

**TESTIMONY OF
LARRY LEIBOWITZ
NYSE EURONEXT
BEFORE THE
UNITED STATES SENATE COMMITTEE
ON
BANKING, HOUSING, AND URBAN AFFAIRS
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Introduction

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee, my name is Larry Leibowitz, and I am Group Executive Vice President and Head of U.S. Execution and Global Technology for NYSE Euronext. I greatly appreciate the opportunity to share with the Committee our written testimony on the subject of today's hearing. We are grateful for the Committee's leadership in addressing the market structures issues that are the focus of so much debate in today's evolving marketplace.

This is a timely subject worth examining for several reasons. SEC Chairman Schapiro has announced that the Commission is undertaking a broad review of market structure issues; and, in fact, has already made several proposals, all steps in the right direction. These issues are important in the context of both the financial regulatory reforms the Committee is considering and the advances in market practices and technology that have become the focus of the public, regulators, legislators, market participants, analysts, and commentators.

NYSE Euronext is a leading global operator of financial markets and provider of innovative trading technologies. The company operates cash equities

exchanges in five countries and derivatives exchanges in Europe and the United States, on which investors trade equities, futures, options, fixed-income and exchange-traded products. With more than 8,000 listed issues, NYSE Euronext's equities markets -- the New York Stock Exchange, NYSE Euronext, NYSE Amex, NYSE Alternext and NYSE Arca -- represent nearly 40 percent of the world's equities trading, the most liquidity of any global exchange group. NYSE Euronext also operates NYSE Liffe, the leading European derivatives business, and NYSE Liffe US, a new US futures exchange. We also provide technology to more than a dozen cash and derivatives exchanges throughout the world. The company also offers comprehensive commercial technology, connectivity and market data products and services through NYSE Technologies.

Regulation is an integral and important part of the NYSE Euronext business structure. It is our belief that smart regulation—when properly administered—adds value to the marketplace overall, as well as to our business model. The current attention by this Committee, the SEC, and policymakers and commentators to the questions of how to update market structure regulation to address today's marketplace is timely and of utmost significance to our own business as well as the marketplace as a whole.

Specifically, today I would like to address:

- the evolution of the equity markets since the adoption of Regulations ATS and NMS in 1998 and 2005, respectively;
- the SEC's dark pool proposals;

- the SEC’s proposal to eliminate “flash” orders;
- high frequency trading;
- colocation; and
- direct market access.

In each case, I would like to identify what we view as the principal issues and ideal solutions.

Evolution of the Equity Markets

In 1998, the SEC adopted Regulation ATS and Rule 3b-16, which allowed new electronic trading markets to operate as exempt “alternative trading systems” instead of complying with the extensive regulatory requirements borne by registered exchanges. Although electronic trading systems were exchanges in all but name, prior to Regulation ATS they were regulated not as exchanges but solely as broker-dealers, with some additional reporting requirements. The SEC’s purpose in adopting Regulation ATS was to encourage “innovative new markets” while providing “an opportunity for registered exchanges to better compete with alternative trading systems,” by reducing the regulatory disparities that existed at the time between regulated exchanges and automated trading centers,¹ Regulation ATS sought to achieve these purposes by exempting alternative trading systems from exchange registration subject to conditions that imposed some but not all of the core obligations of exchange regulation on those ATSS,

¹ Regulation ATS Adopting Release, Exchange Act Release No. 40760 (December 22, 1998).

and only when an ATS reached a significant market share threshold. These conditions include disseminating public quotes, providing fair access, maintaining reliable and secure systems, and ensuring the confidentiality of orders. Under the regulations in effect today, quoting and fair access obligations are triggered when a particular ATS crosses a fairly high threshold in volume in a particular security. Taking a step in the right direction, the SEC has recently proposed lowering the threshold that triggers the obligation to publicly display quotes from 5% to .25%. We believe the SEC should review whether the fair access threshold should also be lowered.

Regulation ATS facilitated the development of numerous non-transparent trading systems (informally known as “dark pools”) and transparent electronic communication networks, or ECNs, that disseminate public quotes. Prior to the adoption of Regulation ATS, the U.S. equity markets were primarily characterized by trading on transparent floor-based exchanges, with some blocks trading upstairs on broker-dealer block desks, and some retail orders executed internally by over-the-counter market makers. Regulation ATS fostered new competition from electronic trading markets, some bright, some dark. The competition presented by these new trading centers has changed the operations of exchanges, upstairs block desks, and over-the-counter market makers. For example, transaction volume that occurs off of regulated, transparent exchanges now routinely exceeds one-third of total market volume. This shift demonstrates

the growth of highly competitive markets, but itself suggests that we are at a point where a reexamination of our market structure is warranted.

Today we have the opportunity to step back and consider how to ensure that the regulatory framework keeps pace with the changes that Regulation ATS fostered. Before the adoption of Regulation ATS, the SEC rightly identified the need to bring parity to the regulatory treatment of registered exchanges and ATSS. Although the SEC's actions facilitated significant innovation and lower costs for investors as a result of the competition among the various market centers, it is important that policymakers continue to evaluate the marketplace and the effects of regulatory reforms to assure that they are achieving objectives that make sense in today's market and have not exposed the marketplace to regulatory arbitrage among participants. We must reexamine whether the SEC achieved its parity objective with the implementation of Regulations ATS and NMS and whether market practices and technology have outgrown the original designs of Regulations ATS and NMS. In particular:

- ATSS that are under the 5% volume threshold that triggers the public quoting requirement are able to quote privately, using prices that are based on the public quote that is formed for the most part by registered exchanges. There is a cost to creating the public quote, and private ATSS are not contributing to that cost by contributing their quotes. As off-exchange transaction volume grows, there is a greater risk that this pattern could harm the

effectiveness and the integrity of the public quote. The recent proposals by the SEC to address this issue, as well as their anticipated concept release, are important steps in the right direction.

- As trading spreads across more bright and dark markets, it becomes increasingly difficult to monitor, both for practical data aggregation reasons and because the task of monitoring trading is spread differently across self-regulatory organizations, without any one SRO seeing the majority of trading. At a minimum, the cost of surveillance of the equity markets should be spread across all trading centers and should be fairly and proportionately borne by each marketplace, whether an SRO or not. ATs do not bear direct surveillance obligations as exchanges are required to do, and do not contribute directly to the costs of market surveillance conducted by other SROs. We should look to create a more equitable and consolidated approach to marketplace surveillance.
- Registered exchanges are subject to an extensive registration process to ensure that their trading systems comply with national market system principles and that they are structured and funded to operate effectively as self regulatory organizations. Exchanges also must submit their rule changes for prior SEC approval. It is important to recognize that this rule review by the SEC is not a

quick rubber stamp process: many of the strongly-held market structure principles of the SEC are not expressed through notice and comment rulemaking, but through the conditions and limitations the SEC imposes on exchange rules through the approval process. This process often is very time consuming. ATNs are not subject to similar oversight, because they do not need to seek approval to operate or file their rules for approval. As a result, ATNs are able to modify their rules and respond to user feedback quicker than registered exchanges, and they are not subject to the SEC's behind-the-scenes application of market structure principles. ATNs should be subject to SEC approval before becoming registered, and prior SEC review and, where appropriate, approval of their material system changes.

- And, most fundamentally, there is the question of whether trading centers that account for a substantial percentage of all trading volume should be permitted to benefit from any exemption from fair access and quoting obligations, at least with respect to small-sized orders.

The regulation of ATNs requires additional changes to achieve the Regulation ATN objectives. Not just the ATN threshold for public quoting, but the ATN threshold for fair access should be lowered below 5%. In fact, to lower the quoting threshold but not the fair access threshold is counterintuitive: it is like

requiring a department store to advertise its sale prices but allowing the guards at the door to deny entry to all but the most privileged customers.

Other jurisdictions are undertaking similar reviews. For example, Charlie McCreevy, EU Commissioner for Internal Market and Services, has stated that the European Markets in Financial Instruments Directive (MiFID), the EU's analogue to Regulation NMS, needs to be reexamined in light of the rise of dark trading venues, which he said "gives rise to questions as to whether there are unfair commercial advantages for the operators of these venues and whether the trend undermines price discovery, market integrity and efficiency for the market as a whole."²

The SEC's Dark Pool Proposals

In 2005, the SEC adopted Regulation NMS, with the goal of establishing a truly integrated national market system. Since then, the rise of dark trading venues has contributed to fragmentation, undermining the goals of Regulation NMS. Requiring ATs to publicly display quotes and treating actionable indications of interests as firm quotes under Regulations NMS and ATS would help forestall further fragmentation by integrating many ATs into the national market system of displayed quotes.

² Speech by Charles McCreevy, "Towards an Integrated Approach to Regulation Across the EU" (September 18, 2009), *available at*, <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/398&format=HTML&aged=0&language=EN&guiLanguage=en>

Last week, the SEC proposed several rule amendments to address some of these issues. The SEC's proposals would (1) amend the definition of "bid" or "offer" in Regulation NMS to require actionable indications of interest to be included in the public quote stream; (2) lower the volume thresholds that triggers the quote display obligations of ATSS from 5% to 0.25%; and (3) require trades reported by an ATS to identify the ATS on which the trade took place (today the trades are reported generically as having been executed "over-the-counter"). These proposals represent a useful and productive first step.

Moving forward, it is important to address the additional market structure issues that I mentioned earlier: flash orders, high frequency trading, colocation, and direct market access. We understand that the Commission plans to publish a concept release exploring these topics, and in particular whether high frequency traders are contributing to liquidity in the displayed markets, whether long-term traders have shifted into dark markets, and whether these changes have resulted in greater volatility in the displayed and dark markets overall, to the detriment of long-term investors. While, as described below, we do not believe that high frequency trading and colocation in particular raise these concerns, other issues like flash orders are more problematic. We welcome the SEC's review of this area.

Flash Orders

The rapid growth and widespread use of flash orders in part demonstrates how the regulatory framework has not kept pace with the evolution of the market. In this

regard, the SEC should be commended for its recent proposal to eliminate flash orders. We agree with the SEC that flash orders undermine public price discovery and the efficient functioning of the markets by drawing liquidity away from the displayed markets and by allowing unsurveilled information leakage. In addition, flash orders represent a form of “unfair access” because a flash order is only available to a select group of market participants, thus the broader market is disadvantaged because a displayed order was not given the opportunity to execute against the order that was flashed to a select group. This undermines the incentive to display limit orders, which play an essential role in the public price discovery process by establishing outer limits as the market price moves. Flash orders also create a two-tiered market as they allow select participants to have advance access to order information in a given security. And flash orders create the opportunity for a recipient of the “flash” to trade on the public markets utilizing the information that the “flash” revealed about the price movement in a security, with no surveillance oversight of recipients of the information.

Flash orders are an example of an innovation that if left unchecked would harm the markets and the integrity of public price discovery and create advantaged groups. On the other hand, there are innovations in technology and market practice that benefit the broader market. One example of a beneficial innovation is high frequency trading.

High Frequency Trading

High frequency trading is a natural evolution of longstanding practices of active market participants and traditional market makers. A variety of firms engage in high frequency trading, including firms that have evolved from more traditional market making models. High frequency trading firms engage in various trading strategies, but generally operate by entering orders on a highly automated and high-volume basis, based upon proprietary algorithms. Many orders are entered seeking rapid execution at their limit price and are cancelled immediately if not executed instantaneously.

High frequency traders represent a significant portion of trading volume on the NYSE and other U.S. market centers. For example, it is estimated that high frequency traders accounted for approximately two-thirds of all volume on U.S. equity markets over the last nine to 12 months.³ High frequency trading should not be confused with flash orders. In fact, one analysis has suggested that almost all high frequency trading takes place outside of the flash process.⁴ High frequency traders provide substantial liquidity to the market, a positive development that should be encouraged. We believe that absent the liquidity provided by high frequency trading, the volatility in the equity markets would be much greater. In addition to providing liquidity, high frequency trading firms

³ See Rosenblatt Securities Inc, Trading Talk: An In-Depth Look at High-Frequency Trading (September 30, 2009).

⁴ See *id.*

contribute to the narrowing of spreads, resulting in lower transaction costs for all market participants.

High frequency traders invest in systems and trading algorithms that enable them to respond quickly to price changes by entering and cancelling many orders at a time. As a result, high frequency traders trade at higher speeds and in greater volume than many other investors. But it is worth recalling that differences in speed and volume have always existed, and are harmful to investors only if they are on balance taking liquidity that would otherwise be available to other investors, or are manipulating the market in some manner. We have not observed either of these concerns.

Colocation

Colocation is the practice of trading firms locating their servers at the physical location of a trading center's matching engine servers. In today's electronic trading environment, orders travel extremely quickly, so the physical proximity of a trading firm's server to the market affects execution speed (at a rate of approximately 1 millisecond per 100 miles). This puts a firm located in, for example, San Francisco at a significant speed disadvantage to one in New York. In fact, a lack of available colocation facilities could trigger a scramble for real estate located next to market centers on behalf of parties that are outside the regulatory reach of the SEC or exchanges. The practice of colocation has been commonplace in both the equities and derivatives markets, and is the logical result of the automation of the U.S. marketplace. As U.S. market structure has

evolved (due to Regulation ATS, Regulation NMS and other factors driving electronic automation and fragmentation), aspects of trading technology infrastructure (especially colocation) have started to commingle with the market structure itself.

We do not believe that retail investors are disadvantaged by colocation. In fact, most retail orders do not enter the market directly, but rather through wholesalers, who instantaneously fill orders out of inventory at prices determined by the National Best Bid or Offer (“NBBO”), or place orders on exchanges using their own collocated infrastructure. Retail investors thus benefit from the utilization of colocation through tighter spreads, lower volatility and deeper liquidity.

Colocation provides operational, not informational advantages. There have always been operational differentials in the marketplace, as a result of technological innovation and the extent to which participants choose to compete by spending resources on those innovations. Computers reading price feeds and making decisions have always been faster than people in their broker’s office reading a ticker screen. As technology has become more prominent in the market, this operational differential has become most easily measured by speed.

While operational advantages are a natural result of a competitive, free market, informational advantages are not – they distort price discovery and unfairly disadvantage other market participants. An informational advantage exists when a market participant has prior access to information that others do not

have, as in the case of flash orders. Colocation does NOT in itself allow a participant to see orders before they hit the marketplace, as flash orders do.

The SEC is presently reviewing the way fees are structured for exchange-owned/controlled colocation space and will require that such colocation fees be filed as is required for any other exchange pricing. The SEC has oversight over the exchange markets that offer colocation, but not colocation offered by ATSS or other third parties who do not operate marketplaces. We think it is important that the SEC consider ways in which to fairly regulate the practice of colocation across marketplaces, regardless of how colocation to a particular marketplace is offered.

It is also particularly important to ensure fair access in connection with colocation in order to prevent both anticompetitive results for regulated exchanges and gaps in oversight regarding colocation by third parties, such as landlords of premises where market centers lease space to host their matching engines. It is impossible to prevent third parties from obtaining space close to an exchange data center and then subletting it to trading firms. Third party data center operators – acting on their own or on behalf of market centers (some of which are regulated and some of which are not) – are under no obligation currently to ensure fair access. As a result, not all markets are regulated equally, which creates competitive disadvantages among marketplaces offering colocation and creates an opportunity for market participants to engage in regulatory arbitrage. In addition, not all markets offer colocation in the same manner (e.g., the NYSE will own our

U.S. equities colocation space and control the entire data center housing the matching engines for our European derivatives exchanges, subjecting us more directly to regulation, but our competitors might provide it via third parties, taking it out of the realm of regulation simply by virtue of the structuring of their real estate arrangements). This could result in an extremely tilted playing field that allows market participants that are significant contributors to overall activity and volume to avoid SEC regulation.

We are working with the SEC to develop best practices for allocation of colocation space. We welcome the SEC guidelines in this area. We encourage the SEC to develop effective mechanisms for monitoring the practice among ATs and third party vendors as well.

Sponsored Access

Firms that colocate at market centers often connect to the market center through a direct market access arrangement. Direct market access refers to the practice for trading firms that are usually not themselves members of a particular trading venue obtaining access to a market center through a broker-dealer's trading identifier, thereby allowing such trading firm to enter orders directly onto the market center's systems. Direct market access takes at least two forms, including: arrangements whereby a member of a market center permits a sponsored participant to (1) enter orders directly onto the market without first passing through the member's systems (including risk management systems),

sometimes referred to as “unfiltered” or “naked” access,” or (2) enter orders directly onto the market through the member’s systems (including risk management systems).

We support the SEC’s initiative to develop clear, consistent supervisory standards for sponsoring firms in order to ensure that there are adequate risk controls in place to minimize systemic risk as a result of inadequate oversight of trading activity; we also support FINRA’s efforts to monitor the sponsoring firms’ risk management procedures – a role that properly belongs with a regulatory agency capable of examining across the industry in a consistent manner instead of in the hands of discrete exchanges with varying examination methodologies and processes.

Conclusion

In conclusion, NYSE Euronext supports leveling the playing field between ATSS and registered exchanges by (1) requiring ATSS that cross a more realistic threshold in volume to be required to quote publicly, as the SEC has recently proposed; (2) reducing the Regulation ATS fair access threshold in parallel with the quoting threshold; (3) requiring ATSS to contribute to their proportional cost of market surveillance and for there to be a universal surveillance authority; and (4) requiring ATS rule changes to be subject to regulatory oversight and approval similar to the oversight and approval process that applies to registered exchanges. In addition we advocate:

- eliminating flash orders, as the SEC has recently proposed;⁵
- encouraging high frequency traders to continue to play the market stabilizing role that was demonstrated during the market stresses experienced last year;
- ensuring that there is no regulatory disparity between market centers that offer colocation opportunities in owned data centers and non-exchange third-party data centers that offer colocation opportunities; and
- requiring providers of direct market access to perform pretrade monitoring of the trading activities of sponsored participants in accordance with a uniform rule.

We believe that the SEC is working on these difficult and complicated issues. We support the Committee's continuing efforts in focusing on this area, and would like to thank you once again for the opportunity to share our views today.

⁵ NYSE Euronext will be submitting a comment letter on the Commission's proposal.