NYSE Euronext

TESTIMONY OF
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BEFORE THE
HOUSE FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

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Introduction

Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee, my name is Larry Leibowitz and I am Chief Operating Officer for NYSE Euronext[1]. I appreciate the opportunity to share with the Subcommittee our written testimony on the subject of today's hearing.

We commend the Subcommittee for its rapid response to the trading events of May 6, 2010. We agree with the Subcommittee that an orderly trading environment is fundamental to ensuring the reliability and integrity of our financial markets, fostering investor confidence in the markets, and safeguarding the U.S. financial system and economy. NYSE Euronext has always worked and will continue to strive to be the standard for accountability and transparency in the regulated marketplace. Thus, we believe it is essential to carefully examine the market events that occurred on May 6, 2010 and to consider potential market design and regulatory actions that could mitigate any similar occurrences in the future. NYSE Euronext is firmly committed to working with regulators and market participants toward achieving this critical objective. The trading events of May 6 are indicative of broader changes to markets and trading practices for which

[1] 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, 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 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.

recent advances in technology have been a catalyst, and which the SEC wisely has opened for review.

Today I would like to discuss:

- the trading events of May 6, 2010;
- the actions, and rationale behind those actions, that the New York Stock Exchange took during those events; and
- our recommendations for market design and regulatory changes to avoid similar events and enhance investor safeguards in the future, including:
    - adopting coordinated circuit breakers to address extreme and rapid swings in the prices of individual stocks and revisiting the market-wide circuit breakers developed after the 1987 market break;
    - establishing uniform rules and procedures for cancelling trades; and
    - creating a consolidated audit trail of trading activity.

The May 6, 2010 Market Drop

On May 6, 2010, from 2:40 p.m. to 3:00 p.m. Eastern time, the U.S. equity trading markets experienced a precipitous decline. At its lowest point, the Dow Jones Industrial Average suffered an intraday decline of 998.5 points, representing approximately $1 trillion in market value, with the most severe trading pressure occurring between 2:40 p.m. and 3:00 p.m. Some individual stocks lost nearly 100% of their market value. Although some of the underlying economic and global financial conditions that influenced this selling activity are known, the exact succession of events and what precipitated them remain unclear. The Securities and Exchange Commission (the "SEC") and the Commodity Future Trading Commission (the "CFTC") are aggregating and analyzing trading data from all of the equity and derivatives markets and will form a complete picture of the situation. We and other markets are working with the SEC and CFTC to supply and interpret this data, but we cannot do so on our own, as any single exchange has access only to the data from trades sent to or executed on that exchange.

Trading activity like we experienced on May 6 underscores the importance of the broad market structure review that the SEC is undertaking at present. As you know, in 2005 the SEC adopted Regulation NMS, which is the main set of regulations that govern the interaction of the competing markets in equity securities. Regulation NMS has resulted in a number of benefits to the equity markets, including narrower spreads and a greater use of technology, positioning the equity markets to handle the extreme market stresses that began in the fall of 2008.

Additionally, Regulation NMS resulted in vibrant competition in the markets. We strongly support competition in the equity markets, but competition among trading centers also has resulted in market fragmentation. There are currently upwards of 40 market centers in the equities markets, including registered exchanges and alternative trading systems. When a trading problem occurs, such as the May 6 experience, there is no central mechanism to coordinate a market-wide response. Exchanges have rules for trading halts regarding pending news and trading problems and also have rules to address erroneous trades. And the securities and futures exchanges, along with the Financial Industry Regulatory Authority, have adopted the market-wide circuit breakers developed after the 1987 market crash. However, there are no pre-established mechanisms to address precipitous declines on a stock-by-stock basis, or trading problems that result in market-wide drops of less than 10%.

The May 6 market drop certainly should inform the SEC's current examination of the changes in the markets, and in particular how certain recent advances in technology may have fostered trading practices that negatively impact the entire market. We are committed to working with the SEC and the CFTC as they consider these important issues. As regulators seek to determine whether regulatory action is necessary to address the shifts in market structure resulting from technological change, the events of May 6 make clear that the regulators also need to consider steps to avoid the types of extreme volatility our markets experienced that day. In this context, we believe it is worthwhile to explain the rules of the New York Stock Exchange that are designed to mitigate extreme volatility and how such rules could be used as a template for the broader market.

The New York Stock Exchange's Market Model

The New York Stock Exchange has embraced electronic trading, and its market model provides a combination of cutting edge technology with the best aspects of a floor-based market. Our rules are specifically designed to provide optimal price discovery and mitigate market volatility, and these rules automatically went into action on May 6. Specifically, the hybrid design of the New York Stock Exchange incorporated in its trading structure a type of circuit breaker mechanism, known as Liquidity Refreshment Points ("LRPs"), which temporarily requires stock trading to pause and reaggregate liquidity when significant price moves occur. The LRPs are triggered by specific criteria based on the prices of particular stocks, which criteria are included in our rule book and were approved by the SEC.

LRPs are designed to allow human intelligence to supplement artificial intelligence when trading appears irrational. The New York Stock Exchange's human liquidity providers absorb the news and trading patterns with respect to individual stocks and hold manual auctions of orders. To be clear, the LRP mechanism does not halt trading and it does not allow liquidity providers to step away from the market. Instead, on a brief basis, trading is paused to facilitate more accurate price discovery, mitigate confusion and reduce panic, and prevent the market from experiencing a sudden and significant drop. Our LRPs are analogous to taking the controls of a plane off auto-pilot during turbulence.

Necessarily, and beneficially, this process is more deliberate and time consuming than fully electronic trading. Although Regulation NMS permits electronic trading to ignore the New York Stock Exchange when we are in our circuit-breaker mode, many market participants specifically chose our mode of trading in this time of stress: during the 20-minute period of focus, including the periods when the New York Stock Exchange was in LRP mode on May 6, we executed volume commensurate with, and in many cases even higher than, our normal market share and we traded all orders that were routed to the New York Stock Exchange while the LRPs were in effect. A number of the LRPs in effect on May 6 were resolved in less than one second, and the average time of the LRPs was approximately 40 seconds. I emphasize these points to dispute the notion that NYSE stepped away from the marketplace during this crisis.

We should note that LRPs are not intended to prevent the market from falling; indeed that is not the role of an exchange, and could not be achieved by any one market. Rather, our LRPs are designed to prevent a sudden downdraft on our market from creating panic that could thunder through the financial system. A circuit breaker on a single trading market, such as the New York Stock Exchange, is not able to staunch volatile and panicked trading on other markets especially if those markets choose not to participate in our circuit-breaker mechanisms.

Once the New York Stock Exchange's circuit breakers were triggered, prices on the New York Stock Exchange were dramatically different from prices on electronic exchanges that did not have in place a similar circuit breaker mechanism. Because the New York Stock Exchange had switched to LRPs, and because Regulation NMS allows traders to bypass us, orders were routed to electronic markets that had not mitigated the volatile price declines and which had limited amounts of liquidity on their books. In turn, a spasm of selling spread through the markets with little liquidity, and no opportunity for the markets to pause or human judgment to intervene.

Recommendations

One clear lesson of May 6 is that our markets need a predictable, pre-established, coordinated way to respond to extreme and rapid market volatility. We believe the LRP mechanism functioned well on May 6, and the principles inherent in the LRP mechanism should be extended across the markets. As a first step, we believe that regulators should require all exchanges and market centers to implement a coordinated mechanism to provide a pause before trading crashes through all available liquidity into a free fall. If circuit breakers have been triggered in a security, the resulting pause should apply to all trading in the security irrespective of the market on which trading takes place.

In this regard, we suggest that the SEC should consider amendments to the order protection rules under Regulation NMS. The original intent of the rule may have been to give automated markets the option of bypassing a market that was temporarily operating in a manual mode. In practice, however, the ability of markets to bypass a manual market by default resulted in a situation where markets effectively chose to ignore and trade around our quotes once our circuit breakers were triggered. We certainly are willing to discuss the specific parameters of our LRPs, but the events of May 6 have demonstrated that it is time to reconsider the ability of markets to trade through functioning quotes as a default matter. Moreover, we note that customers have the ability to specifically request, and many do, for their orders to be directed to the primary market. In addition, we believe that it may be prudent to revisit the levels of the market-wide circuit breakers, and consider tightening their levels given the rapidity with which significant market movements can occur.

Further, we believe that developing a workable market-wide process for declaring an ongoing trading halt or reopening trading, even in the most difficult of market conditions, is essential to this effort. Any such mechanism should recognize that in times of extreme stress and volatility, a degree of centralized price discovery may be beneficial for the markets. Thus, we would suggest that the process for reopening trading after a halt should be conducted by the principal listing market for the security, in consultation with the regulators. Similarly, the decision regarding an ongoing market wide trading halt should be made by the principal listing market, as is done now for market wide news pending halts. Of course, as with all regulatory actions, regulators should avoid creating an unfair burden on competition. The public rulemaking process allows for these and other concerns associated with implementing market wide circuit breakers to be aired and resolved. Ultimately, this may best be achieved by consolidating self-regulation in one securities self-regulator, which would require action by Congress.

There are other actions that the regulators could take to address trading activity similar to what the markets experienced on May 6. First, the rules regarding the cancellation of trades should be defined with greater specificity. On May 6, it was announced after markets closed that any trades executed at 60% above or below the last price at 2:40 p.m. would be cancelled. This action was not predictable and caused confusion in the markets. It was an unsatisfactory substitute for the lack of circuit breakers for individual securities. There should be clear rules that set thresholds and circumstances under which trades will be cancelled or adjusted, to correct errors rather than market-wide movements.

In addition, to facilitate a review of extraordinary trading events, there should be a consolidated audit trail that would allow regulators to easily review market-wide trade data. Having such a mechanism in place very likely would have aided the review of the May 6 events. We understand that the SEC is developing a proposal in this regard, and we are committed to working with them on this important initiative.

We also note that the SEC has recently proposed regulations that would govern the risk controls applicable to providers of market access, to provide more transparency to the equities markets more broadly, and more generally review the functioning of the equities markets, and we have expressed our support for many of these proposals. In order to both avoid similar trading events and to facilitate surveillance, there should be uniform standards across markets that govern the risk controls and procedures that market access providers are required to implement. In addition, the SEC has proposed rules to gather information from large traders. These proposals may address some of the problems associated with aggregating and reviewing trading activity.

Conclusion

The events of May 6, 2010 demonstrate that the markets would benefit from a comprehensive structural review of the rapid advances in technology and their effect on trading practices and market integrity. As you know, the SEC has already commenced such a review, issued several rule proposals and has indicated that other proposals are forthcoming. We are committed to working with the SEC in these initiatives. In addition, we applaud the SEC and the CFTC for working together to review the events that transpired on May 6 and to develop a coordinated solution to prevent a recurrence of those events. NYSE Euronext is committed to joining together with all parties to work constructively toward this critical objective.

Once again, thank you for the opportunity to appear before the Subcommittee. I would be happy to answer any questions you have.