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on behalf of NYSE Euronext
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Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance and Investment
"Computerized Trading Venues: What Should the Rules of the Road Be?"

Introduction

Chairman Reed, Ranking Member Crapo and members of the Subcommittee, my name is Joe Mecane and I am EVP and Head of U.S. Equities at NYSE Euronext (NYX) – a leading global operator of financial markets and provider of trading technologies. NYX's exchanges in Europe and the U.S. trade equities, futures, options, fixed-income and exchange-traded products. In the U.S., we operate three equities exchanges, two options exchanges, one futures exchange, and a technology business that provides comprehensive commercial technology, connectivity, and market data products and services.

While the U.S. continues to have the most liquid markets in the world and remains at the forefront of innovative technology used to conduct electronic trading, the infrastructure used to operate the markets each day has grown so sophisticated that few fully appreciate how well our markets actually operate in a highly competitive, fragmented and complex environment. This has made it difficult for market participants, regulators and Congress to determine the extent to which the growth in the number of trading venues, the speed at which trading platforms operate, and use of automated trading are beneficial.

However, in light of the market events that have occurred in recent years, I'd like to focus on how technology and our market structure have created unnecessary complexity and mistrust of markets; and, relatedly, what NYX believes the industry, regulators and Congress should be doing to address it.

Market structure drivers toward computerized trading

Decimalization. Electronic trading has added tremendous benefit to the capital markets, including lower costs of execution, faster speed of execution and, in some cases, greater transparency. However, the trend toward computerized trading was accelerated and fostered by several significant regulatory changes that drove the market to become more electronic. One important factor was decimalization of the markets in 2001, which had an effect of decreasing average spreads by roughly 38% in NYSE- and NASDAQ-listed securities, directly benefiting end investors.[1] At the same time institutional commissions, borne directly by end investors, were declining and decreased 33%[2] in the years leading up to Regulation NMS (Reg. NMS) implementation. In fact, almost all reductions in spreads and commissions occurred prior to the implementation of Reg. NMS and led to a huge expansion of electronic trading because human traders could no longer effectively make markets in this environment, and because institutions and brokers began relying more on algorithmic trading to access the market and reduce their costs of trading. This began a steady progression to have the most sophisticated algorithms and technology, since the smartest, the fastest and the first prevailed – well before the implementation of Reg. NMS in 2007.

Regulation NMS. In 2007, just as the technology among the trading community was becoming more sophisticated, the Securities and Exchange Commission (SEC) adopted Reg. NMS. This regulation gave brokers the freedom to trade around markets such as the New York Stock Exchange (NYSE) when the NYSE was in "slow" mode,[3] and at the same time forced participants to access the national best bid or offer (NBBO) in the market. Because exchanges competed by establishing the NBBO, speed among markets became the competitive differentiator based on one exchange's ability to set the NBBO faster than a competing market. While Reg. NMS also established the Order Protection Rule to protect visible orders and encourage displaying

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[1] Data is calculated based on decrease in dollar value of spreads between 2001 and 2007, when the next major market structure changes were implemented through Reg. NMS. Consolidated Tape Association and NYX.
[2] Tabb Group: *U.S. Long-Only Institutional Average Commission Rates, 2005-2012*.
[3] Reg. NMS: http://www.sec.gov/rules/final/34-51808.pdf.

quotes, today more than 3000 securities have over 40%[4] of their volume occurring off-exchange in dark markets. In the NYSE MKT listed market, which represents 709 securities, off-exchange trading accounted for 42% of the volume in November. This level of off-exchange activity erodes the incentive for market makers to continue to trade the less active securities, has a negative effect on price discovery[5] and threatens to further decrease the incentives for companies to go public.

ATSs and internalization. Today, there are around 63 execution venues in the US markets, including 13 exchanges and 50 dark pools. Exchanges find themselves competing more directly with Alternative Trading Systems (ATSs or dark pools) and broker internalization, which are able to employ different practices than exchanges with far less oversight and disclosure. Some of this competition is through cost, some through order handling practices, and much of it is through client segmentation whereby non-exchange venues are able to incentivize their own or third party liquidity provisions based on the nature of the person they are trading against. As a result of this advantage, large broker-dealers continue to move more order flow into their own private trading venues for a "first look" before routing on to the lit public markets. Since the implementation of Reg. NMS, we've seen two markets evolve – the lit public, regulated and accessible market versus the dark, selective and private non-transparent market.

As you can see, technology and the rules that govern the U.S. equity markets have resulted in the creation of a trading infrastructure primarily focused on speed and resulting complexity through which professional traders can identify and access liquidity – too often at the expense of retail investors and market integrity. To accomplish this, exchanges, brokers, and vendors have had to build expensive networks with the capacity to keep up with the growth of messages delivered each day to market participants seeking liquidity, as well as learn how to interact in a very complex ecosystem.

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[4] Consolidated Tape Association.

[5] CFA Institute: *"Dark Pools, Internalization and Equity Market Quality", October 2012, Weaver: "Off Exchange Trading and Market Quality in a Fragmented Market" (May 2011), Tabb Group: "A Spotlight in the Dark: An Inevitable Debate", November 2012*.

In response to this new flow of orders, exchanges have developed new order types. Order types have different purposes, such as giving cost certainty or competing with the client segmentation that exists off-exchange. Regardless of the reason for the specific order type, most are premised on the goal of attracting liquidity back to the public markets for the purpose of enhancing transparency and price discovery. Moreover, all order types must be pre-approved by the SEC and published for public comment, something that is unique to exchanges and which does not exist for ATSs or brokers who internalize.

Recommendations

The bottom line is that our market structure incentivized these various levels of increased complexity. Our main message is that if we want to reduce the complexity of technology and our markets, we should simplify the overall market structure. Doing so would certainly prove beneficial for the future of our national market system, for investors and issuers, and to the growth and well-being of our economy – including efficient access to capital to fund innovation, new business and job creation.

In this regard, key questions include determining who should lead the change process, and what should be done to correct course while ensuring that we continue to have the most transparent and liquid markets in the world.

NYX believes that the SEC is best suited to propose meaningful market structure changes – and, in fact, regulators in other global markets, including Canada, Australia and Europe, are already taking action. With Congressional oversight, the SEC should continue with the holistic review it began in 2010 with the Concept Release on Equity Market Structure[6] by proposing changes that will promote additional transparency, fairness and long term capital formation. This unfinished initiative needs to be completed and made a 2013 priority.

[6] http://www.sec.gov/rules/concept/2010/34-61358.pdf.

We believe that changes to be considered should include a review of market maker obligations, the Sub-Penny Rule, the Order Protection Rule, tick sizes for illiquid securities, and addressing the conflicts and overlap between broker-dealers and exchanges, including the obligations and responsibilities of each when providing like services.

The Consolidated Audit Trail, proposed by the SEC, also is a vital component to ensuring effective surveillance in a highly fragmented marketplace. Such surveillance should include better identification and reporting on high frequency trading, similar to that being discussed by the Commodity Futures Trading Commission, to increase the transparency of this practice.

NYX also believes that, in light of the existing complexity of the markets and the technology and trading glitches that have occurred this year, all trading venues should ensure a robust set of policies and procedures around their systems development life cycle. Although testing may not be the most exciting part of our markets, the hyper-competition that exists in this industry lends itself to excessive levels of change rates just to remain competitive and compliant with new regulatory requirements. The industry has been faced with implementing new back stops such as single-stock circuit breakers, market-wide circuit breakers, limit up-limit down, and possibly kill switches. These regulatory mechanisms have cost the industry tens of millions of dollars to implement over the past several years and have been developed in response to some of the negative effects of highly complex markets, in an effort to protect against those inevitable situations when the unforeseen occurs.

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Conclusion

In closing, I want to reiterate our belief that although our capital markets are the best in the world, there remains room for improvement. Technology and innovation should not be the cause of crisis and fear in our markets. Under the right conditions and structure, they are assets and produce opportunity for all market participants. Our recommendations have a simple premise: implement market structure changes that enhance transparency, fairness and price discovery for investors and level the playing field for trading venues.

Thank you for inviting me to testify and I look forward to your questions.