TESTIMONY OF NEW YORK STOCK EXCHANGE PRESIDENT THOMAS W. FARLEY
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES
CAPITAL MARKETS, SECURITIES, AND INVESTMENT SUBCOMMITTEE ON
U.S. EQUITY MARKET STRUCTURE PART I: A REVIEW OF THE EVOLUTION OF TODAY'S
EQUITY MARKET STRUCTURE AND HOW WE GOT HERE
JUNE 27, 2017

Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee, we appreciate your interest in the evolution of the U.S. capital markets. My name is Tom Farley and I am President of the New York Stock Exchange (NYSE). Last month, we celebrated the 225th anniversary of the morning when a group of 24 enterprising entrepreneurs inspired by Alexander Hamilton's vision met underneath a buttonwood tree outside 68 Wall Street in lower Manhattan to sign an agreement that would create the New York Stock & Exchange Board and formalize the burgeoning capital markets of the United States. The first stocks and bonds traded on the new exchange included The Bank of New York, which Hamilton founded and is still listed and traded on the NYSE.

Today, the New York Stock Exchange is the world's largest with total listed company market capitalization of $30 trillion representing nearly 40% of the world's total market value. The U.S. capital markets are the destination of choice for investors and companies as they provide unparalleled access to capital, liquidity, and trusted regulation.

The NYSE's core mission has never wavered: we help men and women raise money for their companies so they can build, innovate, discover and grow. In doing so, they spur economic growth by investing and innovating, leading to a higher quality of life for Americans and global citizens. NYSE-listed companies employ 40 million people around the world. From this job creation, to providing funding for technology and medical R&D or industrial investment, to establishing 401(k) plans and programs to give back to their communities -- all of this raises up the citizens of our country and the world.

Our Markets Primary Purpose is to Serve the Needs of Issuers and Investors

Our markets are the strongest in the world and the U.S. continues to lead in capital raised by newly public companies through an IPO. We cannot, however, assume that this will always be the case. Regulations intended to strengthen our markets are in some ways weakening them. One consequence is that the number of exchange-listed companies is half of what it was 20 years ago. In addition, the average market capitalization of exchange-listed companies is six times greater than it was 20 years ago. This means individual and small institutional investors who invest through the public markets are limited in their choices. Also, if smaller, high-growth companies decide to delay accessing the public markets until after they are mature, those same investors will miss benefiting from their significant growth years. It is easy to write off securities regulation as an issue that only impacts Wall Street, but it also meaningfully impacts Main Street.

For the many benefits of being a public company, there are many negatives, including an increasingly complex, fragmented, and opaque secondary market structure for investors and market participants who wish to buy and sell these public companies' securities. Our markets have changed significantly over the past 10 years since the adoption of Regulation NMS. Equity markets are now intensely competitive and innovative. Unfortunately, these positive attributes have also brought with them added challenges of increased fragmentation, lack of obligated liquidity provision, and a decrease in displayed liquidity, particularly in less liquid stocks. We need smarter regulation to address these issues, which are important to both issuers and investors, and NYSE supports the Subcommittee's efforts to take a detailed look at U.S. equity market structure.

Fostering market quality for listed companies and investors is paramount when considering potential changes to the U.S. equity market structure. NYSE is the global leader in market quality, providing stable, displayed quotes with meaningful size and a narrow bid-ask spread. Our market models are constructed to create the right balance between market maker benefits and obligations. The Designated Market Makers on NYSE have more significant obligations than any other class of market maker in U.S. equities. They guarantee all marketable interest will be satisfied in opening and closing auctions, they must contribute to the best quotes in the market a certain percentage of the trading day, and must also provide liquidity at multiple price points to dampen price moves throughout the day. Unlike most market maker incentive programs, these are not voluntary obligations they can ignore when market conditions are less appealing but rather rule-based mandatory obligations that carry regulatory risk. In exchange for those accepting that risk, they are rewarded with a set of incentives, including increased participation opportunities and favorable transaction fee pricing. We invest quite literally, in better market quality for our issuers.

Regulations Should Foster Displayed Liquidity on Which All Market Participants Rely

The NYSE believes that regulation needs to be better designed to protect and reward displayed liquidity, and that any changes to equity market structure should emphasize increased transparency to listed companies and investors. The years following the adoption of Regulation NMS have seen a proliferation of trading venues, including both exchanges and non-exchange venues such as dark pools and broker-dealer internalization engines. Off-exchange trading in the U.S. equity markets for the month of May 2017 was 37.6% of Consolidated Average Daily Volume.[1] Dark pools were originally intended to be venues for large trades but they have become an avenue for skirting regulation and subverting displayed markets. The NYSE believes it is critical for the markets to recognize that these dark venues rely on the public, transparent prices of securities that are provided by exchanges and do not themselves contribute anything positive to price discovery.

In other words, our markets simply do not work without the market participants that publicly display the prices and sizes of trading interest at which they are willing to trade, and without a high-quality public quote, the prices investors receive on their trades in these dark venues will be impaired. Because the quality of public securities quotations is directly related to the proportion of trading interest that contributes to these quotes, the NYSE is concerned that the aggregate effect of dark or internalized activity will continue to degrade the public price discovery process and potentially harm an otherwise healthy public market. This impact will also have detrimental downstream effects on the attractiveness of public markets to listed companies.

A Less Complex Market Structure Would Serve Issuers and Investors

The theme "simplicity" should drive discussion of any changes to equity market structure. While the word "innovation" is a tempting justification for changes designed to give a competitive advantage, many "innovations" in recent years include structures and practices that add

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[1] Source: NYSE

needless complexity to an already overly-complex market structure. In hindsight, there are many “innovations” from the past 10 years in the financial markets that have had dramatic unintended consequences and should have been handled differently.

We hear concern from NYSE listed companies and investors regarding increasing complexity and fragmentation in the U.S. equity markets, and the resulting challenge in finding sufficient liquidity. These worries are particularly acute for listed companies with lower market capitalizations and lower levels of trading activity, and for large investors looking to buy or sell sizable positions. One vital counterpoint to this liquidity challenge is the end-of-day closing auction, where a single process aggregates all buying and selling interest in a stock to determine the official closing price. The closing auction accounts for an average of 6% of an NYSE listed company’s total daily trading volume. The transparency of the auction process allows investors of all types to participate with the assurance of a fair and accessible price. A recent proposal to the SEC, cloaked in the spirit of “innovation,” would further fragment today’s closing auction process. This proposal would increase complexity in our markets, a development which generally favors professional traders at the expense of long-term investors, and could negatively impact the substantial liquidity currently available to all market participants in the closing auction.

SEC Rulemaking Should be Transparent

The tools for regulating the markets need a fresh look. For example, as envisioned by Congress in the Exchange Act Amendments of 1975[2], the U.S. Securities and Exchange Commission (“SEC” or “Commission”) relies on self-regulatory organizations (“SROs”), including exchanges, to design and operate national market system plans (“NMS plans”). When the Commission, by rule or order, requires SROs to develop NMS plans, the SROs must act consistent with their SRO obligations, including compliance with SEC orders pertaining to topics, timelines and boundaries of such NMS plans. As a result, SROs must deliver NMS Plans to the SEC in the timeframe specified and within the guidelines required by the Commission’s order or be subject to a potential enforcement action by the Commission.

The Commission has increasingly outsourced its policymaking to the self-regulatory organizations by relying on NMS plans rather than the direct SEC rulemaking process to

[2] Pub. L. No. 94-29, 89 Stat. 97 (1975).

achieve the Commission's policy goals. In the 25 years between the enactment of the 1975 Act Amendments and the year 2000, only three NMS plans were approved by the Commission -- all related to the collection, consolidation and dissemination of the best bids and offers and transaction reports in cash equity securities and equity options. There are now *eleven* NMS plans. NYSE believes that the Commission should curtail this trend toward the use of NMS Plans to achieve its policy goals and instead directly conduct data-driven SEC rulemaking subject to robust economic analysis and public review and comment. In this regard, NYSE wholeheartedly supports Commissioner Piwowar's recent statement regarding the use of NMS plans for constructing an "Access Fee Pilot" as recommended by the SEC's Equity Market Structure Advisory Committee. [3] While the direct SEC rulemaking process is more labor-intensive to initiate than indirect rulemaking through NMS Plans, we agree that it is the appropriate approach for the SEC to initiate changes to the rules governing the U.S. equity markets.

Conclusion

Smarter regulation of today's equity market structure will ease the burden for entrepreneurs and innovators to access the capital markets and will allow the U.S. to extend its leadership in the global markets. National securities exchanges, such as the NYSE, serve a fundamental role in the national market system by providing listing venues for companies seeking to raise capital and transparent prices for investors and market participants wishing to buy and sell the securities of public companies. This year, NYSE celebrates the 225th year of its proud history in the U.S. capital markets. As the technological and competitive landscape evolves, NYSE will enhance its legacy by continuing to make significant investments in technology and exchange operations, developing new services, and maintaining robust market surveillance.

225 years ago, with George Washington as President, our great nation was well on the way to becoming the Land of Opportunity. All issuers and investors, large and small, should have access to the bounty of the capital markets. On behalf of the NYSE's listed companies and investors, we encourage right-sized regulation for our capital markets system.

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[3] Public statement available at: https://www.sec.gov/news/speech/piwowar-keynote-columbia-university-032317

We look forward to working with the Congress, the SEC and the new Administration to make sure America preserves its status as the world's home of innovation and free enterprise for the next 225 years and beyond. We thank the Subcommittee again for its interest in these matters.