Testimony of
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Hearing on
"Regulation NMS and Recent Market Developments"
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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for the opportunity to participate in this hearing regarding the Securities and Exchange Commission's market structure rule, Regulation NMS, and recent market developments in the industry.

Knight Capital Group, through its affiliates, makes markets in equity securities listed on Nasdaq, the OTC Bulletin Board, the New York Stock Exchange, and American Stock Exchange, both in the United States and Europe.[1] On active days, Knight executes in excess of one million trades with volume exceeding one billion shares.

[1] Knight is the parent company of Knight Equity Markets, L.P., Knight Capital Markets, Inc., and Knight Equity Markets International, Ltd., all of whom are registered broker-dealers. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary. Knight is a major liquidity center for the Nasdaq and listed markets. As a dealer, we make markets in nearly all equity securities. Knight's clients include more than 850 broker-dealers and 600 institutional clients. Currently, Knight employs nearly 700 people. Recently, Knight announced its acquisitions of Direct Trading Institutional, Inc. (DTI), based in Irving, Texas, and the ATTAIN ECN which is based in Montvale, NJ. DTI is a registered broker-dealer and was founded in 1998 to provide institutional investors trade executions and reduced trading costs. DTI now provides execution services to roughly 300 institutions that are trading in excess of 2 billion shares per year. ATTAIN is a registered electronic communications network (ECN) pursuant to Regulation ATS and currently provides facilities for broker/dealer customers to quote Nasdaq listed and OTC Bulletin Board securities. Both acquisitions are currently pending regulatory approval.

Regulation NMS

For several years Knight has called on the SEC to address several problems in the equity markets, namely the lack of market linkages and efficient access to quotes, the ability of ECNs to charge access fees to non-subscribers, and the negative impact of sub-penny quotations. By adopting Regulation NMS, the SEC took an important step to address some of these issues, which have long been areas where potential gaming or distortion create inefficiencies in the markets.

Knight supports the ban on sub-penny quotations and the rule prohibiting locking the quotation of an automated market included as part of Regulation NMS. Sub-penny quotations diminish liquidity at each price point and make it easy for professionals to jump ahead of limit orders. By capping ECN access fees for non-subscribers, Regulation NMS will help to establish more integrity and transparency of the quote. The rule will also address the market distortions such fees cause, mitigating the economic incentive of certain market participants to lock and cross markets, which can lead to confusion in the marketplace.

Knight applauds the SEC for its action in these areas. However, Knight continues to believe that there is no need to extend any form of trade-through rule to all markets due to competitive forces and the lack of data supporting such a rule. As we noted earlier this year in testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee on February 15, 2005, there is no evidence to suggest that an intermarket trade-through rule will increase limit orders, one of its stated goals. However, various data sources reveal that retail investors use limit orders on Nasdaq-listed stocks (with no trade-through rule) much more often than on exchange-listed stocks (with a trade-through rule).[2] Additionally, we believe that the typical U.S. retail investor prefers the use of market orders, as opposed to limit orders, as it provides them the opportunity to immediately gain access to the displayed price and size they see in the market. Further, the SEC's data on trade-through rates is nearly the same for NASDAQ, which currently has no trade-through rule, and the NYSE, which already has a form of the trade-through rule. Finally, we are also concerned that a trade-through rule may have the unintended consequence of further reducing liquidity in the market, particularly if large block-sized prints move offshore.

Knight instead has advocated repeatedly that competition, rather than mandated and prescribed paths to trading, benefits market participants and all investors. For example, the SEC's Rule 11Ac1-5 ("Rule 5") is an excellent example of regulation that increases competition by promoting transparency and comparability. The rule requires market participants to post their execution statistics in accordance with standardized reporting metrics, thus enabling order routing firms to make more informed routing decisions to meet their clients' needs. This has increased competition and pressured market participants to continue to improve the execution of customer orders, while resulting in dramatically reduced costs for investors. We believe the dramatic decrease in brokerage commissions and the split-second executions for most marketable trades in recent years is a direct result of these competitive forces, not regulatory fiat. Therefore, Knight still believes that a regulatory approach encouraging competition such as Rule 5, coupled with strengthened linkage requirements mandating that all markets connect so all displayed quotations can be immediately accessible and executable, would provide a far less disruptive and less costly way to achieve the goals of a trade-through rule.

[2] *See* letter from Jeffrey T. Brown, Senior Vice President, Charles Schwab, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, February 1, 2005.

With the adoption of Regulation NMS, Knight is focused on implementation to ensure compliance and a smooth transition to the new rules. The trade-through rule in particular has numerous exceptions and other requirements that will make implementation extremely challenging. The vetting process which has taken place to date has produced numerous comments, many of which have raised critical issues for this Committee and the SEC. The SEC and its staff should be commended for their hard work in reviewing all of the various comment letters, conducting numerous industry meetings, and for their efforts at drafting the final Rule. As the "devil is always in the details," it will be important to carefully examine the final Rule once published to ensure we fully understand its nuances and then work closely with the SEC staff to address any questions.

I will briefly identify some areas that warrant significant attention as Regulation NMS is implemented.

1. The need for clear guidance from the SEC and an incremental phase-in. We encourage the SEC staff to continue to work with industry on implementation of the rules in a transparent and open manner to achieve consensus on the technical details of Regulation NMS.

The SEC should gradually phase-in and implement the rules, particularly the trade-through rule, in a methodical manner. Regulation NMS provides a limited phase-in of the trade-through rule, beginning with a small group of representative NMS stocks on April 10, 2006, with full implementation by June 12, 2006.

Knight recommends a more incremental phase-in to help ensure that market participants have the system capacity necessary for successful implementation. For example, we suggest that 100 stocks be part of the first phase-in stage, which should last one month, followed by additional phases of 500 stocks per month thereafter. This incremental phase-in approach will allow for a more reasonable implementation schedule and will permit market participants to conduct the proper stress testing on their trading systems for those changes associated with the new requirements.

There is adequate precedent for such a phased-in implementation of major changes to market rules. For example, the implementation of decimal pricing began with a phase-in of decimal pricing in August 2000 and ended with full implementation in April 2001. There are other examples, such as the move from NASDAQ's SelectNet to SuperMontage and the implementation of Regulation SHO, where the SEC took a deliberate and careful approach to implementing new rules. The transition to SuperMontage took several years to implement and included testing the trading systems on weekends for many months. The implementation of Regulation SHO governing short sales includes a one-year pilot consisting of stocks of varying liquidity and size. These examples demonstrate that when the regulators and industry work carefully together on complicated matters, it helps to smooth the transition to the new rules with the least disruption to market participants and investors.

2. Improve connectivity. Regulation NMS permits private linkages to promote more connectivity among the markets. However, the SEC should mandate minimum standards for such linkages and ensure that quotes can be accessed immediately. Knight believes that this requirement alone would have prevented the need for any trade-through rule and provided for a more efficient national market system. Although Regulation NMS encourages connectivity, these provisions should be strengthened to ensure that the markets are linked and accessible, especially in light of the new trade-through rule.

3. **Trade-through rule design.** The most complex aspect of Regulation NMS will be the implementation of the new intermarket trade-through rule. A number of questions remain regarding how to program trading systems for the new trade-through rule. Although the rule provides an exemption from the trade-through rule for flickering quotes, there remain questions as to how this will work in practice. For example, in a flickering quote environment, would the execution of a trade that occurred two cents from the "best price" be considered a trade-through?

With automatic and electronic trading, fast response times are critical for an efficient trading environment. If rules establish specific response times of 1-2 seconds, it may create a safe harbor for markets to respond within that time frame rather than promoting innovation and sub-second response standards. These latencies will ultimately harm the investors, and only serve to reduce transparency and to decrease liquidity.

Rules for response times should be dynamic, reflecting the current state of technology at any point in time. The Securities Exchange Act of 1934 (the "Exchange Act") states that the securities markets are an "important national asset which must be preserved and strengthened."[3] Further, and by way of analogy, when considering unlisted trading privileges, Congress directed the SEC to take into account many factors, including "… the character of trading, the impact of such an extension on the ***existing*** markets for such securities, and…, the progress that has been

[3] See, Section 11A(a)(1) of the Exchange Act, 15 U.S.C. Sec. 78k-1(a)(1).

made toward the development of a national market system" (emphasis added).[4] The message from Congress is clear. The implementation of rules should take into account the impact on "existing markets." Consequently, in ***existing*** markets that benchmark executions in sub-seconds, rules should not be promulgated which encourage or permit much slower executions. To do so, would not only ignore the state of technology in ***existing*** markets, but could also hinder the continued "development of a national market system."

The issues relating to defining "fast" and "slow" markets are equally complex and challenging. For example, who determines whether a quote is fast or slow? Additionally, as currently drafted, the rule applies to "quotes." Thus, market participants will have to develop processes to monitor each stock traded in each market venue. To illustrate the complexity, there are roughly 6,000 securities that trade on Nasdaq and the NYSE. Imagine needing a stopwatch to time the response times of all market participants in those 6,000 issues, clicking on and off with each trade, in each security, by each market participant, every second of the trading day. As you can imagine, there are a number of possible outcomes if there is not sufficient specificity or a bright line to set forth the standards.

Another concern about implementation of the rule lies with the exemption of trade-through protection for slow quotes. Regulation NMS does not exempt trade-throughs of manual quotes from best execution obligations. Knight recommends some form of a safe harbor from best execution obligations for slow quotes. If there is no safe harbor, it could create significant uncertainty and inefficiencies in the markets and it could ultimately defeat the incentives for slow markets to become fast markets.

[4] See, Section 12(f) of the Exchange Act, 15 U.S.C. Sec. 78I(f).

4. Potential gaming opportunities. Careful and poised implementation will be vital in preventing potential gaming opportunities of professional traders who may seize upon unintended opportunities resulting from a rapid roll-out of the rule. A lesson can be learned from the retired Nasdaq Small Order Execution System (SOES) system. SOES was initially designed, in part, to remedy the problems experienced after the 1987 stock market crash to ensure the small orders of many investors could be executed automatically. SOES allowed small orders to be executed automatically against dealer quotes; however, an eventual unintended consequence was the creation of a cottage industry of professional traders, often called "SOES bandits," that took advantage of small quote differences using rapid trading. It took several years to take action against these abuses, some of which impacted small investors by disadvantaging pension and mutual funds. In a similar way, care should be taken not to create gaming opportunities for certain professionals at the expense of most investors.

Recent Market Developments

Competition helps to foster innovation, creativity, and greater efficiencies to the benefit of the individual investor. Knight has always been an advocate of policies that foster competition. For instance, Knight was a proponent of rules that increase transparency and comparability of execution quality. The SEC later adopted Rule 5, which as I described earlier, has provided transparency and comparability of execution statistics. This has increased competition and pressured markets to continue to improve execution and reduce costs of customer orders.

Regulation NMS, to the extent practicable, should avoid prescribing specific paths to trading, which may limit the ability to innovate and to enter markets. Additionally, we need to be mindful of the fact that costs associated with complying with a very intricate rule could create barriers to entry. The current uncertain business and regulatory environment impacts profitability and tends to encourage more consolidation. Clear and effective regulation will help to reduce some of these uncertainties. Although a degree of consolidation is inevitable as firms strive to gain efficiencies and economies of scale, it is unclear to what extent investors may benefit as further consolidation of the markets takes place.

Conclusion

Knight appreciates the constructive role this Committee has played in the oversight of the markets and the rulemaking process. Regulation NMS represents the first fundamental re-write of the market system rules in 30 years. Therefore, we urge the Committee to continue its oversight role as the industry and the SEC work on implementation of Regulation NMS. Your involvement helps to ensure that the U.S. capital markets remain competitive and innovative, thus benefiting all investors.

Thank you for your interest in these issues and for the opportunity to contribute to this important dialogue.