

**WRITTEN TESTIMONY OF HARDY CALLCOTT
SENIOR VICE PRESIDENT AND GENERAL COUNSEL,
CHARLES SCHWAB & CO., INC.**

**BEFORE THE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT-SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES**

JULY 26, 2001

Chairman Oxley, Chairman Baker, Representative LaFalce, Representative Kanjorski, and distinguished members of the subcommittee: My name is Hardy Callcott, and I am senior vice president and general counsel of Charles Schwab & Co., Inc., one of the nation's largest financial services firms. Schwab was founded more than 25 years ago as a pioneer in discount brokerage. Last year, Schwab became the first firm to form a financial holding company under the provisions of the Gramm-Leach-Bliley Act. Today, we have more than 7.7 million active accounts with more than \$850 billion in client assets. About 4.3 million of those accounts are online accounts, making Schwab by far the largest online brokerage in the world. I would like to thank you for the opportunity to present Schwab's views on one of the most important issues facing the U.S. capital markets today: our outdated market data system and its impact on individual investors.

Schwab has been at the forefront of the market data debate for more than two years. As you may know, our firm filed a formal rulemaking petition with the SEC in June of 1999, asking the agency to review and correct what we believed to be the unjustified, unreasonable and discriminatory market-data fee structure. The SEC subsequently issued a "concept release" that outlined several approaches to reforming the system. A public comment period ensued, during which Schwab and dozens of other market participants expressed their views. While there was little consensus on what the appropriate solution should be, there was wide agreement that the current market data system has outlived its usefulness.

In September 2000, the SEC formed an Advisory Committee on Market Information, chaired by Dean Joel Seligman of the Washington University School of Law, to examine the issue in depth and issue recommendations to the Commission. Schwab has a representative among the 25 members of that panel, which has met several times over the last year to discuss the problems and possible solutions. While we believe the process has been an important and useful one, it has been limited in the range of options it is considering. The panel has concluded its meetings, and we understand its report will recommend only marginal changes to the current market data system. This is because, in our view, the panel has steered clear of a number of issues that we believe are critical to any discussion of fundamental reform of the market data system. For that reason, we believe that Congress will have to become directly involved in crafting a system that better meets the needs of today's investors.

Since our original rulemaking petition, the market data debate has expanded – appropriately, we think – to encompass the entire market data structure, not just the fees paid for the data. It is Schwab’s belief that the time has come for a fundamental overhaul of the current structure. The 1975 Act Amendments to the Securities Exchange Act of 1934, which created the current monopoly system for the distribution of market information, may have been a logical reflection of their time. But the information technology, markets and the investors of the early 1970s were a mere shadow of the sophisticated information technology, markets and investors that we have today. The system created in 1975 has outlived its usefulness. It discriminates against individual investors, costs too much, inhibits innovation in market data products, and makes our capital markets operate significantly less efficiently than they should. For those reasons, Congress should craft a new system that deregulates market data distribution to end-users and takes advantage of today’s technology to assure that all investors can have access to the depth of market information necessary to make the best possible investment decisions.

How Individual Investors Are Disadvantaged by the Current System

Individual investors are disadvantaged in four primary ways by the current monopoly system: limited access, inferior product, lack of innovation, and high costs. Individual investors do not receive the same quality or quantity of market data as institutional investors. Individual investors typically receive only the best bid, best offer and last sale price (commonly referred to together as the “NBBO”), while institutional investors have the advantage of depth-of-book data. Today it is technologically feasible for Schwab to provide real-time, streaming quotes to all of our online customers, so that (like institutional investors) they can watch the markets as they move. We have the ability to incorporate real-time market data into portfolio management and investment research tools that could significantly benefit individual investors. The only obstacles are cost, based on how the self-regulatory organizations (SROs, such as NYSE and Nasdaq) charge for market data, and contractual restrictions, based on the SRO’s control of market data usage and distribution through license agreements. This is the case even though the widest possible dissemination of real-time market data would not impose any significant marginal costs on the SROs. Under the current market data system, providing all currently available streaming market data from the SROs to all of our customers who have electronic access to market data would likely cost in the neighborhood of approximately \$157 million a year, or some nine times what we currently pay.¹ As a result, Schwab cannot afford to offer real-time streaming quotes to most of our client base. Indeed, the high cost of market data causes many brokerage firms and Internet companies to offer 15-20 minute delayed data, rather than real-time quotes, even for single snap-shot quotes. In our current decimal markets with rapidly changing quotes, delayed market data is effectively the same as no market data.

¹ This figure conservatively assumes 1.1 million Schwab client households using the web per month, and conservatively assumes only one client per household. Nasdaq Level 2 streaming data would be \$132 million for the year (\$10 per month for each client). OPRA streaming data would be \$13 million for the year (\$1 per month for each client). CTA Tape A (for NYSE listed stocks) would be \$6.3 million for the year (enterprise cap of \$525,000 per month). CTA Tape B (for Amex listed stocks) would be \$6.3 million for the year (enterprise cap of \$525,000 per month). While CTA has an enterprise cap that can reduce costs, it does not make available to the public any market data below the “top of the book.” While Nasdaq does make some depth of book data available to the public through Level 2, it does not offer an enterprise cap.

Historical Background: The Evolution of the Current Market Data System

Market data, quite simply, is the prices at which investors are willing to buy and sell securities, and the prices of completed transactions. Investors rely on this information to evaluate potential investments and to determine the best prices available in the markets. The 1975 Act Amendments to the Exchange Act and the SEC's implementing rules created today's system, which works as follows. Real-time market data – data that shows transactions and quotations as they occur – is created by investors and brokerage firms. Brokerage firms are legally required to provide this information – immediately and without any compensation – to their SROs. The SROs jointly own and operate three “Plans” that administer the consolidation and distribution of real-time market data (the Consolidated Tape Association or CTA for exchange-listed stocks, Nasdaq for NASD-listed stocks, and the Options Price Reporting Authority or OPRA for options) each of which has a government-created monopoly in its respective market. The SROs send their “raw” data to the Plans' information processors (like SIAC), which then distribute the market data to information vendors, such as Bloomberg or Reuters, and also directly to brokerage firms. Brokerages are legally required to buy this information from these government-created monopolies and provide it to our clients. The Plans set the price for market data, define the terms and conditions of distribution, and require prior approval of any brokerage or vendor use of the Plans' market data. Currently, there is no competition to counter this monopoly control.

This short description of market data belies its importance: market data is the critical information that gives the US the most vibrant, open and transparent marketplace in the world. The goal is, and should continue to be, that all investors can see where the market is at a given moment in time. The widespread availability of accurate market data is the key to democratizing our markets – allowing all market participants from the largest Wall Street institution to the working family putting away a few dollars a week to make informed investment decisions.

The irony of our current market data system is the fact that the basic information is created not by the securities markets, but by brokerages like Schwab and our clients. We create the orders and trades, which we are legally required to give to the markets without any compensation. Then we have to buy the data back in order to provide it to our clients. It's a circular system that gives the markets monopoly control over something they didn't create in the first place.

In the 26 years since passage of the 1975 Act Amendments, the securities markets have used that monopoly to control every aspect of market information: the format, the speed, who can receive it, when they can receive it, how they can use it, and how much it costs. The creation of a monopoly system may have been necessary in 1975, but computer and communications technology has advanced so significantly in the years since, that it no longer makes sense. The irony is that the system intended to widely disseminate market information now functions as a barrier to cheaper, more innovative use of data.

Do We Need a Database Protection Bill for Market Data?

A key goal of the Subcommittee today is to understand who owns market data. The securities markets believe that they do, and they want to see that ownership codified in law. For that reason, they have been advocating for three Congresses database protection legislation, particularly bills introduced by Rep. Howard Coble in the 105th Congress (H.R. 2652) and the 106th Congress (H.R. 354), that would grant them a property right over market information.

Market data consists of facts: bid prices, offer prices, last sale prices, limit order prices. No one can own facts – facts are in the public domain. As a unanimous Supreme Court determined in *Feist Publications, Inc. v. Rural Telephone Service Company, Inc.*, the protection of purely factual data, gathered and disseminated with no originality in its selection, coordination or arrangement is statutorily precluded and constitutionally prohibited. Moreover, in the several years that the securities markets have sought property rights in market data facts, they have not presented any example of abuse which would justify requesting such a lucrative windfall at public expense.

Moreover, it is investors and brokerages who create these facts, not the securities markets. If anyone should be granted property rights in market data, it would be the investors and brokerage firms. In fact, today market data is a public good, which since 1975 has been pervasively regulated from the moment of creation by investors and brokerage firms, through its collection and dissemination by securities markets, and its retransmission to brokerages and investors. Granting market data ownership or protection to the securities markets midway through this chain, with no recognition of the value investors and brokerages supply at the beginning of the chain, would be counter to Congress' laudable goal of ensuring ready public availability of information. Schwab is not advocating that brokerages be given property rights to market data. But if we are legally required to provide the information free of charge to the markets, and then are legally required to purchase it from the markets, it would be grossly inequitable to grant those markets property rights in that information in preference to us.

Granting the exchanges – or anyone – a property interest in market data would be contrary to the very purposes of the national market system. Already, the government-mandated monopoly they enjoy stifles innovation, prohibits competition and discriminates against individual investors. A property right over market data would do nothing more than exacerbate these problems and make it even more difficult for individual investors to get a fair shake in today's marketplace. Schwab strongly opposes database protection legislation.²

However, we do believe market data legislation is necessary. Now is the time to end the government-created monopolies in market data created in 1975. It is now possible to replace

² One proposal would codify the "hot news" doctrine that is part of many states' common law of misappropriation. Because market data is to be regulated in the public interest under the Exchange Act, it should be expressly excluded from any such federal legislation. Moreover, the purpose of the hot news doctrine – to protect the interests of the news gatherer from the free-riding of competitors – is inapplicable where, as here, the SROs enjoy a monopoly franchise created by statute. In any event, if a "hot news" property right is to be granted with respect to market data, it should be granted to the original creators of that news: brokerages and investors, not to SROs.

those government-created monopolies with free market competition which will provide higher quality market data to all investors at a lower price.

Problems With the Current Market Data System

- **The Current Market Data System Has Failed to Keep Pace with Technological Innovation and Changes in the Markets**

The reality is that the power and sophistication of our information technology is many magnitudes greater than what existed in the 1970s. Combine that with the explosive growth of individual participation in the markets – and in investor demand and need for quality market information – and it is easy to see that our current system is simply out of date. That system was designed before the technology revolution that has transformed our securities markets. Further, in 1975, securities investing was rare except in the most wealthy US households, and even these households monitored their portfolios for the most part only monthly through brokerage firm account statements. Today, with nearly half of all Americans invested, either directly or indirectly, in the stock market, individuals are monitoring their portfolios like never before. And increasingly investors monitor their portfolios daily or hourly at their desktops.

Moreover, the structure of our securities markets has changed dramatically since 1975. The last year has seen the introduction of decimal pricing in our markets. Decimals have lowered the bid-asked spread for stocks, saving billions of dollars for individual investors. But decimals have also decreased the depth of quotations (the amount of stock available for purchase or sale at the best national quote) by some 60-80%. As a result, the basic market data provided by the markets (the inside bid and ask) no longer provides many investors with enough information to make informed trading decisions.

The relevance of the quotes that the securities markets provide has deteriorated in a post-decimal environment. Nasdaq provides a “Level 2” quote which provides the best quotes provided by each market-maker in a given security. But no securities market provides a retail “depth of book” quote product providing all the purchase and sale interest outside of the (typically small) volumes now available at the national best quote. And the CTA, which processes quotes for exchange-traded stocks, does not even provide a quote product equivalent to the Nasdaq Level 2 quote. As is always true, when the government grants a monopoly, it stifles product innovation and technological development. Indeed, because of the increasing cost and decreasing relevance of the monopoly quotes, Internet portals such as Yahoo! now provide real-time quotes from ECNs such as Instinet and Island in preference to the consolidated quotes produced by the securities markets. Brokerages such as Schwab are legally precluded from providing these alternative quote sources to clients without also having to display the consolidated quotation provided by the SROs.

The increase in online investing has led to dramatic increases in the cost of market data. For the privilege of distributing this fundamental information to our customers, Schwab paid approximately \$16 million to the exchanges in 2000. That figure actually represents a decline – we paid about \$19 million in 1999, but benefited from the markets’ implementation of per quote and per retail subscriber fee pilots, which we believed were in direct response to our petition and

the SEC's Concept Release process. As discussed above, under the current pricing structure, to provide the best available real-time streaming market data to all of our online customers would cause an at least eight-fold increase in Schwab's costs.

- **The Current Market Data Fee Structure is Flawed and Unfair**

Another core problem with the current market data system is the complexity of its cost structure. For each Plan, there are different enterprise fee caps, per-subscriber caps, per-quote fees and monthly per-terminal fees for professional users. Some exchanges offer tiered fees. The Nasdaq has an additional fee structure for "Level 2" quotes. Even more troubling is that the fee-setting process is not transparent. No company knows exactly what a rival might be paying for the same data, because the Plan administrators have substantial discretion in how they apply their "standardized" contracts and fee schedules. The result is a system staggering in its inefficiency. For Schwab, the time required for all aspects of market data administration translates into the equivalent of six and one quarter full time positions. We have some 25 different processes and systems to count, track, report and pay for market data. All together, market data administration, in terms of personnel and systems expenses, costs Schwab approximately \$1 million a year – on top of the actual fees. Once again, in the absence of a government-granted monopoly, a competitive market would never produce such an expensive, costly and bureaucratic fee structure.

One of the most frustrating aspects of the fee-structure system is that no one knows if the fees paid for market data bear any relation to the actual cost of producing and disseminating that data. That was a principal question in our June 1999 rulemaking petition to the SEC, and it remains unanswered to this day. The SEC, in its market data Concept Release, admitted it didn't know how much market data costs to produce. Earlier this year, representatives of the SROs repeatedly said under questioning from members of this Subcommittee that they were unable to provide even a ballpark figure for the costs they incur in processing and disseminating market data. If the SROs do not know how much it costs them to produce their market data, how can investors have confidence that the fees charged for that product are fair, reasonable, and non-discriminatory? The answer is, they can't. In a competitive market, producers would know their costs, and customers could be confident that the fees they pay bear a reasonable relationship to those costs. Moreover, as several SROs begin a move to for-profit status and begin to compete with private sector firms such as ECNs, it is critical that they not be permitted to use their government-granted monopoly to subsidize this competition.

That said, I want to reiterate that, in Schwab's view, this is not simply a disagreement between our firm and the NYSE or Nasdaq over the fees they charge us for access to market data. In fact, there is considerable common ground between the markets, Schwab and other industry participants on issues such as the elimination of the government-mandated plans. This issue is about a regulatory regime that is no longer relevant and, as a result, serves none of the market participants – institutional investors, retail clients, media outlets, data vendors, brokers, dealers and even the markets themselves – well. It's time to reform the system to achieve the goal of ensuring that all market participants have access to a fair, reasonably-priced, efficient and accurate market data.

Blueprint for Reform

Let me turn now to the principles that Schwab believes should form the core of any reform plan. As I said at the outset, it is our belief that these reforms must be undertaken through an overhaul of the 1975 Amendments. The principles for reform include:

Competition. Legislative reform should first and foremost promote access to and competition for innovative market data products and services. To promote competition, legislation must require the SROs to make all of the “raw” market data that brokerages and their clients are required to report to them available to any third party on the same terms as they make it available now to their own processors. This will enable brokerages and market data vendors to disseminate real-time market data independently, in consolidated, unconsolidated, and derivative forms in ways that respond best to investor demands and needs. The current Plans, with their administrative burdens, inefficiencies, and restrictions, should be abolished. Any vendor or brokerage firm should be allowed to obtain the raw data (or a finished product) directly from the SROs themselves. Regulatory oversight would be limited to ensuring that fair and non-discriminatory access requirements are enforced, so that all data vendors have access to the same data at the best price offered by the market to any vendor. The SROs would be required to offer all of the data they collect on these terms: not only the inside quotes but also depth-of-book information. Virtually any of the current organizations that collect market data – from publishing powerhouses like Reuters and Bloomberg to brokerages like Schwab and Internet companies like AOL – could collect and disseminate this data and incorporate the raw data into their own products in a competitive market. The SROs could create affiliates which also could compete in this market. How the information is packaged and sold would be limited only by the pace of technological innovation and creative thinking.

Level Playing Field. A new system must ensure the broadest possible access to the information. Schwab believes that all investors, no matter where or how they trade, must have the information necessary to make a fully informed investment decision. Individual investors should have the same access as institutional investors to see the depth of the market. Moreover, there should be no discrimination as to medium – online clients should have the same access to information as clients using the telephone or conducting face-to-face meetings in a branch office. Today, there are still different fee structures for online brokers – who tend to pay either per-quote or per-client fees – and traditional brokers, who are more likely to pay a flat monthly fee per broker for an unlimited number of quotes. Clients are often not even aware of this difference. The price-setting structure should be the same for all types of investors. And rather than having the SEC mandate a specific set of information that brokerages must provide to clients, brokerages should be allowed to compete by providing different types of information.

Open, Transparent Process. Simply put, all aspects of the market data system, including the setting of market data fees, must take place in the sunshine. Greater transparency of the fees, costs, contracts and policies relative to the collection and dissemination of market data is critical to the creation of a fair and open system that treats all investors equitably. Congress should direct the SEC to end specially negotiated rates, and make all fee schedules, contracts and

agreements public. Transparency is the hallmark of our capital markets – so too must it be the hallmark of our market information system.

No Ownership Over Market Data. Database protection legislation should not give the securities markets a property right over market information. Market data is made up of the facts that are the most critical feature of our capital markets. No one can own this, or any, set of facts. Granting ownership or copyright protection to any one party would simply be contrary to the goal of ensuring broad access to market information.

Limited Oversight. In this new system, the SEC would continue to play a critical role in enforcing the non-discrimination requirements, as well as setting and enforcing general standards for such issues as capacity, sequencing, and synchronization. A new competitive system will allow the agency to focus its resources on ensuring that all investors have appropriate access to information – a goal more in line with the purpose of the SEC.

These broad principles should form the backbone of an overhaul of the 1975 Amendments.

Mr. Chairman, two years ago, this committee played a critical role in shepherding the historic financial modernization bill into law. The next logical step is to liberate the information that drives the securities markets. The information technology available to us today affords us an opportunity to work together to craft a new market data system that combines transparency, competition, innovation and fairness in a way that will benefit investors large and small and solidify the standing of America's capital markets as the envy of the world. On behalf of Schwab and its 7.7 million clients, I ask Congress, and this subcommittee and committee in particular, to undertake this challenge on behalf of all investors.

Thank you very much for the opportunity to share my thoughts with you today.