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THE IMPACT OF MARKET VOLATILITY ON SECURITIES TRANSACTION FEES

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCE AND HAZARDOUS MATERIALS

OF THE

COMMITTEE ON COMMERCE
HOUSE OF REPRESENTATIVES

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THE IMPACT OF MARKET VOLATILITY ON SECURITIES TRANSACTION FEES

TUESDAY, JULY 27, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2322 Rayburn House Office Building, Hon. Michael G. Oxley (chairman) presiding.

Members present: Representatives Oxley, Largent, Lazio, Shimkus, Fossella, Blunt, Towns, Engel, DeGette, Barrett, Luther, Pallone, and Rush.

Staff present: Brian McCullough, professional staff; Robert Simison, legislative clerk; David Cavicke, majority counsel; Linda Rich, majority counsel; and Consuela Washington, minority counsel.

Mr. OXLEY. The subcommittee will come to order. The Chair will recognize himself for an opening statement.

The Dow average has been closing near or above 11,000 points in recent weeks. When I became chairman of this subcommittee at the start of 1997, I remarked how unprecedented the sustained growth in the markets had been. At that time we thought it impressive that the Dow was approaching the 7,000 point barrier.

Remarkably, the trend has continued. Every week a new IPO, a new Internet stock price going through the roof, and online trading, bringing the markets directly into the homes of individual investors. These are all positive benefits of one of the strongest economic periods this country has ever enjoyed. Our robust markets have translated into more jobs, better services and better quality of life as they have kept our economic engine going.

But with the good, we must also be prepared for the bad. There is the possibility of inflation and therefore the possibility of higher interest rates that could naturally follow this economic boom.

Are there other potentially damaging effects of our recent good fortune that we can prevent? We know the capital markets have been good for investors, but could they be better, more efficient than they are today?

Those are some of questions that will be discussed today. One such question has to do with the effect of the record-breaking performance of the securities markets on transaction fees.

The impact that market volume has had on these fees has gone largely unnoticed outside of those who directly pay the bill. But it should not be overlooked. As more and more Americans rely on in-

vesting in the markets for retirement through work-sponsored retirement plans, IRAs and individual stocks, these fees are paid indirectly by the investor. With the growing importance of these savings mechanisms, it is incumbent upon Congress to do everything possible to ensure that our markets are operating at maximum efficiency.

In that regard, I am proud to say that this committee has continued our commitment to improve our markets whenever possible. This subcommittee has produced several legislative efforts that will result in greater transparency in our markets, that will benefit investors and market participants.

The most relevant legislative efforts to today's hearing is a new fee structure enacted into law in 1996 under the leadership of Chairman Bliley. The intention was to provide a more stable funding structure for the SEC and reduce fees over time to reflect the cost of running the agency. At the time, total fee revenue collected was roughly $700 million, or more than double the cost of funding the SEC. Last year, fee revenue collected by the SEC was approximately $1.7 billion, more than 5 times the cost of funding the SEC, which again raises the concern that these fees are an unnecessary tax on the investor.

This hearing will focus on the current status of the application of securities transaction fees and their impact on capital formation, the efficiency of the markets, investor savings and any competitive disparity that may result from these fees. Our witnesses will share their views on how these fees impact their normal course of business and what the larger implications for our economy might be. With this information, we will be able to determine if this is an issue the Congress should reexamine. Should the Commerce Committee decide to reexamine the fee structure, there are several legislative proposals which deal with this concern that we may wish to discuss.

However, I would like to remind my colleagues and witnesses that this is an oversight hearing only. We will not be addressing any particular legislative proposal on this issue today. I welcome our witnesses and look forward to their views on this subject.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. JOHN SHADEGG, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA

Thank you Mr. Chairman. I am pleased the subcommittee is addressing today the collection of securities transaction fees and their impact on the nation's equities markets. I share the concern held by Chairman Oxley and other members of this subpanel regarding the skyrocketing fee collections that have resulted from an unprecedented bull market over the last several years. I commend the Chairman for his leadership on this issue.

Currently, several securities fees are charged for various activities associated with the equities markets. These fees are intended to compensate for the operations of the federal securities regulator, the Securities and Exchange Commission (SEC). The current budget for the SEC is roughly $340 million, annually. However, the projected revenue for securities fees in FY1999 is $1.6 billion.

Two of the more predominant securities fees are the Section 6(b) registration fee and the Section 31 transaction fee. The Section 6(b) registration fee is paid by corporations when they register new securities for sale to investors. The rate of this fee is $200 per $1 million in securities sold, or 1/50th of 1 percent. The Section 31 transaction fee, collected on the sale of corporate stock on exchanges and the Nasdaq market, is currently at a rate of 1/300th of 1 percent.

In 1996, Congress passed the National Securities Markets Improvement Act which lowers the rate of these fees over 10 years. The Section 6(b) fee will decline to 1/150th of 1 percent or $67 per $1 million in 2007. The Section 31 fee will be reduced from 1/300th to 1/800th of 1 percent in 2007. However, even with these reduced fee rates, revenue from securities fees continues to increase, far outweighing the SEC's annual budgetary needs to regulate the equities markets.

These so-called "user fees" are, in fact, an unnecessary burdensome tax on America's investors. I believe Congress must enact legislation to further reduce the rate of securities fees and put an end to this unfair tax on investors in the stock market. I look forward to hearing from the witnesses assembled today to testify before this subcommittee. In particular, I am interested to hear their thoughts on the concerns some experts have regarding the reduction in fees and a possible downturn in the market. Again, I thank the Chairman for bringing this issue before the subcommittee today and I yield back the balance of my time.

PREPARED STATEMENT OF HON. VITO J. FOSSELLA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Thank you, Mr. Chairman. I want to start by thanking Chairman Oxley for scheduling this important OVERSIGHT hearing. I know that the issue of SEC transaction fees is one in which the Chairman has had a longstanding interest, and I commend him for his leadership on this and many other issues that are important to securities professionals and investors in my district and across the United States. I share the Chairman's commitment to addressing the issue of excessive Section 31 fees in a bipartisan, timely and meaningful fashion.

I also want to thank the witnesses for appearing today. These folks and the industry they represent are an integral part of our economy—they provide the oil which makes it possible for our economic engine to continue running at peak efficiency. They help raise the capital necessary for businesses to invest in new jobs and equipment, and they are vital liquidity providers that help keep our secondary trading markets vibrant.

As you will hear today, the government collected over $1.75 billion in SEC fees last year, which is over five times the SEC's budget. The SEC performs a crucial function, admirably I might add—of protecting the integrity of the U.S. capital markets, and helping them remain the deepest, most liquid and efficient in the world. Having said that, there is simply no public policy rationale to justify such an absurd amount of user fee collections. SEC fees have become a tax on capital formation and on securities trading. This tax disproportionately impacts areas such as my home, Staten Island, New York, which has one of the largest concentrations of securities professionals in the country.

I have introduced legislation, H.R. 1256, that would address this issue, and I also want to thank Chairman Oxley for working with me and other interested Members of this Committee to shed some light on this growing problem. I also want to acknowledge the efforts of the lead Democrat on the bill, Bob Menendez of New Jersey, who has worked closely with me on this issue.

I am pleased that my bill now has 53 cosponsors from both sides of the aisle, including conservatives, moderates and liberals—reflecting what I believe is the essentially nonpartisan, nonideological nature of this issue. I also want to thank my 20 colleagues on this Committee who have joined as cosponsors of H.R. 1256. As Members may know, my legislation would cap the amount of SEC fees at levels closer to what was intended in 1996, when the various SEC fees were restructured. This legislation is similar in approach to a bill that was scored as revenue neutral by the CBO last year.

I am pleased to note that SEC Chairman Arthur Levitt recently told this Subcommittee that he believes the most appropriate way to address this problem is through a flexible cap—which is exactly the type of approach embodied in my legislation. Nevertheless, I want to stress that while I feel that my legislation represents the best approach, as I have stated before, I would be fully supportive of any solution that this Committee in its wisdom deems appropriate.

Once again, I want to commend Chairman Oxley for holding this hearing, which I believe is an important step towards enactment of real Section 31 fee relief. I understand that the Chairman is holding open the option of holding a separate LEGISLATIVE hearing at a later date, during which the Committee could explore the merits of specific proposals to address the Section 31 fee issue. I will await such an opportunity to discuss the details of my proposal, but it is my hope that we will indeed be able to move forward towards a mark up of legislation to provide American investors and securities professionals with much-needed relief from Section 31 fees.

Thank you, Mr. Chairman, and I look forward to the testimony of this excellent panel.

PREPARED STATEMENT OF HON. TOM BLILEY, CHAIRMAN, COMMITTEE ON COMMERCE

I would like to thank the Chairman of the Subcommittee for holding this oversight hearing today. It is vital that this Committee maintain a close eye on all aspects of our securities markets. As more Americans invest their hard earned dollars in the markets for retirement, we must ensure that the markets are as fair and efficient as possible. Concerns have been raised that the revenue generated by securities transaction fees has increased so quickly that it does not correspond with those goals. Investors and businesses that rely on capital may actually be disadvantaged by excessive transaction fees. That is money that could be put to use elsewhere for more savings and investments.

This is not the first time that this Committee has dealt with the fee structure. In 1996, Congress determined that the fee revenue generated by the securities markets had grown to such a level that it was a tax on investors. Fees needed to be reduced to more closely reflect the SEC's budget. It was also determined that the SEC should have a more sound funding structure. This accomplishes both goals. After difficult negotiations with the Senate and the Administration, we enacted changes to the fee structure as part of a larger securities markets reform legislation. The intention was to save investors money and eliminate the reliance on fee revenue to fund the SEC. Having spent many hours working on that legislation, I have a special interest in today's hearing.

In the 1996 Act, we applied transaction fees to NASDAQ traded stocks for the first time to eliminate any competitive advantages they had over exchange listed stocks. Removing competitive discrepancies is good public policy. Unfortunately, it was impossible to anticipate the explosive growth in the stock markets. Annual trading volume is reported to be up nearly 50 percent over the last 2 years from the 1996 level. The impact of this dramatic increase has contributed largely to the enormous level of total fee revenue being collected.

At the time we were considering the legislation in 1996, fee revenue collected was double the cost of funding the SEC. There was a consensus that this was a problem worthy of Congressional action. Despite the intentions of that legislation, fee revenue being collected has increased dramatically. With last year's total fee revenue of $1.7 billion collected—over 5 times the cost of funding the Commission—this Committee may want to consider reexamining this issue.

The focus of the problem in 1996 was on the revenue being generated by increases to the fee rate for securities registrations. We heard the arguments, and agreed that it was a tax on capital formation. We provided significant relief in the legislation for registration fees. These changes will become more evident with each passing year as the rate continues to decline.

Now, with transaction fees applied across the board to include NASDAQ traded stocks, the issue is somewhat different. Combined with the unprecedented level of market volume, the transaction fees are generating far more revenue than was ever contemplated. This raises serious public policy concerns when the laws we enact do not function in the manner we intended.

Investors should not be paying more for a stock than its worth, nor should they be paying excess fees that could be invested. I look forward to learning how the transaction fees impact American investors, the quality of our markets, and our economy. If these fees do pose unnecessary burdens on our investors and capital markets, it may be an issue that we need to reexamine.

PREPARED STATEMENT OF HON. FRANK PALLONE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Thank you, Chairman Oxley. I want to commend you and Ranking Member Towns for holding this important hearing on Section 31 fees. I know that this Committee will carefully consider the facts regarding the current SEC fee structure and hopefully move to change the law to bring Section 31 fees in line with the needs of the Securities and Exchange Commission. I believe this is an issue of importance to all savers and investors. In the end, it is individual Americans who pay these fees. The payment of excessive fees directly reduces their hard-earned savings.

Excess Section 31 fee collections also have a negative impact on financial firms located in New Jersey, many of whom are NASDAQ market makers. For many, Section 31 fee payments have become quite onerous, comprising a significant portion of their overhead. I note that today we will hear from Steve Nelson from Herzog

Heine Geduld, a New Jersey firm and Mr. Kearney's group, the Securities Traders Association, which also has many members in the State of New Jersey.

I have cosponsored H.R. 1256, the "Savings and Investment Relief Act of 1999," a fee cap bill introduced by Reps. Fossella (R-NY) and Menendez (D-NJ) as well as H.R. 2441 "The Fairness and Securities Transaction Act" cosponsored by Rep Lazio (R-NY) and Towns (D-NY) which would lower the rate. Twenty-four members of this Committee have collectively cosponsored both bills. Clearly something needs to be done to correct this situation and I believe either approach, if properly structured, could meet our policy concerns.

In closing, let me state that I strongly support full and ample funding for the SEC. The Agency does an admirable, professional job and should be given ample resources. However, the government should not continue to collect fees that are five times in excess of what is necessary to run the SEC.

Mr. OXLEY. Let me now turn to our panel and introduce the witnesses. Our first witness is Mr. William J. Brodsky, Chairman and CEO of the Chicago Board Options Exchange, who has been here in the past; Mr. Andrew Cader, Senior Managing Director, Spear, Leeds & Kellogg of New York, on behalf of the Specialist Association of the New York Stock Exchange; Mr. Steve Nelson, Vice President of Special Projects for Herzog Heine Geduld, on behalf of the Securities Industry Association; and Mr. Art Kearney, Director of Equity Capital; and John G. Kinnard & Company from Minneapolis, representing the Securities Traders Association.

Welcome to all of you for appearing here today, and let us begin with Mr. Brodsky.

STATEMENTS OF WILLIAM J. BRODSKY, CHAIRMAN AND CEO, CHICAGO BOARD OPTIONS EXCHANGE; ANDREW CADER, SENIOR MANAGING DIRECTOR, SPEAR, LEEDS & KELLOGG, ON BEHALF OF THE SPECIALIST ASSOCIATION OF THE NEW YORK STOCK EXCHANGE; STEPHEN J. NELSON, VICE PRESIDENT OF SPECIAL PROJECTS, HERZOG HEINE GEDULD, ON BEHALF OF SECURITIES INDUSTRY ASSOCIATION; AND ARTHUR J. KEARNEY, DIRECTOR OF EQUITY CAPITAL, JOHN G. KINNARD & CO., ON BEHALF OF SECURITY TRADERS ASSOCIATION, ACCOMPANIED BY LEE KORENS, PRESIDENT AND CEO, SECURITY TRADERS ASSOCIATION

Mr. BRODSKY. Thank you, Mr. Chairman. I will ask to have my testimony entered into the record.

Mr. OXLEY. Without objection, all of the members' opening statements as well as the witness' testimony will be made a part of the record.

Mr. BRODSKY. The Chicago Board Options Exchange is the world's largest options exchange. We trade options on 1,300 stocks and over a dozen stock indexes, including the Standard & Poor's 500 Index, the NASDAQ 100 and the Dow Jones Industrial Average. Our volume has been averaging almost a million contracts per day which accounts for 51 percent of all listed options volume in the U.S. On behalf of the CBOE, I commend you for holding this hearing on the transaction fees collected by the SEC. As an organization whose products are subject to transaction fees, and who represents market professionals who pay such fees, we have a strong interest in bringing the fees paid more into balance with the budget of the SEC.

Fees have been imposed on listed securities transactions since the passage of the Securities Exchange Act of 1934 for the purpose

of funding the operations of the SEC, along with fees such as those for registering securities. The legislative history behind these fees does not show any intent by Congress to use them as a general revenue source, but rather evidences an intention to use the fees solely to defray the costs of regulating the securities markets.

The amount of fees now collected, however, greatly exceeds the SEC's budget. We believe that fees revenues in excess of the SEC's budget represents a tax on capital which penalizes investors and businesses and puts the U.S. Securities markets at a competitive disadvantage. As you observed earlier, the National Securities Improvement Act of 1996, or NSMIA, restructured various fees with the intention of creating a predictable funding source of the SEC and reducing, over time, the fees collected by the SEC. This act was intended to bring the SEC fee collections more into line with the level of funds appropriated by Congress. This goal has been thwarted, however, because of the market averages greatly increasing to levels unforeseen in 1996, and trading volume has increased substantially since that time. As a result, these collections have increased significantly.

I will not go through the numbers that you have already mentioned, only to say that waiting until fiscal year 2007 for reductions will result in investors paying hundreds of millions of dollars and maybe billions of dollars more in fees than those needed to support the agency.

What I want to talk about next is why I am here and why the options business is uniquely challenged in this area and where we are seeking your help.

As the largest securities options exchange, we are particularly disadvantaged by the imposition of these fees which competitively injure us in a number of ways. First the transaction fees applies to stock index options traded on the CBOE that compete with stock index futures and options on stock index futures traded on U.S. Futures exchanges, as well as off-exchange derivatives markets such as swaps and over-the-counter options. Stock index futures and options on stock index futures and off-exchange derivatives are not subject to section 31 fees at all.

This adds a competitive penalty for the use of exchange-traded securities such as stock index options and places these products at a substantial competitive disadvantage. Broad-based stock index options compete directly with these products on the futures exchanges. They are used by the same customers and are employed for the same risk-shifting purposes.

As part of the decision whether to use an option or a future for a particular strategy, a customer or trader will evaluate the costs of both products to determine which will be more effective. Because section 31 fees places the equivalent of a transaction tax on exchange-traded securities such as stock index options but not on stock index futures or options on stock index futures, the fees can be a determining factor in the decision of which product to select.

I implore Congress to remedy this disparity by eliminating section 31 fees for broad-based stock index options so that they can compete on a level playing field with economically equivalent products. I think probably the best way to explain this, Mr. Chairman, is because of the legislative accord that goes back 17 years that is

called Shad-Johnson, what you have is a disparity where you have in the city of Chicago economically equivalent products trading in 2 or 3 different exchanges. One is being taxed by Federal law, and the other is not.

And my favorite example would be—take an airplane ticket. And if I said to my staff, you can fly American or United from Chicago to Washington, and one has a Federal tax of $18 and the other doesn't, which plane will they use when you hold them to a standard of fiduciary responsibility of getting the best price? And we have this anomaly that until now we really have not had a forum to bring to your attention.

The second area is a complicated area that relates to the option business, and that relates to what we call spread strategies or other transactions that relate to multiple legs of a transaction. And the way that this tax was structured, when people used these strategies, they can be very expensive based upon the way that the tax applies. And what we are asking for in consideration by the committee is that the committee look at the total transaction and not the individual legs of the transaction.

I would be happy to go into this with you now or later or with your committee staff, but it is in my testimony. It is somewhat complex, but when this law was devised, options didn't exist. Option strategies didn't exist, and the tax on option strategies has created some very anticompetitive results which I don't think that the committee intends. And I am happy to go through it now but it is in my testimony.

In conclusion, I would say that aside from the relief that I requested, the stock index options and the spread transactions, we also favor an acceleration in the timetable approved by Congress in 1996 for reducing section 31 transaction fees. A stepped-up timetable to reduce the fees as soon as possible is justified by the unanticipated increase in market activity which has resulted in significant overfunding. The reduction would benefit all market participants, including individual investors, pension funds, mutual funds, and market professionals who provide customers with on-demand liquidity and maintain orderly markets.

Consequently, we support the legislation such as H.R. 4269, introduced last year, and recently introduced H.R. 2441, which would reduce fees on securities transactions while maintaining the full funding of the SEC.

I want to make very clear that we have no desire to do anything that would limit or in any way threaten the underpinning of the SEC's funding, but obviously the numbers have become so compelling that there is an opportunity to reduce the fees.

We are also aware that the introduction of H.R. 1256, which would cap the transaction fee once a stated amount of revenue has been collected in any given year—while we generally favor anything that would reduce the burden of what we believe is an unfair and unnecessary tax on investors, we believe that reducing the percentage rate at which the fee is imposed on all investors is a more equitable and easier-to-administer solution to the problem than making the fee apply at its existing rate to certain investors while making it not apply to others.

We also believe that a reduction in fees is more consistent with the approach taken in NSMIA. NSMIA provided that the transaction fee was reduced from 1/300 of 1 percent to 1/800 of 1 percent in fiscal year 2007. While the act was intended to bring SEC collections more in line with the level of SEC funding appropriated by Congress, the gradual percentage reduction has not been swift enough to prevent transaction fees from greatly exceeding the levels envisioned during the consideration of that act. Consequently, an accelerated reduction in the percentage of fees is needed at this time.

Mr. Chairman, we commend you and the committee for your recognition of this problem and look forward to working with you to solve it. Thank you for giving me the opportunity to present the views of the Chicago Board Options Exchange and particularly how the impositions of section 31 fees hurts the options markets. Thank you very much.

[The prepared statement of William J. Brodsky follows:]

PREPARED STATEMENT OF WILLIAM J. BRODSKY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHICAGO BOARD OPTIONS EXCHANGE

I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange ("CBOE"). I would like to present CBOE's views on the transaction fees imposed by Section 31 of the Securities Exchange Act of 1934.

The CBOE is the largest options exchange in the world. We trade options on 1,300 stocks and over a dozen stock indexes such as the Standard & Poor's 500 Index, the Nasdaq 100 Index, and the Dow Jones Industrial Average. Our volume averages over 900,000 contracts per day, which accounts for 51% of all the listed options volume traded on U.S. securities exchanges. On behalf of the CBOE, I commend you for holding a hearing on transaction fees collected by the Securities and Exchange Commission. As an organization whose products are subject to transaction fees, and who represents the market professionals who pay such fees, we have a strong interest in bringing the fees paid more into balance with the budget of the SEC.

Fees have been imposed on listed securities transactions since the passage of the Securities Exchange Act of 1934 for the purpose of funding the operations of the SEC, along with other fees such as those for registering securities. The legislative history behind these fees does not show any intent by Congress to use them as a general revenue source, but rather evidences an intention to use the fees solely to defray the costs of regulating the securities markets. The amount of fees now collected, however, greatly exceeds the SEC's appropriated budget. We believe that fee revenues in excess of the SEC's budget represent a tax on capital which penalizes investors and businesses and puts the U.S. securities markets at a competitive disadvantage.

The National Securities Markets Improvement Act of 1996 (NSMIA) restructured various SEC fees with the intention of creating a predictable funding source for the SEC and reducing, over time, the fees collected by the SEC. NSMIA was intended to bring SEC fee collections more in line with the level of funding appropriated by Congress. This goal has been thwarted, however, because market averages have greatly increased to levels unforeseen in 1996, and trading volume has increased substantially since that time. As a result, actual collections of transaction fees are significantly exceeding the levels projected during consideration of NSMIA, and they are projected to do so into the future. The revenue generated by Section 31 transaction fees alone in fiscal year 1998 was $476 million, which exceeded the SEC's entire appropriated budget of $315 million by $161 million. In fiscal year 1999, total SEC fee collections are expected to exceed $1.6 billion, more than four times the Commission's appropriated funding of $337 million. We strongly support adequate funding for the SEC, whose regulatory program contributes to the strength and integrity of U.S. securities markets, and would not want legislation to result in a reduction of SEC appropriations. On the other hand, the transaction fee has greatly exceeded revenue expectations since the passage of NSMIA two years ago. The excess amount represents a hidden tax on all investors. Waiting until fiscal year 2007 for a reduction in the transaction fees will result in investors paying hundreds of millions of dollars in fees over and above those needed to support the cost of regulation.

As the largest securities options exchange in the world, we are particularly disadvantaged by the imposition of transaction fees, which competitively injure us in a number of ways. First, the transaction fee applies to stock index options traded on the CBOE that compete with stock index futures and options on stock index futures traded on U.S. contract markets as well as with off-exchange derivatives such as swaps and over-the-counter options. Stock-index futures, options on stock index futures, and off-exchange derivatives are not subject to Section 31 fees. This adds a competitive penalty to the use of exchange-traded securities such as stock index options and places stock index options at a substantial competitive disadvantage. Broad-based stock index options compete directly with stock index futures and options on stock index futures. They are used by the same customers and are employed for the same risk shifting purposes. As part of the decision whether to use an option or a future for a particular strategy, a customer or trader will evaluate the costs of both products to determine which will be more cost-effective. Because Section 31 fees place the equivalent of a transaction tax on exchange-traded securities such as stock index options but not on stock index futures or options on stock index futures, the fees can be a determining factor in the decision of which product to select. I implore Congress to remedy this disparity by eliminating Section 31 fees for broad-based stock index options so that they can compete on a level playing field with economically equivalent products.

Second, options traders often use multi-part strategies such as spreads and straddles that involve multiple transactions as part of a single trade. Each part of the trade is subject to Section 31 fees, which, when combined, adds a significant cost to these strategies. For example, a so-called box spread involves four simultaneous trades as part of a single transaction. Each of the four trades is charged a Section 31 fee. In the case of many box spreads, the impact of the transaction fee is compounded by the fact that, although the spread as a whole represents a market-neutral position used by market makers as a financing technique, it is often the case that two parts of the spread represent deep-in-the-money, high premium trades. This can cause the transaction fee, which is based on the premium paid on the sell sides, to be disproportionately high. This can act as a huge disincentive for market makers to engage in these trades, thereby depriving the market of added liquidity. I urge Congress to examine whether there are ways to reduce the special burden that transaction fees place on box spreads. For example, the fee could be calculated on the basis of the average price of all the parts of the spread, which would reduce the overall amount of the transaction fee for the strategy. We are ready to work with you to find a way to ensure that multi-part trades such as box spreads are not subject to a special, compounding cost from Section 31 fees.

In these and many other ways, Section 31 fees act as an expensive surcharge on securities options. Our options markets are the best in the world, offering both retail and institutional investors an opportunity to reduce or transfer risk in an efficient manner. With international competition from overseas derivatives markets and growing competition domestically from new options markets and over-the-counter derivatives, however, it is increasingly difficult to compete because of the loadstone of transaction fees on our products.

Aside from the relief I have requested for stock index options and box spreads, we also favor an acceleration of the timetable approved by Congress in 1996 for reducing the Section 31 transaction fee. A stepped-up timetable to reduce fees as soon as possible is justified by the unanticipated increase in market activity which has resulted in significant overfunding from fee collections. The reduction would benefit all market participants, including individual investors, pension funds, mutual fund investors, and the market professionals who provide customers with on-demand liquidity and maintain orderly markets. Consequently, we support legislation such as H.R. 4269, introduced last year, and the recently introduced H.R.2441, which would reduce fees on securities transactions while maintaining the full funding of the SEC.

We also are aware of the introduction of H.R. 1256, which would cap the transaction fee once a stated amount of revenue has been collected in any given year. While we generally favor anything that would reduce the burden of what we believe is an unfair and unnecessary tax on investors, we believe that reducing the percentage rate at which the fee is imposed on all investors is a more equitable and easier to administer solution to the problem than making the fee apply at its existing rate to certain investors, while making it not apply at all to others.

We also believe that a reduction in fees is more consistent with the approach taken in NSMIA. NSMIA provided that the transaction fee would be reduced from 1/300 of one percent to 1/800 of one percent in fiscal year 2007. While NSMIA was intended to bring SEC fee collections more in line with the level of SEC funding appropriated by Congress, the gradual percentage reduction has not been swift enough to prevent transaction fees from greatly exceeding the levels envisioned dur-

ing consideration of NSMIA. Consequently, an accelerated reduction in the percentage of the fees is needed.

We commend your recognition of this problem and look forward to working with you to resolve the problem. Thank you for giving me the opportunity to present the views of the CBOE and, particularly, how the imposition of Section 31 fees hurts the U.S. options markets.

Mr. OXLEY. Thank you, Mr. Brodsky.

Mr. Cader.

STATEMENT OF ANDREW CADER

Mr. CADER. Thank you, Chairman Oxley and members of this subcommittee. I am Andrew Cader, I am Vice President and Member of the Board of Directors of the Specialist Association of the New York Stock Exchange. I am pleased to appear before you to present the Association's views concerning the transaction fees imposed by section 31. By way of further background, I am also the Senior Managing Director of Spear, Leeds & Kellogg, the largest specialist operation on the New York Stock Exchange and the American Stock Exchange. Spear, Leeds also maintains a significant presence as an over-the-counter market maker, and clears trades for a number of smaller specialists and market makers who are particularly adversely impacted by section 31 fees.

We are also ourselves members of and clear for many members of the CBOE. I sit on the board of directors of the SIA, who Steve Nelson is representing, and our over-the-counter group is in fact in the same business as Herzog Heine Geduld and we are members of the STA as well. So I think we have a broad experience with all of the liquidity providers who are impacted by this. As you may suspect, I have strong views on the topic.

The Specialist Association is comprised of 27 broker-dealer firms which include all of the individual specialists of the New York Stock Exchange. Our specialists are at the heart of the auction market of the world's most active stock exchange. The New York Stock Exchange's auction trading marketplace is the mechanism through which the prices of stock listed on the exchange are discovered and liquidity is provided to buyers and sellers. We supply liquidity when necessary to the proper operation of the market, acting as buyer or seller in the absence of public demand to buy or sell in our respective specialty stocks. We coordinate orderly trading in those stocks.

Over 169 billion shares of stock were traded on the exchange in 1998 in over 135 million transactions. Specialists participated as principal, buying or selling for their own accounts in 12.5 percent of those transactions, paying in excess of $30 million in section 31 fees last year, an amount we expect to increase to in excess of $40 million this year. A total of $242 million was paid in section 31 fees in 1998 on New York Stock Exchange transactions by all stock exchange member firms and their customers.

Beginning the 1930's, the Federal Government through the SEC has collected fees in respect to sales securities registered under the Securities Act of 1933, the section 6(b) fees, and, in respect to the sales effected in the trading markets subject to regulation under the exchange act, section 31 fees. Although these fees were conceived as user fees to defray the costs of Federal securities regulation, the amounts collected have exceeded the cost of running the

SEC ever since 1983. As will be discussed momentarily, those collected amounts now surpass the SEC's budget by a factor of greater than 5.

In short, the section 6(b) and section 31 fees have become a general tax on capital raising. Moreover, as I will discuss in a moment, section 31 fees represent a tax imposed at a particularly inopportune time in the life cycle of a specialist's or market maker's capital and its deployment in the marketplace.

Before going further, please let there be no misunderstanding. We support continued full funding for the SEC, an agency that has overseen our constantly growing, remarkably fair and efficient markets, that raise new capital and serve the public investor, contributing to our worldwide reputation for fairness and integrity. What we object to is misuse of the financing mechanism designed to compensate the government for providing that funding—the section 31 fees, through overcollection of the fee and application of the proceeds to completely unrelated objectives.

When congressional appropriators began to increase the section 6(b) fees annually in 1990, various Members of Congress recognized that the fee increases amounted, in reality, to a new tax because the amounts collected so significantly exceeded the SEC's annual budget. In 1993, the House responded by unanimously passing a bill that, after fiscal 1998, would have required the SEC to set and collect fees for the exclusive purpose of recovering for the government the cost of funding the SEC's regulatory activities. No further action was taken on that bill.

A similar effort was made by both Chambers of Congress in 1996, in the National Securities Markets Improvements Act, to compel a slowdown and finally a reduction in the amounts of section 6(b) and 31 fees collected. The basic idea of limiting the section 31 fee to the cost of funding the SEC, however, has proven to be very elusive.

In fiscal 1997, the SEC's collections from 6(b) and 31 fees and all other sources grew to $990 million, significantly more than 3 times the agency's budget of $305 million. To bring transaction fees back into line with the cost of running the SEC, a bipartisan bill was introduced in the House in 1998 to cap section 31 fees. Another bill was introduced in the House in that year that would have cut the section 31 fee in half rather than capping it. These initiatives were cosponsored by over 60 House members, and one or the other was endorsed by, among many others, the STA, the Chicago and Pacific Stock Exchanges, the Securities Industry Association, the NASD, the Profit Sharing/401(K) Council, Americans for Tax Reform, the National Taxpayers Union, Citizens for a Sound Economy, the U.S. Chamber of Commerce, as well as the New York Stock Exchange and our Association. Neither bill was voted upon.

More recently, two new bipartisan bills have been introduced in the House to remedy the section 31 fee: H.R. 2441 and 1256 introduced by Representatives Lazio and Towns and Representatives Fossella and Menendez respectively. Each have garnered more than 30 cosponsors. In fiscal 1998, the SEC's fee collections mushroomed to an astounding $1.78 billion. That is, the SEC's fee collections amounted to 5½ times its $322 million budget.

Our colleagues of the Security Traders Association have laid out in detail in their written testimony to the subcommittee the history of how the section 31 fee has been transformed from an SEC funding mechanism into a general tax and the efforts of Members of the House and the Senate over the last decade to return the section 31 fees to its original purpose. We wish to associate ourselves with the STA's recitation of that history and see no need to repeat or elaborate upon it.

As things stand, the section 31 fee cannot be viewed as anything but a tax on the sale of securities, a purpose for which it was never intended. That tax, although levied in relatively small increments, is creating a near billion dollar drag on the capital markets. That drag on our markets represents a cost paid by all investors, including the huge number of individually small participants in mutual funds, pension plans, and other forms of retirement accounts.

Moreover the section 31 tax is imposed at a particularly inopportune time in terms of its ultimate effect on market liquidity. Unencumbered by section 31 fees, revenue generated by specialists and market makers and other liquidity providers in securities transactions would in many cases be put to its normal use and leveraged in a manner allowing those market professionals to provide liquidity to the market in a multiple exceeding many times the absolute amount of the revenue itself. Thus, investors and the market in general lose more than simply the amount of the section 21 fees themselves in terms of sacrificed market liquidity.

We would also be wise to remember that we have had the benefit of a thriving and competitive bull market for an unprecedented number of years, as the chairman mentioned in his opening remarks. During such times, the impact of measures placing inappropriate burdens on capital formation and market activity can be softened or blunted. As is often the case with respect to ill-advised policy, it is only when market conditions eventually decline and liquidity becomes more scarce that the full brunt of a cloaked tax, such as the current section 31 fees, will be felt by us all. This will be particularly true to the extent that market prices might stagnate or decline, but today's record volume levels remain the norm.

In conclusion, general tax revenue is the objective of other laws, not the exchange act. Congressional action to restore the unintended tax now represented by the section 31 fee to its original purpose—to fund the operations of the SEC and not for any other type of Federal expenditure, is long overdue.

We applaud your inquiry into this matter and hope for a solution in the near term. We would support any realistic method of achieving the objective of bringing the revenue collected from the section 31 fee back into line with the SEC's annual budget.

The Association is thankful for the opportunity to express our views on the section 31 fee. Thank you, Mr. Chairman. I would be pleased to respond to any questions you or your staff have now or later.

[The prepared statement of Andrew Cader follows:]

PREPARED STATEMENT OF ANDREW CADER, VICE PRESIDENT, THE SPECIALIST ASSOCIATION OF THE NEW YORK STOCK EXCHANGE

Chairman Oxley, Members of the Subcommittee, good morning. I am Andrew Cader, Vice President and member of the Board of Directors of The Specialist Asso-

ciation of the New York Stock Exchange. I am pleased to appear before you to present the Association's views concerning the transaction fees imposed by Section 31 of the Securities Exchange Act of 1934. By way of further background, I also am a Senior Managing Director of Spear, Leeds & Kellogg, the largest specialist operation on the New York Stock Exchange and American Stock Exchange. Spear Leeds also maintains a significant presence in the over-the-counter market, and clears trades for a number of smaller specialists and market makers who are particularly adversely impacted by Section 31 fees. Therefore, as you might suspect, I have strong views on today's topic.

The Specialist Association is comprised of 27 broker-dealer firms which include all of the individual specialists of the New York Stock Exchange. Our specialists are at the heart of the auction market of the world's most active stock exchange. The Exchange's auction trading marketplace is the mechanism through which the prices of stocks listed on the Exchange are "discovered" and liquidity is provided to buyers and sellers. We supply liquidity when necessary to the proper operation of the market, acting as buyer or seller in the absence of public demand to buy or sell in our respective specialty stocks. We coordinate orderly trading in those stocks. Over 169 billion shares of stock were traded on the Exchange in 1998 in over 135 million transactions. Specialists participated as principal, selling for their own accounts, in 12.6% of those transactions, paying in excess of $30 million in Section 31 fees last year (an amount we expect to increase to in excess of $40 million this year). A total of $242.6 million was paid in Section 31 fees in 1998 on NYSE transactions by all NYSE member firms and their customers.

Beginning in the 1930s, the federal government, through the Securities and Exchange Commission, has collected fees in respect to the sales of securities registered under the Securities Act of 1933 ("Section 6(b) fees") and in respect to the sales effected in the trading markets subject to regulation under the Exchange Act ("Section 31 fees"). Although these fees were conceived as user fees to defray the costs of federal securities regulation, the amounts collected have exceeded the cost of running the SEC ever since 1983. As discussed below, those collected amounts now surpass the SEC's budget by a factor of five. In short, the Section 6(b) and Section 31 fees have become a general tax on capital raising. Moreover, as I will discuss in a moment, Section 31 fees represent a tax imposed at a particularly inopportune time in the life cycle of a specialist's or market maker's capital.

Before going further, please let there be no misunderstanding. We support continued full funding for the Securities and Exchange Commission, an agency that has overseen our constantly growing, remarkably fair and efficient markets that raise new capital and serve the public investor, contributing to our worldwide reputation for fairness and integrity. What we object to is misuse of the financing mechanism designed to compensate the government for providing that funding—the Section 31 fee—through over-collection of the fee and application of the proceeds to completely unrelated objectives.

When Congressional appropriators began to increase the Section 6(b) registration fees annually in 1990, various members of Congress recognized that the fee increases amounted, in reality, to a new tax because the amounts collected so significantly exceeded the SEC's annual budget. In 1993, the House responded by unanimously passing a bill that, after fiscal 1998, would have required the SEC to set and collect fees for the exclusive purpose of recovering for the government the cost of funding the SEC's regulatory activities. No further action was taken on that bill. A similar effort was made by both chambers of Congress in 1996 in the National Securities Markets Improvements Act, to compel a slow-down and, finally, a reduction in the amounts of Section 6(b) and 31 fees collected. The basic idea of limiting the Section 31 fee to the cost of funding the SEC, however, has proven to be very elusive.

In fiscal 1997, the SEC's collections from Section 6(b) and 31 fees (and all other sources) grew to $990 million, significantly more than three times the agency's budget of $305 million. To bring transaction fees back into line with the cost of running the SEC, a bipartisan bill was introduced in the House in 1998 to cap Section 31 fees. Another bill was introduced in the House in that year that would have cut the Section 31 fee in half rather than capping it. These initiatives were cosponsored by over 60 House members and one or the other was endorsed by, among many others, the Security Traders Association, the Chicago and Pacific Stock Exchanges, the Securities Industry Association, the NASD, the Profit Sharing/401(k) Council, Americans for Tax Reform, the National Taxpayers' Union, Citizens for a Sound Economy, the U.S. Chamber of Commerce, as well as the New York Stock Exchange and our Association. Neither bill was voted upon. More recently, two new bipartisan bills have been introduced in the House to remedy the Section 31 fee problem. H.R. 2441 and 1256, introduced by Representatives Lazio (R-NY) and Towns (D-NY), and Rep-

resentatives Fossella (R-NY) and Menendez (D-NJ), respectively, each have garnered more than 30 cosponsors.

In fiscal 1998, the SEC's fee collections mushroomed to an astounding $1.78 billion. That is, the SEC's fee collections amounted to five and one-half times its $322 million budget.

Our colleagues of the Security Traders Association have laid out in detail in their written testimony to the Subcommittee the history of how the Section 31 fee has been transformed from an SEC funding mechanism into a general tax and the efforts of members of the House and Senate over the last decade to return the Section 31 fee to its original purpose. We wish to associate ourselves with the STA's recitation of that history and see no need to repeat or elaborate upon it.

As things stand, the Section 31 fee cannot be viewed as anything but a tax on the sale of securities, a purpose for which it was never intended. That tax, although levied in relatively small increments, is creating a near billion-dollar drag on the capital markets. That drag on our markets represents a cost paid by all investors, including the huge number of individually small participants in mutual funds, pension plans, and other forms of retirement accounts.

Moreover, the Section 31 "tax" is imposed at a particularly inopportune time in terms of its ultimate effect on market liquidity. Unencumbered by Section 31 fees, revenue generated by specialists and market makers in securities transactions would, in many cases, be put to its normal use and leveraged in a manner allowing these market professionals to provide liquidity to the market in a multiple exceeding the absolute amount of the revenue itself. Thus, investors and the market in general lose more than the simply the amount of the Section 31 fees themselves in terms of sacrificed market liquidity.

We would also be wise to remember that we have had the benefit of a thriving and competitive bull market for an unprecedented number of years. During such times, the impact of measures placing inappropriate burdens on capital formation and market activity can be softened or blunted. As is often the case with respect to ill-advised policy, it is only when market conditions eventually decline and liquidity becomes more scarce that the full brunt of a cloaked tax such as the current Section 31 fees will felt by us all. This will be particularly true to the extent that market prices stagnate or decline, but today's record volume levels remain the norm.

In conclusion, general tax revenue is the objective of other laws, not the Exchange Act. Congressional action to restore the unintended tax now represented by the Section 31 fee to its original purpose—to fund the operations of the SEC, and not for any other type of federal expenditure—is long overdue. We applaud your inquiry into this matter and hope for a solution in the near term. We would support any realistic method of achieving the objective of bringing the revenue collected from the Section 31 fee back into line with the SEC's annual budget.

The Association is thankful for this opportunity to express its views on the Section 31 fee. Thank you, Mr. Chairman.

I would be pleased to respond to any questions you, other Representatives, or your staff may have.

Mr. OXLEY. Thank you, Mr. Cader.

Mr. Nelson.

STATEMENT OF STEPHEN J. NELSON

Mr. NELSON. Chairman Oxley, Congressman Towns, members of the subcommittee, I am Steve Nelson, vice president of Herzog Heine Geduld, a leading NASDAQ market maker. I am here today representing the Securities Industry Association. Thank you for inviting me to testify at this hearing on the subject of securities transaction fees. This is a subject on which the chairman of the full committee, Congressman Bliley, has been a leader for a number of years and we are grateful to him for the leadership he has provided.

Chairman Oxley, we commend and appreciate your interest in the subject of today's hearing, and, more broadly, your interest in fair, efficient, and internationally competitive securities markets. We look forward to working with you on this issue.

Congressman Towns, we are also grateful for the work you have done to reduce regulatory burdens and reduce costs to investors. We appreciate your continued interest and involvement in issues affecting the securities markets.

We also wish to express our special gratitude to Congressman Lazio, Congressman Fossella, and Congressman Menendez for the leadership they have demonstrated on the subject of SEC transaction fees.

We know that our markets have been made better and fairer by the presence of a strong and effective Securities and Exchange Commission. And because it is in our interest and, more importantly, in the public interest to have an effective SEC, the SIA has been a strong supporter of full funding for the agency so it can carry out its important mission of investor protection. Our support for legislation today to reduce the excess fees charged to the industry, investors, and issuers will still provide more in revenues than the budget of the SEC.

NSMIA was adopted in 1996 with the goal of bringing fees collected by the SEC more in line with the cost of running the agency. But in 1996, no one anticipated the explosion of market activity that has taken place over the past several years. In particular, no one could have predicted the phenomenal influence that online investors would have on equity markets. The investing public has found a new way to participate in the markets, and we believe at Herzog Heine Geduld that this is only the beginning. Fees now paid by investors, issuers, and the industry amount to 5 times the cost of running the SEC. We do not believe it is in the interest of investors or in the interest of our capital markets for these fees to so grossly dwarf the regulatory costs involved.

The fees have a particularly profound impact on NASDAQ market makers and on specialists in traditional exchanges who perform similar functions. The market makers' business is similar in many ways to that of the grocer who buys milk for 10 cents and hopes to sell it for 11. The section 31 fee is particularly burdensome to a market maker because where the fee exceeds the cost of regulation, it amounts to a tax on the market makers' gross revenues. The fee must be paid, whether we sell the milk profitably for 11 cents or at a loss for 9.

In the last several years, technological advances have lowered transaction costs. These reduced costs have encouraged more trading activity. We have larger share volume and even larger trading volume but margins have also declined. We are selling more milk but we are making less on each sale. As transaction volume and market evaluations have increased, the amount of fees collected under section 31 has ballooned. In contrast, our profit margins have declined.

As a result, section 31 fees comprise an increasing share of our gross trading revenues, even though the rate of the fee has remained constant. Herzog Heine Geduld's payments of section 31 fees currently amount to more than 3 percent of our gross trading revenues. Market makers must continue to make significant investments in technology to handle ever-increasing volumes. The increase in volumes is accompanied by lower margins and increasing SEC fees. We are on a collision course that, if left uncorrected, will

have a significant effect on the ability of market makers to conduct their business profitably.

We believe that our equity markets, much admired and envied throughout the world, would operate much less efficiently if there were no market makers. This result was certainly not intended by Congress. The language of section 31 states that transaction fees to be collected by the SEC are designed to recover the cost to the government of the supervision and regulation of the securities markets and securities professionals and costs related to such supervision and regulation.

We have demonstrated that we are more than willing to pay the costs associated with regulation. But it is simply not right to charge investors, issuers. And market makers 5 times the cost of regulation. At a minimum, a burden of this size with its potential to adversely effect the structure of the capital markets should not be allowed to happen inadvertently because of changing circumstances.

Mr. Chairman, we urge you to craft a solution that will better align fees with the cost of regulation. We have confidence that Congress, once it reviews the facts, will make a decision that is in the interest of millions of investors. We are committed to work with this subcommittee to find an appropriate solution. Thank you for the opportunity to testify. I am ready to answer any questions.

[The prepared statement of Stephen J. Nelson follows:]

PREPARED STATEMENT OF STEPHEN J. NELSON, VICE PRESIDENT, HERZOG HEINE GEDULD

Chairman Bliley, Chairman Oxley, Congressman Towns and Members of the Subcommittee, I am Steve Nelson, Vice President of Herzog Heine Geduld, a leading NASDAQ market maker. I am here today representing the Securities Industry Association.[1] Thank you for inviting me to testify at this hearing on the subject of securities transaction fees. This is a subject on which the Chairman of the full Committee, Congressman Bliley, has been a leader for a number of years, and we are grateful to him for the leadership he has provided.

Chairman Oxley, we commend and appreciate your interest in the subject of today's hearing and, more broadly, your interest in fair, efficient and internationally competitive securities markets. We look forward to working with you on this issue.

Congressman Towns, we are also grateful for the work you have done to reduce regulatory burdens and reduce costs to investors. We appreciate your continued interest and involvement in issues affecting the securities markets.

We also wish to express our special gratitude to Congressman Lazio, Congressman Fossella and Congressman Menendez for the leadership they have demonstrated on the subject of SEC transaction fees.

We believe it is critical that Congress examines the issue of SEC fees, because the facts and assumptions on which enactment of the current statutory fee structure was based have changed. Fees that were developed several years ago to fund the cost of regulating the securities markets now exceed the government's cost of regulation to such a degree that they constitute a tax on capital formation, and a special tax on every American investor.

Our securities markets serve as a strong engine of growth and job creation for our economy, furnishing the seed capital for start-up companies, providing the liquidity essential to bring investors into the market, harnessing investment for growth and expansion for our economy, and creating savings and investment vehi-

[1] The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates approximately $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about the SIA is available on its home page: http://www.sia.com.)

cles for millions of Americans. Today, forty-eight percent of U.S. households own stock, directly or indirectly. By the year 2000, the number of individuals who own stock is likely to exceed 80 million. The more than 600,000 men and women who go to work in the securities industry every day work hard to ensure that we have the fairest, deepest and most liquid securities markets in the world.

We know that our markets have been made better, and fairer, by the presence of a strong and effective Securities and Exchange Commission. And, because it is in our interest—and, more importantly, in the public interest—to have an effective SEC, the SIA has been a strong supporter of full funding for the agency, so that it can carry out its important mission of investor protection. In the past, the SIA has supported full funding for the SEC, even at times when budget freezes and budget cuts were being pressed on all federal agencies. Our support for legislation today to reduce the excess fees charged to the industry, investors and issuers will still provide substantially more in revenues than the budget of the SEC.

Three years ago, the industry was asked to step up to the plate and pay additional fees in order to help Congress move to a more reliable funding mechanism for the SEC. We agreed to do so, because we believed it was in the long term interests of our markets. The fee structure adopted as part of the National Securities Markets Improvement Act of 1996 for the first time assessed transaction fees on the NASDAQ markets. This provision was intended to establish parity between the fees assessed on exchange and NASDAQ markets.[2] While it was expected that, as a result of these changes, the fees paid by investors and the industry would increase in the near term, the ultimate goal of NSMIA's fee provisions was to bring fees collected by the SEC more in line with the cost of running the agency.

At the time these provisions were enacted, no one anticipated the explosion of market activity that has taken place over the past several years, and that appears to be continuing and increasing. In particular, no one could have predicted the phenomenal influence that online investors would have on the equity markets.

In 1996 average daily trading volume on the exchange, NASDAQ and regional markets was 1.0 billion shares a day, by 1998 it had risen to 1.5 billion shares. Total annual share volume in these markets was 261 billion shares in 1996; by 1998 volume had risen to 400 billion shares traded annually—a 50% jump in just two years.

Transaction volume has increased even more dramatically than share volume with the rise in popularity of online investing. In 1996, when Herzog Heine Geduld moved into its new trading room in Jersey City, our facilities were handling on average approximately 25,000 trades each day. Since the beginning of this year, less than four years later, we have averaged more than 100,000 trades each day, and we are experiencing a 10% growth in trade volume each quarter. The investing public has found a new way to participate in the markets, and we believe that this is only the beginning.

During this period, SEC appropriations have risen in an effort to give the SEC sufficient resources to oversee the markets and enforce the federal securities laws. However, the increase in transaction and other fees paid by investors, issuers and the industry has far exceeded the increase in the cost of running the SEC. The following chart sets forth the fees collected by the SEC during fiscal years 1996-1998 and estimated to be collected during the current and next fiscal year (including Section 6(b) fees, Section 31 fees, and other fees), compared with the amounts appropriated or requested to be appropriated to the SEC during these years (dollar amounts in millions):[3]

	§ 6(b)	§ 31	Other	Total	SEC Budget
FY 1996	$575	$134	$65	$774	$297.4
FY 1997	653	274	63	990	305.4
FY 1998	1,034	632	114	1,780	315.0
FY 1999 (est.)	1,040	432	50	1,522	337.4

[2] NSMIA provided for a gradual reduction over 10 years in filing fees for securities registration statements under Section 6(b) of the Securities Act of 1933. The securities registration fee was set at $295 per $1 million in 1998, to be lowered over time to $67 per $1 million in 2007. NSMIA also expanded the reach of securities transaction fees, which previously had been assessed on transactions in exchange-registered securities, to include transactions in NASDAQ markets. The transaction fee, under Section 31 of the Exchange Act, was set at 1/300 of one percent during the years 1997 through 2006, and was scheduled to be reduced to 1/800 of one percent in 2007.

[3] Where estimates of fee collections are indicated, they are OMB estimates; CBO estimates may differ. SEC appropriations for certain years are stated as the amounts requested; actual funding amounts may differ slightly.

	§ 6(b)	§ 31	Other	Total	SEC Budget
FY 2000 (est.)	1,079	491	50	1,620	360.8 (Req.)

Fees now paid by investors, issuers and the industry amount to five times the cost of running the SEC. In 1998 alone, while the SEC's budget was just over $315 million, securities registration, transaction and other fees collected by the SEC totaled more than $1.7 billion. From FY 1998 through FY 2000, if the present trend continues, the amounts paid by investors, issuers and the industry will have exceeded the SEC's budget by more than $3.8 billion. We do not believe it is in the interest of investors—or in the interests of our capital markets more broadly—for these fees to so grossly dwarf the regulatory costs incurred. These fees drain capital from the private markets—removing it at the very beginning of the capital raising process—and diverting it into the U.S. Treasury.

The fees have a particularly profound impact on NASDAQ market makers and on specialists at traditional exchanges, who perform similar functions. The market maker's business is similar in many ways to that of the grocer, who buys milk for ten cents and hopes to sell it for eleven. The Section 31 fee is especially burdensome to a market maker because, where the fee exceeds the cost of regulation, it amounts to a tax on the market maker's gross revenues, unlike an income tax, for example, which taxes profits. In other words, we must pay the fee whether we sell the milk profitably for eleven cents or are forced by market conditions to sell at loss for nine cents. Moreover, the Section 31 fee must be paid before the electric bill, the rent, salaries to the staff or even federal and state income taxes, and whether or not our business is profitable.

In the last several years, technological advances have lowered transaction costs. These reduced costs have encouraged more trading activity—larger share volume and even larger trading volume. Margins have also declined, but to some extent, increases in volume have compensated for lower margins. We are selling more milk, but making less on each sale. These declining margins have greatly magnified the effect on our industry of the Section 31 tax—the portion collected in excess of the cost of regulating the NASDAQ and Exchange equity markets.

Section 31 fees are based on the value of transactions. As transaction volume and market valuations have increased, the amount of fees collected under Section 31 has ballooned. In contrast, the market maker's revenue on these transactions, our profit margins, have declined. As a result, Section 31 fees comprise an increasing share of our gross trading revenues, even though the rate of the fee has remained constant. Herzog Heine Geduld's payments of Section 31 fees currently amount to more than 3% of our gross trading revenues. To illustrate the significance of this tax, the current amount of the Section 31 fee is about twice as much as the rent paid on the property that houses our Nasdaq trading operations.

Market makers must continue to make significant investments in technology to handle ever-increasing volumes. The increase in volumes is accompanied by lower margins and increasing SEC fees. We are on a collision course that, if left uncorrected, will have a significant effect on the ability of market makers to conduct their business profitably. We believe that our equity markets—much admired and envied throughout the world—would operate much less efficiently if there were no market makers.

This result certainly was not intended by Congress. When Congress adopted NSMIA's fee provisions, its intent was clear. The language of Section 6(b) states that the registration fees to be collected by the SEC under that section "are designed to recover the costs to the government of the securities registration process, and costs related to such process . . ." The language of Section 31 states that the transaction fees to be collected by the SEC "are designed to recover the costs to the Government of the supervision and regulation of securities markets and securities professionals and costs related to such supervision and regulation . . ."

Unfortunately, the fees have far exceeded the cost of regulation. They divert resources which could be used more productively elsewhere in our economy; and they discourage capital investments in technology that could be used to make our equity markets more efficient and attractive to investors. This is real capital that could be used to fund new businesses, to build plants, to create jobs, and to add to the national wealth.

There may be some who believe that, since the U.S. stock market is near an all time high, market makers, specialists and other market participants somehow can, or should, pay these fees. So what if they pay a little more here or there?

In the first place, specialists' and market makers' profits are not related to the value of stocks. Our willingness to devote capital to making markets necessarily de-

pends on our ability to make a fair and reasonable profit on transactions. We have demonstrated that we are more than willing to pay the cost associated with regulation. But, it simply is not right to charge investors, issuers and market makers five times the cost of regulation. At a minimum, a burden of this size, with its potential to adversely affect the structure of the capital markets, should not be allowed to happen inadvertently because of changed circumstances.

Mr. Chairman, we urge you to craft a solution that will better align fees with the cost of regulation. We have confidence that Congress, once it reviews the facts, will make a decision that is in the interest of millions of investors. We are committed to work with this subcommittee to find such a solution.

The securities industry is faced with a number of challenges in the immediate future: how to make a successful conversion to the Year 2000, so that it is seamless for investors and issuers; how to make systems "Euro" compatible; how to make the conversion and expand quote capacity to accommodate decimalization; how to ensure that investors and issuers benefit from the explosion in technology and electronic commerce; and, how to meet the competitive challenges of globalization. All of these challenges have required, and will continue to require, significant financial investment on our part, as well as the time and efforts of our most talented industry professionals. We intend to meet these challenges, to maintain and enhance the international preeminence of our capital markets, to help fund the continued growth of the U.S. economy, and to ensure that investors and issuers have even more opportunities in the next century.

Thank you again for the opportunity to testify. I am ready to answer any questions.

Mr. OXLEY. Thank you, Mr. Nelson.

Mr. Kearney.

STATEMENT OF ARTHUR J. KEARNEY

Mr. KEARNEY. Chairman Oxley, members of the subcommittee, thank you for the invitation to testify before you today on the subject of SEC transaction fees, an issue in which you have had an interest for quite some time. I do very much appreciate this opportunity to present the views of the Security Traders Association, and I applaud your leadership in scheduling a hearing on this important issue.

I also want to specifically commend Congressman Fossella, Congressman Lazio, and Congressman Towns for the outstanding leadership that they have shown on this issue this year as well as Congressman Bob Menendez. Mr. Chairman, with your permission I would like to summarize my written testimony and I would ask that my full written testimony be made part of the record.

I am Arthur Kearney, Chairman of the Security Traders Association, the STA, and Director of Equity Capital Markets and a member of the board of directors of John G. Kinnard & Company, a broker-dealer located in Minneapolis, Minnesota. I am accompanied by Lee Korens, President and CEO of STA, who is available to answer any questions.

STA is composed of 34 regional affiliates and over 7,000 individual members throughout North America and Europe, and it is the largest group of its kind in the world. Our membership represents all facets of the securities industry. While many members are traders for securities firms and institutions, others are partners, specialists, floor traders, proprietors, or registered representatives, all of whom are charged with the responsibility of executing orders at the fairest prevailing prices.

Mr. Chairman, in my written testimony I have provided a fairly detailed description of the history and structure of SEC fees, so I will give a brief overview and turn to our position.

Before I start, however, I do want to thank this committee for its longstanding interest in this issue and its hard work in attempting to reduce these fees paid by the investing public and securities professionals. As you know, the government collects various Securities and Exchange Commission SEC user fees imposed by the securities laws in order to recover the Federal Government's cost of running the SEC, including transaction fees on sale of stocks assessed pursuant to section 31 of the 1934 act.

Over time, these fees have grown to significantly exceed the SEC's budget. By 1996, collected fees exceeded the SEC's budget by a factor of more than 2 to 1. Under this committee's leadership, Title 4 of the NSMIA of 1996 significantly restructured the various SEC fees with the intent of reducing total SEC fee collection over time and providing the SEC with a more stable funding source.

We commend Chairman Bliley and others on this committee for working tirelessly to produce legislation designed to reduce these fees. Indeed, the committee prevailed in designing a fee structure which explicitly contemplated that section 31 fees would recoup the cost of the SEC's supervision and regulation of the securities markets and securities professionals. Unfortunately, actual fees collections have significantly outpaced the CBO's and OMB's conservative estimates of market growth relied on by this committee and Congress.

In fiscal year 1997, actual collections from all sources grew to $990 million, over 3 times the SEC's budget of $3.5 million. In fiscal year 1998, the excess worsened considerably when actual fees collection ballooned to a staggering $1.78 billion, 5½ times the SEC's $322 million budget. Clearly, this is not the scenario the committee intended when it redesigned the SEC funding structure in 1996 to reduce the amount of fee surplus.

I want to emphasize that the issue here is not SEC funding. The issue is that the government is taking in over 5 times as much fee revenue as is reasonably needed to fund the SEC's activities. What was explicitly designed to be a user fee has become a large unintended back-door tax on the securities markets.

Excessive SEC fees have a tremendous negative impact on securities professionals. The effect is particularly severe for NASDAQ market makers and exchange specialists who often must trade from their own accounts in order to fulfill their legal responsibility to maintain orderly markets and to provide customers with on-demand liquidity. Section 31 transaction fees operate as a tax on the gross trading revenue of these professionals. One STA member firm which makes markets in NASDAQ 100 stocks, estimates that its section 31 fee payments amounted to a whopping 6 percent of OTC trading income over a recent 16-month period.

Another firm found that its section 31 fee payments were twice the amount of its rental payments for the building housing its trading activities.

Let me also give you my perspective as an employer in the regional brokerage and underwriting business. Our firm trades NASDAQ stocks and underwrites IPOs and secondaries. Some of the recent ventures we have been involved in include Excelsior-Henderson, a motorcycle manufacturer, and Zomax, an optical media softwear company. These are the types of companies that

create 75 percent of all new jobs in America. We also make markets in approximately 175 NASDAQ stocks, and Kinnard employs over 350 people.

Section 31 fees operate as a gross receipt tax. This means that the fees are paid before Federal and State taxes, before salary and before allocations of overhead. The result is to magnify the impact on our firm's profitability. Changes in the NASDAQ market, which include increasing cost pressures associated with the newer handling rules, the regulatory-driven computer upgrades and monitors, have greatly reduced the profitability of NASDAQ market making activities across the board. Excessive section 31 fees only exacerbate the situation.

Mr. Chairman, excessive section 31 fees negatively impact our trading revenue, and reduced revenues translate directly to fewer jobs. As a manager, when I am looking at a reduced revenue from section 31 fees, it means I can hire one less analyst, one less trader, one less support staff. Reduced revenues go right to our bottom line and right to our core business decisions. It is really that simple. Excessive fees also contribute to reduced liquidity in the markets. The major impact falls on thinly traded stocks of those small and startup companies in which we specialize. STA urges Congress to take swift corrective action to eliminate the SEC transaction fee excess and reduce the burdensome and unintended tax on America's savers, investors, and securities professionals. While this result could be achieved through a number of approaches, STA is committed to support any initiative that produces meaningful relief for all investors.

STA is encouraged by the continuing commitment of this committee to reduce SEC fees, as reflected in Chairman Oxley's scheduling this hearing, and the fact that 24 Commerce Committee members have cosponsored two separate bills this year to address the issue. We are also heartened that SEC Chairman Arthur Levitt testified in March that the fee problem needs to be addressed and pledged to work with Congress to fashion a solution.

In closing, Mr. Chairman, STA applauds you for scheduling this prompt hearing on an issue of great importance to our members across the United States. Thank you, and I will be happy to answer any questions.

[The prepared statement of Arthur J. Kearney follows:]

PREPARED STATEMENT OF ARTHUR J. KEARNEY, CHAIRMAN, SECURITY TRADERS ASSOCIATION

I. INTRODUCTION

Chairman Oxley, Chairman Bliley, Members of the Subcommittee, thank you for the invitation to testify before you today on the subject of SEC transaction fees, an issue in which you have had an interest for quite some time. I do very much appreciate this opportunity to present the views of the Security Traders Association, and I applaud your leadership in scheduling a hearing on this important issue. I also want to specifically commend Congressman Fossella, Congressman Lazio, and Congressman Towns for the outstanding leadership they have shown on this issue this year, as well as Congressman Bob Menendez.

I am Arthur Kearney, Chairman of the Security Traders Association—the STA—and Director of Capital Markets and a Member of the Board of Directors at John G. Kinnard & Co., a broker/dealer located in Minneapolis, Minnesota.

STA is composed of 34 regional affiliates and over 7,000 individual members throughout North America and Europe, and it is the largest group of its kind in the world. Our membership represents all facets of the securities industry. While many

members are traders for securities firms and institutions, others are partners, specialists, floor traders, proprietors or registered representatives—all of whom are charged with the responsibility of executing orders at the fairest prevailing prices. *The fact is that no one speaks for individual professionals in the securities industry better than STA. It is the only organization that represents, at all levels, the interests of over 7,000 individuals.*

Before I start, however, I do want to take a moment to thank this Committee for its longstanding interest in this issue and its hard work in attempting to reduce these fees paid by the investing public and securities professionals.

II. HISTORY OF THE SEC FUNDING STRUCTURE

Public Law 104-290, the National Securities Market Improvement Act of 1996, was signed into law by President Clinton on October 11, 1996. The Act combined securities and mutual fund market reforms with a reauthorization of the Securities and Exchange Commission (SEC). The Act extended the imposition of the Securities Exchange Act of 1934's Section 31 transaction fees to NASDAQ stock transactions. The SEC reauthorization was the result of a complex deal worked out between House and Senate authorizers and appropriators, the Office of Management and Budget (OMB), and the SEC, following years of Congressional wrangling over a new SEC funding mechanism.

Background

Since the 1930s, the federal government has levied SEC fees on the regulated community, including registration fees authorized by Section 6(b) of the Securities Act of 1933, and transaction fees authorized by Section 31 of the Securities Exchange Act of 1934. These fees were deposited in the Treasury's General Fund as general revenues. The SEC received no credit for collected fees and could not directly use the funds, but rather was funded through an annual appropriation from the Appropriations Committee. Since 1983, the SEC has been a net contributor to the Treasury, collecting far more fees than necessary to cover its budget.

In 1990, the budget rules were significantly changed. Specifically, the 1990 Budget Enforcement Act set limitations on specific spending categories and created "pay-as-you-go" procedures to require offsets for decreases in revenue or increases in entitlement spending. These rules put severe restraints on discretionary spending, forcing appropriators to choose among competing programs. The SEC was thus forced to compete for discretionary funding with the Departments of Commerce, Justice and State. The income collected by the SEC fees did not create any additional funding for the appropriators.

Beginning in 1990, appropriators decided to respond to the problem of insufficient resources to fund competing programs by imposing one-year rate increases in the Section 6(b) registration fee in the annual Commerce, Justice, State Appropriations Bill through which the SEC is funded. The amounts attributable to such increases were credited against the agency's appropriation account as an offsetting collection. Offsetting collections are deposited in special appropriations accounts, as opposed to the General Fund, and are available to appropriators to finance agency activities. This funding mechanism increased the overall funds available to the appropriators.

This practice eventually led to objections by various Members of Congress on both jurisdictional and public policy grounds. Since the agency was collecting far more in fees than its budget required, opponents argued that increasing SEC fees constituted a tax. Members began to call for a new SEC funding structure that allowed the government to cover the costs of the SEC's regulatory activities without artificially inflating the cost of raising capital in the markets. In 1993, this Committee, under the leadership of then-Chairman Dingell and current Chairman Bliley, crafted a bill which would have established a mechanism by which the SEC would set and collect fees solely to recover the costs of its regulatory activities.[1] The House subsequently passed the bill unanimously.

During that same year, the House and Senate again passed an SEC appropriations measure which raised registration fees and credited the amount as an offsetting collection. After several complaints were lodged with the Appropriations Committee by both House Ways and Means and House Energy and Commerce Committee members, language was included in the conference report on the Commerce, Justice, State Appropriations bill conference report indicating that the practice would be ended.

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[1] H.R. 2239, passed on July 20, 1993, would have authorized the SEC to continue to collect general revenues for fiscal years 1994 through 1998, in order to avoid raising the deficit and maintain pay-as-you-go budget scorecard neutrality. After fiscal year 1998, SEC fees would have been set and collected so as not to exceed the costs of running the agency.

Funding Crisis

The funding situation came to a head the following year. When the Commerce, Justice, State Appropriations Bill for fiscal year 1995 came to the floor of the House on June 28, 1994, the bill again contained a provision that would have imposed additional registration fees as offsetting collections. House Members frustrated with the Senate's failure to act on the SEC funding issue succeeded in striking the provision from the House bill on procedural grounds, and subsequently prevailed in an effort to keep the provision out of the conference agreement. This move left the SEC with an appropriation of $59.6 million, significantly below the $297 million originally provided by appropriators. The agency indicated that it would have to severely restrict its operations beginning in October 1994 absent Congressional action.

This funding crisis prompted Congress, with the help of this Committee's leadership, to pass a stop-gap measure (P.L. 103-352), authorizing the registration fee increase[2] and offsetting revenue practice for another year, in order to fund the agency through 1995. House Report 103-739 indicated that this was done as a one-time fix to avert an SEC shutdown, and contemplated passage in the next Congress of an SEC reauthorization that would "eliminate the need for one-year-at-a-time increases in registration fees." The bill originated in the House Ways and Means Committee with the support of the this Committee. The stage was thus set for an SEC reauthorization that would establish a predictable and adequate fee structure to recover funds solely to offset the cost of the agency's regulatory activities.

Action in the 104th Congress

During 1995, the first session of the 104th Congress, control shifted to the Republican party and the legislative agenda was crowded, leaving unaddressed the SEC fee issue. However, in light of the prior year's funding crisis, the Administration's FY 1996 budget proposal submitted at the beginning of 1995 stressed the need for a sound, stable and long-term funding structure for the SEC. H.R. 2076, the Commerce, Justice, State Appropriations Bill which passed that year, was vetoed by the President due to unrelated policy disputes, and the SEC's FY 1996 budget was funded by a series of continuing resolutions. Finally, an omnibus spending bill (H.R. 3019) was passed, providing SEC funds for the remainder of the year.

In 1996, House Commerce Committee Chairman Bliley (R-VA) introduced H.R. 2972, the SEC Reauthorization Act of 1996. The bill was designed ultimately to end the appropriators' practice of funding SEC activities through the yearly ritual of raising registration fees as offsetting collections. The proposal would have reduced 6(b) registration fees over a 6-year period, incrementally extended the Section 31 transaction fees to NASDAQ trades, and reduced the rate for all transaction fees beginning in 2002. In total, the package was projected to reduce fee collections by $751 million by 2002. Initially, a portion of the fees was to be deposited as offsetting collections. Beginning in 2002, all fees would be deposited as general revenue and no fees would be allotted as offsetting collections. Thus, by 2002, the SEC would rely on the allocation made to the appropriators for Commerce, Justice, State and related programs. The House unanimously passed H.R. 2972 on March 12, 1996.

A similar transaction fee provision was included in a bill also introduced in 1996 by then Senate Banking Securities Subcommittee Chairman Gramm (R-TX), S. 1855. However, Gramm and then Senate Banking Committee Chairman D'Amato (R-NY) agreed to postpone consideration of the SEC reauthorization in response to concerns by Senate Democrats and the Administration. They were concerned that ending the offsetting collections funding practice would require appropriators to fund the SEC's full budget out of the General Fund, subject to the discretionary spending caps, forcing reductions in other programs.

The House passed H.R. 3005, the Securities Amendments of 1996, on June 19, 1996, but not before adding the SEC reauthorization provisions originally embodied in H.R. 2972. The Senate amended and passed H.R. 3005 without the fee provisions on June 27, 1996, setting up a conference in which the SEC fee issue would have to be resolved. The fee issue was highly controversial in conference. Negotiations among House and Senate authorizers and appropriators, the OMB, and the SEC held up the bill for weeks and threatened to entirely derail the legislation. An agreement was finally reached on the fee issue and the bill was passed in the closing days of the 104th Congress. The conference report was agreed to by the House on September 28, 1996, and by the Senate on October 1, 1996. H.R. 3005 became P.L. 104-290 when the President signed the bill on October 11, 1996.

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[2] The fee was continued at 1/29 of 1% of the maximum offering price of the securities, the rate supplied in the FY 1994 Commerce, Justice, State Appropriations Act. Without the stop-gap extension, the rate would have fallen to its statutorily authorized rate of 1/50 of 1%.

Under the complex deal worked out in conference, registration fees are gradually reduced until FY 2007, when they drop dramatically. A portion of the registration fee is deposited as General Fund revenue, and a portion is made available to appropriators as offsetting collections. Transaction fees remain at 1/300 of 1% until FY 2007, when they drop dramatically. Beginning in 1997, NASDAQ trades became subject to the full transaction fee rate. While the exchange transaction fees are collected as General Fund revenue, the NASDAQ transaction fees are deposited as offsetting collections and must be triggered on each year by Appropriations Act. By pushing general revenue losses into the out-years, the new fee structure avoided budget scoring problems.

III. CURRENT SITUATION AND IMPACT

Unfortunately, actual fee collections have significantly outpaced the CBO's and OMB's conservative estimates of market growth relied on by this Committee and Congress. In fiscal year 1997, actual collections from all sources grew to *$990 million dollars*—over three times the SEC's budget of $305 million. In fiscal year 1998, the excess worsened considerably, when actual fee collections ballooned to a staggering $1.78 *billion*—five and one-half times the SEC's $322 million budget. Clearly, this is *not* the scenario this Committee intended when it fought to redesign the SEC funding structure in 1996 to reduce the amount of the fee surplus.

I want to emphasize that the issue here is *not* SEC funding. The issue, very simply, is that the government is taking in over five times as much fee revenue as is reasonably needed to fund the SEC's activities. What was explicitly designed to be a user fee has become a large, unintended backdoor tax on the securities markets.

Excessive SEC fees have a tremendously negative impact on securities professionals. The effect is particularly severe for NASDAQ market markers and exchange specialists, who often must trade from their own accounts in order to fulfil their legal responsibility to maintain orderly markets and to provide customers with on-demand liquidity. Section 31 transaction fees operate as a tax on the gross trading revenue of these professionals. One STA member firm which makes markets in about 100 NASDAQ stocks estimated that its Section 31 fee payments amounted to a whopping 60 percent of OTC trading income over a recent sixteen month period. Another firm found that its Section 31 fee payments were twice the amount of its rental payments for the building housing its trading activities.

Let me also give you my perspective as an employer in the regional brokerage and underwriting business. Our firm trades NASDAQ stocks and underwrites initial public offerings and secondaries. Some of the recent ventures we have been involved in include Excelsior-Henderson, a motorcycle manufacturer, and Zomax, an optical media software company. These are the types of companies that create 75 percent of all new jobs in America. We also make markets in approximately 175 NASDAQ stocks. Kinnard employs over 350 people.

Section 31 fees operate as a gross receipts tax. This means that fees are paid before federal and state taxes, before salary, and before allocations for overhead. The result is to magnify the impact on our firm's profitability. Changes in the NASDAQ market—which include increasing costs pressures associated with the new order handling rules and regulatory driven computer upgrades, among others—have greatly reduced the profitability of NASDAQ market making activities. Excessive section 31 fees only exacerbate this situation.

Mr. Chairman, excessive section 31 fees negatively impact our trading revenue, and reduced revenues translate directly into fewer jobs. As a manager, when I am looking at reduced revenue from section 31 fees, it means that I can hire one less analyst, one less trader, one less support staff. Reduced revenues go right to our bottom line, and right to our core business decisions. It's really that simple. Excessive fees also contribute to reduced liquidity in the market. The major impact falls on the thinly traded stocks of those small and start-up companies in which we specialize.

I should also note that it appears the primary factor contributing to the transaction fee collection overage is that the projections for the dollar volume growth in the markets have been based on extremely conservative assumptions. Actual transaction fee collections have consistently outpaced the government's projections by a significant amount. The transaction fee overage is not a result of a temporary spike in volume, but is a recurring and compounding problem. Without a statutory correction that somehow limits the amount of fees collected, the amount of the fee collection overage will continue to grow exponentially into the foreseeable future.

IV. CONCLUSION

STA urges Congress to take swift, corrective action to eliminate the SEC transaction fee excess and reduce this burdensome and unintended tax on American savers, investors and securities professionals. While this result could be achieved though a number of approaches, STA has committed to support *any initiative* that produces *meaningful relief* for all investors.

STA is encouraged by the continuing commitment of this Committee to reduce SEC fees, as reflected in Chairman Oxley's scheduling this hearing and the fact that 24 Commerce Committee members have cosponsored two separate bills this year to address this issue. We are also heartened that SEC Chairman Arthur Levitt testified in March that the fee problem needs to be addressed, and pledged to work with Congress to fashion a solution.

In closing, Mr. Chairman, STA applauds you for scheduling this prompt hearing on an issue of great importance to our members across the United States. Thank you, and I will be happy to answer any questions.

Mr. OXLEY. Thank you, Mr. Kearney. That completes the testimony of our witnesses. There are 4 minutes left in the vote. We will stand in recess for 15 minutes.

[Brief recess.]

Mr. OXLEY. The subcommittee will reconvene. Let me begin with some just general questions from the Chair.

Part of the problem of the excessive fee revenue stems from record-breaking volumes on transactions. I would like to ask, do you believe that the markets will continue to experience similar volume levels in the future? Is this a temporary phenomenon or is this something that is not going to abate any time soon?

Mr. KEARNEY. If you look at all of the market design and everything that is in front of the NASD and the SEC for approval and all of the regulatory changes, et cetera, they are going to make access to liquidity easier and easier. They are going to make access so you as an individual investor will be able to buy or sell a security at a lower rate and faster. Everything leads me to believe that these volumes are going to continue to explode and increase at rates that we don't even—we have no comprehension of. The fragmentation of the market today is actually slowing down the volumes. If they address those fragmentation issues, it is going to go higher.

Mr. NELSON. We think that the markets have changed. Up until, I would say the fall of last year, as a general proposition, the big institutions and institutional investors set prices in the markets. They would give us huge orders. They really were the stopgap in the market.

Last year for the first time, the online investor really came of age. Thousands of 200, 300, 500 shareholders would simply overwhelm these institutional orders and sweep them away in a tide up and tide down. I think—we think that this is just the start of this. The public has just now figured out what online trading is all about. All of the big bull tracking firms are standing in line and putting in systems that have always traditionally gone through a broker, which, in a fairly steady fashion, are now going to be hitting these machines. I think we have just seen the beginning of an overwhelming increase in volume.

Mr. OXLEY. Mr. Cader.

Mr. CADER. I would agree with all of that. I would point out additionally as we see the demographic and economic underpinnings of the markets and volumes seem likely not to change in the near fu-

ture—and you can have a discussion whether that argues for higher or lower stock prices—but stock ownership and stock trading that has accrued to individuals has exploded in a way that history suggests does not go away quickly, no matter which way prices move in.

Several dynamics of market structure which are likely to change and which are familiar to all of you from looking at the industry and from reading the papers, such as decimalization, such as 24-hour trading or extended-hour trading, which will also be upon us soon, are almost certain to increase volume even aside from whatever other secular or cyclical trends might drive volume up or down.

So for demographic and economic reasons, volumes will trend up, you will have an additional likelihood of volume going up even more if in fact decimalization and extended hours are, as I suspect they are, helpful to and friendly to investor access to the marketplace.

So I think there are a lot of reasons to believe that whether prices go up or down—which, of course we don't know—that volumes will continue at particularly high levels.

Mr. OXLEY. Mr. Brodsky, the same thing in Chicago?

Mr. BRODSKY. I would say the same thing, not only in Chicago but all over the world. You have seem the democratization of equity markets, and it is to a large extent attributable to the work that this committee has done over the years, the SEC has done. And we are seeing more and more business not only from abroad but from a younger group of investors. I think that it does flow through all of the things that the people spoke before me have said.

I will give you a general statistic. The fastest growth in our business is through people who use the Internet, through brokerage firms. Our Web site, 2½ years ago, in a month had 50,000 hits, and recently it was 50 million. These people are using electronics as a way of accessing markets.

I agree with what was said. The combination of after-hours trading and the greater competition, we expect even though we are the first option exchange in the world, in the next year or 2, there will be at least electronic competitors. This will add to volume.

Mr. OXLEY. I will begin with you, Mr. Brodsky. First of all, are you subject to 6(b) registration fees on stock options?

Mr. BRODSKY. No, we are just subject to section 31.

Mr. OXLEY. Let me skip then to Mr. Cader. What is the difference in the impact on investors between the two different fees, 6(b) and section 31?

Mr. CADER. I will speak to what I call the multiplier effect of the section 31 fees. The 6(b) fees are leveled now at the point in the capital-raising process where transactions take place with the help of market makers, specialists and liquidity providers, all different names for folks doing what we are talking about.

The underwriting fees occur once in the cycle of a security being distributed from an issuer to an owner. The section 31 tax which falls upon the liquidity providers falls at a point in the capital-raising and, in fact, the capital-transferring process, which is what happens when shares trade on an exchange. The tax falls not only on the investors who trade those securities one to the other, but

disproportionately on those members of the community who are the liquidity providers. Liquidity providers, who go by names like specialist and market maker, are simply those who turn the capital over many, many more times than typically a service provider such as a grocery store selling milk will do so.

X dollars in the hands of a market maker or a specialist actually gets deployed many, many, many times over in the course even of a few hours, certainly a few days, taking the other side of customer trades. What happens on the exchanges is that customers—buyers and sellers—look for each other to find the best price available at the time when they wish to transact. In a perfect world, which of course we don't live in, one customer finds another and they both wish to transact the same amount at the same time. No need for intermediaries.

The intermediaries, who are the buyers and sellers in the absence of customers who meet each other, fill in the gaps between supply and demand, time and time again during the day.

So the section 31 tax takes money out of the hands of those who at the point of sale, the place where the transactions take place, would actually use that money many, many, many times over to satisfy many, many customer needs, one after the other, during relatively short spans of trading.

A specialist or market maker in the security will buy from one customer and sell to another, filling in those imbalances, literally, in trades that are seconds apart.

So the tax falls, aside from the question of whether overfunding is appropriate or not, the tax falls at the worst possible place given the acknowledged role of the intermediary liquidity provider in the system, which serves investors by assuring that there will always be buyers and sellers there to meet them in the marketplace, with reasonable capital, able to trade at reasonable prices at all times.

Mr. OXLEY. Mr. Nelson and Mr. Kearney?

Mr. NELSON. We don't have a corporate finance business so I cannot speak about 6(b) fees.

Mr. KEARNEY. I would just say that 6(b) fees are usually put into the cost of the whole deal, so they are spread to the corporate issuer, to the lawyers, to the bankers so it is more of a—it doesn't affect the trading firms so much. It is backed into the cost of doing the deal.

Mr. OXLEY. Thank you. The Chair now recognizes the ranking member, the gentleman from New York, Mr. Towns.

Mr. TOWNS. Thank you, Mr. Chairman. There have been some folks who have recommended that we cap the fees. Let me get your views on that in terms of capping.

Mr. KEARNEY. I would just like to say that from the perspective of STA, we would take any relief whatsoever. However, I think most of my colleagues and constituents in the STA believe that a cap is probably the way to go, and the logic behind it is if you have a rate increase, you basically have a moving target.

In 1996 we built a formula based on what we thought the volumes would be in 1998, 1999 and 2000 and we missed the mark tremendously. If we were to do a rate decrease again, we are trying to predict what the volumes will be going forward. Are volumes

going up? If they go down, the SEC might be underfunded. Therefore, a cap seems to be the most logical solution to the problem.

Mr. TOWNS. I am trying in my own mind, trying to figure how a cap would work. Say, for instance, if there is a lot of activity in the first 3 months, and therefore you cap it, and then I recognize the fact that this is going to happen and so I will do business until after the cap, it seems to me a degree of unfairness.

Mr. KEARNEY. The degree of unfairness—there are certain firms that are in favor of the rate cut and that is because it will be fair economically, it will benefit them the most. I think they are probably the smaller percentage of the types of firms in the industry. And probably if you look at the total industry, the fairest to the broad industry would be the cap.

How would you compute it? I am not sure if I can answer that question today. But I think given the amount of dollars at stake, I think the securities firms could probably reach some kind of a consensus.

Mr. TOWNS. Thank you.

Mr. BRODSKY. My problem is that this tax falls not only on the professionals that make the markets but also on customers, and you can't predict when a customer is going to buy or sell securities. This is a tax that falls on sales of securities. If the cap were reached on July 1, people who trade at the first half of the year would pay it, but those who traded the second half wouldn't pay it. My feeling is unless you can figure out an administrative way to deal with it, that a reduction is the fairest, because then it applies to everybody in a proportionate way.

The committee decision has to be grounded on what is fiscally prudent to fund the SEC, making certain assumptions, and also that is realistic in terms of administration. We have a situation now where the amount of overfunding is so great it may be that you can have it—a fee can be scaled down over a period of years, but we would accelerate when it would start.

Under the law that is in effect now, the scale-down wouldn't begin until 2007. Obviously we are way ahead of ourselves in terms of where the volume was. I think we have a threshold, based upon the chairman's questions, where we really believe that the volume is not going to go down appreciably, and you are at 5 times funding. Reasonable people ought to be able to sit down and figure out what is a reasonable amount of coverage for the current funding needs of the agency and have the fee reduced accordingly and start that reduction soon.

Mr. NELSON. I represent the Securities Industry Association and I can tell you that the industry wants relief. Much of the discussion that we have had among ourselves about what approach to get to that relief has really involved a question of what would be most likely to sell up here on the Hill.

I can tell you that we would very much appreciate any advice that the committee can give us as to what is likely to work. That has been a big topic of conversation among us.

Mr. CADER. From the specialist perspective, we are in alignment with Steve's viewpoint. The issue is what is the most feasible way to get some relief. I think technically it appears to us that both a

cap could work and a reduction could work and I would agree with what Steve said.

Mr. KEARNEY. That is exactly our position at STA.

Mr. TOWNS. Do you have any idea how a cap might work?

Mr. CADER. I think there are a variety of ways that a cap could work. I think they are too technical to elaborate in more than a few seconds or minutes here. I think we would all be glad to come help out with that. I think there are ways that either approach could work. I think the industry and you all have dealt with more complicated mathematical propositions than this one. I don't think that it would be hard.

Mr. TOWNS. Section 31 fees are leveled across all securities products. Why should options be singled out for special treatment?

Mr. BRODSKY. I am asking for relief not on all option trades but only on option trades where there is an economically equivalent product trading on futures exchanges in the United States, because we have a jurisdictional disparity in this country which, as I said earlier, this committee is fully aware of in terms of the Shad-Johnson Accord, where you have an S&P option trading on the Chicago Mercantile Exchange, where there is no tax because it is a futures product; and yet we have an S&P 500 option trading on the CBOE and there is a full tax because it is a securities product.

And I don't think that this committee would feel very happy about the fact that people would choose to use a futures product because there is no tax and not a securities product because there is one. And I don't think that this was ever envisioned, and as we have studied the issue and talked to customers, they are, as all customers are in the world we live in today, very price sensitive. They say, Why should we pay a tax?

I was President of the Chicago Mercantile Exchange almost 13 years, and the futures exchanges have been strong and successful in not having any transaction tax on any of their trades. The securities industry is saying that we want the SEC funded, and funded fully, and we want to work with the committee. You have another industry that is trading, in this case, similar products and they say, We don't want any funding for our agency, let it come out of the General Treasury. We need to plead for this committee to understand that only a small amount of our products are subject to tax which are competitive with another industry in our same city. And we need help from this committee.

Now, I will tell you as a percentage of our total business, it is a relatively small percent of our total business, less than 25 percent of our business. But yet it is brought home to us every single day that there are these competitive disparities that, by the way, in the past and maybe even now—because the Agriculture Committee is looking at the Share Johnson Accord that can create jurisdictional battles between this committee and the Agriculture Committee. If we can't seek help from this committee, there is no place we can come.

Mr. OXLEY. The Chair recognizes the gentleman from Staten Island, an aforementioned sponsor of one of the bills dealing with section 31 fees.

Mr. FOSSELLA. Thank you, Mr. Chairman. I want to really compliment you for advancing this issue once again. You made a com-

mitment to all of us that you would hold this hearing as soon as possible after H.R. 10 was passed, and I want to thank you because I think we need to maintain what this hearing is all about and what our focus should be. Clearly, what I think we need to do is understand that we want to return section 31 fees to what they were originally intended to do.

The witnesses all testified that they fully recognize the importance of the SEC in maintaining the integrity of our financial markets. Clearly I share, and I think every member of this committee shares, that view.

We also need to understand what this fee, euphemistically, really is; and that is, a tax or drain on capital. If you own a mutual fund or stock or are involved in a pension plan, you are affected by this tax. And the question now becomes what do we do?

Some of the witnesses went into elaborate detail as to the history of the SEC fee and how we got to this point. But my view is very simple. To do what is logical, to do what is right, to adequately fund the SEC, and then what is left over send back to investors, send back to the people who are paying that fee right now.

I have a question for Mr. Brodsky. You are obviously a strong supporter of a rate cut, and I can understand where you are coming from. The reality, I guess, up here is whether this has been scored and whether it is revenue neutral and whether you know that to be true or not.

Mr. BRODSKY. Well, if we look at the numbers that Chairman Oxley spoke about in his opening remarks, clearly the amount of money that is raised by this fee far exceeds the agency's needs, and if you go back to the legislative history of this law that goes back to 1934, it was never intended to do anything other than the operating expenses of the SEC on an annual basis. I don't know if you call it revenue neutrality.

I think there is coverage for the SEC's operating expenses from this fee, and it is really a question of how this committee will address itself to finding a way to scale back the amount raised and yet be sure that the SEC's operating expenses are covered.

Mr. FOSSELLA. I guess the general thing we need to find out is whether this complies with the budget rules in the pay-go provisions. Let me be clear, I share the view of everybody. I have a bill, a cap on the fee, and there is another bill introduced by my good colleague, Rick Lazio, and Congressman Towns. At the end of the day, we need to cut bait and do what is right, whether it is the rate cut or the cap. I think we have talked about that a number of times.

I have a question, I guess, that Chairman Levitt of the SEC, who is going to be integral to this process, has testified before the Senate and before this committee that he would prefer a cap on the fee. I am curious, Mr. Kearney, what is your view on Mr. Levitt's testimony?

Mr. KEARNEY. I wasn't allowed in the meetings when he was making his decision, but there is a proposal that the SEC has signed in March 1999 that gives some relief. However, it doesn't look like it is going to get implemented this year because of some regulatory problems, which is the riskless principle which will give

the industry an $8 to $10 million relief. Maybe that is some of the logic that Mr. Levitt was using.

I think his fears are that the volumes in this market are very unpredictable. If volumes should decrease, and we have seen that—I have seen it get really bad, and volumes do go away—if that should happen, would the SEC be underfunded? And I think one of the things he used in his testimony was the 1994—when the SEC had to go to Congress and ask for additional funding, if I recall. I think he is just being prudent in saying there is a possibility that revenues—that transaction revenues could decrease and the Commission could be underfunded, and the Commission might have to increase their budgets due to the Internet phenomenon, et cetera.

So we have to make sure that we do collect enough to run the Commission. And I think that is his logic, and that would be mine if I was in his chair. Maybe it is a compromise: a rate reduction, and once you hit that number, it is capped. There probably is going to have to have to be a compromise somewhere.

Mr. FOSSELLA. Anybody else have any thoughts? Mr. Nelson.

Mr. NELSON. No.

Mr. FOSSELLA. Thank you, Mr. Chairman, for bringing attention to this matter. Like so many fees out there which have overextended their original purpose, now it has become an avalanche of money into the General Treasury. We have to maintain the trust of the American people and indicate that a user fee is just that, and not become just an unnecessary—or a tax to spend as folks see fit. Thank you.

I want to compliment my colleague from New Jersey, Bob Menendez, who has helped me advance this issue as well.

Mr. OXLEY. I thank you for your attention to this issue.

The Chair now recognizes the gentleman from Minnesota, Mr. Luther.

Mr. LUTHER. Thank you, Mr. Chairman. I certainly want to thank all of the panelists, and particularly I want to make note of the fact that Mr. Kearney is from Minneapolis, Minnesota and with an outstanding firm there, a very well-respected firm, and I certainly appreciate him being here.

Mr. KEARNEY. Thank you.

Mr. LUTHER. I think you have done a fine job of covering the subject on the rate cap and this principal trade issue that you dealt with. And you have touched on this area and ,Mr. Brodsky, I think you have done a good job of mentioning the notion that there are sometimes equivalent products, one is covered and one isn't.

I think as we look at this issue, anything any of you can do to help us understand where there is a current unfairness in the current system, that is where there is substantially equivalent products, one is covered and one isn't, or maybe where there are some proposals which structure the transactions in such a way that they are covered by some places, not covered by other places, anywhere where there is unfairness in the current system, I think that would be very, very helpful to us as we look at this issue.

If you want to comment on that or if you want to supplement anything that is in your experience with any other instances along those lines, I think that would be very helpful to us. Obviously

there might be some public policy reasons for treating them differently. I think most of us would agree if we are going to have good, fair, free and open markets, that we would not want to have arbitrary differences applying to the same equivalent products or transactions.

So anything that you want to comment on or anything you can supplement on that issue of fairness among transactions or products, I think would be very helpful.

Mr. BRODSKY. I appreciate your comment. I think I would ask if we could work with the staff and give them all of the examples and information that would be appropriate for the committee to have so you can see it in black and white.

Mr. KEARNEY. The only comment that I would make is as it relates to the professional who is creating the liquidity that is needed to maintain the markets, and that is the specialist and the NASDAQ trader. That is the probably the person who is impacted the greatest with this rule because of the way that we commit our capital. And then to reliquefy as a trader, you don't want to hang on to positions. That is where the big effect is being felt, at the trading desks, both at the specialist level and at the NASDAQ level.

Mr. NELSON. I think it is useful to just think about it a little bit. The problem is that this is a moving target. One of the things that you are seeing going on right now in my industry, in the market-making industry, is that there are efforts, rules being proposed, committees forming to talk about different ways, that when you sum it all up will be a way of avoiding this tax. A lot of those moves have to do with transforming the NASDAQ market into something, an agency market rather than a principal market. If it is an agency market, then the professionals who do the transactions are not involved in the tax.

The problem with all of that is that I don't think that when Congress put this fee in place, they intended to transform the market into something other than what it was. They thought that the market was going to stay the way that it was. I think if we are just talking about the amount necessary to fund the SEC, that is what would happen. People would pay this little bit and that would be that.

When it gets to be an enormous amount where it begins to affect your profitability, people begin to look for ways to change their business and accommodate this problem. That is the kind of change that I don't think it is in anybody's best interest to make willy nilly. That is something that people should think about. This is a market that has done a lot for the economy, and a lot of the problems we are currently seeing in terms of volatility, that was just unheard of a little while ago, are related to this problem of trying to shift away from principal trades and agency trades and avoid this tax and other issues that have come up in a similar way.

That is what is going on. And so I think we can talk about what is happening now today and what people perceive as unfair, but you have to understand that is going to change, and in 6 months or a year there will be a new landscape out there and it might not be the kind of landscape that you might like.

Mr. CADER. I think from our perspective that really the greatest economic impact and the greatest fairness on public policy implications simply has to do with the outsized amount of money that is collected. I think there are, from time to time, fairness issues between markets, NASDAQ and New York Stock Exchange, Chicago Board Options Exchange, and those are worth paying attention to. But I think from our perspective they are somewhat dwarfed by the $1.8 billion next to the $320 million. So I think as the markets continue to evolve in ways that we sometimes influence and sometimes don't and often can't predict, have a way of accommodating themselves through whatever fee structure is imposed, the less onerous that structure is, the less the markets will be faced with doing what Steve has just talked about and responding to tax and fee policy rather than competitive issues.

Mr. OXLEY. The Chair now recognizes the gentleman from Long Island, Mr. Lazio.

Mr. LAZIO. I want to thank the panel for their testimony and their efforts to try to find consensus, which I don't need to understate to this group, I think. It is in the end a question of fairness, I think. If you distill it down to its most basic level, where you have the SEC operating at a cost to the public at about $324 million and you have collections through the section 31 fees 5 times that amount, and growing as volume increases, you obviously have a huge discrepancy.

My first question is, Why should an average investor care? It is broadly true that Americans no longer save their money in mattresses. They are less likely to keep their savings in banks. And they are increasingly planning for their retirement through 401(k)s and other pension vehicles. Almost half of all Americans have some equity stake through mutual funds by virtue of a direct equity bond investment.

Let me ask Mr. Cader first, it doesn't amount to so much per small investor, does it? Why should it matter to an average American?

Mr. CADER. I wouldn't stand here and argue that the extra $1-$2 billion, a portion of which comes out of investors' pockets, is going to have a significant impact on their economic behavior. Given the capitalizations of the equity markets and the size of trading, I wouldn't put forth the proposition that the difference of a billion dollars or so means people will buy stocks or not buy stocks.

However, it is important, No. 1, for a fairness reason; because as someone said, a billion dollars here and a billion dollars there, before you know it, it is economically significant.

Going back to the points that I raised during my testimony, that portion of the section 31 fee which falls specifically on the market makers, the specialists and liquidity providers, offers the possibility for an unpredictable and insidious and significant impact, although an indirect one on investors, the users of the markets, in the event that conditions are not as friendly as they are today. And by the way, the environment, the business environment for liquidity providers continues to get more competitive and margins go down for good reasons. Those reasons are competition, technology, and the ongoing benefits that are provided to consumers because of that.

Mr. LAZIO. Let me get to this point which is this liquidity issue. Mr. Brodsky had raised it in his testimony and you raise it now. Can you explain how the fees impact on the ability of specialists, market makers, to provide more liquidity and why that is important to the individual investor that there be this type of liquidity so that the market operates efficiently?

Mr. CADER. It is important because what markets consist of simply are investors who wish to buy and sell, looking for an investor with exactly the opposite opinion at the same time. A buyer for every seller. And markets exist and the need for liquidity providers exists because investors don't show up at the same time, at the same price, with the same quantity of shares. So the liquidity providers, which is the fancy word for the buyers—the ever-present assigned obligated risk-taking buyers and sellers in all of the marketplaces, use their money, their capital, to take the other side of investors' trades, hundreds of thousands, millions of times a day. So capital that is taken from the hands of the liquidity providers is then not available to use to satisfy investor needs in the marketplace every day.

And to the extent that market conditions are more or less friendly, and friendly meaning a market in which—that is not going up or down too much—which indicates that supply and demand to a certain extent balance out, as opposed to markets that are moving sharply which indicates an imbalance—the more sharply the markets are moving around, the more the investors with their actions are stating that there is not sufficient liquidity and requiring the assigned obligated risk-takers, the market makers, to step in and buy and sell with their money to take the other side of investors' trades.

Mr. LAZIO. Let me distill this. The more thinly the market is traded, the less liquidity there is, the more volatility there is potentially in price; which, am I correct in assuming that the smaller investors are probably more likely to be adversely affected in a situation like that as opposed to the more sophisticated players that are more attuned to what is going on?

Mr. CADER. Smaller investors generally have fewer choices how to mitigate or deal with volatility.

Mr. LAZIO. This is not only a tax on capital, it is passed on to individual and institutional investors, and it increases the transactional costs when technology is lowering transactional costs and Americans are more and more likely to be investing in markets. But it also potentially adversely affects small investors because of this volatility.

Mr. CADER. That is correct. And it happens in an indirect way, which is why it is a little hard to explain. The money is not being taken out of the smaller investors' pocket, but it is being taken out of a system which is designed to benefit the small investor at the very place where it can be most needed to serve the small investor under stressful market conditions.

Mr. LAZIO. One last question, and I want to pay honor to my colleague, Mr. Fossella, for his work on this issue as well. But for some arcane budgetary rules, is there any market reason why a rate reduction is not a more efficient, more predictable, and fairer way to go than a cap?

Mr. CADER. As I think I mentioned before, what is—I think what is most important to us is that we find a way to some relief, and since I am unfamiliar with the budgetary process and the process here——

Mr. LAZIO. Forget about the budgetary. That may end up dictating results, but just in terms from the market standpoint.

Mr. CADER. I don't think see where it matters. I can draw on a piece of paper a solution either way, or a hybrid solution that would involve a reduction and then a cap. I honestly couldn't see why one is more or less workable than the other.

Mr. BRODSKY. All of us are looking for relief and it really becomes a question of how it can be administered and if there is a way where a cap can work, that is fine. I think that from my perspective, about half our business is done through the liquidity providers.

Again, I echo Mr. Cader's comments that we have many small investors, and if you make it more expensive for the liquidity providers, it impedes their liquidity for the small investor. I just wonder whether a cap can be—for the benefit of the public investor—can be applied in a fair and even way as opposed to liquidity providers. Because a cap liquidity provider, they are in the market all of the time. But if I am an investor that trades at the beginning of the year, and not at the end, I probably don't benefit in terms of the specific fees.

But I think all of us are saying we really appreciate what you are doing. How it gets done is not as important, as we all believe 5 times the agency's funding makes no sense and it is fundamentally unfair. So if the committee in its wisdom says we would rather do it one way than the other, we are as willing to figure that out administratively. But there are administrative dynamics that come into play.

Mr. LAZIO. Thank you.

Mr. OXLEY. I thank the gentleman for his leadership. The Chair now recognizes the gentleman from Illinois, Mr. Rush.

Mr. RUSH. Thank you, Mr. Chairman. Mr. Chairman, I want to commend you for chairing this very important hearing. I want to also welcome Bill Brodsky from the Chicago Board Options Exchange to this hearing and it is good to have him here. The Chicago Board Options Exchange is an integral part of not only the Nation but the city of Chicago and we want to do all that we can to ensure that it is a healthy exchange and we want to make sure that the section 31 fee issue is resolved amicably among all of the different parties.

I have a question for Mr. Brodsky. It has been suggested that the excess fees are back-door taxes which place U.S. Securities markets at a competitive disadvantage. Do you have projections of the impacts on the securities market if we as Members of Congress do not act to resolve the section 31 fee issue?

Mr. BRODSKY. Well, thank you for your warm welcome and it is good to see you, Congressman.

The markets that we are all living in right now are changing more rapidly in the current era than they have in many years, and I too have been in the business over 30 years. There are exchanges outside the U.S. That are banging on the doors to try to bring ter-

minals into the U.S. And trade products. How that impacts on our competitiveness is very much a concern of ours.

What we want to do is maintain the strong regulation that we have in this country and make sure that it is paid for, but be mindful of the fact that if we charge more for that than necessary, it can limit our competitiveness. I think that is something that this committee, in its oversight of the securities markets, should be concerned about, whether it is section 31 fees or anything else.

Right now, the largest derivative exchange in the world is no longer in the U.S., it is in Germany and Switzerland, and it is all screen based, and the biggest products that they trade are equity derivative products. If they try to offer products similar to ours without these kinds of fees, that is a great concern to us. To the extent that they offer them as securities exchanges in the U.S., they would be subject to our fees, but right now they are not registered as securities exchanges in the U.S.

Mr. RUSH. Mr. Nelson, would you respond to my question also?

Mr. NELSON. We have an office in London. We trade 500 European stocks. Those stocks are not subject to these fees. They are traded on EASDAQ, they are traded on the Deutsche Borse, and the London Stock Exchange. Some of those stocks are also traded as NASDAQ stocks here in the United States and some of them as listed stocks.

I can tell you that customers who have the opportunity to buy those stocks over in Europe usually do. They are cheaper typically to do that. I don't know whether that trend will continue. I think to give a complete picture, their securities markets are not nearly as well developed or technologically advanced. It is much more difficult to do business in Europe, I can tell you that firsthand. A lot of things will have to change before we would really believe that those markets would outdo what we do here in the United States. But certainly there is that opportunity and they are very aware of it over there. They really want to develop their markets in a way that will be competitive. This will be a problem, I think, as time goes on.

Mr. RUSH. Currently there are two legislative proposals, two bills before this committee and before the Congress.

Is there any way that any of you would suggest that we improve upon those bills or are those bills—if the Congress in its wisdom passes one over the other, would that be satisfactory? Or can we improve either of those bills?

Mr. KEARNEY. My own insight, I think that from the perspective of a cap, I think that speaking to the regulators and to other people, Chairman Levitt, et cetera, I think that is probably going to be the easiest, something in the form of a cap is going to be the easiest bill to pass. If you don't put that in, I think the regulators might put a major objection to anything that we are trying to change. That is probably what is leading the STA to lean toward some form of capping it, because the chairman of the Commission has basically said more than once that he is in favor of some type of relief, but it has to have some form of a cap in it. So for simplistic reasons, we would be in favor of something along those lines. We will take anything, but I think that is the logical process. You tend to go where you are being directed.

Mr. RUSH. Mr. Cader?

Mr. CADER. As I said before, I really believe, mechanically, either approach is workable. The greater the size of reduction, the greater the amount of money released back into capital markets to serve investors, the happier we will be and the better off the public will be. I think it is up to you all, with as much help as we can give you, to craft the most workable option.

Mr. RUSH. Mr. Brodsky, would you describe the role of options in the overall picture of securities markets and how these section 31 fees impact on capitalization, market capitalization?

Mr. BRODSKY. First of all, I think the question is an appropriate one, except that there is a time constraint. But I would say to you that the listed option business as it exists today was created in Chicago in 1973 and there are now 55 exchanges which have copied the CBOE model. The option market is integral to the securities business. It has provided risk-shifting abilities, both for individual investors and market makers so they can provide more liquidity to the markets. It gives investors, both small investors and very large investors, both individuals and institutions, a way to manage their risk that never before existed, and I think it has thrived because the regulation in the U.S. Has been so effective and there has been fairness to public investors. So it adds a lot of liquidity to the markets.

My friend Dick Grasso at the New York Stock Exchange will always tell me that the Chicago Board Options Exchange send the NYSE more business a day than any other entity because our market makers are liquidity providers. When they deal in options for small public customers, we will hedge on the New York Stock Exchange or in the NASDAQ market in enormous quantities. So we have added liquidity to the system and everyone benefits.

I think particularly at a time like this where we have 5 years of unprecedented growth in equity markets, option markets provide customers of all types, individuals, institutions, large and small, with the ability to basically buy insurance on their stocks. So when you have a stock that has gone up 5 times, you don't want to sell it, you want to keep it, an option contract can give you the way of buying insurance on your stock the same way you buy insurance on your house or car, and I think in that respect options have added a tremendous amount to the vibrancy and integrity of the U.S. Markets.

Mr. OXLEY. The gentleman's time has expired. The Chair now recognizes another gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. I also want to extend my welcome to Mr. Brodsky, and I don't think that Illinois takes a second seat in financial services to any New York facility. All of these New Yorkers are on this bill but we have great boards of trades and options and the Mercantile and so we are proud to have you here. I think you hear commonality on the need to get the fees in line with the exact expenses. Look, all the New Yorkers are leaving now.

And I am a proponent of budget simplification. I do think that it is a tax imposed upon the consumers if there is additional money over the identified costs of the services in which the fee was in place to begin with. So I think there is pretty much unanimity. I

think the question debated here is caps versus deceleration of fees and how that would have happened, and I do feel that it will adversely affect the international competition if these fees remain in place. If they are fees in excess of the fees needed to fund the Commission, then I think it will adversely effect us.

Mr. Brodsky, in your statement you talk about—for the sake of argument, what kind of acceleration of the reduction fees would you recommend? What is the disadvantage of having the cap in place?

Mr. BRODSKY. First of all, in terms of acceleration, I think the whole panel is in agreement that we seek relief as soon as possible. We know how difficult it is to get consensus on these things. But the sheer numbers indicate that there is money that could be used elsewhere to add to the capital markets, and I think that again I will share the views of those on the panel. We are looking for relief and looking for relief promptly, but we don't want to jeopardize the funding of the agency, and we would rather find some way to sit down—whatever the committee thinks it can get done, we would like it to get done.

Mr. SHIMKUS. You are being very gallant and political in terms of not wanting to stir up the chairman based upon his proposal, and I understand that.

The question that we have to address—and if you want to do that with staff as we deal with this—I think members are going to want to know why you prefer one or the other and what would be the benefits and disadvantages of each. But I guess I will just defer to the chairman as we move forward, if that is something that we want to do, to try to get a delineation between staff. But either you have a lot of agreement that there is an excess of charges being collected, that it ought to be in line with what the actual costs are, so what is the proper way to go about it for the industry; and you all as panelists should say, We don't like the cap, this is why. Or, We want immediate changing of the fee structure now; and then who, what, when, where, why and how?

I am going to have to go to the floor to preside as Chair, and I yield back the balance of my time, or if anyone wants to answer. If we want to get into which one is better, I will leave that up to the chairman's discretion.

Mr. OXLEY. I think we have had a pretty good discussion on that. That is something that we need to work with the appropriate parties and staff on that, which will clearly be part of the work product of our worthy staff during the August recess while the members are back at the county fairs.

Mr. BRODSKY. Mr. Chairman, while Mr. Shimkus is still here, I appreciate your comments about Illinois, but I must say something. I was born in Brooklyn and I grew up on Long Island, and with Mr. Towns and Mr. Lazio, I had to say that.

Mr. OXLEY. The gentleman's time has more than expired.

Mr. LAZIO. Easy, easy.

Mr. RUSH. We don't hold that against him, Mr. Chairman.

Mr. OXLEY. The gentlewoman from Colorado, Ms. DeGette.

Ms. DEGETTE. I guess I would like to have Mr. Brodsky answer Mr. Shimkus's question. We can all pussyfoot around here and talk to staff during the recess. We have no county fairs in my district

in August. Tell us why you don't favor the caps and what you would prefer to see.

Mr. BRODSKY. In my prepared remarks, I favored the general reduction over the cap because I am not aware of how we could administer the cap as it relates to smaller investors. The cap, I think, would work well with the professionals who are trading all of the time, so when you reach X amount, you know that you don't pay any more. But investors don't trade on some sort of particular schedule. They do things because it either moves them or because it is in their economic benefit to do so. I am not ruling it out as being a bad thing, I am just not aware of how people would administer a cap for millions of investors who pay the fee as well.

I can't tell you in dollar terms how much of it is paid by the liquidity providers versus the investor, and I know liquidity providers pay a very large amount because they do provide the grease that oils the wheels. But clearly I as an individual investor will sell stock or sell options at odd times during the year; and how does the cap work? You are not going to administer it from millions of individual accounts.

Ms. DEGETTE. I wonder if some of the rest of you would comment on that issue, how you would administer this for small investors.

Mr. KEARNEY. It is probably not dissimilar to the Social Security tax or whatever. We have a lot of caps in this economy that, yeah, you participate early and you don't participate later, and I think that one of the things STA is looking at is what is doable. And I think that the Commission is looking at some form of relief. However, they are in fear of having to go back to Congress at a further date if the securities business should slow down.

I think that some type of compromise, a rate decrease with a cap, is probably the most logical thing. It is not going to be fair to everybody. A rate increase will benefit certain people. A cap will benefit certain people more or less. I don't think that you can reach a compromise that is going to be fair to every investor and the liquidity providers and everybody involved in this.

The reason that we teed this up was because of the amount of dollars that are being collected by the government. So maybe the consensus is you do a rate decrease. You have a cap just in case the thing starts to decrease to where the SEC is uncomfortable, and that is probably something that the chairman would go along with—Chairman Levitt. He is going to be an obstacle if we don't—we have to listen to him. He has a lot of responsibility.

Ms. DEGETTE. And I think one thing we have unanimous agreement on in this room is that we need to do something to establish a stable fee structure that adequately reflects an offset of the SEC's regulatory activities. And the only question we have got is how do we do that.

Mr. Brodsky, let me ask you one more question and maybe the others can comment. Just to play devil's advocate, if we reduce the section 31 transaction fees, how can we be sure that this will not jeopardize SEC revenue fees over the long term, where there is significantly reduced market activities and the possibility of severe market downturns? A lot of you think that this will not be a problem, but I would like to hear your comments on it.

Mr. BRODSKY. I think if you look at the overall trend of volume in business over the last 20-30 years, the overall trend is clearly up. You would not necessarily have to have a cap that would go from here to here, but it could be scaled down over a period of years, and the committee meets more than once a year and they can keep an eye on it.

I think there are lots of ways to do it. Again, I think it doesn't have to be all done in 1 year, but we have to recognize that the trend has been clearly dramatically up over every 3- to 5-year period of time that has existed.

Ms. DEGETTE. Do the rest of you have comment on that issue? No? I have stumped the panel.

Mr. NELSON. The reality is that there are significant design issues with either approach. We recognize that. We did not come prepared today to talk about this issue. I didn't. And this is something that we would love to get into in more detail, but it is a complex issue. There are—each side—you have certainty on one side, which is what you are referring to right now: the certainty that the SEC will be funded, the certainty that they will not be overfunded against a potentially greater relief through a rate reduction.

It is a very difficult design issue and it is something that really needs to be explored in a lot of depth. We would love to get into that. We came here today to talk about the issue of funding. That was our mandate and that is what we came prepared to talk about.

Ms. DEGETTE. Whatever we end up coming up with, Mr. Chairman, if we can try to design it as well as we can to be accurate and to minimize future congressional involvement. I know this would be a goal shared by all members of this panel. I yield back the balance of my time.

Mr. OXLEY. That is exactly what we would try to achieve. This is going to take some heavy lifting, but once that is completed, we would hope that we could put it on automatic pilot and go on to other project.

We thank all of you for what was a most impressive testimony and response to questions. I think we have teed up the issues very, very effectively. And now we will start the hard work of putting together some ideas as to how we best move forward. We look forward to working with all of you toward the same goal. The subcommittee stands adjourned.

[Whereupon, at 12 noon, the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

PREPARED STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION

Thank you for giving the Securities and Exchange Commission (SEC or Commission) the opportunity to present this statement concerning securities transaction fees. The SEC shares the Subcommittee's concern that fee collections are currently well in excess of initial projections. The existing fee structure, last revised in 1996, was the product of many years of negotiations, involving many players with competing interests. However, tremendous market growth in recent years has pushed fee collections far beyond the levels anticipated during those negotiations. The SEC welcomes an inclusive, reasoned dialogue on fee collections.

History of Fees

Federal securities laws direct the Commission to collect three different types of fees: registration fees, transaction fees, and fees on mergers and tender offers. Securities registration fees (Section 6(b) fees) are paid by corporations and investment companies when they register securities for sale. These were first enacted at a rate

of 1/50th of 1 percent under Section 6(b) of the Securities Act of 1933. Starting in 1990, the Section 6(b) fee rate was increased yearly through the appropriations process. The first 1/50th of 1 percent goes directly to the U.S. Treasury and is unavailable for funding the SEC. The amount over the 1/50th of 1 percent (called offsetting collections) can be used to fund the agency through appropriations.

Transaction fees (Section 31 fees) are paid when securities are sold. These were enacted at a rate of 1/300th of 1 percent on exchange-listed securities under Section 31 of the Securities Exchange Act of 1934. Proceeds from this fee are deposited directly in the U.S. Treasury and are not available to fund the agency.

Fees on mergers and tender offers are paid by corporations directly to the U.S. Treasury and also are not available to fund the agency.

The SEC's fee collections have been a subject of concern since 1983, when the Commission first began contributing more to the U.S. Treasury than was required to fund the agency. In 1988, the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs requested that the SEC examine its fee collections and funding structure. The report prepared by the SEC in response to this request was the first step in the process that eventually led to the compromise reached in Title IV of the National Securities Markets Improvement Act of 1996 (NSMIA).[1]

Fee Agreement in NSMIA

Title IV of NSMIA mandates a fee structure that was the result of extensive negotiations between six different Congressional Committees, the Administration, and the SEC.

In general, the NSMIA fee structure was designed to:

- gradually reduce total fee collections;
- "level the playing field" by extending Section 31 transaction fees, which had previously only applied to transactions involving exchange-listed securities, to securities subject to "last sale reporting" in the over-the-counter market;
- gradually reduce the SEC's reliance on fee collections, thereby increasing the amount of new budget authority required to fund the agency through the appropriations process; and
- provide the SEC with a stable, long-term funding structure.

NSMIA set in motion a gradual reduction in Section 6(b) registration fee rates over a ten-year period intended to more closely align fee collections with the funding needs of the SEC. Specifically, NSMIA authorized the Commission to collect securities registration fees at the rate of 1/50th of 1 percent of the aggregate offering price in fiscal year 2006, declining annually from 1/34th of 1 percent in 1998. In fiscal year 2007, the rate will be further reduced to 1/150th of 1 percent. In addition, NSMIA classified the portion of the Section 6(b) fees in excess of 1/50th of 1 percent (*i.e.*, the portion declining from 1998 to 2006) as offsetting collections that can be used directly to fund Commission operations, subject to prior approval by the Commission's appropriations committees.

NSMIA also provided equity in the application of Section 31 fees by authorizing the SEC to collect these fees on transactions in the over-the-counter (OTC) market involving securities subject to "last sale reporting." Unlike the Section 31 fees imposed on sales of exchange-listed securities, these new OTC fees are classified as offsetting collections and, therefore, can be used to fund Commission operations, subject to approval by the Commission's appropriations committees. Under NSMIA, all Section 31 fees will fall to 1/800th of 1 percent in fiscal year 2007.

Because the fees collected by the SEC are tied—directly and indirectly—to market activity, they are nearly impossible to predict accurately. The fee rates established in NSMIA were based on 1996 projections of market activity. However, the tremendous growth in the markets over the past few years has far exceeded the 1996 estimates on which NSMIA was based, resulting in fee collections well in excess of original estimates. Unfortunately, the potential for either excess collections or shortfalls is inherent in activity-based fees.

While the NSMIA fee structure has eliminated the funding uncertainties and crisis situations that surrounded the agency's funding from the late 1980s to the mid-1990s, it has not reduced total collections due to unexpectedly strong market activity.

Budget Enforcement Act

The rules enacted as part of the Budget Enforcement Act (BEA) have restricted efforts to undertake a comprehensive fee reduction. The BEA splits our fee collec-

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[1] Report submitted in response to the request of the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs (S. Rpt. 100-105), December 20, 1988.

tions into two different categories: mandatory and discretionary. Under the BEA, any fees in existence prior to 1990 are deemed mandatory and are deposited directly into the General Fund of the U.S. Treasury; they are unavailable for SEC use. The SEC's fees that fall into this category are:

- the first 1/50th of 1 percent of Section 6(b) registration fees;
- Section 31 fees on transactions involving exchange-listed securities; and
- fees on mergers and tender offers.

These fees, which account for nearly 70 percent of total SEC collections, are estimated by the Congressional Budget Office (CBO) to exceed $1.1 billion in fiscal year 2000. Because these collections currently are protected by the BEA rules, they cannot be reduced without a corresponding increase in revenues or decrease in federal spending elsewhere. According to CBO's estimates, to fully repeal these fees, other collections flowing to the Treasury's General Fund would have to increase by $9.6 billion over the next seven years, or spending from the General Fund would have to be reduced by the same amount.

The remaining 30 percent of SEC collections are unaffected by the requirements of the BEA. These "discretionary" fees, available for use by our appropriators under NSMIA, are the fees previously identified as our offsetting collections. Specifically, they are:

- Section 6(b) registration fees collected above 1/50th of 1 percent; and
- Section 31 fees on transactions in securities subject to "last sale reporting" in the over-the-counter market.

The following chart shows the current CBO estimates of total fee collections broken down between mandatory and discretionary under the BEA.

($ in millions)

Fiscal Year	Mandatory	Discretionary	Total Collections
2000	$1,155	$501	$1,656
2001	$1,206	$498	$1,704
2002	$1,260	$503	$1,763
2003	$1,314	$516	$1,830
2004	$1,422	$508	$1,930
2005	$1,544	$552	$2,096
2006	$1,675	$601	$2,276
2007	$783	$285	$1,068

As the chart illustrates, total fee collections are projected to increase through fiscal year 2006, and then fall sharply in 2007 when the final NSMIA fee reductions go into effect.

Fee Reductions

The Commission recognizes the magnitude of this issue, and has tried to reduce fees, where possible, when it is within its authority to do so. The Commission has taken two specific actions to reduce fees and administrative burdens. In 1996, fees for filing certain disclosure documents were eliminated, saving public companies an estimated $8 to $12 million per year. While this is a small amount relative to the size of the industry, it is significant in reducing the administrative burden on registrants, as well as the SEC. In addition, the Commission responded to industry concerns that there was a double counting of transactions in the over-the-counter market imposing an unfair burden on certain market participants. The Commission encouraged and actively supported changes in industry practices to eliminate this problem and approved NASD rule proposals to implement this change in March 1999.

Conclusion

Today, we are faced with fee collections well above the levels anticipated in NSMIA. As stated earlier, CBO's estimates for fiscal year 2000 fee collections are $1.66 billion. Not only is that amount far greater than our funding requirements for fiscal year 2000, but 70 percent of that figure is unavailable to fund the agency because of the restrictions imposed by the BEA rules.

However, we are still faced with many of the same issues that required years of Congressional negotiation and that resulted in the compromise embodied in NSMIA. Any alternative funding mechanism must:

- provide full funding for the SEC;
- spread the costs of regulation among those who benefit;
- consider the effect of market conditions on collections; and

- address the competing interests of all parties.

The SEC welcomes the opportunity to discuss this issue and appreciates the help and support of all the interested parties in ensuring that the SEC remains adequately funded regardless of the funding approach taken.