

“BEST EXECUTION, PRICE TRANSPARENCY, AND LINKAGES: PROTECTING THE INVESTOR INTEREST”

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Thank you very much for that warm introduction. I must say, there are few things that make me more nervous than speaking in front of Joel Seligman. There is perhaps no other person who knows more about the history of our securities markets and the SEC than Joel. I've often thought that if the wing of the Library of Congress containing the nation's historical documents on our markets was to burn down, the first thing our government would do is call up Joel, with pen in hand, and ask politely, "Could you just start from the beginning?"

But when Dean Seligman looks back on these formative times for our markets, I think it's safe to say that there will be plenty for him to write about. Today, our capital markets are experiencing change at a pace and on a scale we've never seen before—driven by the forces of technology and competition. New market entrants, new ways to invest, and new investors are changing the face and form of America's markets.

Seven months ago, I talked about a regulatory framework that I believe will continue to give competition the space and sustenance to flourish. In it, multiple market centers compete with one another to produce faster and cheaper executions of securities transactions. A few months later, I addressed a broker's duty of best execution, which serves as a guardian of competition among our markets. Last week in Chicago, I talked about the two remaining pillars of our National Market System: transparency and linkages.

Today I want to revisit the components of best execution, transparency, and linkages, but I want to approach them from a slightly different angle. Often, when we discuss concepts such as "trade execution" or "price visibility" or "order interaction," it's easy to get mired in highly technical, even puzzling details. These are not necessarily straightforward concepts, and meaningful debates about their impact on our markets often demand rigorous analysis. It's easy to lose sight of what's at the very core of these principles—and that's serving the investor interest. Execution quality takes some effort to consider, but it is more than worth it for most investors.

Best execution is the duty of brokers to obtain the best execution reasonably available for their customers. Put another way, it is a pledge by

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brokers that they will act in the best interest of their customers. Transparency, on the other hand, is when prices can be seen across all the different market centers and exchanges. This makes it possible for brokers to locate the best price in the overall market. And linkages provide a way for brokers to access those prices and execute trades. It does little good to see the best price if there is no way of accessing it.

The working confluence of these three principles fosters a marketplace that serves both investors and efficient capital formation. But as is often the case when theory is tested in the more rigorous medium of reality, new challenges and unexpected obstacles arise. Best execution, price transparency, and effective linkages become more complex when we consider both today's market developments and the diversity of America's investors.

BEST EXECUTION

When someone talks about achieving the "best" execution of a trade, what exactly does that mean? The truth is, best execution encompasses a number of factors, starting with the price of the execution and the opportunity for price improvement—that is, finding a better price somewhere in the open market. Other factors include speed and the likelihood that the order will actually be executed. For institutional investors, anonymity and liquidity might be overriding concerns. In any case, the quality of execution must always be viewed from the investor's perspective—not the firm's.

At the same time, increased competition among market centers has provided new alternatives as well. Some market centers guarantee immediate automated execution of trades. Others promise the possibility of getting the investor a better price than the market is offering. Where one trading platform might provide anonymity for large orders, another will promise "optimal" executions by searching many market centers for very specific opportunities.

As you can imagine, all of these dynamics must be balanced. For example, it goes without saying that, at some point, a customer will sacrifice some chance of a better price for speed, and visa versa. You won't find many investors willing to wait a week to get a small amount of price improvement if they think the market for that security may move quickly. On the other hand, I suspect most retail investors would willingly sacrifice 5 or 10 seconds in order to get a chance for a better price.

Now, some firms have told us that execution speed is the most important factor in their routing decisions. But far too many of these firms have not conducted regular and rigorous reviews of execution alternatives—reviews to

determine whether there are other places that offer faster executions, or executions that are just as fast but with a greater likelihood for price improvement. Firms must be proactive in engaging their customers and ascertaining their needs.

Now, I'm sure that some in the industry think that the Commission has a myopic, picayune focus on price improvement. "What's the big deal?" they ask, "if the difference is only 1/16th?" Well, consider these numbers. If your order is executed at one increment away from the best price -- 1/16th—that's \$62.50 out of your pocket on a 1000 share order. That's more than four times the commission that many on-line brokers advertise today. To an investor, that's real money.

Firms must consider and analyze execution alternatives that go beyond just the firm's economic self-interest. Some firms are currently asking the different market centers for execution quality statistics, including speed of execution and percentage of price improvement. Others route "test trades" to gather the same data. I applaud these efforts. They are encouraging first steps on the road toward better markets—markets tailored to the needs of customers.

TRANSPARENCY, LIMIT ORDERS, AND THE PRICE SETTING MECHANISM

Even if brokers establish very clearly the investing objectives of their customers, brokers must be able to *see* the best prices in the market if they are to truly achieve best execution. As more and more market centers compete for customer orders, it's imperative that prices are visible to every broker or dealer in every market.

But transparency does more than just allow brokers and investors to view prices—it serves an important function in the price-setting process. How does transparency impact prices? One of the ways is through its most powerful agent—the limit order.

There are essentially two types of customer orders: market orders and limit orders. When an investor places a market order, a broker executes the trade at the best current price in the market. In this way, investors can be viewed as *price-takers*. In contrast, limit orders—orders to buy and sell a security at a specified price or better—enable investors to compete for better prices than the market is offering. Limit orders, in other words, allow investors to be *price-setters*. And that's a unique opportunity. Makes you wish we had limit orders for buying gasoline.

Limit orders serve a critical market function by helping reveal the supply and demand for a security. More simply put, they show how many shares of a particular stock customers are willing to buy or sell, and at what price. As a

result, limit orders increase the information available to the overall market and allow all market participants to better determine prices.

But limit orders have done more than just promote price discovery; they have begun to level the playing field between dealers and the investing public. There was a time when investors had no choice but to accept the price set by dealers in the OTC market. But through the use of limit orders, investors now have become an integral part of the price setting process, allowing prices to be determined by the forces of competition.

In 1997, the Commission decided to foster this kind of price competition by enacting the Limit Order Display Rule. It simply stated that dealers holding customer limit orders that are equal to or better than the market price must either execute the orders immediately or display them to the market. The point of the rule was to make the most motivated buyers and sellers visible to the broader market—increasing the chance that those who stood up and improved the price would be rewarded.

Since then, the investing public has benefited from greater competition and more fully realized price transparency. It is now clear that the Order Handling Rules—which include the Limit Order Display Rule—are largely responsible for narrowing spreads by over 30%. Most of that decrease in spreads—the difference between a dealer's bid and offer—is due to the display of customer limit orders.

I believe that our markets should embrace a broader, deeper transparency than what exists in our markets today. Currently, most market participants can see only the “top” of a market's limit order book—that is, the single best quote available. But this says very little about the rest of the supply and demand for a particular security. In many respects, when it comes to price transparency today, seeing the top of the book is like seeing the tip of an iceberg—and having no idea how much rests below.

With the impending changeover from fractions to decimal pricing, and quote increments move to pennies, this top layer will represent an even thinner slice of the total buying or selling interest for that security. In fact, in going to pennies, market participants could now see a sliver of customer demand that is about 1/6-th the size currently visible. In many respects, decimalization makes greater transparency a market imperative.

Important and encouraging steps are being taken by our markets. The NYSE has proposed making the specialist's book of limit orders visible to its members and the broader public. The Nasdaq has submitted a plan to create a SuperMontage that will aggregate and display orders and quotes of all participating market makers—not only at the current best prices, but several increments away from the best price. And some ECNs already make their entire book visible to the public via the Internet on a real-time basis. These

are all forward looking initiatives that answer the investor's call for greater transparency and more efficient pricing.

But we can do more. Last week, I called for all market participants to move toward open books across all markets. Now is the time for a voluntary private sector initiative in this important area—one that does not require major systems engineering.

If our markets—exchanges, dealers, and ECNs—were to make their limit order books available to the public, vendors could consolidate this data and package it in a form that would be most useful to their customers. Presumably, nearly all market participants would want to purchase this data and broker-dealers would make it available to investors—including retail investors.

Of course, some customers would prefer not to have their limit orders displayed, and I am not suggesting they be forced to do so. But the choice should rest with investors—not market intermediaries. As an investor bidding on the price of a security, wouldn't you want to know how many people want to buy or sell that same security, and how much they are willing to pay or sell it for? The ability of all investors to see the depth of supply and demand in any stock would be a giant step towards a true National Market System.

LINKAGES

But there is another crucial component to ensuring that investors receive the best possible prices that the open market has to offer—and that is effective linkages between markets. Even if all market participants could see the best quotes across all market centers, there must be a way for customers—most commonly through their brokers—to access those different markets quickly and efficiently.

If quote prices are changing rapidly, often the market where the broker routes an order no longer offers the best price by the time that order arrives. Intermarket linkages help ensure that the order still gets the best price at the point of sale. What's more, intermarket linkages also help promote price equilibrium across markets, thereby enhancing our markets' efficiency.

Historically, the Commission has played an active, but limited role in promoting better intermarket linkages. The linkages that the Commission has insisted upon have been basic connections that protect customers from pricing disparities – that is, different prices in different markets for the same security. And while the SEC has prodded, it has not dictated the details of the linkage. In considering reforms to the current linkage system, we should be mindful of certain fundamentals.

Market centers, in a dynamic National Market System, must be able to hone a niche, develop a brand, or offer value-added features. Any linkage must accommodate innovation and the imperative to compete on the basis of value. Moreover, intermarket linkages are not intended to promote unlimited free access to a competitor's market. Why, for example, would anyone purchase a seat on the NYSE if a connection to ITS—the listed market linkage—offered equivalent benefits?

The sophistication of brokers in providing linkage to competing markets will only expand as technology reveals new possibilities. We can expect similar advances in linkages between markets as cutting-edge private sector connections between ECNs, for example, continue to develop. In any event, we must continue to insist on basic connectivity between markets in pursuit of a more effective and more efficient National Market System. Investors who put their hard earned dollars in America's capital markets deserve the price efficiency that a more interconnected market provides.

CONCLUSION

In many respects, we are at a point of passage for our markets—of what they have been, and what they will become. Amidst this transformation, we must remain focused on those fundamentals that will best serve investors no matter what future course our markets take. Today, with more market centers than ever before, transparency and linkages have become even more critical to providing those who act on behalf of investors the opportunity and the tools to effectively serve their customers.

The duty of best execution—through transparent pricing and effective linkages—must be woven more fully into the fabric of our markets. It must be at the very core of our promise of integrity to investors. It must reinforce competition—rewarding those markets that improve upon their execution quality. As we embark upon what I hope and expect will be a century replete with opportunity, innovation and drive, let us continue to embrace these principles, not only for the sake of investors, but for the promise of America's markets in tomorrow's global marketplace. The quality of our markets must be our competitive advantage. And nothing honors this dedication to quality more than a commitment to achieving the best possible execution of any order, by any investor, from anywhere in the world.

Thank you very much.