The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

MEMO# 18056

October 7, 2004

ICI 2004 EQUITY MARKETS CONFERENCE SPEECHES

[18056] October 7, 2004 TO: BOARD OF GOVERNORS No. 64-04 CEOS CLOSED-END INVESTMENT COMPANY MEMBERS No. 67-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 92-04 SEC RULES MEMBERS No. 149-04 SMALL FUNDS MEMBERS No. 110-04 UNIT INVESTMENT TRUST MEMBERS No. 39-04 RE: ICI 2004 EQUITY MARKETS CONFERENCE SPEECHES On September 23, Institute General Counsel Elizabeth Krentzman, the Securities and Exchange Commission's Division of Market Regulation Director Annette L. Nazareth, Nasdaq's President and Chief Executive Officer Robert Greifeld, and the New York Stock Exchange's Chief Executive Officer John A. Thain spoke at the Institute's 2004 Equity Markets Conference.* Their remarks are summarized below. Remarks by Ms. Krentzman Ms. Krentzman, who provided the conference's opening remarks, noted that the mutual fund industry had reached the first anniversary of the mutual fund scandal and that to sustain the confidence of investors, the industry "must dedicate itself to fulfilling its obligations as fiduciaries." Ms. Krentzman observed that "[a] vigorous and successful compliance program is an essential part of this proposition." Turning to the topic of market regulation, Ms. Krentzman remarked that "a well- regulated, fair, and efficient securities market" is "vitally important" to the Institute and its members. She noted that the Institute continues to take an "active role" in the development of regulatory initiatives that would change the way the securities markets are structured. For instance, she noted the Institute's ongoing examination of the effect on mutual funds of the * A copy of Ms. Krentzman's opening remarks are available on the Institute's website at: http://www.ici.org/statements/remarks/04_emc_krentzman_spch.html#TopOfPage. Ms. Nazareth's, Mr. Greifeld's, and Mr. Thain's remarks may be found at: http://www.sec.gov/news/speech/spch092304aln.htm, http://www.nasdaq.com/newsroom/presentations/documents/ICI_speech_Sept2304.pdf, and http://www.nyse.com/p1021232175378.html?displayPage=http%3A%2F%2Fgoogle.nyse.com%2Fsearch%3Fsite%3 Dnyse%26output%3Dxml_no_dtd%26client%3Dnyse%26proxystylesheet%3Dnyse%26filter%3D0%26restrict%3D%26 getfields%3Ddescription&q=speeches, respectively. 2 SEC's proposed Regulation National Market System (NMS). She also noted the Institute's continued promotion of more efficient trading of listed securities on the NYSE, such as the decision of the new leadership at the Exchange to take the first step towards bringing automation to the Exchange through their recent hybrid market proposal. Ms. Krentzman expressed support for Regulation NMS and urged the SEC to focus its efforts on the "core principals of a national market system – efficiency, competition, price transparency, and the direct interaction of investor orders." In closing, Ms. Krentzman observed that the current debate over market structure affords the SEC the opportunity to undertake long overdue reforms that would improve the quality of our markets and move us closer to a "true

national market system.” Remarks by Ms. Nazareth In her keynote address, Ms. Nazareth noted that the SEC is in the “thick of a rulemaking process” that could result in some of the most important changes to the U.S. equity market structure since 1975. Recognizing there have been “dramatic” changes to the markets over the past several years, Ms. Nazareth remarked that the SEC has determined that the following areas are “ripe” for review: the ITS trade-through rule, intermarket access requirements, subpenny quoting, and the allocation of revenues produced by the consolidated data networks. Before beginning her discussion of the views raised by commenters to Regulation NMS, Ms. Nazareth reflected upon the comment process generally. In an effort to demonstrate the challenges the SEC staff faces in assessing opposing views expressed in the comment process, Ms. Nazareth provided examples of initiatives that have generated significant consternation over the years, such as the firm quote rule, elimination of fixed commissions, and the Order Handling Rules. She noted that in Regulation NMS, the SEC seeks to balance the comments consistent with its guiding principles “to enhance best execution; improve market efficiency; enhance price discovery; provide competition; encourage display of limit orders; and above all, do no harm.” Ms. Nazareth remarked that Regulation NMS comments were perhaps most disparate with respect to the trade-through rule. She noted that overall the vast majority of commenters supported the principle of price protection, although they expressed different opinions on the best way to achieve that goal. For instance, institutional commenters were nearly unanimous in their strong support for a trade-through rule without an opt-out exception. Other commenters supported a trade-through rule, but specifically conditioned their support on inclusion of an opt-out exception. Still other commenters, such as electronic markets and electronic traders, did not believe that any trade-through rule was necessary. Ms. Nazareth stated that there was wide support for the concept of allowing “automated” or “fast” markets to trade through non-automated or “slow” markets. Ms. Nazareth observed that the intent of the NYSE’s proposed enhancements to its Direct+ automatic execution system (hybrid market proposal), is to position itself to satisfy a trade-through rule that incorporates the automated vs. manual quote approach, rather than the automated vs. manual market approach. 3 Ms. Nazareth stated her belief that whatever final Regulation NMS rules the SEC may adopt, “they will signal the [SEC’s] continued belief in a core set of principles, ” such as the protection of limit orders and the fulfillment of the agency duty of best execution. She indicated that it is her hope that the SEC will consider Regulation NMS before year-end. In closing, Ms. Nazareth remarked that it is “an historic moment in market regulation” and the SEC has an “opportunity to make some pivotal changes that could guide our equity markets into the new century.” Remarks by Mr. Greifeld Mr. Greifeld observed that the goal at Nasdaq is to “facilitate” the broker-dealer function and to ensure that Nasdaq’s activities never compete with this function. He noted that Nasdaq’s goal is to “practice the highest standards of public company governance, to provide effective utility services, to the industry, and bring to the market the innovations that result from the spirit of competitive capitalism.” With respect to competitive dynamics in the market data industry, Mr. Greifeld noted that Nasdaq is advocating a “dramatic” reduction in the fees that investors pay for market data and that as a matter of public policy “let us charge a basic rate for basic data that is reflective of the current cost of providing such data.” Mr. Greifeld remarked on Nasdaq’s recent changes to its opening and closing processes. “The lack of an opening and closing process has always been an area where the Nasdaq market could be improved.” He stated Nasdaq saw a “great opportunity to improve the Nasdaq market and leapfrog the opening and closing processes” by studying the role specialists play on manual floor based markets and how the electronics are utilized in the electronic European markets. He noted that Nasdaq is “thrilled” with the performance of its closing cross and eagerly awaits the launch of its opening cross on October 25th. Turning to Regulation NMS, Mr. Greifeld remarked that Nasdaq spent many hours of management time formulating its position, but recently realized they had made a "fundamental" mistake in their consideration of Regulation NMS. He noted that although its "cerebral" discussions were a success, Nasdaq failed to realize that Regulation NMS is "as much about practicality as it is about philosophy." Commenting on a situation that the SEC has identified as a "false positive," Mr. Greifeld questioned the practicality of a trade-through rule. "If the quote update rate on a particular stock is faster than the response time on an order to trade that stock, [then] the ability of the broker/dealer to avoid a trade though is a matter of luck." He noted that it is "impossible to build a fair system of regulation where the violators are forced by the rule to always violate the rule." To limit the incidents of false positives, Mr. Greifeld observed, the SEC may be forced to specify certain parameters regarding how long a quote must be standing and low long a quote is in the market before that quote is considered traded through. Such parameters, he noted, may result in a trade-through rule not being applied to 90% of the trading activity in a given stock. "What would be the benefit of this huge expenditure when the [trade -through] rule itself would not even apply to a large percentage of trading activity." Mr. Greifeld remarked that "[w]e are witnessing the direct intersection of regulatory initiatives with technology realities of the marketplace." 4 Remarks by Mr. Thain Mr. Thain began by noting the changes the NYSE has undergone this past year in the areas of independence, separation of duties, and transparency. With respect to independence changes, Mr. Thain noted that the NYSE established a smaller and more independent Board of Directors to replace the old Board, which he viewed as "too big" at 27 members. In the area of separation of duties, Mr. Thain remarked that the Exchange separated the chairman and chief executive officer positions as a way of creating "one further check on the CEO at the board level." He observed that about a third of U.S. companies have a similar structure. Mr. Thain also remarked that the NYSE separated the regulatory function from the business operations of the Exchange. He explained that he runs the business of the NYSE and Rick Ketchum runs the regulatory function and reports directly to a subcommittee of the board. The third way that the NYSE separated responsibilities, Mr. Thain noted, was between the Board of Directors and the Board of Executives. Mr. Thain explained that the new Board of Executives consists of representatives from the NYSE's constituent populations, such as listed companies, member firms, lessor firms, various buy side representatives, and individual shareholder representatives. With respect to transparency, Mr. Thain observed that the Exchange now provides "public-company type disclosure, " in its annual report, such as "real financials" with "real footnotes" and the compensation of the top five officers. Mr. Thain next discussed the NYSE's hybrid market proposal. He noted that the NYSE has much lower volatility in the trading of its listed company stocks compared to electronic markets and lower transaction costs in the trading of its company stocks. Mr. Thain acknowledged, however, that the NYSE is not fast. "It takes longer, on average, to trade on the stock exchange than it does on an electronic market." He indicated that the Exchange's customer base, particularly the buy side, has not liked the fact that the Exchange cannot trade electronically, instantaneously and anonymously. In an effort to be more customer-sensitive, Mr. Thain remarked that the NYSE has recently filed three rule changes with the SEC, including the hybrid market proposal. In response to suggestions that the NYSE become more like an ECN, he noted that the NYSE does not want to be an ECN. "There are things that are better on the [NYSE]; our opens and closes are better[,] how we deal with order imbalances, how we deal with unusual events." Mr. Thain emphasized that any changes made to the Exchange should keep what is good about the Exchange but still give customers a choice, such as the ability to execute against the best bid and the best offer electronically, instantaneously and anonymously. He noted that the NYSE's goal is to be electronically accessible "virtually" all of the time. "[I]t's not going to be electronically accessible all the time because that's bad for the marketplace." He explained, for example, that the Exchange wants to continue handling big order imbalances manually, on the floor, with the specialists. Mr. Thain next observed that the Intermarket Trading System does not work. As support for this, he explained that the Exchange recently conducted a two-week experiment in three stocks that yielded no executions when the stocks were routed through ITS to other marketplaces. “If we want the inter-market structure to really work, we have to fix ITS because it doesn’t work today.” In closing, Mr. Thain remarked that with respect to Regulation NMS, the proposed opt-out exception is “bad public policy.” “[E]ven if the SEC allowed it, you all 5 shouldn’t do it because if you opt-out, if you internalize trades, if you don’t expose your customers’ orders to the marketplace, if you don’t get your customers the best price, this is going to be the future mutual fund scandal or investment banking broker scandal, this is going to be the problem in the future.” Jane G. Heinrichs Assistant Counsel