NYSE Euronext

U.S. Commodity Futures Trading Commission
The Honorable Gary Gensler
Chairman
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

U.S. Securities and Exchange Commission
The Honorable Mary Schapiro
Chairman
100 F Street, NE
Washington, DC 20549

September 21, 2009

RE: SEC-CFTC Joint Hearings follow-up

Dear Chairman Gensler and Chairman Schapiro:

I appreciated the opportunity to testify at the joint meetings of the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") on September 2 and 3, 2009, on the subject of harmonization of market regulation.

Pursuant to your request at the hearing, in addition to our previously submitted written testimony, we are providing here our views on several issues you raised at the hearing: co-location practices and regulation in the equities and derivatives markets; promoting competition in the derivatives markets through fungibility of futures contracts; and the implications to regulation of exchanges as public companies.

1. Co-location practices and regulation

Co-location is the practice of trading firms locating their servers at the physical location of an exchange's matching engine servers. The reasons for, and users of, co-location are the same in both the equities and futures markets: In today's electronic trading environment, orders travel extremely quickly, so the physical proximity of a trading firm's server to the market affects execution speed (at a rate of approximately 1 millisecond per 100 miles). This puts a firm located in San Francisco at a speed disadvantage to one in New York. The practice has been commonplace in both the equities and derivatives markets, and is the logical result of the automation of the U.S. marketplace. As U.S. market structure has evolved (due to Reg ATS, Reg NMS and other factors driving electronic automation and fragmentation), aspects of capital markets technology infrastructure (especially co-location) have started to co-mingle with the market structure itself.

It is important to note that retail investors are not disadvantaged by co-location. In the equities markets, trading has evolved and expanded to include a web of connectivity around market centers, of which high-frequency traders, broker-dealers and hedge funds form a part. Retail investors usually do not directly touch market centers anymore, and in the futures markets, do not have any direct interaction with market centers. Instead, retail investors enter through the infrastructure surrounding the markets; and by using this infrastructure, the retail investor often indirectly gets the same advantage as the high-frequency traders of the world

without bearing the full costs of the infrastructure (including any costs relating to co-location). Retail investors also benefit from the presence of high-frequency traders through tighter spreads, lower volatility and greater liquidity.

Co-location provides operational, not informational advantages. There have always been operational differentials in the marketplace, as a result of technological innovation and the extent to which participants choose to compete by spending resources on those innovations. Computers reading price feeds and making decisions have always been faster than people sitting at a computer watching a screen. As technology has become more prominent in the market, this operational differential has become most easily measured by speed.

Operational advantages are a natural result of a competitive, free market. Informational advantages are not – they distort price discovery and unfairly disadvantage other market participants. An informational advantage exists when a market participant has prior access to information that others do not have, as in the case of “flash orders”. With co-location, the information is made available at the same time to all market participants and the difference with respect to receipt of the information lies in the operational capacity of the trading firm’s systems. Co-location does NOT allow a participant to see orders before they hit the marketplace, as “flash” orders do.

With “Flash,” or “Step-Up” orders, certain equities and options markets give select market participants prior access to orders before the entire market. With these types of orders, the select market participants that have prior access to the orders are given an informational advantage. We believe this informational advantage is unfair and serves to undermine market integrity and price discovery. None of NYSE Euronext's cash and futures markets provide flash order functionality. We strongly support the SEC's proposal to ban this unfair and damaging practice. We are unaware of any futures market offering flash quote functionality. We urge the CFTC to remain vigilant to ensure that the practice is not permitted in the futures markets.

Both the SEC and CFTC have oversight over the markets that offer co-location. The SEC is currently reviewing the way exchange-owned/controlled co-location space is charged and when done by an exchange, will require that co-location charges be filed as with any other exchange pricing. We believe we offer co-location on a fair and equitable basis, consistent with the fair access requirements of the Securities Exchange Act of 1934.

It is particularly important that regulation to ensure fair access in connection with co-location be structured to prevent both anticompetitive results for regulated exchanges and gaps in oversight regarding co-location by third parties. It is impossible to prevent third parties from obtaining space close to an exchange data center and then subletting it to trading firms. Third party data center operators – acting on their own or on behalf of market centers – are under no obligation currently to ensure fair access. As a result, not all markets are regulated equally, which creates competitive disadvantages among marketplaces offering co-location. In addition, not all markets offer co-location in the same manner (e.g., we will own our U.S. equities co-location space and control the entire data center housing the matching engines for our European derivatives exchanges, subjecting us more directly to regulation, but our competitors might provide it via third parties, taking it out of the realm of regulation simply by virtue of the structuring of the offering). This could result in an extremely tilted playing field based on real estate proximity.

The CFTC and SEC should ensure that entities offering exchange co-location develop fair allocation methodologies that treat similarly situated participants equitably and at reasonable fees. To level the playing field, we think that third parties acting on behalf of exchanges or in collaboration with exchanges (e.g, rebate or revenue sharing arrangements) should be deemed facilities of that exchange and thereby subject to the same requirements regarding fair and equitable allocation.

2. Promoting competition in the futures markets through fungibility of futures contracts

One suggestion for harmonizing securities and futures regulations and increasing competition among trading facilities in the futures markets is the adoption of fungibility for futures contracts similar to the structure for securities and equity options. For these equities markets, fungibility means the regulatory designation of one utility clearinghouse for all trading facilities and the ability of traders to put on and take off positions at different trading facilities. This horizontal platform for clearing has worked well to promote competition among securities and equity options trading facilities, driving the cost of execution lower and narrowing the spreads between buyers and sellers.

However, there are significant drawbacks to this model when it comes to on-exchange derivatives. A trading facility that uses a utility-style clearinghouse is less likely to innovate for product development if competitors can immediately piggy-back off their ideas through a horizontal clearing model. For this reason, all futures markets globally currently operate under a vertical clearing model.

The disincentive to innovate has not been an issue for the equities markets since companies—rather than exchanges—issue securities that are fungible by design. In other words, IBM stock is IBM stock, no matter what secondary market it is traded on. On the other hand, it is the exchanges--rather than the companies--that design and list futures contracts with endless possibilities for design of contract terms. Most futures exchanges would not invest time and capital into designing better products for investors unless they can have an opportunity to recoup this investment, which the vertical clearing model allows.

Changing the regulations to create one utility clearinghouse for futures would also be a significant disruption to the market and risks the migration of business offshore in an age of electronic trading that enables an exchange to be located nearly anywhere the world.

If not full blown fungibility, then what is the solution? Clearly, it is not sustainable for one exchange to have 96 percent of the U.S. market share of trading volume and more competition would benefit the market. Short of fungibility, there are several less disruptive but effective steps that can be taken by regulators to improve competition among trading facilities for the benefit of investors.

First, regulators should take a more aggressive stance in using their anti-trust authorities to ensure that exchanges and clearinghouses and their rules are not anti-competitive. For example, the CME has utilized its rule 432D to prohibit firms from moving their open interest to competing exchanges through block or exchange of futures for futures trades. CME has interpreted this type of activity as a wash trade that is prohibited under its rules. Clearly, this activity is not the traditional wash trade prohibited by the Commodity Exchange Act that is

used to churn trades and defraud customers. Rather, it is an activity with the strong economic purpose of providing choices to investors who are seeking alternative venues to conduct trades. If the agencies do not believe they have sufficient authority to prevent such anti-competitive behavior, then they should ask Congress for this ability given the courts and Department of Justice have given great deference to the agencies in this area.

Second, and related to the prior item, the "stickiness" of the vertical clearing model can be improved by clarifying the process and rights for market participants that want to move open interest to competing exchanges. In the past, exchanges have claimed that open interest is owned and controlled by the clearinghouse and exchange.

Certainly, clearinghouses have a strong interest in managing their positions due to the systemic risk inherent in the business. But the uncertainty of who owns and controls open interest has deterred market participants from taking positions to competing exchanges. The agencies should clarify the rights of market participants and clearinghouses regarding open interest as well as the process by which participants can transfer positions to other exchanges. This would significantly improve the ability of other exchanges to compete for business. Enhanced transparency of clearing fees would also allow users of the markets to be informed buyers of these services.

Third, the agencies should approve more competitors in this space, especially those with innovative market structures that have the best chance to compete for market share. In June, NYSE Euronext and DTCC announced their intention to form New York Portfolio Clearing—a joint venture that will allow market participants that hold both cash positions at the DTCC and futures positions resulting from trades executed on NYSE Liffe US to receive risk-based portfolio margining. With the approval of this venture, regulators will be able to monitor a more holistic view of the markets and identify positions of firms with large exposures that may not have been visible to them under the current distinct margining systems. If over-the-counter products migrate to this clearinghouse model, the comprehensive view of regulators across asset classes will be even more complete. NYSE Euronext is investing significant capital, intellectual property and is contributing essential proprietary technology in order to deliver these innovative efficiencies to the market. After a brief period of exclusivity to build critical mass, NYPC will be open to clear trades executed on any qualifying futures exchange. This approach balances the need to incentivize exchanges to innovate with the need to foster a healthy level of competition among exchanges after a limited start-up period of time.

In the long run, this may provide a market structure template for regulators to consider that combines the benefits of both the horizontal and vertical clearing models, allowing exchanges to innovate and capture a return on investment for a limited period of time but ultimately opening up the model for competition once a critical mass of trading is established.

3. The implications of regulation of exchanges as public companies

NYSE Euronext, like most exchanges in the U.S. and internationally, is a public company. The movement of most exchanges to a public corporate structure has given exchanges opportunities to innovate, expand and grow. As an exchange and self-regulatory organization we occupy a role that is central to market integrity and investor confidence. Accordingly, the corporate governance structure of public exchanges is particularly

significant. A strong, independent board is essential to ensuring that management of the exchange is accountable not only to our shareholders, but also to the financial markets more broadly. It is critical that the regulatory function of self-regulatory organizations, in particular, be overseen by board members who are independent from management. NYSE Euronext recommends that exchange boards have a significant representation of independent directors and that the regulatory functions of the exchange be overseen by independent directors.

In addition, as noted in our written testimony, as a public company our ability to compete and innovate are significantly affected by regulation. The rules-based regulatory approach under the securities laws and the SEC, which requires exchanges to file new rules and products and any amendments to them with the SEC for approval, has led to significant delays in the implementation of some rules at exchanges, as well as deferral or outright loss of new product innovation of exchange-traded products, many of which ultimately end up in the OTC market. The uneven application of regulation among different trading platforms for securities has allowed competitors to freely and quickly benefit from the efforts endured by regulated exchanges without shouldering any responsibility for the associated regulatory burdens, such as intermarket surveillance. As we stated in our testimony, NYSE Euronext recommends the SEC adopt a rule and product certification regime similar to the CFTC or make amendments to its current regime that creates greater predictability, fairness and flexibility.

Thank you again for providing NYSE Euronext with the opportunity to present our views on these issues. We greatly appreciate your leadership as both agencies work to develop a more efficient and effective, harmonized regulatory structure for the equities and derivatives markets. We would be happy to discuss further any of the issues raised in this letter. Should you have any questions, please contact Clarke Camper or Linda Rich at (202) 347-4300.

Sincerely,

NYSE Euronext

cc: SEC Commissioners
CFTC Commissioners