmful to the National Market System and impair investor confidence (such as dealers trading ahead of, or neglecting to display, customer limit orders). In these unusual situations, the only effective course of action is for the Commission to exercise its regulatory authority to adopt uniform “rules of the road” that benefit the National Market System as a whole.<sup>42</sup> By adopting or by encouraging self-regulatory organizations to adopt rules that set standards, address the harmful effects of specific practices, or knock down barriers to competition, the Commission can achieve benefits for the National Market System that could not be obtained through any other means.

It’s very exciting exploring strange, new, and uncharted worlds and discovering new possibilities. Fortunately, while we frequently don’t have a map, we do have a mandate that keeps us on course: maintain fair and orderly markets and protect investors.

Thank you.

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<sup>42</sup> See *supra* note 35.

