

Statement of Cameron Smith
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House Financial Services Subcommittee on
Capital Markets, Insurance, and Government
Sponsored Enterprises
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Chairman Baker and Members of the Subcommittee:

I commend the Chairman and the Members of the Subcommittee for holding these hearings concerning an integral part of our securities markets – market data. As the pioneer in providing investors with unprecedented access to market information through the Island BookViewerSM, Island greatly appreciates the opportunity to share its views on market data. Due to the technological advances in communication that allows the dissemination of market data at cost levels unimaginable just a few short years ago, we have a unique opportunity to revisit our policies regarding market data. Within this context, it would be a mistake to grant exclusive proprietary ownership rights in market data before reviewing the outdated policies that create regulatory monopolies for the producers of market data. Therefore, we should embrace those reforms that promote competition and innovation. In so doing, we will further the principles of transparency and access that have been the bedrock of our capital markets.

INTRODUCTION

I am Cameron Smith, General Counsel of The Island ECN (“Island”). Island is an automated trading system for equity securities. It gives brokers the power to electronically display and match customer orders in equity securities. We function as a pure auction market -- directly matching buy and sell orders. Island was founded approximately four and one half years ago with the intent of providing all market participants - from individual investors to large financial institutions - with the ability to

execute securities transactions on a level playing field, at an extremely low cost and without the presence of intermediaries or dealers.

Island is a network of approximately 700 broker-dealers representing a diverse array of market participants. On an average day, Island will trade over 320 million shares – approximately 16% of the transaction volume on Nasdaq. Through June of this year, Island has traded over 44,073,432,288 billion shares worth almost \$1,541,710,680,625.42 during 2001.

One of the key reasons for Island's success is its commitment to providing investors with more accurate and complete information. Specifically, in sharp contrast to quotation information provided by traditional markets that provide the high bid and low offer, Island is the first marketplace to provide a free, real-time display of all orders in its market through the Island BookViewerSM. Why is this so important? In addition to providing the investor with the highest bid or lowest offer in a security, the Island BookViewerSM enables an investor to see all buy and sell orders entered into Island for display. This insight allows investors to better gauge supply and demand and thus more accurately price their orders. This additional level of transparency has become increasingly important to investors with the introduction of decimal pricing. With the advent of decimal pricing, oftentimes liquidity is spread out over more price points, making it necessary to see more than just the highest bid or lowest offer.

Perhaps more importantly, the public display of the Island BookViewerSM reduces the informational and temporal advantages traditionally enjoyed by market makers and specialists, thus creating a level playing field for all investors. By eliminating these time and place disparities, Island helps lower the hidden costs of trading associated with higher spreads and inferior executions.

In the context of policies regarding market data, it is important to understand the benefits that accrued to investors as a result of Island's policy of providing its own real-time market data for free to all investors. Since Island introduced the BookViewerSM in 1998, hundreds of thousands of investors have visited the Island web-site to get the latest market information. In light of the popularity of the Island BookViewerSM, the New York Stock Exchange has recently announced OpenBook, and Nasdaq plans to introduce the so-called "Super-Montage" in 2003. Both initiatives are designed to provide investors and market participants with a broader and deeper level of market data. It was the very success of Island's BookViewerSM and its competitive effect on the market that drove these subsequent market reforms.

Consequently, we risk undermining the very process of competition and innovation if each market were granted an exclusive proprietary right in its market data. Such a regime would prevent market participants, such as Island, from continuing to provide investors with newer, better market data related services. In such an environment, for instance, the Island BookViewerSM may never have been introduced, and investors would never have had unprecedented access to buy and sell information.

I certainly understand the sentiment of those who believe that the producers of information, whether it is market data or other valuable data, should retain a proprietary right in such data and be compensated by those who elect to use such data. Yet, market data is unique in that it is produced in an environment that is the subject of extensive federal government regulation. In fact, the processing and dissemination of market data is currently done through a regulatory created monopoly overseen by the United States Securities and Exchange Commission.

Let me now outline the extent to which federal regulation surrounds all aspects of market data.

- By regulation, all broker-dealers are required to be members of Self-Regulatory Organizations such as the National Association of Securities Dealers or the New York Stock Exchange.
- By regulation, Self-Regulatory Organization members are required to report transactions exclusively to the applicable SRO such as Nasdaq or the NYSE.
- By regulation, this information is required to be consolidated and made available to investors.
- By regulation, any party disseminating market data must only disseminate consolidated market data that includes data from every Self-Regulatory Organization.

As you can see, there are no competitive free market forces at work with respect to market data. The producers of market data, the broker-dealers, are required by regulation to give the data to the applicable Self-Regulatory Organization. Thus, the ownership of the data by the Self-Regulatory Organization is solely due to the regulatory structure, especially in instances where the SRO adds no or little value to the transaction. Further, when the SROs sell the data, there is no competitive market that determines the appropriate price for the data. The price is determined by the SROs, subject to SEC approval. The SEC is, therefore, entrusted with the difficult task of regulating market data fees.

Given the regulatory monopoly bestowed on Self-Regulatory Organizations, it would be inappropriate to provide additional ownership rights in market data without first substantially revising the regulatory structure that governs market data. Creating a proprietary right without addressing the regulatory monopoly on market data would only further reduce what little innovation and competition remains with respect to market data. Instead, Island urges the Subcommittee to address the overall regulatory regime governing market data and focus on how best to foster competition.

One of the key regulatory requirements underpinning the current regulatory monopoly enjoyed by the SROs is what is known as the vendor display rule. In its simplest terms, the vendor display rule requires every vendor and market participant to disseminate only consolidated quotation information that includes data from every Self-Regulatory Organization. Due to the vendor display rule and the fact that only consolidated data can

be disseminated, there is no market-based pricing of market data. Instead, market participants and vendors requiring market data must pay whatever price the SROs jointly decide to charge, subject to SEC approval.

The decision as to whether to abrogate the vendor display rule is the key decision in creating a truly competitive market for market data. The SEC's role in regulating rates for market data and the monopoly power of the SROs derive directly from this rule.

Thus, the issues related to market data rates that Charles Schwab, among others, has long raised all emanate from the existence of the vendor display rule. Given its importance, the vendor display rule must be re-examined.

Too often, and at the expense of any real discussion on the issue, any debate concerning the vendor display rule has been framed as whether consolidated data is beneficial to the market place. The real question, however, is whether consolidated market data would be available in the absence of government regulation. Without allowing market forces to operate, we will never know if investors would receive more and better market information at a lower cost. I believe the forces of competition and innovation would deliver a better product than we have today.

Ultimately, the decision concerning whether to continue the vendor display rule should only be made after careful consideration of the costs and benefits of the current regulatory scheme. Let me identify three clear costs: First, the current regulatory structure confers monopoly power on the SROs that can only be checked by government

regulation. Thus, due directly to the vendor display rule, the SEC is required to play the difficult role of rate-maker. Any so-called reforms, such as competing consolidators, that leave intact the vendor display rule, fail to address this point.

Second, the vendor display rule subsidizes smaller markets, thus distorting competition between markets. For example, the market data for the NYSE is generally much more informative and, therefore, valuable than the market data from the regional markets. Due to the vendor display rule, however, regional markets receive as much on a per trade basis as the NYSE, even though their data is less valuable to market participants and investors.

Third, the vendor display rule harms innovation. There are many ways to represent market data, but they are either directly prohibited or just become too costly due to the existence of the rule. For instance, a market maker that sought to provide additional market data such as the depth of its book to its customers would be prevented from doing so without providing consolidated data as required by the vendor display rule. The requirement of consolidated data, however, would make providing any additional data far too costly. As a result, investors may actually be receiving less market information due to the vendor display rule.

In defense of the vendor display rule, some insist that all investors should only receive consolidated data or they may be misled or misprice orders. Thus, the vendor display rule protects investors by ensuring that all investors receive a minimal amount of

information. In particular, consolidated market data, it is asserted, allows investors to gauge whether they receive best execution from their broker. It is Island's position that if the purpose of the vendor display rule is to ensure that investors receive the best price, there are alternative methods to achieve this goal without distorting the entire national market system.

The second main argument in support of the vendor display rule is that it prevents certain dominant markets from charging exorbitant rates for the market data. I believe, however, that it would be counter to the interests of any market, dominant or not, to charge members exorbitant rates for its market data. For example, consider the New York Stock Exchange. The NYSE generally earns revenues from market data, transaction fees, and listings. If the NYSE were to begin charging exorbitant rates for market data, this could negatively impact its other revenue streams. Thus, the NYSE, and every other market, has an incentive to widely distribute its market data. Indeed, Island gives its market data away for free over the Internet.

While a thorough discussion of the costs and benefits of the vendor display rule is best left to another time, I hope that in my brief remarks the members of the Subcommittee have gained an appreciation for the importance of the vendor display rule and the importance of truly analyzing its costs and benefits.

CONCLUSION

In conclusion, Mr. Chairman, I appreciate the Subcommittee's interest in the issues surrounding market data and agree that my remarks only touched on some of the more significant issues surrounding market data and the vendor display rule. What should be clear from my testimony, however, is that given the comprehensive regulatory structure governing market data, it is not an appropriate time to create additional proprietary rights in market data. I look forward to working with you and your colleagues in introducing competition and innovation to market data and thereby strengthening our nation's equity markets.