May 7, 2010

Via Electronic Mail (rule-comments@sec.gov)

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549
Attention: Ms. Elizabeth M. Murphy, Secretary

Re: SEC Release No. 34-61358; File No. S7-02-10

Ladies and Gentlemen:

We are writing to comment on the Concept Release on Equity Market Structure (the “Concept Release”) issued by the Securities and Exchange Commission (the “Commission”) under the Securities Exchange Act of 1934 (the “Exchange Act”). We applaud the Commission’s focus on the several important topics covered in the Concept Release. We concur that the many rapid changes in our nation’s secondary markets in equity securities warrant a Commission review to be sure its regulations under the Exchange Act continue to serve the public interest and to achieve the congressional objectives of that Act. While we think some of the questions and solutions on which the Commission focuses in the Concept Release are the right ones, others are not, as we discuss below.

Co-location and Time and Place Advantages

The Commission correctly identifies co-location (that is, the placement of an order-generating engine in close proximity to an exchange’s order-receiving portal) as an important issue. As it is now evolving, co-location involves the allocation of a scarce resource. If not closely supervised, particularly given the for-profit nature of exchanges today, it is potentially a significant source of monopolistic abuse by the larger exchanges. One aspect of co-location is that, unless it is made fairly available to a broad range of market participants, it will entrench the initial subscribers and freeze out new entrants, which would not be in the public interest. The Commission should take a particularly active role in monitoring and evaluating the operation of co-location and require changes as necessary to serve the public interest. This will entail the Commission exploring ways of making co-location available to data vendors that will redistribute market information rapidly to subscribers including the middle market and thus make more equitable access to this valuable resource, as well as agency brokers and other market participants. Co-location “slots” are undoubtedly going to be a scarce commodity, much like
terminal “slots” at LaGuardia and other high-volume airports. If the SEC and the exchanges are going to provide for fairness in the allocation of these slots, it may be necessary to step back from — i.e., not allow — the closest proximity so that no one group of applicants is favored over another and so that new entrants can be fairly accommodated. Without this commitment to allow non-discriminatory access for new entrants — many of whom may not even presently exist — co-location will create an insurmountable barrier to entry for new competitors. That would effectively lock-in a two-tier market, instead of permitting new technology to promote broader dissemination of information and trading opportunity.

We agree with the Commission’s conclusion that proprietary trading firms that achieve rapid market access through their use of superior technology are not analogous to exchange specialists, which in many cases were given valuable monopoly market-making franchises. The exchanges’ regulation of specialist conduct in that environment, recognizing their unique time and place advantages, made sense in theory. As the Commission knows, however, specialist regulation on the NYSE was a notorious failure in practice and at last the Commission had to bring enforcement proceedings against all seven remaining specialist firms, alleging among other things chronic failures to comply with their supposed affirmative and negative trading obligations.¹

In any event, the advantages of market proximity proprietary firms acquire in a competitive environment, even given co-location, are much different from the monopoly position exchange specialists formerly enjoyed and the Commission should not impose on the proprietary “upstairs” firms, or on the operators of alternative trading systems, the affirmative and negative obligations or other regulatory limits that the exchanges allegedly attempted, with greater or lesser vigor, to enforce against specialists.

**Sub-penny Trading**

We respectfully recommend that the Commission not permit sub-penny trading under current circumstances. Sub-penny pricing would not save investors any significant amounts of money in our view and it would involve a substantially increased level of complexity and expense in the handling of orders. The programming required to provide for subpenny trading would be substantial in the equity markets and probably a multiple of that in the options markets and there would be commensurate increases in reporting, recordkeeping and other costs. In addition, as noted below, if the “NBBO” is to be quoted in sub-pennies, that will further degrade the information value of the best bid and best offer, which today convey much less information about liquidity for a given security than they did when the minimum trading increment was a sixteenth or an eighth of a dollar.

Market Data

As the Commission knows, market data has been called the “oxygen of the markets”. Particularly as the decimalization of the markets has reduced the amount of trading interest displayed at the best bid or best offer, depth-of-market data have become increasingly important. That will be all the more so if the Commission heeds the request of exchanges to trade in increments finer than a penny.\(^2\) We have argued, and continue to believe, that the trading interest displayed in the consolidated tape should be expanded in order to compensate for some of the transparency lost to decimalization — not potentially further diminished by the prospect of sub-penny trading. At the moment, unique and valuable market data is held by each market center that has any significant market share in any sizable number of securities in which there is significant trading interest. As a monopolist, each market center that has such data has broad discretion at the moment in setting prices, which are not constrained by significant competitive forces. Greater transparency in fee setting would create an environment in which basic market data would be more readily available.

Scope of “Dark Pool” Regulation

We strongly support greater transparency in the market. We are concerned, however, about what appears to be deliberate vagueness in terms of defining what constitutes an “order” for purposes of the Commission’s regulation of electronic display functions. While we understand the motivation not to create an incentive to evade regulation, we suggest the Commission nevertheless needs to draw bright lines in this area to provide appropriate guidance to us and to other designers of display mechanisms who are trying to comply with the Commission’s rules. In the context of antifraud regulation, the Commission has always chosen wisely not to draw a “blueprint for fraud” by defining fraud to too much precision. Regulatory requirements are quite another arena, however. We respectfully suggest that, to deliberately create ambiguity as to when an indication of interest will be deemed to constitute an order, as Regulation ATS and its adopting release do\(^3\) is not appropriate because market participants need to know where the lines are. We recognize that terminology alone should not be determinative. We suggest instead that the Commission should specify that an indication of interest will be treated as an order only where, by the rules governing participants in an electronic system the parties are contractually bound to treat the indications as binding or where there is automatic execution of “indications” — where the party that submits what it calls an “indication” will automatically execute an order s receives in response.


\(^3\) See SEC Release No. 34-40760 (December 8, 1998) in text accompanying nn. 44-49.
We also believe it would be beneficial for the Commission to evaluate closely the incentives order-entry firms have to prefer one execution venue over another in placing customer orders. As the Commission knows, Rule 606(a)(1)(iii) of Exchange Act Regulation NMS requires order-entry firms to disclose payment-for-order-flow and profit-sharing arrangements with the top 10 venues to which they direct order flow. We suggest the Commission may wish to direct order-entry firms to demonstrate through transaction-cost analytics whether situations in which the order-entry brokers have payment-for-order-flow or profit-sharing arrangements are giving their customers a best-execution benefit or are instead simply taking a benefit for themselves.

We also suggest the Commission may wish to study the economic benefits to investors arising from brokers’ internalization of orders in dark pools. Given the absence of transparency attending dark pools, it may be that the price improvement opportunities are small, even de minimis, and in some cases are outweighed by the opportunity costs incurred by not directing the order flow to an ATS that matches orders at the mid-market price. We suggest this may well be a fruitful area for the Commission to explore.

Regulation of Alternative Trading Systems

The Commission asked in the Concept Release whether, in the interests of fairness, alternative trading systems should be regulated more extensively than they are today under Commission’s Regulation ATS.\(^4\) It is worth recollecting how ATSs came into existence and some of the significant differences between ATSs and exchanges. Regulation ATS came into existence after a joint U.S. Department of Justice and SEC investigation chronicled extensive price fixing in the Nasdaq market.\(^5\) The combined impact of the Order Handling Rules\(^6\) and Regulation ATS resulted in a quantum leap forward in transparency. That has combated price-fixing and served investors well. One answer to this proposition is that there is today a measure of unfairness in that the exchanges but not alternative trading systems share in market data fees from the consolidated tape.

There should be a strong showing that the public interest is served by reducing the capacity of ATSs to thrive. There has been no such showing. Indeed, we have heard exchanges argue it would be in the interest of the exchanges to regulate ATSs more aggressively. We have not seen evidence why that which is in the exchanges’ interest is necessarily in the public

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\(^4\) *Id.* in text accompanying nn. 88-90.

\(^5\) *See* SEC Release Nos. 34-51163 (February 9, 2005) (report of Section 21(a) Investigation re Nasdaq) and 34-40760 (December 8, 1998) (adoption of Regulation ATS).

\(^6\) *See* SEC Release No. 34-37619A (September 6, 1996).
interest. The Commission’s regulation has been premised in most cases on a desire to serve the public interest and the protection of investors and to be based on sound analysis rather than political expediency.\(^7\) We respectfully suggest that the Commission should not be swayed by the entreaties of the exchanges to regulate the alternative trading systems more extensively, but should instead look to the investors’ needs, which we do not think justify increasing the regulatory burdens on alternative trading systems.

As exchanges complain about regulation, they do not dwell on the rather substantial advantages that accrue from being an exchange, as opposed to being an alternative trading system. To take one example, let us look at consolidated tape revenue that accrues to exchanges, but not to alternative trading systems. As reported by the Commission, these data fees in 2008 were about 97.1% profit and 2.9% expense in the case of Network A ($209,218,000 in revenues as against $6,078,000 in expenses), 97.4% profit and 2.6% expense in the case of Network B ($119,876,000 in revenues as against $3,066,000 in expenses) and 96.8% profit and 3.2% expense in the case of Network C ($465,955,000 in revenues as against $14,873,000 in expenses).\(^8\)

This illustrates a broader point. Alternative trading systems such as DirectEdge, BATS, Island, Arca and of course Nasdaq registered as exchanges as soon as their market shares became large enough to permit it. If the burdens of being an exchange places these entities at a severe disadvantage vis-à-vis ATSs, why did these ATSs become exchanges as soon as they could? We would suggest this inexorable movement of large liquidity centers in the equity markets seeking to become exchanges is compelling evidence that the economic advantages of being a registered exchange are substantial. The Commission should greet with some skepticism suggestions from exchanges to increase the level of regulation of competitors in the interest of “fairness”.

**Access to Alternative Trading Systems**

The Commission seeks comment in the Concept Release on whether trading systems offering undisplayed liquidity are subject to appropriate regulatory requirements.\(^9\) Previously,

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\(^7\) *But see* e.g., Nina Mehta, “SEC Let Politics Spur Short-Sale Decision, Sirri Says,” Bloomberg, March 30, 2010, available on the Bloomberg Professional service at NI SEC <GO>.

\(^8\) Concept Release in text following n.43. *Contrast* these precise cost data in the case of the consolidated tape with Nasdaq’s representations to the public that there is no way to come up with any accurate cost data for depth-of-book data. SEC Release No. 59039 (December 2, 2008) at n. 167, quoting Statement of Janusz Ordover and Gustavo Bamberger, dated August 1, 2008, “It is widely accepted that there is no meaningful way to allocate ‘common costs’ across different joint products. For this reason, ‘cost-based’ regulation of the price of market data would require inherently arbitrary cost allocations.”

\(^9\) *Id.* in text following n. 88.
the SEC proposed reducing the fair access threshold from 5% of the average daily trading volume in a security to 0.25%.\textsuperscript{10} As we commented in response, we endorse that proposal and believe the Commission should go further:

The Proposed Amendments leave unchanged the five percent average daily volume threshold that triggers the fair access obligations in Regulation ATS. Under these provisions, an ATS that has five percent or more of the average daily volume with respect to an NMS stock must establish written standards for granting access to trading on its system and may not unreasonably prohibit or limit any person in respect to access to services offered by such ATS by applying such written standards in an unfair or discriminatory manner. While increased integration of best-priced orders into the national market system is an important goal, its effects may be muted if an ATS is not required to provide corresponding access to trading on its systems for such securities that would qualify under the reduced volume threshold. We suggest, therefore, that the Commission include in the Proposed Amendments similar amendments that would lower the average daily volume threshold set forth in Rule 301(b)(5)(1)(A) from five percent to 0.25 percent as well and, if the Commission reduces the display threshold further, that it extend an equal reduction to access.\textsuperscript{11}

**Monopoly Rents for “Core” Market Data**

A related issue is why the exchanges have been allowed to extract such extravagant monopoly rents through the consolidated tape. The Commission is required to determine whether data fee charges are “fair” and “reasonable”. How that can be squared with monopoly fee revenues that generate over 90% profit deserves close scrutiny. As the Commission knows, the Congress in enacting the 1975 Amendments to the Exchange Act was doubtful that a monopoly securities information processor was even necessary and it warned against unregulated monopolies:

\textit{[I]n situations in which natural competitive forces cannot, for whatever reason, be relied upon, the SEC must assume a special oversight and regulatory role. An exclusive processor for a national market system would create such a situation and so would self-regulatory projects which are not economically self-sufficient, which enjoy an effective monopoly, or which are merchandised to members on a basis other than cost and quality of services. The bill would give the SEC broad authority over and significant responsibility for the development and operation of}

\textsuperscript{10} SEC Release No. 34-60997 (November 13, 2009).

\textsuperscript{11} Letter from Kim Bang to SEC (Feb. 22, 2010) [footnotes omitted].
such facilities, subject of course to any ultimate judicial reconciliation of the policies of the Exchange Act with those of the antitrust laws.\textsuperscript{12}

We respectfully suggest that the Commission, in its examination of basic issues of equity market structure, should revisit whether the exchanges should continue to receive these extravagant, monopolistic subsidies, which after all are paid for by investors who transact in the markets and buy necessary market data. The hundreds of millions of dollars of annual profit charged to the public for market data bear no reasonable relation to the cost of collecting and distributing the market data and is an unjustifiable and, we suggest, illegal subsidy for the exchanges.\textsuperscript{13} Particularly since the exchanges’ responsibilities for examining member firms have now been assigned to the Financial Industry Regulatory Authority, it is not clear why exchanges should enjoy these monopoly rents.

**Direct “Naked” Market Access**

We believe the Commission is correct in focusing on whether those who avail themselves of direct access to the markets via electronic access devices provided to them by broker-dealers are subject to appropriate controls to minimize the risk of systemic problems. We applaud the Commission’s focus on this issue in the Concept Release and in the Commission’s release on risk management controls for brokers or dealers with market access, SEC Release No. 34-61379 (January 19, 2010) (the “Market Access Release”). We note, however, that the exchanges have had rules and policies governing direct market access for a number of years, as the Commission notes and summarizes in the Market Access Release. As the Commission knows, exchange members have offered direct market access to their institutional clients via the New York Stock Exchange’s Direct Order Turnaround (“DOT”) system for well over 15 years and similar access has been provided by other exchanges. We are not aware of any significantly greater incidence arising from non-members’ direct market access than exchange members themselves have caused in their own order transmissions.

Nevertheless, we think the approach the Commission favors is the right one, requiring brokers that offer direct market access to institute pre-trade verification procedures to ensure compliance with law, pre-existing credit and concentration limits and the like. Our support is based on our prediction that these standards can be implemented with minimal increases in latency. If that is not the case — and presumably other commenters will address that issue — we

\textsuperscript{12} Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S.249, S. Rep. No. 94-75, 94\textsuperscript{th} Cong., 1\textsuperscript{st} Sess. 12 (1975).

\textsuperscript{13} See, e.g., Rule 603(a) of Regulation NMS, 17 CFR § 242.603(a), adopted under Section 11A(c)(1) of the Exchange Act, 15 U.S.C. § 78k-1(c)(1), which requires an exclusive processor that distributes information with respect to quotations for or transactions in an NMS stock to do so on terms that are fair and reasonable and that are not unreasonably discriminatory.
would recommend the Commission pare down the requirements to the extent necessary to avoid undue increases in latency. We believe, also, that the Commission should not treat broker-to-broker access in the same way as customer access since the Commission’s concerns can be accommodated by requiring one or the other brokers, but not both, to impose the requisite verification procedures on the customer for which the trades are being submitted.

### Directional Trading

The Commission expresses concern about trading practices as “order anticipation” and “momentum ignition” strategies. In the case of order anticipation, unless the use of that strategy takes improper advantage of client trading interest or actual orders — as in the case of front-running — the Commission should not be concerned about it. It is inevitable that professional investors will develop computer-driven modeling that will try to predict how other market participants are likely to behave and will try to get out in front of them, or piggyback on them, for commercial advantage. We think those strategies and devices should not be the sort of regulatory concern unless a duty of some sort is being violated — such as a fiduciary duty to customers — and there is no general duty to the market at large other than a duty to refrain from fraud and manipulation. On the other hand, the Commission’s description of momentum ignition — involving the spreading of false rumors and the rapid submission and cancellation of many orders to “spoofer” algorithmic traders — in fact would appear to be fraudulent and manipulative and, if that is the case, should be prosecuted as such. We recognize that proving such cases is often difficult and enforcement lawyers therefore prefer mechanical rules that do not turn on a person’s intent or the effect of the person’s conduct. We believe, however, that the Commission should generally refrain from imposing such rules unless the conduct being prohibited is clearly manipulative or deceptive. By their very nature, “prophylactic” rules tend to outlaw things that have not been shown and cannot be shown to be harmful and they often are overly proscriptive.

We point out, moreover, that some trading that could be described as directional is in fact a helpful way for investors to specify their investment choices in terms of future market movement. For example, “paired orders” involve a type of equity hedge that is of significant value to many investors: an investor specifies, say, that if IBM hits $X, an order should be generated to buy X shares of IBM and to sell Z shares of Microsoft. Alternatively, an investor might enter a “contingent order,” specifying that, say, if the DJIA hits 12,000, orders for five pre-selected trades should be entered or, if the new employment data hits a given benchmark, some specified group of other orders should be entered. Through sophisticated order types such as these, investors can implement economic strategies that in a given instance may (or may not) result in positive returns but are in any event a helpful part of the toolkit available to the professional investor and should not be viewed with suspicion.

### Long-Term vs. Short-Term Investors

One salient feature of the Concept Release is the suggested disparity of treatment between long- and short-term trading strategies. The Commission sets forth in the Concept Release an interpretation of its duties under the Exchange Act to the effect that it should favor
the interests of long-term investors over those of short-term investors, apparently on the basis of its statutory mandate in Exchange Act Section 3(f) to promote capital formation:

Prior to discussing these particular areas of concern in this release, the Commission believes it is important to assess more broadly the performance of the market structure, particularly for long-term investors and for businesses seeking to raise capital. Assessing overall market structure performance should help provide context for particular concerns, as well as the nature of any regulatory response that may be appropriate to address concerns. . . . In assessing the performance of the current equity market structure and whether it is meeting the relevant Exchange Act objectives, the Commission is particularly focused on the interests of long-term investors. These are the market participants who provide capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time. . . . Where the interests of long-term investors and short-term professional traders diverge, the Commission repeatedly has emphasized that its duty is to uphold the interests of long-term investors.

Concept Release in text at n. 51-53.

We question, however, whether the Commission’s approach is sound as a factual matter, or authorized as a legal matter. The data the Commission published in the Concept Release show that a large portion of transactions on exchanges — possibly over 60% by volume — is effected algorithmically, at high speed, by programmed trading systems. Algorithmic trading is by nature short term and is not confined to a small, exclusive set of wealthy individuals and hedge funds eager to exploit short-term advantages to the detriment of “real” investors. In fact, as the Commission knows, many institutional investors, including pension funds, endowments and others that represent the interests of many thousands of “small” investors, invest in hedge funds and other investment vehicles that engage in short-term trading as well as longer term trading. It is naturally the case that professional investors will have greater scale economies than are available to the individual investor and will make substantially greater investments in the latest technology to obtain superior and more rapid access to the markets than an individual investor trading directly could ever achieve. Particularly since institutional investors are investing on behalf of their many thousands of individual owners, we think the issue of “fairness” is not a useful inquiry.

As a legal matter, the Exchange Act does not authorize the Commission’s view that its duty is to “uphold the interest of long-term investors” over those of short-term ones. This approach misconstrues and misapplies the Commission’s statutory mandate, including the Exchange Act Section 3(f) mandate to “consider whether [rulemaking] action will promote . . .

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14 Concept Release at n. 67.
capital formation." The Congress’s frequent use of the term “investors” in the Exchange Act does not suggest any such discrimination on the basis of holding period is contemplated or even authorized. The Congress directed the Commission to protect investors generally — as opposed, presumably, to service providers such as brokers, dealers and the exchanges themselves — but did not distinguish, or authorize the Commission to distinguish among investors on any basis or to discriminate against any class of investor.

An appeal to long-term investors as promoting capital formation is unavailing. As the Commission knows, capital formation does not generally occur in the secondary markets. It occurs through issuers’ private placements with “angel” investors, venture capital funds and others as well as through public securities underwritings, including dividend reinvestment plans and other direct public placements by issuers. On the other hand, of course, the shares trading in the secondary markets have already been sold to the public by their issuers, in many cases years ago, and the issuers get no new remuneration from resale of those shares; the shares are no more involved in current capital formation than a gold ingot.

To be sure, the secondary markets provide liquidity for securities that have already been issued, but that benefit does not inure directly to companies seeking to raise capital. Secondary market liquidity makes investment in follow-on offerings more attractive that it would be if there were less liquidity or no liquidity, but that liquidity is increasingly provided by short-term traders, as noted above. There is no valid basis, therefore, for believing that a bias in favor of long-term investors promotes capital formation or is authorized in the Exchange Act.

This is not to say, however, that ultra-high-speed trading and other algorithmic trading do not bear watching. Market disruptions such as occurred on May 6, 2010 are widely reported to have resulted, or been exacerbated, by program trading15 and the Commission should closely examine what happened, whether any wrongdoing was involved and whether additional “fail-safe” controls should be implemented by the exchanges, by member firms or by others to guard against future incidents of market turmoil.

Flash Orders

The Commission’s decision to ban “flash orders”16 was nevertheless correct. Unlike its policy on short-term versus long-term investment, the flash order is an abuse since it involves giving a special and undeserved benefit to one group of traders that allows them advance


16 SEC Release No. 34-60684 (September 18, 2009), discussed in the Concept Release in text accompanying nn. 13 & 53.
knowledge and an opportunity to jump ahead of others’ orders. We respectfully suggest, moreover, that the Commission should take the same position with respect to flash orders on the options exchanges.

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We would be pleased to discuss these matters further with the Commissioners or the Staff, respond to any questions that you may have, or provide any additional comments or information that you may request.

Respectfully submitted,

Raymond M. Tierney III by R..D.B.

cc: The Hon. Mary L. Schapiro, Chairman
The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
Mr. Robert W. Cook, Director, Division of Trading and Markets
Mr. James A. Brigagliano, Deputy Director, Division of Trading and Markets
Mr. David S. Shillman, Associate Director, Division of Trading and Markets
Mr. Henry T.C. Hu, Director, Division of Risk, Strategy, and Financial Innovation
Mr. David M. Becker, General Counsel and Senior Policy Director