Testimony Concerning

"Dark Pools, Flash Orders, High Frequency Trading, and Other Market Structure Issues"

by

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Chairman Reed, Ranking Member Bunning and Members of the Subcommittee, I would like to thank you for the opportunity to testify today on behalf of Direct Edge, the operator of the third-largest stock market in the nation. Over the past two years Direct Edge's market share of U.S. stock trading has risen to approximately 12 percent, up from only 1 percent in early 2007, because we have innovated in response to changing market structure to provide new solutions for brokers and their customers. Certain of these changes have triggered a debate over the past several months regarding the structural integrity of our equities markets, which is now at a critical juncture. Individual investors are in need of greater clarity and education as to how our stock market operates, and how to improve it. In this regard, the work of the Subcommittee in conducting this hearing is timely and valuable.

Direct Edge believes that current market structure issues should be framed so that investors understand how the evolution of stock trading benefits them, and that through careful examination, appropriate regulatory protections can be preserved without taking steps that would ultimately undermine investor confidence by restricting innovation, competition and efficiency. To this end, Direct Edge offers guiding principles for any market structure reforms, in order to focus the current dialogue on what really matters – improving our stock market for the benefit of the nation's investors.

1. Current market structure is fundamentally fair and sound

By every quantitative and qualitative measure, the U.S. cash equities market serves as a model for the world, performing as well as it ever has in terms of its liquidity, implicit and explicit transaction costs, and transparency. During the worst financial crisis of our lifetime, the U.S. equity market was continually liquid and efficient, while price discovery for certain other financial instruments, such as auction-rate and mortgage-backed securities, was virtually non-existent. Recent developments have not materially eroded the efficiency of our marketplace.

While the evolution of the technology, functionality and economics of trading require everyone to adapt, that should not be the root reason for market structure reform. Though trends and changes always require a continual analysis of how regulation needs to respond, this should not be confused with a broader need to re-architect our market due to any underlying fundamental flaw or unfairness.

2. High-frequency trading and technology are valuable components of modern market structure

The innovation and efficiency that technology has brought to stock trading inures to the benefit of every American investor. When decimalization came to the equities markets in April 2001, there was a near-total evaporation of traditional capital commitment, with market makers far less willing to provide competitive bids and offers as spreads narrowed. Firms willing and able to adapt to this new reality, along with new competitors, rose in their place with business models predicated on extremely efficient use of technology to facilitate our markets. Without these trading firms continuously providing liquidity, the market transition to pennies would have been much more turbulent and expensive for investors. The benefits of high-tech trading continue to this day in several forms, including more efficient price discovery, lower investor costs, and greater competition, which benefits all investors. All brokers have in some form deployed high-frequency technology, to the point that retail investors can have their orders executed in under a second via the Internet from anywhere on the planet.

As with the technological transformation of any market, issues have emerged that warrant close examination and likely new regulation. High-frequency trading strategies are now pursued by unregulated entities who have been given broker-like access to exchanges without adequate control of the compliance or systemic risks, often called "naked access". Exchange products that offer brokers a direct presence at exchange data and trading facilities – often called "co-location" – need to be regulated in the same manner as transaction and other exchange fees so that all investors have confidence that equal access and opportunity are being provided. Any evaluation of these issues and potential remedies should start, however, from a productive vantage point that when well-regulated, high-frequency trading and technology are generally healthy and positive.

3. <u>Exchanges are not always the best place to execute a trade</u>

Even though Direct Edge currently operates one exchange facility and has applied to operate two new exchanges, we do not believe that our market structure would be well-served by requiring all orders to be placed on exchange facilities. The equity exchange and over-the-counter markets have existed symbiotically side-by-side for over thirty years, to the great benefit of retail and institutional investors. There are many legitimate economic, execution quality, and policy reasons why investors and their agents seek an off-exchange execution, whether in a dark pool, through an institutional or whole-sale market maker, or other means.

Exchanges do, however, play a critical role in providing pre-trade transparency and price discovery, which benefits those who trade off-exchange. The recent Securities and Exchange Commission proposal to increase the post-trade transparency of dark pool activity is an appropriate first step in monitoring the balance between on and off-exchange trading and providing insight to the investing public. If the level of overall market share among exchanges were to fall precipitously below historical norms, it would be appropriate to examine what further steps would be needed to maintain the role exchange liquidity and price discovery plays in our market. But with on-exchange liquidity consistently above 70% in recent times, we are simply not near such a point.

To preserve the place of exchanges as central hubs of trading interest, regulation that drives the displayed exchange markets and non-displayed off-exchange markets further apart must be avoided. Direct Edge pioneered the use of flash order technology in the equities markets precisely to give retail and other investors' access to dark pool and other off-exchange liquidity they previously never had access to, and our data shows investors receive better prices on their trades as a result. This is what any good exchange does – bring buyers and sellers together in a way that makes sense for all concerned. True inequities should be examined and eliminated, and the thoughtful approach the Securities and Exchange Commission has taken to date should be commended. But undue focus on optional, esoteric order types, at the expense of ignoring the broader trends that motivate customers to use these tactics, at a minimum would provide only false comfort to investors, and potentially leave them more at risk than ever before.

4. Brokers are best equipped to choose how to execute their customer orders

Every order type offered by an exchange or other market center provides some combination of immediacy, explicit fees, implicit costs, opportunity for price and/or size improvement and market impact. Investors that value an immediate execution above all else use market orders, taking the price the market gives them and foregoing a chance to do better. Those who seek price improvement use limit orders, knowing full well they may wind up not trading at all. There are countless other examples of how order flow should be managed in light of investor objectives and preferences.

Brokers are best suited to decide when and how to use the tools exchanges provide in executing customer orders. Delegation of the responsibility to manage these aspects of execution quality by an investor to a broker is, for all but the more sophisticated or self-directed investor, a critical concept in how markets operate.
The vast majority of brokers fulfill their fiduciary obligations with integrity and extreme efficiency. While each broker brings their own perspective and execution strategy to the table, investors are free to choose among scores of reputable, experienced brokers using a range of criteria and information as the basis for deciding who to employ.

5. <u>Equal access prevents "two-tier markets"</u>

The broad array of market technologies and products that brokers have at their disposal is greater than ever. This empowers brokers to customize their order-execution approach to the needs of their business and customers. Every broker does not do everything the same way, at the same speed, or with the same resources. Brokers choose which exchanges to become members of, and then choose to use the products or services offered by the exchange at their discretion. Investors participate by choosing their broker and level of self-direction they engage in. This is part of the fabric of competition, rather than a flaw in market-based capitalism.

When a broker or investor elects not to utilize certain functionality, technology or strategies, it does not imply that those who do are somehow unfairly advantaged. Markets need to be fundamentally fair, but that is not achieved on the basis of attempting to mandate that everyone has 'sub-standard but equal' capabilities. With equivalent access to exchanges for brokers and transparent competition for customer business among brokers, all market participants benefit from both fairness and differentiation.

6. <u>In debating the need for market structure reform, a broad, data-driven approach is optimal</u>

Market structure reform that takes the entire context of recent trends into account generally produces better results than issue-by-issue reforms. The National Market System encouraged by the Securities Act Amendments of 1975, the Order Handling Rules of 1996 and even Regulation NMS are all viewed as having successfully advanced the liquidity, transparency and efficiency of our markets. Their strengths lie in the comprehensive nature of the approach taken. Emergency actions can be counterproductive because they tend to ignore root causes and the likely unintended consequences. When considering market structure reform, Direct Edge strongly believes in a "big picture" approach. We also highly value objective data over subjective intuition or conjecture. To do otherwise could alter a market structure that is generally performing well without an adequate basis for believing improvements will result.

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Conclusion

Our stock market is the model for the entire world because we anticipate and implement change better than anyone, and adapting regulation is a key element of this. If we can address outstanding issues in a constructive fashion, focusing on how to improve regulation while promoting what currently works well, we will have provided a strong structural foundation upon which our nation's economic recovery can be realized. Once again, I'd like to thank the Subcommittee for the opportunity to testify and I look forward to answering your questions.