STATEMENT OF
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on

COMPUTERIZED TRADING VENUES: WHAT SHOULD THE RULES OF THE ROAD BE?

before the

SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
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INTRODUCTION

Chairman Reed, Ranking Member Crapo and other members of the Subcommittee, thank you for the opportunity to testify this morning on the topic of "rules of the road" for computerized trading venues. On behalf of a leading agency broker, my goal is to offer an unbiased, fact-based view on the current state of U.S. equity market structure.

ITG is a NYSE-listed company with 17 offices across 10 countries and nearly 1,100 employees. As an agency broker, ITG provides trading services, technology, analytics and research to a wide array of leading asset managers. Throughout our 25-year history, we have worked in partnership with major mutual funds, pension funds and other institutional investors, innovating to improve trading and investment performance. In my testimony today I would like to offer a brief overview of current market structure, discuss some recent events which have impacted investor confidence and look at some ways to restore this confidence. There has been much written of late about the quality of our equity markets. This morning we hope we can infuse some data and analysis into the debate.

MARKET STRUCTURE

Competition amongst market centers and broker dealers spawned by the passage of Regulation ATS in December 1998 has led to intense competition for liquidity and ultimately to fragmentation. This fragmentation has undoubtedly introduced complexity into our marketplace but has been a positive force in reducing execution costs.

Technology has provided market participants, including retail investors and mutual funds,

with the tools necessary to aggregate liquidity and derive the full benefit of free market competition for order flow.

Global asset managers, as fiduciaries, have an obligation to achieve best execution. The global market standard requires all asset managers of size to measure the quality of their execution and its effect on the investment process. ITG is the world's largest provider of TCA, or Transaction Cost Analysis. We measure millions of trades executed on behalf of hundreds of global asset managers. Our TCA data clearly demonstrates that institutional investors have benefited greatly from the evolution of U.S. market structure. Over the past 12 years, there has been a 70% decrease in average total equity trading costs in the U.S. As the data indicates, U.S. market structure is not broken. The current ecosystem of displayed and dark markets has resulted in significantly reduced costs that in almost all cases have been distributed back to investors. There is no evidence to suggest that competition and fragmentation have damaged price discovery or harmed capital formation.

ITG is not a market maker, and we do not take on proprietary positions. In other words, we do not have "skin in the game" when it comes to the debates around broker internalization, as our system provides "meaningful price improvement" to buyside investors as described in Regulation NMS. Based on our data, we would conclude that Broker-Dealer internalizers, or broker-dealer dark pools as they are sometimes known, provide a useful permeable layer between the client and the displayed markets. Brokers have a fiduciary responsibility to their clients while exchanges do not, and these liquidity pools would not exist unless benefit was derived by the customer. Most recently, Australia and Canada have imposed regulations around internalization that will provide

us with data sets to examine when considering the implications of potentially taking similar action here in the U.S. Early returns do not look promising in terms of the effects on liquidity and trading costs. Regressing to an oligopoly of U.S. exchanges is clearly not the answer.

INVESTOR CONFIDENCE

Unfortunately, the evidence also suggests that the investing public has become disenchanted with equities. According to the Investment Company Institute, over half a trillion dollars has been pulled from U.S. equity mutual funds since the start of 2008. Much of this can be attributed to the reduced risk appetite of baby boomers and the relative safety of bonds supported by easy monetary policy.

The May 2010 Flash Crash, the Facebook IPO, and Knight Capital's trading debacle this past summer provide little comfort that U.S. equity markets are a safe place to trade or invest. Add in the suspicions that the investing public has about high frequency trading and its perceived impact on the quality of markets, and you have a recipe for anecdote and conjecture overcoming facts and reason.

Where speed is concerned, it is clear that the law of diminishing returns must be applied to further dramatic shifts in the foundations of our equity marketplace. Microseconds versus milliseconds do not matter to the wider, more important, audience. We need to restore investor confidence, but not at the cost of disturbing the progress that has been made.

RECOMMENDATIONS

In our opinion, we can focus on five tangible initiatives to accomplish this:

- The SEC's Consolidated Audit Trail, if implemented properly and cost effectively, will give investors confidence that regulators can police bad actors and predatory strategies.

- The consistent application of the Market Wide Circuit Breakers and the Limit-Up Limit- Down Plan to all market centers would likely prevent a market disruption of "Flash Crash" proportions.

- Costs should be borne by market participants who create excessive quote traffic without executing order flow.

- Market data should be distributed to all market participants equally.

- Marketwide risk should be monitored at a central clearing house that would have the ability to terminate a broker-dealer's connectivity to the national market system in the event of a rogue program released to the market.

CONCLUSION

These five measures would give the investing public the protections they need to confidently invest in the world's strongest and most resilient market while still deriving all of the cost savings and liquidity benefits which have been achieved over the past decade. Lastly, as the regulations called for by the Dodd-Frank Act begin to take hold across other asset classes, the lessons we have learned in equities will be applied to those markets.

Price discovery, central clearing, transaction cost analysis, and pre- and post-trade transparency will become as deeply integrated into foreign exchange and fixed income markets as they are in equity markets. And innovation will come more quickly to those markets because of the lessons learned in equities. For this reason, our equity market structure is all the more important to our broader financial system.

Thank you again for the opportunity to share our views on these important questions. I would be happy to answer any questions at the appropriate time.

EXHIBIT A:

Responses to Written Questions Posed by the Subcommittee:

1. There are currently 13 equities exchanges in the U.S., more than 40 "dark pools," and 200 broker-dealers who can execute order flow internally. What are the strengths and weaknesses of this market structure?

The fragmentation of the U.S. equity markets over the past 10-15 years largely resulted from free market competition. The current market structure has yielded huge benefits in terms of cost savings for retail and institutional investors. ITG's own data indicates that total trading costs for U.S. equities have fallen more than 70% over the past decade. The increase in the number of execution venues has also led to a more robust national market system, with built-in redundancies and no single point of failure.

A potential weakness of this market structure is its innate complexity. Unlike the days when equity trading was essentially an oligopoly of the exchanges, today the proliferation of competing brokers, dark pools, and exchanges may be difficult for even many investment professionals to fully grasp. This complexity and the perceived lack of market structure transparency have grown to the point where it may be impacting investor confidence.

2. How has technological innovation and competition between an expanding set of trading venues impacted investor protection, market integrity and capital formation?

Increased competition between trading venues has benefited investors by significantly reducing trading costs while simultaneously protecting against predatory pricing and abuses such as the NYSE specialists front-running scandal a decade ago and the

NASDAQ dealer scandal of the mid-1990s. While there has been an expansion in the number of trading venues, the integrity of the market has not suffered as a result. During the post-Lehman financial meltdown in 2008, U.S. equity markets functioned efficiently and without any dislocations despite massive spikes in volatility and volume. In contrast, the over-the-counter markets for derivatives such as Collateralized Debt Obligations and even short term commercial paper seized up for days or even weeks at a time, with pricing that was aptly described as "marked to mayhem."

Regarding capital formation, we would argue that macro influences such as weak economic growth and political uncertainties may act as a deterrent to firms looking to raise equity capital. However, U.S. market structure is by no means a hindrance to capital formation. Through the end of November this year, firms have raised more than $57 billion through U.S. initial public offerings and another $182 billion in follow-on offerings. These figures indicate that the U.S. market raised more capital than all other global stock exchanges combined during the same period.

3. How have liquidity and price discovery been impacted by the flow of stock trading volume to off-exchange venues?

The prevailing view by academic experts in market microstructure is that the increase in off-exchange execution in the U.S. has, on balance, had a positive impact on both liquidity and price discovery.[1] We believe that the off-exchange crossing of blocks of

[1] *See*: Haoxiang Zhu, MIT, "Do Dark Pools Harm Price Discovery?" November 2012.
http://www.mit.edu/~zhuh/Zhu_darkpool.pdf
Also: Bhuti, Rindi, Werner: "Diving into Dark Pools" June 2010
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1630499

stock, which we effect through our POSIT alternative trading system ("ATS"), actually reinforces the price discovery mechanism of the exchanges. Specifically, we cross blocks on an agency basis and report the transactions in real-time. In addition, similar to other off-exchange venues, POSIT executes client orders at prices that are within the prevailing market quotes (the so-called "National Best Bid and/or Offer", or "NBBO"). As of October 2012, approximately one-third of U.S. stock trading volume was executed in off-exchange venues. In the absence of any compelling argument or hard data that suggests a negative impact on liquidity and/or price discovery by off-exchange venues, we reject the false notion that the U.S. equity markets have reached some sort of "tipping point" for this type of trading activity. It should also be noted that the exchanges employ trading models that are used by their member firms such as the acceptance and execution of un-displayed or "dark" orders. For years, the exchanges have offered their member firms the capability to provide and/or execute against dark liquidity and their interests in this type of flow is increasing as evidenced by the implementation of Retail Liquidity Pilot Programs by several exchanges.

4. It has been reported that a substantial amount of trading volume in the stock market is conducted by what are commonly referred to as high frequency traders. How has high frequency trading impacted liquidity, price discovery and equity market structure?

High-frequency trading has grown along with the technological advances in electronic trading and it expanded rapidly after the implementation of Regulation NMS (National Market System). While it is tough to estimate how much volume is generated by high frequency traders (HFTs) in the U.S. equity markets, it is generally thought to be

approximately 50% of total trading activity. During the past five years as HFT has become a more prominent feature of the U.S. equity markets, average stock spreads have narrowed and liquidity, as measured by the average depth of order books, has increased. While increased liquidity and narrower spreads are a benefit for investors, HFT strategies have also caused a substantial increase in message traffic, *i.e.* information concerning share prices and indications of interest, or IOIs. This sharp increase in message traffic is a negative result of HFT growth, acting as a *de facto* tax on all market participants. As we suggested in a speech to the Security Traders' Association in 2010, high-frequency traders who create massive amounts of tick data without resultant liquidity from executed orders should share the burden this creates for our industry. This could take the form of a message data fee for traders who have an extremely low ratio of order submissions to executions, similar to the excessive message fee programs that were proposed by NASDAQ and Direct Edge earlier this year.

It is worth noting that a universally recognized definition of HFT has proved elusive, although CFTC Commissioner Scott O'Malia's proposed 7-part definition offers a good roadmap.[2] HFT is more of a strategy or a trading style than a discrete set of investors. We would caution against an overly aggressive approach to policing behaviors which are perceived to be the domain of HFT, such as algorithmic trading. Algorithms have become a commonplace tool for virtually all institutional investors, including pension funds and mutual funds. Imposing heavy regulatory burdens on algorithmic trading

[2] See: http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/hftdefinitionletter111711.pdf

would have a negative impact on all market participants, not just those engaging in strategies similar to those employed by HFTs.

5. Exchanges have converted from mutually-owned not-for-profit organizations to publicly-owned for-profit companies. How has this influenced the operating model? Should exchanges still be self-regulatory organizations?

On balance, it is a positive development that U.S. exchanges are transparent, publicly-traded companies which are incentivized by the demands of the marketplace. This development has increased competition and lowered costs for the member firms of the exchanges, thereby benefiting the investing public. The question of whether for-profit exchanges should remain as self regulatory organizations ("SROs") is worth examining. As SEC Commissioner Dan Gallagher stated at the SIFMA Market Structure Conference in October 2012[3], the self-regulatory framework is premised on circumstances that no longer exist. He proposes an in-depth examination of this issue and we would agree that it is a matter worthy of regulators' attention.

6. The SEC recently held a technology roundtable on how to minimize trading errors and market malfunctions, as well as how to respond to any that occur in real-time. What changes need to be made to help fortify our markets, especially during times of market stress?

ITG participated on Panel One of the SEC's Market Technology Roundtable, which was held on October 2, 2012. The topics of discussion for Panel One addressed the prevention of errors through the design, deployment, and development of robust trading systems. ITG maintains that existing rules and regulations such as the Market Access

[3] See: http://www.sec.gov/news/speech/2012/spch100412dmg.htm

Rule,[4] Rule 201 of Regulation SHO,[5] and the Single Stock Circuit Breakers[6] have improved market conditions by requiring market participants to more closely monitor their respective trading activities for regulatory, financial, and operational risk. In addition, we believe that the Limit Up / Limit Down Plan[7] and Market Wide Circuit Breakers,[8] which will take effect on February 4, 2013, will result in the implementation of more robust policies, procedures, and automated controls concerning risk management and the prevention of trading errors. In light of the existing regulatory infrastructure along with the complex and dynamic nature of trading technology, careful focus is required when considering new regulations. Instead of implementing additional regulatory obligations, existing rules and regulations should be improved and updated, and industry guidelines and best practices should be promoted. Individual market participants could further contribute to the reduction of trading errors and liquidity failures by employing certain "best practices" including, but not limited to: (1) extensive design and functionality reviews of software code; (2) rigorous testing of software code prior to deployment; (3) robust testing environments using real time order flow and market data; and (4) incremental deployment of new code under close surveillance and monitoring by trading and technology professionals. Exchanges could assist broker-dealers in improving their risk management controls by providing enhanced drop copies

[4] *See* 17 C.F.R. §240.15c3-5.

[5] *See* 17 C.F.R. §242.201.

[6] *See* Exchange Act Rel. No. 62251 (June 10, 2010), 75 FR 34183 (June 16, 2010) ("Approval Order of Single Stock Circuit Breakers").

[7] *See* Exchange Act Rel. No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012) ("Order Approving Limit Up-Limit Down Plan on a Pilot Basis).

[8] *See* Exchange Act Rel. No. 67090 (May 31, 2012), 77 FR 33531 (June 6, 2012) ("Order Approving the Modification of the Market-wide Circuit Breakers").

of order handling and execution activities that are integrated with real-time execution and monitoring systems. Such information could help market participants track and determine when exchange monitored thresholds are breached.

Finally, market participants should seek to improve and/or enhance their respective redundancy systems and business continuity plans. Recent events such as Hurricane Sandy provided a harsh reminder that exchanges and member firms must be prepared to switch to secondary systems and alternative power sources from remote locations in order to provide trading services to their customers and maintain market integrity.

For more detailed information and analyses concerning the prevention of transaction errors and liquidity failures through the design, testing, and deployment of trading systems and technology, please see ITG's October 22, 2012 letter to the Securities and Exchange Commission in connection with the SEC's Market Technology Roundtable.[9]

7. What measures are being taken by market participants and regulators to secure data in today's markets?

Data security is a matter of paramount importance for all market participants, particularly when it comes to sensitive client information or trade data. We, along with the vast majority of other market participants, take this responsibility seriously and we safeguard our data using a combination of up-to-date technological measures, strictly enforced information barriers, and robust policies and procedures concerning information security and protection of client confidential information. We strongly believe that regulators

[9] *See*: http://www.itg.com/news_events/papers/SEC-Technology-Roundtable-2012.pdf

should be held to the same high standards as other market participants when it comes to data security, particularly as plans are laid for a Consolidated Audit Trail for the U.S. equity market.

8. What regulatory or legislative changes should be considered by regulators or Congress in order to protect investors; maintain fair, orderly and efficient markets; and facilitate capital formation?

Although the U.S. equity markets have faced challenges over the past decade, they could be fairly ranked as among the most transparent, competitive, resilient, and efficient markets in the world. As mentioned earlier, we believe that U.S. regulators should improve and update existing rules and regulations while also promoting industry guidelines and best practices. We believe that the markets would benefit from a modest, clearly defined set of modernized laws, regulations, and SRO rules, which are enforced consistently and fairly. Such action would cause market participants to implement more robust regulatory policies, procedures, and controls and reduce the inconsistent enforcement of regulatory obligations, thereby inspiring investor confidence and encouraging continued capital formation. To achieve this goal, the regulators require appropriate monitoring and surveillance tools at their disposal, most notably a staff which is knowledgeable in market structure and also a consolidated audit trail (CAT) in order to properly monitor market activity. Steps are being taken towards a CAT, but it is not happening quickly enough in order to improve investor confidence.

EXHIBIT B

Biography of Robert C. Gasser, CEO and President of ITG

Bob Gasser is Chief Executive Officer and President of ITG. Mr. Gasser was previously CEO at NYFIX, Inc., a global electronic trade execution firm.

Before NYFIX, Mr. Gasser was Head of U.S. Equity Trading at JP Morgan. Concurrently, Mr. Gasser served on the Board of Directors of Archipelago Exchange as well as on the NASDAQ Quality of Markets Committee and the NYSE Upstairs Traders Advisory Committee. Mr. Gasser holds a Bachelor of Science degree from the Georgetown University School of Foreign Service.