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<u>INTRODUCTION: WHAT IS AN EXCHANGE?</u>

An exchange used to be a place – yes, a physical place -- where people would come together to buy or sell, hoping to achieve the best price for themselves. The more the exchange was able to attract <u>all</u> of the buy and sell interests in a product, the more the prices on the exchange would reflect the true state of supply and demand.

Along with the exchanges the role of brokers emerged. They would represent their customers' buy or sell interests. With brokers came the crucial question of trust. Can you trust your broker? Regrettably, many chapters of the history of financial markets must be devoted to recounting the myriad innovative and ingenious ways brokers have devised to steal from their clients.

The first great online trading revolution involved the telegraph and telephone lines, and with them more and more people were able to trade securities in smaller lots. As the number of trades increased, the relationship between brokers and clients became more impersonal and distant. Even so, as long as all the transactions had to take place on centralized exchanges with basic rules rules of fair trade, our markets had order and transparency. Customers could be reasonably sure that there was a limit to the amount for which their brokers could fleece them.

Fast forward to today and we cannot make the same claim. In the last 20 years came computers, electronic communications, electronic exchanges, dark pools, flash orders, multiple exchanges, alternative trading venues, direct access brokers, OTC derivatives, High Frequency Traders, MiFID in Europe, Reg. NMS in the U.S. --- and what we have today is a complete mess.

<u>CRISIS OF TRUST</u>

It is not so much anymore that the public does not trust their brokers. They do not trust the markets, the exchanges, or the regulators either. And why should they, given our showing in the past few years?

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To the public the financial markets may increasingly seem like a casino, except that the casino is more transparent and simpler to understand. Just as the emerging markets led by the BRICS are doing a wonderful job establishing their market economies with their exchanges as their centerpieces, we have a crisis of trust in the developed world.

I must confess to you that I was an ardent proponent of bringing technology to trading and brokerage. Unfortunately, I only saw the good sides. I saw how electronic trading and recordkeeping could be used to force people to be more honest, to make the process more efficient, to lower transaction costs and to bring liquidity to the markets.

I did not see the forces of fragmentation and the opportunity for people to use technology to keep to the letter but avoid the spirit of the rules -- creating the current crisis. It is vitally important that we bring an end to this crisis of trust before it spreads any further; that we bring back order, fair dealing and trust in the marketplace. And it is the regulated exchange community that has the opportunity and the wherewithal to do it.

INTERNALIZATION IN OTC AND EXCHANGE-LISTED MARKETS

The root of the problem, as always, is short-sighted greed on the part of the brokers. Transparent commissions are not enough for them. They want to take more from their customers but without the customers seeing exactly what it is that they are paying. This is done by what is called internalization, which is easiest to illustrate with OTC products. The banks simply take the opposite side of the customers' orders at prices that leave the banks with undisclosed but huge profits.

How do we know that the profits are huge? Just look at the banks' quarterly financial reports on derivatives dealings. Even the more modest estimates exceed $100 billion per year, worldwide. Customers are on the other side of those trades. Customer losses are on the other side of those bank profits. The amazing thing is that those banks are able to convince their customers that this is good for them and moving these contracts on to the exchanges would harm the customers.

How do they do this? What dark arts do they employ to maintain the status quo? I think their magic consists of such mundane things as million dollar paychecks to the salesmen, golf outings, tickets to games, dinners, Cuban cigars and probably some other blandishments that should not be discussed in polite company.

And of course, the fact that most OTC derivatives "customers" are not playing with their own money. The customers are finance or investment staff that work for large corporations, state or municipal governments, pension funds and insurance companies. These end-user employees get to drink the fine wines, but it is the shareholders or taxpayers that pay for the overpriced derivatives.

This same thing is happening in more subtle ways in exchange listed products. In Europe, investors have a long tradition of investing through their banks. Smaller banks work with larger banks that sit on exchange boards. The boards make rules for the exchanges that allow the trades to take place not at the exchange but somewhere else, merely being reported to the exchange for clearing. As long as the price is anywhere between the lowest bid and the highest offer that was posted on the exchange any time during the day, it is accepted. Some exchanges will accept a trade as long as it is priced anywhere within 10% of the posted bid or offer.

In these scenarios the exchanges' traditional function -- matching competing bids and offers, resulting in price discovery -- is not used by the brokers, but the brokers are willing to pay the same amount in fees to the exchanges just for the clearing. So the exchanges get the same revenue either way. But I ask you: Is this sustainable? Is there real value added? Is this a healthy, vibrant business model? Or will these exchanges atrophy like unused limbs?

In the U.S., the picture is not very different. Brokers internalize stock trades and put them up at the clearinghouse. They at least are supposed to provide best execution, but best execution is vaguely defined and poorly enforced. Brokers in the U.S. must post reports showing where they route their customers' orders. But do you suppose that brokers care what's reflected in those reports? They do not.

It should be shocking, but it probably is not, that according to the Rule 606 reports mandated by the U.S. Securities and Exchange Commission, no major online broker, with the sole exception of Interactive Brokers, sent more than 5% of its orders to an organized exchange. More than 95% of their orders go to internalizers!

These brokers ignore the exchanges and sell the orders to internalizers, thereby avoiding exchange fees and getting a nice little payment from the internalizers in return. This payment for order flow adds up to real money after millions of orders are taken into account. The internalizers are supposedly matching the best prices prevailing at the exchanges, so that they can argue that the customers get the best prices.

But do they really? Of course not. If they did, an independent study would not have found that the one broker that actually routes the vast majority of its orders to public exchanges -- and I will not name this broker again -- obtains executions that are on the average 28 cents better per 100 shares in the U.S., and an absolutely stunning 2.84 Euros better per 100 shares in Europe. As much as I love this brokerage firm, it may not be doing anything all that special. It is mostly just quickly routing each order, or parts of an order, to the public exchange with the best posted prices for that order, and quickly rerouting if another exchange becomes more favorable.

FURTHER CONSEQUENCES OF INTERNALIZATION

Beyond the impact for individual customers, let's look at the impact of internalization on publicly disseminated prices. Such prices do not even exist for OTC products. But what do public prices mean any more on exchanges where customer orders are no longer routed and it is now only market professionals trading with each other?

On exchanges now we have old style market makers stubbornly clinging to the idea that they will be paid for providing liquidity, trading with High Frequency Traders of various kinds--some providing liquidity, some picking off slow quotes, or playing tricks like quote stuffing or manipulative algo trading -- such as suddenly sweeping the market, lifting all offers and as all the machines run for cover, selling it back for a profit.

Where are we heading? These fast money players will eventually burn out. Sooner or later the regular losers will leave and the regular winners will have nobody to trade with except when they make a mistake. The result will be that spreads will widen, which will be welcome news for the internalizers because they will now be able to take the other side of the customer order flow that they buy on a wider market.

As indicated in the recent flash crash report by the U.S. CFTC and SEC, internalizers suck off all the customer orders, but when an imbalance develops they are unable to handle it and they throw the switch to route the orders back to the exchanges, which no longer have the liquidity to deal with it. Since the bulk of the volume is now being traded at prices relative to a displayed market that is no longer driven by real supply and demand, sudden imbalances of buy and sell orders will occur more and more often, giving our industry more and more reputational headaches.

In the long run, customers reading their brokerage statements will realize that trading is expensive and they will do less and less of it. The long term trend of ever lower transaction costs and ever higher investor volumes and liquidity has reversed. We are now going in the opposite direction. Organized exchanges are providing a less and less stable footing to the evolving global market-economy.

WHAT CAN BE DONE?

First, we must get the customer orders to come back to the exchanges, to be matched there and cleared there. Exchanges must be able to convince their governments, their regulators and the public that open competition among bidders will result in a better price than no competition, and that the more orders that go to the exchange the more competition there will be.

This is not a difficult argument to make. Whether it be military procurement or electricity or climate credits or anything else, officials and regulators on all sides of the political spectrum seem to realize that a transparent bidding process, such as takes place on well regulated exchanges, fosters capitalism and free markets and yet also serves the public interest and protects the little guy.

Second, we must address the issue of fragmentation among exchanges themselves. Some amount of competition between exchanges is a good thing. It keeps costs down, technology up to date and services improved. But having too many exchanges creates difficulties for brokers and regulators and undermines the very purpose of an exchange. In order for brokers to provide best execution, they must be connected to all the exchanges or entrust their orders to another who is. Exchange linkage software is becoming more expensive and difficult to build and maintain, as it has to cope with the complexities of figuring out where best to send an order depending upon who the order belongs to and how much each exchange charges or rebates for what product and for what kind of order.

The right number of exchanges for a class of products is difficult to say, but I believe that if there are fewer than three exchanges in a given product space, the entrance of more should be encouraged. But when we get to five or six, some consolidation should be in order. As for dark pools, they should be made to come into the light and become regulated exchanges, or be restricted to very large institutional participants or be eliminated.

Third, while we are talking to regulators, we should not forget to bring up the dangers of proliferating clearing houses. Like the fragmentation of trading, the fragmentation of clearing seems to be following close behind. I was stunned to read the other day that in the U.S., CFTC Chairman Gensler expects to have as many as 20 central clearinghouses. A central clearinghouse means nothing if it is central only in name. 20 clearinghouses are no better than 20 dealers.

If you say that these 20 clearinghouses in the U.S. will clear different products, that does not give me much comfort because many of these products correlate and are often used to hedge each other. Having partially offsetting products clear at different clearinghouses is dangerous and creates payment gridlock, as we found out during the ‘87 crash. That is what gave birth to cross margining, but cross margining among 10 or 20 clearinghouses would create mind-numbing complexity.

Collecting margins is not the clearinghouse's only function. When a clearing member fails, the clearinghouse has to be able to step into the failing clearing member's position and liquidate that position while trying to minimize losses and public panic. And here we come full circle, because if there is not a liquid market at the exchange, how will that position be liquidated? If it is a large position, what is the clearinghouse going to do? If the losses exceed the clearinghouse's resources, who will end up with those losses? The other members will, but if some of them do not have sufficient funds, we will be faced with a domino effect. So it is ultimately in the interest of the clearinghouses and all of their members to have a liquid, transparent market at the exchanges where all buy and sell interests are expressed.

THE FUTURE OF MARKET MAKERS

Are market makers necessary in mature markets? I am not sure. Many futures exchanges have functioned well for decades without designated market makers. On the other hand, if an exchange would like to be assured of the continuous availability of buyers and sellers, it should have registered market makers with serious affirmative obligations. But if you want them to assume those obligations you must give them something in return, preferably something that will not cost you any money, such as modest preferential access.

Market makers, not so much in stocks as in options, must maintain tens of thousands or hundreds of thousands of quotes at the exchanges, and when some input makes them move those quotes they must move them in a matter of milliseconds. On the opposite side, we have High Frequency Traders who are waiting for just such an input signal to quickly grab those quotes that have not yet been moved. This is not an even playing field. It obviously takes much longer for the market maker to move thousands of quotes than for the HFT to hit a handful.

If you want to have market makers you should give them some modest preferential access. Hold every order for a tenth of a second with the exception of market maker quote updates for products in which the market maker is registered and has affirmative obligations. There is simply no other measure that can protect market makers against being picked off. If you do not do this, market makers will either make wide markets or just cease to be registered as market makers.

In return you should require market makers to provide liquidity and not take liquidity in some very high percentage of their trades and give the market makers strict quoting requirements.

CONCLUSION

The financial markets of at least the world's developed countries are at a turning point. Technology, market structure and new products have evolved more quickly than our capacity to understand or control them. The result has been a series of crises over the past few years that have caused many investors to lose confidence or to think that the whole system is a rigged game.

This is a very dangerous development because the purpose of our financial markets is to guide the evolution of our economies by allocating capital to industries and companies that we want to grow, and to allow businesses and investors to efficiently manage risk. If the public comes to perceive that the financial markets are a con game and that they are the marks, then companies and entrepreneurs will not get the funds they need to grow our economies, provide jobs and raise living standards.

Exchanges should use their innovative energies to come up with new products to enhance our ability to transfer and distribute risk across all geographies and industries. This is where ultimately your growth should come from.

But in the short run you must increase liquidity and trading volume on your exchange by getting the flow back to your matching engine. You must go on a campaign to convince the end customer, individual or institutional alike, that they are better served by their brokers when their trades are routed to a transparent exchange where the prices are determined by free market forces in open competition, rather than to some hidden, internalized market with no competition.