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December 21, 2009

By e-mail

Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: File Number S7-27-09
Regulation of Non-Public Trading Interest
Release No. 34-60997

Ladies and Gentlemen,

Liquidnet, Inc. appreciates the opportunity to comment on the Securities and Exchange Commission's rule proposal on the Regulation of Non-Public Trading Interest.[1]

We divide the Commission's proposals into two parts:

- The proposals to reduce the Regulation ATS order display threshold from 5% to .25% and to treat "actionable IOIs" as quotes. We refer to these as the "pre-trade proposals".

- The proposal to require that post-trade reports identify the ATS where a trade is executed. We refer to this as the "ATS identification requirement" or the "post-trade proposal".

We appreciate the Commission's proposed block exemptions from the pre-trade and post-trade proposals. Our concern is that these exemptions are too narrowly drafted. As presently drafted, the rule proposal will result in higher trading costs for the 42 million American households that invest in equity mutual funds[2] - and millions of other households that are pension fund beneficiaries – without any countervailing benefit. We believe the adverse effects on individual investors could be minimized with appropriate modifications to the proposed block exemptions, as discussed below.

[1]Securities and Exchange Commission, Release No. 34-60997, "Regulation of Non-Public Trading Interest", File No. S7-27-09, November 13, 2009. ("Proposing Release")
[2]Investment Company Institute, *2009 Investment Company Fact Book*, 49th Edition, Section 6, www.icifactbook.org (accessed December 18, 2009).

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Our comment letter is broken out into seven Annexes.

Annex A – Origin and benefits of block order pools in reducing trading costs

In Annex A, we discuss the origin and benefits of block order pools in reducing trading costs for the execution of institutional block orders. Liquidnet and other systems that focus on execution of institutional block orders (we refer to them as "block order pools" or "block order systems") reduce trading costs for mutual funds and other institutional investors. These cost savings are passed on to the 42 million households in the US that invest in mutual funds. This represents cost savings for an estimated 100 million individual Americans.[3] In Annex A of our comment letter we discuss the historical development of block order systems and the role that these systems play in reducing trading costs for institutional investors.

Annex B – The pre-trade rule proposal, as currently proposed, will raise trading costs for individual investors without any countervailing benefit

In Annex B of our comment letter we discuss our general concern that the proposals in the release will raise trading costs for individual investors without any countervailing benefit.

We firmly believe that the institutional trader is the person best qualified to decide how to execute block orders for his or her customers in the most efficient manner. Institutional traders are constantly faced with the challenge to reduce trading costs for block orders. To the extent that we take away choices from the institutional trader in how to most efficiently execute a block order, we will increase trading costs for the 42 million American households that invest in equity mutual funds and millions of other households that are pension fund beneficiaries. With the increasing sophistication of short-term traders in detecting and profiting from the block order flow of long-term investors, it is important to preserve the institutional trader's ability to manage trading costs for block orders. This includes the ability for the institutional trader to control how information about the institution's block order is disclosed to other market participants.

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In Annex B we address a number of the issues raised by the Commission in the proposing release. We do not believe that the Commission has presented sufficient evidence to justify the rule proposal. According to NYSE Euronext, "... there have been many improvements to the

[3] For 2005 to 2007, the US Census Bureau estimated that the average US household size was 2.6. The last census taken in 2000 reported that the average household size was 2.59. www.factfinder.census.gov (accessed December 18, 2009). This would represent approximately 109 million Americans. We note that this is an approximation because we do not know whether the average household size for households that own mutual funds is larger or smaller than the average household size for households that do not own mutual funds. We have no reason to believe that this statistic would be disproportionately larger or smaller, so we believe 100 million individuals is a reasonable approximation.

overall market quality in NYSE-listed securities." NYSE Euronext notes that "these improvements include lower price volatility, tighter spreads ... and overall greater depth of liquidity."[4] According to a report by the Department of Justice, "there is significant competition among multiple equity trading venues, with low execution fees, narrow spreads, and widespread system innovation – all to the benefit of consumers."[5] Robert Colby, former Acting Director, Deputy Director and Chief Counsel of the Commission's Division of Trading and Markets, recently noted at a webinar sponsored by the Investment Company Institute that "the retail investor has never had better trading conditions than it has today." [6] He noted specifically that there are "brokers that are willing to trade at very low commission rates and you can get both a narrow spread and a low commission rate."[7] The Commission has noted the "very substantial availability of undisplayed liquidity for executing retail orders at non-exchange venues, particularly OTC market makers and liquidity pools sponsored by broker-dealers." [8] The Commission further notes that "this undisplayed liquidity enables retail investors to receive executions for most of their orders at prices equal to or better than the NBBO, regardless of the displayed size at the NBBO."[9] Based on these statements, we are unclear as to what data the Commission is relying upon to support the proposed pre-trade rule changes, particularly where these changes (absent appropriate flexibility for execution of block orders) will result in higher trading costs for the tens of millions of American households that invest in mutual funds.

* * * * *

We identify in detail in Annex B the inconsistent aspects of the rule proposal in that equivalent activities are subject to different regulatory treatment. What the Commission refers to as "actionable IOIs" are nothing new. So-called "actionable IOIs" are simply order notifications – i.e., letting someone know you have an order. Order notifications have been around since the dawn of trading and are still prevalent in many forms today, including on principal and agency trading desks and the NYSE floor. In fact, they are a fundamental element of how the equity markets have always operated and continue to operate today.

The Commission's proposal would apply restrictions on ATSs that have never been applied to other market participants performing the equivalent function, including agency trading desks, firms that execute as principal, firms that cross customer orders as agent, firms that internalize customer orders and floor brokers. Because of the disparity in application of the display

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[4] NYSE Euronext, *U.S. Equities News*, April 2009.

[5] United States Department of Justice, "Comments of the United States Department of Justice, Review of the Regulatory Structure Associated with Financial Institutions", January 31, 2008, p. 20.

[6] "Trading 101: Webinar on the Basic Elements of Securities Trading and Market Structure for Funds", sponsored by the Investment Company Institute, November 16, 2009. ("ICI Webinar")

[7] ICI Webinar.

[8] Securities and Exchange Commission, Release No. 34-59039, "Self-Regulatory Organizations; NYSE Arca, Inc.; Order Setting Aside Action by Delegated Authority and Approving Proposed Rule Change Relating to NYSE Arca Data", File No. SR-NYSEArca-2006-21, December 2, 2008, p. 96. ("NYSE Arca Order")

[9] NYSE Arca Order, p. 96.

requirement across different categories of market participants performing the same function, we expect market participants will structure around the rule restrictions to achieve the same result, but in a less efficient manner. We discuss this in detail in Annex B, including specific examples of how market participants could structure around the new rule restrictions and how attempting to address these alternative structures would mean the end of principal trading desks, agency trading desks and floor brokers, which would be a bad result for investors.

* * * * *

We also disagree with the assertion that dark pools have created a "two-tier market". Our H2O system, for example, welcomes institutional and retail order flow. Liquidnet is not unique in actively seeking to attract institutional and retail order flow. It is a general principal of trading systems that they seek to attract order flow, so we are not clear why trading systems would seek to limit access to order flow representing long-term institutional or retail investors, nor is there any evidence for this in the release. In fact, the Commission has specifically noted the

> "... very substantial availability of undisplayed liquidity for executing retail orders at non-exchange venues, particularly OTC market makers and liquidity pools sponsored by broker-dealers." [10]

Since institutional and retail brokers representing long-term investors can participate in dark pools, dark pools do not create a two-tiered market. If the Commission has evidence to support the assertion that retail brokers are excluded from alternative trading venues, we think it should be presented and discussed.

Contrary to the Commission's intended result, the rule proposal will reduce the opportunity for order flow from retail brokerage customers to interact with Liquidnet H2O and other alternative trading venues that provide price improvement. The result will be less interaction of order flow, fewer opportunities for price improvement and higher trading costs for retail brokerage customers.

* * * * *

We discuss each of these points, and other important points, in detail in Annex B.

[10] NYSE Arca Order, p. 96. Curiously, when the Commission wants to speak favorably about so-called "dark pools", it refers to them as "liquidity pools". We have to wonder whether there would have been a need to issue this rule proposal had dark pools been tagged with a more neutral label like "liquidity pools".

Annex C – The Commission can minimize the adverse impact of the pre-trade proposal on individual investors with appropriate modifications to the proposed block order exemption

In Annex C we discuss the Commission's proposed block order exemption from the pre-trade proposal. We appreciate the Commission's recognition of the role of block order pools in reducing institutional trading costs.[11] We also appreciate, and agree with, the Commission's proposal for a block order exemption from the pre-trade proposal.

We believe that the proposed block order exemption is a good starting point. Our concern with the proposed block order exemption is that it is too narrowly drafted and takes away flexibility from the institutional trader to most efficiently execute block orders. If the rule proposal were adopted as proposed, institutional traders would be restricted from using various systems and products that they use today for executing block orders. Institutional traders use these systems and products to reduce their trading costs for executing block orders. This means that if we restrict use of those systems and products, we will increase trading costs for institutions seeking to execute block orders. This ultimately means higher trading costs, and lower investment returns, for the tens of millions of households that invest in mutual funds.

* * * * *

In Annex C of our comment letter we recommend three narrowly-tailored modifications to the proposed block order exemption to ensure that institutions maintain flexibility in their use of systems and products for executing block orders.[12]

- ***Definition of a block.*** We propose that the definition of block order be expanded to facilitate efficient execution of block orders for mid, small and micro-cap stocks. We propose that a block order be defined as an order with a principal value of $200,000, an order for 10,000 shares or more, or an order that represents 1% or more of a stock's average daily trading volume (ADV).[13] We also would propose providing flexibility to the Commission at any time to set the block threshold at $200,000 for any or all of the 50-most actively traded stocks in the market.

- ***Flexibility for execution of a block order.*** In proposing the block exemption, the Commission recognizes the institution's legitimate interest in protecting its customers' block order information. This interest should apply regardless of whether the institution's block order is executed in one large execution or in multiple smaller

[11] Proposing Release, pp. 4-5.

[12] As noted above, we recommend that the Commission not proceed with the pre-trade rule proposal (specifically, we are concerned with the proposal to reduce the ATS order display threshold). However, if the Commission decides to proceed with the pre-trade rule proposal, it is important that the Commission provide appropriate flexibility to ensure that the adverse effects on long-term investors are minimized.

[13] We would propose to measure ADV based on a 10-day trailing average (see Annex C for more detail).

executions. We propose that the block exception should apply as long as the order notification sent by the broker or ATS is of block size. We also would propose an additional condition (sometimes described as a "trade-at" requirement) where the execution must provide meaningful price improvement to both sides to the trade, defined as either a mid-point execution or a minimum of one-cent price improvement.

- ***Program trades.*** We recommend that the Commission provide an exemption for program trades where the principal amount of the program is $3,000,000 or higher.[14]

* * * * *

In considering the issue of choice and flexibility, we need to consider not only systems and products that exist today, but also systems and products that will be created in the future to reduce trading costs for long-term investors. In a rapidly changing market, where short-term traders (sometimes referred to as "high-frequency traders") are developing increasingly sophisticated tools to profit from the order flow of long-term investors, we must be careful not to impose restrictions on long-term institutional investors that will restrict their options for efficiently executing block orders and hinder their ability to adapt to future market developments.

Annex D – Alternate proposals to address the challenges faced by individual investors that do not restrict competition or raise trading costs for tens of millions of investors

In Annex D we discuss what industry experts have identified as the current challenges faced by individual investors in the current market environment, and we put forth for consideration five sets of proposals for regulatory change that seek to address these challenges. We hope that the Commission would respectfully consider these proposals as an alternative to the proposals put forth by the Commission. All of our proposals are aimed at improving the market for individual investors, whether they invest through mutual funds or retail brokers accounts.

We have been careful in our proposals to avoid recommendations that seek to restrict the business of our competitors, as we believe these types of proposals, generally proposed by Wall Street competitors to advance their own self-serving competitive interests, invariably end up hurting individual investors. We hope that the Commission is mindful of this issue when reviewing comments on the rule proposal from various market participants.

[14]Our first preference is that the Commission not proceed with the pre-trade rule proposal. Our second preference is that the Commission adopt the pre-trade proposal with the fewest conditions and the greatest level of flexibility for investors. Our third preference is that the Commission adopt the pre-trade proposal with our three proposed modifications.

Annex E – The post-trade proposal

With regard to post-trade transparency, we support real-time identification to the Commission and FINRA of the ATS, dealer or crossing broker that executes every trade. We also support public identification of the venue where trades are executed. Our concern relates to the timing of this disclosure, as this disclosure could provide information to short-term traders seeking to take advantage of block order information of long-term institutional investors. Some of our institutional customers would not object to end-of-day public identification of this information. Other institutional customers that we have spoken with are concerned that even end-of-day reporting could be problematic for block orders that are executed over multiple days. We think it is important for the Commission to have a dialogue with institutional traders about this issue to help determine the appropriate solution.

We also believe that any post-trade identification requirement should apply equally to ATSs, dealers and crossing brokers. We discuss our views on the post-trade transparency proposal in more detail in Annex E.

Annex F – Legislative history

In Annex F we review the legislative history of the Securities Acts Amendments of 1975, which had the primary objective of creating the national market system.[15] The Securities Acts Amendments placed the primary focus on competition in achieving this objective.[16]

The legislative history makes clear that Congress did not contemplate imposing order display obligations on customers (i.e., institutional and retail investors).[17] The limit order display rule, adopted by the Commission in 1996, also did not impose a display obligation on customers; to the contrary, it was carefully drafted to ensure that the customer had complete discretion with respect to order display.[18]

As far as we are aware, Regulation ATS was the first rule to impose a display obligation on customer orders,[19] but this has not been a concern because the order display threshold was set at 5%.[20] With the proposed lowering of the ATS order display threshold to what is essentially a 0% threshold, the Commission is for the first time proposing a significant restriction on how

[15] Securities Acts Amendments of 1975, P.L. 94-29.
[16] Senate Report (Banking, Housing and Urban Affairs Committee) No. 94-75, April 14, 1975 (To accompany S.249), p. 8. ("Senate Report")
[17] Senate Report, p. 18. See Annex F for more detail.
[18] Securities and Exchange Commission, Release No. 34-376619A, "Order Execution Obligations", File No. S7-30-95, September 6, 1996. ("Order Execution Adopting Release")
[19] Technically, the display obligation falls on the ATS, but since ATS's trade as agent, in reality the display obligation falls on the institution using the ATS. Also, Regulation ATS imposes a display obligation, but not in all circumstances; Regulation ATS imposes a display obligation when an institution wants to disseminate its order information to two or more market participants.
[20] Securities and Exchange Commission, Release No. 34-40760, "Regulation of Exchanges and Alternative Trading Systems", File No. S7-12-98, December 8, 1998. ("ATS Adopting Release")

customers can communicate their orders. This restriction will mean increased trading costs for individual investors.

These issues are discussed in detail in Annex F.

Annex G – Some final thoughts on the pre-trade proposal

In Annex G we provide some final thoughts on the pre-trade proposal, including the need to take into account the best execution benefits that mid-peg executions[21] provide to individual investors through reduced market impact and price improvement. We also discuss the importance of the Commission acting in a prudent and thoughtful manner when considering significant market structure changes, as it has done in the past.

We also consider the future. While no one can predict the future, it seems clear to us that the ability of short-term traders to detect and profit from institutional order flow will continue to increase in sophistication. The last thing we should be doing at this time is adopting rules that leave institutions with fewer choices for protecting the block order information of their customers.

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Before proceeding to our detailed discussion of these issues, we would like to thank the Commission for putting forth these issues for discussion and for providing a 90-day comment period. The current market structure is very complex, and public discussion of these issues will yield greater public understanding of the issues and hopefully lead us to solutions that benefit individual investors. Because of the complexity of these issues, we hope that the Commission considers these proposals very carefully to ensure that there is sufficient data to support the adoption of any specific proposals.

You will note that this letter is fairly lengthy. This reflects the complexity of the issues and our view that we need a reasoned and thoughtful discussion of these issues, as opposed to an exchange of hyperbole and talking points by Wall Street competitors. Throughout this letter we quote extensively from industry researchers who have studied the equity trading markets for many years, and we hope that the views of these experts, along with the views of the mutual funds and other institutional investors who trade on behalf of 42 million American households, will be given serious consideration as part of the rulemaking process.

We would like to thank the Commission for the opportunity to comment on this proposal, and we look forward to participating in what we anticipate will be a thoughtful and reasoned analysis of the current market structure issues. This process has been extremely beneficial so far

[21] "Mid-peg executions" are trades executed at the mid-point between the highest displayed bid and lowest dispayed offer in the market at the time of execution.

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in creating greater awareness of how the equity markets operate, and we look forward to the ongoing discussion of market structure issues.

Very truly yours,

Seth Merrin, Chief Executive Officer

Anthony Barchetto, Head of Trading Strategy

Jay Biancamano, Global Head of Marketplace

Vlad Khandros, Market Structure Analyst

Howard Meyerson, General Counsel

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Annex A

Origin and benefits of block order pools in reducing trading costs

This Annex describes how block order pools reduce trading costs for institutional investors and the 42 million American households for whom they trade. We start with a brief background on Liquidnet's block order pools because we will be referring to Liquidnet's systems at various points in this letter. It is important to understand that the discussion in this Annex is not about Liquidnet specifically but is about the general role played by block order pools in reducing trading costs.

Background on Liquidnet's block order pools

We launched our negotiation system in 2001. Our negotiation system facilitates direct one-to-one negotiation of block trades between institutions. The average size of trades manually negotiated in our negotiation system is 50,229.[22] This is 187 times larger than the average execution size on the New York Stock Exchange, which is 269 shares,[23] and 185 times larger than the average execution size on NASDAQ, which is 272 shares.[24]

We launched our H2O system in 2005. Our H2O system allows institutional block liquidity to interact with broker, ECN and exchange liquidity in a manner that protects the confidentiality of the institution's block order information. The average size of institutional customer orders accessing our H2O system is 46,875 shares, and the average size of the underlying order in the institution's order management system for these orders is 251,279 shares.[25]

For calendar year 2008, BrokerEdge™ (the successor to Plexus Group, a research firm that has studied trading costs for many years) ranked Liquidnet as the #1 broker overall for equity trade cost performance across global trading firms. In this survey, Liquidnet also ranked #1 in 23 of 37 execution performance categories.[26]

We refer to our negotiation and H2O systems as "block order pools" or "block order systems" because they facilitate execution of institutional block orders. When an order for 50,000 shares is introduced into a market designed to handle 200 or 300 share orders, there invariably will be

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[22] Liquidnet trading statistics: 2009 (January 1 to October 31).

[23] http://www.nyxdata.com/nysedata/default.aspx?tabid=115 (January 1 to October 31) (accessed December 18, 2009).

[24] http://www.nasdaqtrader.com/Trader.aspx?id=DailyMarketFiles (January 1 to October 31) (accessed December 18, 2009).

[25] Liquidnet trading statistics: 2009 (January 1 to October 31).

[26] Investment Technology Group "ITG Broker Edge™ Core Broker Report" for U.S. trades for the four quarters ended December 31, 2008, cited in April 30, 2009 press release, "Liquidnet Ranked #1 in 62% of all Execution Categories According to ITG Broker Edge™ Core Broker Report".

price movement against the institution as market intermediaries seek to trade ahead of these orders. Block order pools are designed to reduce or eliminate these adverse price movements.

Origin of non-displayed liquidity

To evaluate the policy issues surrounding non-displayed liquidity, it is important to understand how and why non-displayed liquidity and block order pools arose.

According to Dr. Erik Sirri, former Director of the Commission's Division of Trading and Markets,

> "... dark pools of liquidity have been around for a long, long time. The single largest dark pool in the world for many decades could be found on the trading floor of the New York Stock Exchange. The floor traders there manually represented a pool of undisplayed liquidity that could be accessed only by sending an order to the floor to probe buying and selling interest.
>
> Dark pools are solutions to a perennial trading dilemma for anyone that needs to trade in substantial size, particularly institutional investors. They provide a mechanism for such transactions to interact without displaying the full scale of their trading interest."[27]

Non-displayed liquidity has existed since the dawn of institutional trading. Historically, an institution would parcel out a block order in pieces to a broker-dealer block trading desk. The purpose of sending the order piecemeal was to protect the institution against the market impact cost that would result from exposing the full order to the broker-dealer, who could use that information to trade against the institution.

This traditional way of doing business had certain advantages, but two major downsides:

- ***Exposure of order/market impact.*** The broker-dealer could detect that the institution had a large block to trade and use that information to trade against the institution, resulting in a worse execution price for the institution (often referred to as "market impact cost").

- ***Fragmentation.*** In many cases, because the potential market impact costs for trading a block order were so high, a significant portion of the institution's block order would remain unexecuted on the institution's desk, unable to interact with other liquidity in the market.

[27] Erik Sirri, Director, Division of Trading and Markets, Securities and Exchange Commission, "Keynote Speech at the SIFMA 2008 Dark Pools Symposium", February 1, 2008, p. 2. ("Sirri")

Elkins McSherry is a research firm that has studied trading costs for many years. According to a report by Elkins McSherry:

> "Information leakage arises when an institutional broker proves to be less than discreet while handling an order. If word leaks that money manager XYZ is buying or selling a major position, traders can and will jump in front of that order in an effort to capture a portion of the inevitable price movement, adversely affecting the overall market impact for manager XYZ and ultimately reducing the overall performance of the portfolio. Often, because of the potential for information leakage, investment managers will concede a certain degree of price to preserve anonymity for their trade executions."[28]

The Commission similarly has identified the challenge traditionally faced by institutions in executing block orders:

> "... a significant implicit cost for large investors (who often represent the consolidated investments of many individuals) is the price impact that their large trades can have on the market. Indeed, disclosure of these large orders can reduce the likelihood of their being filled."[29]

Origin and benefits of block order pools

Block order pools were established to address the problem of information leakage. A block order pool protects the confidentiality of the institution's block order while enabling the institution's block order to interact with other institutional block orders and other liquidity in the market.

Analyses by industry experts between 2003 and 2005 provide informative background on the development of block order pools and their benefits for institutions and the overall market.

According to Wayne Wagner, Chairman of Plexus Group, in testimony before the United States Congress in March 2003:

> "For institutional trades to squeeze through the market, they must be ground down to a size that can be accommodated in the market. In the process, the time to complete the order necessarily lengthens.

[28] Anders Amundson, "Market impact: transaction cost analysis and the financial markets," *The Capco Institute Journal of Financial Transformation*, undated, pp. 30-31.

[29] Securities and Exchange Commission, Release No. 34-42450, "NYSE Rulemaking: Notice of Filing of Proposed Rule Change to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation", File No. SR-NYSE-99-48, February 23, 2000, p. 10. ("Rule 390 Proposal")

> This creates opportunities for market insiders and middlemen to make money through unnecessary inter-positioning and parasitical front-running. The resulting delay and impact costs reduce investment performance.
>
> The best market for small investor trades may not serve very well those same small investors who invest via mutual funds and other co-mingled investments. Facilities where large buyers can meet large sellers without leakage will benefit all investors."[30]

According to Professor Robert Schwartz, Marvin M. Speiser Professor of Finance and University Distinguished Professor at the Zicklin School of Business, Baruch College, CUNY,

> "As noted, quantity discovery is a major function of a marketplace. While a market center such as the NYSE may play the dominant role with regard to price discovery, an ATS such as Liquidnet or ITG's Posit can play a major role with regard to quantity discovery. These systems do so by enabling large buyers and sellers to meet directly.
>
> An ATS's quantity discovery role can beneficially effect price discovery for the broader marketplace. If restrictions are placed on how large buy orders can meet large sell orders away from a primary market center, price dislocations can occur. That is, elephants that are not able to trade with each other can upset the apple cart (or, some might say, the alpha cart) and cause a sharp accentuation of intra-day price volatility."[31]

According to Benn Steil, Senior Fellow in International Economics at the Council on Foreign Relations,

> "The problem is that continuous electronic auction markets, as useful as they are, have flaws that are apparent to any institutional trader. They require institutional-sized orders to be chopped up into small bits, each often as little as 1 percent of actual order size, and executed over days or weeks in order to avoid huge market impact costs. That's why in every major U.S. or European marketplace -- New York, Nasdaq, London, Frankfurt, Paris -- about 30 percent of trading volume is executed in blocks, "upstairs," away from these systems.

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[30] Wayne H. Wagner, Chairman of Plexus Group, Testimony before the Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, Washington, D.C., March 12, 2003, p. 6.

[31] *Securities Industry News*, February 14, 2005.

> More importantly, new electronic systems are expanding to make this block trading more efficient. Liquidnet is the most prominent example. By foreswearing limit-order display, or "pre-trade transparency," in favor of a structure in which potential matches are revealed only to the relevant buyer and seller, institutions are encouraged to reveal their true order size to the system."[32]

Recent commentary from market participants on the benefits of block order pools

In November 2008, the Committee of European Securities Regulators ("CESR") published a "Call for evidence on the impact of MiFID on secondary markets functioning", seeking feedback from market participants in Europe on the impact of the Markets in Financial Instruments Directive.[33] As part of this process, CESR solicited feedback from market participants on dark pools.

The significant majority of responding parties, including many buy-side market participants who invest on behalf of tens of millions of European citizens, identified the benefits of dark pools.

The European Banking Federation, whose membership includes approximately 5,000 European banks,[34] wrote:

> "Dark pools have an important role in that they allow the execution of large orders without creating a market impact. Pre-trade transparency requirements for such types of orders would otherwise lead to artificial price distortion. I.e., without the possibility of trading in dark pools the investor would be forced to execute the transaction in tranches."[35]

The Association of British Insurers wrote:

> "Our members believe there are benefits to the dark pools of liquidity, namely the reduction of market impact as CESR highlights. Portfolio managers often trade in large sizes so minimizing market impact – and thus reducing the cost of trading - is of great importance to them."[36]

The Investment Management Association, the trade body for the UK's asset management industry,[37] wrote:

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[32] *Securities Industry News,* March 28, 2005.
[33] Ref. CESR/08-872, November 3, 2008.
[34] http://www.fbe.be/Content/Default.asp (accessed December 18, 2009).
[35] "EBF Response to CESR Call for Evidence on the Impact of MiFID on Secondary Markets Functioning", January 9, 2009.
[36] "Call for evidence on the impact of MiFID on secondary market functioning - The ABI's Response to CESR 08-872", January 2009.
[37] www.investmentuk.org (accessed December 18, 2009).

> "IMA members believe that dark pools are helpful in trading large blocks of stock particularly in minimizing market impact and in achieving best execution."[38]

NYSE Euronext wrote:

> "The trend towards smaller execution sizes in central 'lit' order books boosts the demand for alternative trading models. Dark pools respond to this demand by offering the industry a place for trading large orders with minimal impact on prices and allow professional investors to search counterparty. Therefore, we strongly believe that there are benefits in offering services complementary to order books."[39]

Benefits for listed corporate issuers

Block order pools are beneficial for listed corporate issuers because they make it easier for institutions, the largest group of long-term investors, to trade large block orders. Jeffrey Morgan, CEA, President and CEO of the National Investor Relations Institute, noted in a recent article written for investor relations professionals that, "dark pools are a way to increase liquidity in your stock and for investors to trade large blocks in an economical and efficient manner."[40]

In a recent notice to investor relations personnel, Mr. Morgan wrote as follows with respect to the Commission's rule proposal on non-displayed liquidity:

> "In certain cases, pre-trade transparency is to the detriment of institutions or investors if traders front run these orders, affecting market price for the ultimate order and possibly even driving out legitimate long term investors. For this reason, the SEC has proposed an exclusion for large block trades (> $200K) to protect order anonymity. The lack of transparency limits the market impact costs associated with this block trade information leakage.
>
> Enabling institutional investors to trade a large block efficiently is important for all issuers. It's especially important for small and mid cap stocks that are typically less liquid and therefore more difficult to trade without moving the market. While this proposal appears to make sense for large block trading, the challenge for the SEC will be creating certainty

[38] "Call for Evidence on the Impact of MiFID on Secondary Market Functioning", January 8, 2009.
[39] "Comments from NYSE Euronext in Response to CESR's Call for Evidence on the Impact of MiFID on Secondary Markets Functioning (CESR/08-872)", January 2009.
[40] Jeffrey Morgan, "New Market Structure: A Primer for IROs", *IR Magazine*, November 2009.

> that long term investors are not disadvantaged by market trading and front running at any level."[41]

Greater awareness of the role of block order pools

One significant benefit of the Commission's proposal has been an enhanced recognition of market structure issues by the public and their representatives, including a greater recognition of the challenges faced by institutions in executing block orders.

In a letter to Mary Schapiro, Senator Charles Schumer wrote,

> "... I recognize the important role that certain ATSs fulfill by executing large block orders on behalf of institutional investors in a non-display environment, and I would urge the Commission to consider an exception to the one-percent threshold as may be necessary to facilitate such block execution services."[42]

Senator Jack Reed noted at a recent Senate subcommittee hearing on market structure that,

> "Dark pools and other undisplayed forms of liquidity have been considered useful to investors moving large numbers of shares since it allows them to trade large blocks of shares of stock without giving others information to buy or sell ahead of time."[43]

Senator Jim Bunning noted at the hearing the difficulty of executing blocks in the displayed markets. Senator Bunning stated at the hearing: "If I'm going ... to trade 100,000 shares of IBM ... I will not get the best price for that 100,000 shares if I'm the seller unless I break it down and do it in many, many smaller pieces."[44]

Senator Bob Corker similarly noted at the hearing:

> "... it seems to me that the dark pools are an outgrowth of electronic exchanges where people are trying to sell large blocks of shares in a way that used to be done by individuals, so if we're going to be almost all electronic exchanges ... what is another mechanism for large institutional

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[41] Jeffrey Morgan, "President's Note", *IR Weekly*, December 1, 2009, p. 2.

[42] Letter dated October 20, 2009 from Senator Charles Schumer to Chairman Mary Schapiro, p. 4. ("Schumer Letter")

[43] Transcript of the Hearing of the Securities, Insurance and Investment Subcommittee of The Senate Banking, Housing and Urban Affairs Committee on "Dark Pools, Flash Orders, High Frequency Trading and Other Market Structure Issues", October 28, 2009, pp. 1-2. ("Senate Subcommittee Hearing Transcript"). The four Senators on the subcommittee who attended the hearing were Senators Jim Bunning, Bob Corker, Jack Reed and Charles Schumer.

[44] Senate Subcommittee Hearing Transcript, p. 25.

traders with large blocks of stock? What is a fairer way for them to be able to make those types of trades without moving the market substantially and really harming the very people they're investing for? What is a better mechanism than a dark pool?"[45]

[45] Senate Subcommittee Hearing Transcript, p. 36.

Annex B

The pre-trade rule proposal, as currently proposed, will raise trading costs for individual investors without any countervailing benefit

In this section we address various issues raised in the proposing release, including transparency, spreads, access and fragmentation. We do not believe that the Commission has presented sufficient data to demonstrate either that the current market structure is harmful for individual investors or that the specific proposals proposed by the Commission will help individual investors.

This is a significant concern considering that the proposal will mean higher trading costs for the 42 million US households that invest in mutual funds and other investment vehicles. Since institutional traders access block order systems to reduce their trading costs, if we restrict their ability to use these systems, it will, by definition, mean higher trading costs.

1. Institutional trading costs

Eleven years ago the Commission issued a rule proposal on "Regulation of Exchanges and Alternative Trading Systems."[46] The rule proposal was ultimately adopted as the current Regulation ATS.[47] At the time, a number of institutions expressed concern that the rule proposal would restrict their ability to execute customer block orders, resulting in higher execution costs.

Patrick J. McCloskey, Senior Vice President of Wellington Management Company, LLP, wrote:

> "Forcing display of our order size will ultimately result in poor executions to the detriment of our clients. It is a simple fact of supply and demand that displaying large institutional orders to the market invites price dislocation when there is no contra side interest. Without the benefit of established mechanisms to protect the size of our orders, such as those provided by electronic brokers, we are faced with the undesirable alternative of exposure to the street, losing our anonymity."[48]

Susan Ellis, Vice President of Trading at Granahan Investment Management, wrote:

> "As an institutional investor, we not only have to make good decisions, but also have to trade our orders so as not to lose money in the execution. To the end, we believe it essential that we maintain the ability

[46] Securities and Exchange Commission, Release No. 34-39884, "Regulation of Exchanges and Alternative Trading Systems", File No. S7-12-98, April 17, 1998. ("ATS Proposing Release")
[47] ATS Adopting Release.
[48] Letter from Patrick J. McCloskey, Wellington Management Company, LLP, to Jonathan G. Katz, November 23, 1998.

to trade directly with other institutions and interested brokers anonymously so that we can preserve the returns our professional analysis has achieved – for our retail investors."[49]

Tracey Altebrando, Head Trader at Metropolitan Capital Advisors, wrote:

"MCA's investors benefit from the choices that are available to get the best execution. An important choice is whether or not to publicly display my orders. Choosing not to publicly display my orders enables me to protect my trading strategy and efficiently and anonymously execute my trades.

In summary, requiring the display of these orders would limit my ability to achieve efficient, anonymous and low cost execution."[50]

J. Eric Vaughan, President of Ohio Valley Management, wrote:

"This new proposal, we believe, will make the ability to trade even more difficult. The volatility of individual stocks will increase, and the only individuals who would benefit from this and prior public display regulation changes are the electronic day traders."[51]

Roy Behren, President of Westchester Capital Management, Inc., wrote:

"Having access to multiple sources of liquidity without having to reveal our ultimate intent to the entire market increases our funds' performance and ultimately our bottom lines. To avoid the market impact that a fully transparent quote would have on our orders, we may have to take trades to less transparent dealers or compromise executions by breaking up orders into smaller pieces. Whatever we are ultimately forced to do, our clients will suffer in the form of increased execution costs.

For these reasons, we oppose the proposed institutional order display requirement and urge the SEC to reconsider adopting any such rule."[52]

John D. Robinson, Head Trader of Longwood Asset management, wrote:

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[49] Letter from Susan Ellis, Granahan Investment Management, Inc., to Jonathan G. Katz, November 16, 1998.
[50] Letter from Tracy Altebrando, Metropolitan Capital Advisors, Inc., to Jonathan G. Katz, November 25, 1998.
[51] Letter from J. Eric Vaughan, Ohio Valley Management, to Jonathan G. Katz, November 27, 1998.
[52] Letter from Roy Behren, Westchester Capital Management, Inc., to Jonathan G. Katz, November 18, 1998.

> "There is not a level playing now in regards to who has to disclose what to the market and it will only become more tilted if this rule in implemented.... In particular, if SOES traders catch wind of large institutional orders, they will try to create short-term price swings to the detriment of other market participants."[53]

* * * * *

Eleven years have passed. At the time, the Commission set the ATS order display threshold at 5%. This has significantly minimized any adverse effect of the ATS order display requirement. With the Commission's proposal to reduce the ATS order display threshold from 5% to what is essentially a 0% threshold, the ATS order display requirement will apply to full effect to the detriment of institutions seeking to execute block orders.

A lot has changed in the past eleven years, and a lot has stayed the same. In the past eleven years we have witnessed decimalization, the growth of electronic block order trading systems, the order protection rule, the creation of FINRA and the development of smart order routing and algorithmic trading. During this time we have seen reduced spreads, faster execution times and greater electronic connectivity of market participants.

At the same time, institutions still have the challenge of executing block orders in an environment where market intermediaries seek to detect and profit from the institution's block order information. Eleven years ago some of these intermediaries were known as "electronic day traders" or "SOES traders"; today some of them are known as "high-frequency traders". Regardless of what we call these intermediaries, we must ensure that institutions have appropriate flexibility in how they communicate their block order information to achieve the most efficient execution of customer orders.

2. *Growth of dark pools and other non-displayed liquidity*

In the proposing release, the Commission notes that, "in recent years, an increasing number of dark pools have organized to provide their customers with electronic access to dark liquidity sources."[54] The Commission further notes that "... dark pools with their 7.2% market share collectively represent a significant source of liquidity in NMS stocks."[55]

Focusing specifically on dark pool volume provides an incomplete view of the issue of non-displayed liquidity. It is more relevant to look at the relative volumes of quoting and non-quoting venues. Dr. Erik Sirri, former Director of the Commission's Division of Trading and Markets, notes:

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[53] Letter from John D. Robinson, Longwood Asset Management, to Jonathan Katz, November 25, 1998.
[54] Proposing Release, p. 6.
[55] Proposing Release, p. 7.

> "One of the common concerns expressed about the rise of dark ATSs as a trading venue, however, is that they threaten to supplant quoting venues and cause the equity markets to become less transparent. At least thus far, this concern does not appear to be well-placed. Rather than focusing too narrowly on the expanding trading volume of dark ATSs, a more telling measure of the health of quoting venues is to compare the cumulative trading volume of quoting venues with the cumulative trading volume of dark venues.
>
> As I will discuss shortly, these volume percentages reveal that quoting venues collectively have maintained a remarkably stable percentage of total equity trading. Instead of a migration of trading volume from quoting venues to dark venues in recent years, most of the movement in trading volume has been within each of the two categories of quoting venues and dark venues; that is, volume has shifted among various quoting venues and among various dark venues, but has not shifted out of quoting venues into dark venues. The quoting venues – exchanges and ECNs – have engaged in a fierce battle for order flow for many years. Similarly, the increasing percentage of trading volume of dark ATSs largely has come as the percentage of trading volume of broker-dealer internalizers has declined.
>
> ...
>
> The rise of dark ATSs has not, contrary to what might be expected, led to a decline in the success of the business model for quoting venues...."[56]

Consistent with this analysis, Senator Jack Reed noted at a recent Senate subcommittee hearing that "according to the SEC, the overall proportion of displayed market segments – those that display quotations to the public – has remained steady over time at approximately 75 percent of the market."[57]

3. *Actionable indications of interest*

The Commission writes in the release that,

> "In recent years, a number of dark pools have begun to transmit IOIs to select market participants that convey substantial information about their available trading interest. These messages are not included in the

[56] Sirri, pp. 3-4.
[57] Senate Subcommittee Hearing Transcript, p. 1.

> consolidated quotation data, although, like displayed quotations, they can be significant inducements for the routing of orders to a particular venue.
>
> ...
>
> Although these IOIs may not explicitly specify the price and size of available trading interest at the dark pool, the practical context in which they are transmitted renders them 'actionable'...."[58]

The Commission treats "actionable IOIs" as a new phenomenon, but what we're really taking about are order notifications, which have been around since the dawn of trading and are still prevalent today in many forms, including on the NYSE floor.

From the time that we introduced our H2O product to the market in 2005, we have referred to the messages that our H2O system sends out as "order notifications". Since 2005, we have used this term consistently in our trading rules document that we provide to our customers and the Commission.

We call them order notifications because we are notifying the recipient of the order notification that we have an order. The recipient of the order notification can then transmit an order back to our H2O system for execution. The execution occurs in our H2O system. There is a slight distinction between an order and an order notification. If we send an order to the recipient, the order would be executed in the recipient's system; this is not the case with the order notifications that our H2O system transmits. It is probably most accurate to categorize an order as a type of order notification, i.e., one where the order notification can be executed by the recipient.

In some ways, an order notification is similar to a quote, because the recipient of the quote can transmit an order to execute against the quote. The difference between a quote and an order notification is that a quote is publicly displayed. If we consider our H2O system, where all order notifications execute at the mid-point of the national best bid and offer in the market at the time of execution, these order notifications cannot be displayed as quotes because they have no fixed price. It is probably most accurate to categorize a quote as a type of order notification.

Whether something is characterized as an order, an order notification or a quote, the key element is that it is "firm" or "binding", meaning that no further affirmative action by the creator of the order, order notification or quote is required for execution of the trade. We have always understood that the order notifications sent by our H2O system are orders for purposes of Regulation ATS.

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[58] Proposing Release, pp. 11-12.

Over time, as more industry participants began to provide electronic order notifications, they started to refer to them as "indications of interest". We have always assumed this terminology originated from someone in the industry in an attempt to characterize their binding orders as non-binding indications, thereby evading specific regulations applicable to binding orders.

There is a key difference between "indications of interest" (sometimes referred to as "IOIs"), on the one hand, and order notifications, orders and quotes, on the other hand. IOIs are non-binding, meaning that a further affirmative action by the party submitting the IOI is required before an execution can occur. That is why the term "actionable IOI" is a contradiction in terms. "Actionable" refers to a firm order; IOI refers to a non-binding indication. It's one or the other; it can't be both.

* * * * *

If we understand that "actionable IOIs" are really order notifications, we can see that they are no different than the order notifications that have been around since the dawn of trading and continue today, including on block trading desks, the floor of the NYSE and broker internalization systems.

If we look at the world of manual block trading, we see that an institution can send a firm order or a non-binding IOI to a trading desk. Let's assume the institution sends a non-binding IOI. At that point, the trading desk can send out non-binding IOIs to other institutions and brokers. If a recipient of the IOI contacts the trading desk, the trading desk can facilitate negotiation of a cross trade between the two parties. At some point during this negotiation process, the two parties firm up their orders, which means they must communicate firm orders to each other via the block trading desk negotiation process. These communications are no different than the order notifications that are communicated by ATSs.

If we look at internalization, we see the same process. A routing broker sends a customer order to a market maker, high-frequency trading firm or a trading desk (a "market intermediary"), and the market intermediary executes the order against the customer. The customer order is only disclosed to the market intermediary.

Negotiations between floor traders on the NYSE floor involve the same process. At some point during the negotiation process, both sides have to firm up their interests and are communicating firm orders to each other. This is a necessary condition for a trade to occur. As noted by NYSE Euronext in its comment letter on the Commission's recent rule proposal on flash orders:[59]

[59] Securities and Exchange Commission, "Elimination of Flash Order Exception from Rule 602 of Regulation NMS", Release No. 34-60684, File No. S7-21-09, September 18, 2009. ("Flash Orders Proposing Release")

> "One of the long-standing practices among brokers, both on equities and options trading floors and in 'upstairs' locations, is to negotiate, at the customer's instruction, with other brokers for a trade of a non held order."[60]

Dr. Sirri notes the equivalence of dark pools and floor trading:

> "... dark pools of liquidity have been around for a long, long time. The single largest dark pool in the world for many decades could be found on the trading floor of the New York Stock Exchange. The floor traders there manually represented a pool of undisplayed liquidity that could be accessed only by sending an order to the floor to probe buying and selling interest."[61]

* * * * *

In each situation identified above you have targeted disclosure of an order by one market participant to a limited number of other market participants who could have the other side to that order. Internalization is probably the most extreme example because only the broker executing the order against the customer sees the customer's order. We don't understand why order notifications would be acceptable in the manual world for so many decades (including at all times prior to and following the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934), but are now objectionable in the electronic world. We similarly do not understand why electronic order notifications are problematic when they involve ATSs but are acceptable when they involve internalizing market makers, agency trading desks, principal trading desks, and floor brokers.

Just to be clear – these are all legitimate trading activities, and we are not questioning them or suggesting that they be restricted. Our question is why equivalent activities would be viewed so differently by the regulators.

4. Fair competition

In the proposing release, the Commission indicates that the proposed rules "would apply equally to all types of trading venues and help promote fair competition among them."[62] To the contrary, the rule proposals would increase the disparity in regulation of different categories of market participants performing the equivalent activity.

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[60] Letter from Janet Kissane, General Counsel, NYSE Euronext, to Elizabeth M. Murphy, Securities and Exchange Commission, November 23, 2009, p. 6. ("NYSE Euronext Comment Letter")
[61] Sirri, p. 2.
[62] Proposing Release, p. 9.

Under Rule 602 of Regulation NMS, each "responsible broker or dealer" is subject to a public quoting obligation.[63] But looking at the definition of "responsible broker or dealer" in Rule 600(a)(65) of Regulation NMS, this obligation only applies to brokers or dealers who communicate bids or offers through an exchange facility.[64]

This means that any firm that trades as principal is free to transmit order notifications without restriction. Of course, if the firm registers as a market maker, the firm would be subject to the display obligation, but registration as a market maker is optional for a principal-trading firm. This is different from ATS registration – a firm that trades as principal can choose whether or not to register as a market maker; a firm that executes electronic agency crosses must register as an ATS.

The same disparity in regulatory treatment applies for firms that trade as agent. A firm that routes orders as agent, but does not cross trades, is not subject to a display obligation. Similarly, a firm that engages in manual agency crossing is not subject to a display obligation.

* * * * *

Because of the disparity in application of the display requirement across different categories of market participants performing the equivalent function, we anticipate that firms will restructure their trading business in response to the rule proposal.

For example, instead of a firm sending multiple order notifications from its ATS, a firm could send multiple order notifications from its trading desk. A recipient of the order notification could then send back a responsive order notification to the trading desk, at which point the trading desk could route an order to the recipient for execution. This alternative approach works because a display obligation applies to ATSs but not to other agency trading firms.

As a second alternative, an ATS could send out sequential order notifications so that an order notification is never sent to more than one recipient at any time. The first order notification would have to be canceled before a second order notification could be sent.

A third alternative would be to break an order into smaller child orders and send different portions of the order to different order recipients so that the same shares were not sent to the same recipient. If an order is received from one recipient, the ATS could execute that order against the portion of the order transmitted to that recipient and re-allocate other portions of that order to the recipient to see if there is more flow.

A fourth alternative would be to use "immediate or cancel" (IOC) orders in place of order notifications. The sending of multiple IOC orders in succession is sometimes referred to as

[63] 17 CFR 242.602.
[64] 17 CFR 242.600(a)(65).

"pinging". Pinging would achieve an equivalent result to an order notification but in a less efficient manner. For example, if a block order pool has a match for 10% of orders on average, instead of the block order pool sending one order notification message to a smart order router, the smart order router could send ten pings to the block order pool.

A fifth alternative would be for a trading desk to transmit a non-displayed order to an exchange and then separately send order notifications notifying recipients that the sender has transmitted a non-displayed order to the exchange.

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The reason many of these alternatives work is that communicating an order notification to one person who could have a contra order is not covered by the quoting restrictions. The Commission understands that if it tried to prohibit an order notification to one recipient, it also would have to prohibit internalization, block trading desks and the working of orders by floor brokers. This would be a bad result for investors because it would restrict the choices available to investors for executing their orders.

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You will, no doubt, hear arguments that the rule proposal levels the playing field between exchanges and ATSs. But there is an important distinction that must be made. Exchanges and ATSs both engage in electronic, agency crossing. An exchange operator is free to set up an affiliated ATS to conduct all or a portion of its electronic, agency crossing business. In fact, as noted by Robert Colby at a recent webinar sponsored by the Investment Company Institute, "exchanges have their own dark pools."[65] But if an ATS wants to conduct electronic, agency crossing, it cannot conduct that business through a trading desk.

This is the same distinction as noted above with respect to firms that trade as principal. A firm that trades as principal can choose whether or not to register as a market maker and, thus, whether or not to be subject to a display obligation. In fact, a firm can set up two affiliates, one that trades as a market maker and one that trades as principal but is not a market maker. In contrast, a firm that engages in electronic, agency crossing must register as an ATS and become subject to a display obligation.

* * * * *

The Commission states in the release that,

> "The proposals in this release ... do not attempt to address all of the issues regarding dark liquidity. The proposals instead address three issues

[65] ICI Webinar.

> with respect to dark liquidity that the Commission preliminarily believes warrant attention, are sufficiently discrete, and as to which the Commission has sufficient information to proceed with a proposal."[66]

We believe it is the antithesis of discrete to propose restrictions that apply to one category of market participant without applying those restrictions to other market participants performing the equivalent function. As evidenced by our discussion in this section, issues regarding dark liquidity, and market structure in general, are inter-related, and it is not possible to consider the issue of dark pools without a comprehensive evaluation of the role of dark liquidity in the current market structure. If rules are adopted that apply inconsistent standards to different categories of market participant performing the same function, the result will be market participants restructuring their activities in a manner that elevates form over substance, and we will end up with market participants attempting to achieve an equivalent result, but in a less efficient manner.

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We note that the use of electronic order notifications can provide certain advantages over the traditional telephone and face-to-face notifications. These advantages include a better audit trail, eliminating the traditional Wall Street "winks and nudges" and providing greater control to the institutional trader over how information about the institution's order is disseminated. But ultimately this is not an issue of which competitor can convince the Commission that its system or process is better for investors. Invariably, each competitor will argue to the Commission why its system or process is superior to all the others and that customers should be prohibited from using all the other systems and processes.

Instead, this is an issue of providing a level playing field to ensure that market participants engaging in an equivalent activity are subject to an equivalent level of regulation. The rule proposal would create an unlevel playing field by applying different levels of regulation to competitors engaging in the same activity. Even today, ATSs are subject to obligations that do not apply to agency trading desks, principal trading desks and floor brokers performing the equivalent function. The Commission's rule proposal would increase this disparity in regulatory treatment to the detriment of individual investors.

5. Transparency

In considering the issue of pre-trade transparency, it is important to recognize that institutions have a legitimate need to protect the confidentiality of their block orders. Placing arbitrary restrictions on institutions in locating contras will lead to higher trading costs for institutions, which ultimately means higher trading costs, and lower investment returns, for the millions of

[66] Proposing Release, p. 8.

individual beneficiaries of the accounts managed by these institutions. Further, as discussed below, the Commission's proposals will result in less market transparency because they will restrict the ability of institutional liquidity to interact with other liquidity in the market.

* * * * *

Market forces address the issues of transparency and liquidity in the global equity markets. Market providers are incentivized to provide facilities for the posting of displayed bids and offers because this attracts order flow to the markets that they operate. Market intermediaries are incentivized to post displayed bids and offers through these facilities because this attracts order flow to these intermediaries who profit from the bid-offer spread and liquidity rebates offered by the various markets.

Let's start with market providers. As recently explained by the NYSE and NASDAQ in a brief that they filed jointly, market forces incentivize markets to provide facilities for displayed liquidity:

> "Wide distribution of an exchange's market data, including depth-of-book order data, increases market participants' knowledge of all displayed orders that are available on that exchange. This means that buyers interested in purchasing securities at particular prices have better chances of locating on that exchange sellers willing to meet those prices, resulting in more trades executed on that exchange and more revenue from transaction fees."[67]

In support of their argument, the NYSE and NASDAQ cite "the real-world example of Island ECN". According to the NYSE and NASDAQ:

> "After Island ceased displaying its order book to the public in three very active exchange-traded funds ... in which it enjoyed a substantial market share, Island experienced a 50% drop in its market share in those funds."[68]

With regard to market participants, market spreads, along with other financial incentives provided by markets to participants who provide liquidity, generate transparency by compensating providers of liquidity.

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[67] Initial Brief of Intervenors NYSE ARCA, Inc. and NASDAQ Stock Market, LLC, in the case of NetCoalition; Securities Industry and Financial Markets Association, Petitioners, Securities and Exchange Commission, Respondent, United States Court of Appeals for the District of Columbia Circuit, Appeal Nos. 09-1042 & 09-1045, November 16, 2009, p. 17. ("NYSE and NASDAQ Joint Brief")

[68] NYSE and NASDAQ Joint Brief, p. 18.

According to Rosenblatt Securities, a firm that provides research on the operation of the US equity markets, high-frequency traders have brought certain benefits, along with certain challenges, to the market. They cite "massive liquidity provision" as the most obvious benefit. Rosenblatt Securities explains:

> "HFT ... make shares available for purchase or sale at specific prices on a scale never before seen in securities markets. This flood of limit orders upholds the spirit of Regulation NMS, which was designed to make price formation – and, by extension, capital raising – as fair and efficient as possible."[69]

Consistent with the analysis by the NYSE, NASDAQ and Rosenblatt Securities, Dr. Sirri notes that "the rise of dark ATSs has not, contrary to what might be expected, led to a decline in the success of the business model for quoting venues...."[70] The decision by the BATS and Direct Edge ECNs to apply for exchange status so soon after their respective launches further supports Dr. Sirri's conclusion that quoting venues remain a viable, and even appealing, business model. Currently, BATS operates as an exchange, having won approval from the Commission in August 2008, while Direct Edge maintains its ECN status pending approval of its exchange application by the Commission.[71]

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Another important piece of evidence to consider is quoted spreads. If market forces were not providing sufficient incentives for displayed liquidity, this would presumably lead to the widening of quoted spreads. But as discussed in the section below on quoted spreads, the data shows that quoted spreads continue to get narrower, not wider. This is additional evidence supporting the conclusion that market forces provide sufficient incentives for displayed liquidity.

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According to Dr. Sirri, "attempting to force market participants to display their trading interest when they do not wish to do so would be both fruitless and counter-productive."[72]

In this regard, Raymond James noted the following in a research report discussing the Commission's rule proposals:

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[69] Rosenblatt Securities Inc., "Trading Talk – An In-Depth Look at High-Frequency Trading", September 30, 2009, p. 25. ("Rosenblatt Securities")
[70] Sirri, pp. 3-4.
[71] Alexandra Zendrian, "Direct Edge: Exchange in 2009," *Forbes.com*, May 19, 2009, http://www.forbes.com/2009/05/19/stocks-exchanges-direct-markets-economy-sec-equities.html (accessed December 18, 2009); Jonathan Stempel, "BATS Trading wins SEC approval for exchange status," *Reuters*, August 19, 2008, http://www.reuters.com/article/idUSN1845653320080819 (accessed December 18, 2009).
[72] Sirri, p. 6.

> "Like most governmental regulations, we think it is likely that the three proposals will have unintended consequences. We think they will tend to make dark pools even more dark by forcing them to not share their information with other parties ...."[73]

As noted by NYSE Euronext in an equivalent context, with respect to negotiations by NYSE floor brokers, "limiting a floor broker's authority to negotiate an order in a regulated environment prior to an execution will achieve nothing more than moving this negotiation process away from the open transparency of the trading floors ...."[74] We believe the same principle applies with respect to ATSs, as regulations designed to mandate greater transparency most likely will lead to less transparency.

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If market forces are working to provide market transparency, we are unclear as to why this rule is being proposed. Moreover, we expect an unintended consequence of the rule proposal will be less transparency, as institutions, with fewer options, are forced to play their cards closer to the vest.

6. Quoted spreads

The Commission writes in the release that,

> "Actionable IOIs with prices (whether explicit or implicit) better than the NBBO would effectively narrow the quoted spread for an NMS stock, if included in the consolidated quotation data."[75]

The Commission assumes in this statement that market participants who send order notifications with prices that are better than the NBBO also would be willing to post a quote at that price. But we have to take into account the differing motivations and objectives of the different categories of market participant.[76] For example, an institution might be willing to send an order notification to execute at the mid-point of the NBBO, but that same institution might not be willing to post a bid or offer at that price because of concerns about information leakage.

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[73] Raymond James, U.S. Research, Financial Services Industry Brief, October 22, 2009, p. 1. ("Raymond James")
[74] NYSE Euronext Comment Letter, p. 8.
[75] Proposing Release, p. 13.
[76] The proposing release makes various references to the "public", "market participants" and "investors" in the abstract, without identifying the categories of investor that make up the "public" and explaining how different categories of investor benefit from, or are harmed by, the current market structure and would benefit from, or be harmed by, the Commission's proposals. Throughout this comment letter, we specifically identify and discuss institutional investors, retail brokerage customers and the various categories of market intermediary in attempting to determine the challenges faced by each category of investor and regulatory solutions that could address those challenges.

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If we look at the data, it appears that spreads in the market overall are narrowing. According to Rosenblatt Securities, high-frequency trading has "clearly played a big role in narrowing spreads, which results in reduced transaction costs for all market participants."[77] Rosenblatt Securities notes,

> "Indeed, a recent NYSE Euronext study of quoted spreads before and after the enactment of Regulation NMS shows that spreads have declined markedly in the era of HFT dominance, even when volatility, as measured by the CBOE's Volatility Index (VIX) was very high."[78]

TD Newcrest, an industry analyst based in Canada, notes in a research report on the equity markets that retail investors specifically benefit from reduced spreads,

> "... given that retail investors tend to issue marketable orders more frequently than institutional investors and bid-ask spreads have narrowed thanks to electronic market makers. This is important because rarely do retail orders outsize the prevailing bid-ask spread, especially in today's market in which high frequency liquidity providers tend to stack bids and offers at the National Best Bid or Offer (NBBO)."[79]

Statements by NYSE Euronext, the Department of Justice and a former head of the Commission's Division of Trading and Markets support this analysis.

According to NYSE Euronext, "... there have been many improvements to the overall market quality in NYSE-listed securities." NYSE Euronext notes that "these improvements include lower price volatility, tighter spreads ... and overall greater depth of liquidity."[80]

According to a report by the Department of Justice, "there is significant competition among multiple equity trading venues, with low execution fees, narrow spreads, and widespread system innovation – all to the benefit of consumers."[81]

Burton Malkiel, Professor of Economics at Princeton University, and George Sauter, Managing Director and Chief Investment Officer of Vanguard Group, reach a similar conclusion:

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[77] Rosenblatt Securities, p. 25.
[78] Rosenblatt Securities, p. 25.
[79] The Equity Division of TD Securities, *S&P/TSX Bulletin*, "High Frequency Trading Strikes a Chord with Politicians, Regulations and Market Participants", p. 6. ("TD Newcrest")
[80] NYSE Euronext, *U.S. Equities News,* April 2009.
[81] United States Department of Justice, "Comments of the United States Department of Justice, Review of the Regulatory Structure Associated with Financial Institutions", January 31, 2008, p. 20.

> "Transactions costs have declined significantly over the past 10 years, thanks to the many structural changes in equity markets, including trading in decimals instead of eighths, the proliferation of scores of trading venues that function as exchanges, and an explosion of high-frequency trading. Vanguard has estimated that total transactions costs on an average trade have fallen by more than 50%, resulting in approximately $1 billion of annual savings to its investors. When magnified across the whole investment industry, investors have probably saved tens of billions of dollars in transactions costs."[82]

* * * * *

At a recent conference sponsored by the Investment Company Institute, Robert Colby, who has previously served as Acting Director, Deputy Director and Chief Counsel of the SEC's Division of Trading and Markets, emphasized that "retail never had better trading conditions than it has today."[83] Mr. Colby noted, in particular, that investors benefit because there are "... brokers that are willing to trade at very low commission rates, and you can get both a narrow spread and a low commission rate."[84]

Interestingly, Mr. Colby distinguishes between the investment-focused retail brokerage customer and the short-term trading retail brokerage customer:

> "And finally, if a retail investor is trying to trade on an extremely active basis and compete on second-by second or minute-by-minute trading flows, they're going to have difficulty doing that, not because they're not allowed to, but because it requires a level of automation and broadband connectivity that may be beyond their price range. But most individuals don't need to trade like that, and probably shouldn't be trading like that. They need more of a buy-and-hold approach. And for them if they decide to buy individual stocks the market is very liquid and very cheap for them."[85]

The distinction made by Mr. Colby is an important one that the Commission should keep in mind as it evaluates these issues.

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[82] Burton G. Malkiel and George U. Sauter, "A Transaction Tax Would Hurt All Investors", *The Wall Street Journal*, December 8, 2009.
[83] ICI Webinar.
[84] ICI Webinar.
[85] ICI Webinar.

Testimony at the recent Senate subcommittee hearing on market structure by Christopher Nagy, Managing Director of Routing Strategy at TD Ameritrade, supports the analysis above by Rosenblatt Securities, TD Newcrest, NYSE Euronext, the Department of Justice, and Mr. Colby. According to Mr. Nagy,

> "Our nation's stock markets have evolved dramatically over the course of the last decade. In 2001, the average individual investor transaction took upwards of 18 seconds to receive an execution while today that same transaction is done in less than one second. These changes have been driven primarily by technological innovation but also in response to carefully crafted regulations. In addition, the move to decimalization early in the decade reduced spreads by up to five and a quarter cents whose benefits went largely into the pocketbooks of individual investors.
>
> In fact, today the individual investor enjoys superior pricing, lightning-fast execution fulfillment and ample liquidity in the markets. At no other point in the history of the markets has the individual investor been closer in terms of pricing to that of the institutional trader. Variations of dark pools have been in our markets for decades, taking on various forms from a broker taking an order over the phone to a floor broker acting as agent."[86]

We also note the following analysis in a research report by Raymond James,

> "... regarding the degradation of trade execution quality for the 'average investor,' there has been a disappointing lack of evidence to suggest this is in fact a legitimate concern at this time. For example, one would also expect wider bid-ask spreads. However, we are not aware of any concerted effort to validate these suspicions, and in fact the data that we have seen (via Rule 606 reports, Rule 605 reports, broker-dealer analysis, etc.) would seem to indicate that trade execution has not suffered."[87]

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Finally, we look at the data. Industry data supports the analysis that quoted spreads are narrowing. According to Rule 605 data compiled by Thomson Transaction Analytics Reports, the average quoted spread for NYSE-listed securities has decreased from 5.60 cents in 2004 to 1.35

[86] Senate Subcommittee Hearing Transcript, p. 11.
[87] Raymond James, p. 3.

cents in 2009, and the average quoted spread for NASDAQ-listed securities has decreased from 12.36 cents in 2004 to 1.82 cents in 2009.[88]

It also is noteworthy that execution times have dropped during this period. According to data from Rule 605 reports compiled by Thomson Transaction Analytics Reports, the average execution time for NYSE-listed securities has decreased from 10.5 seconds in 2004 to 1.2 seconds in 2009, and the average execution time for NASDAQ-listed securities has decreased from 2.8 seconds in 2004 to 1.6 seconds in 2009.[89]

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There is a theoretical hypothesis that order notifications widen quoted spreads by disincentivizing the display of liquidity. There also is a theoretical hypothesis that order notifications reduce quoted spreads by making it easier for a market intermediary who opens a position with a displayed order that is executed to close out the position with a corresponding mid-point execution. The important point is that these are theoretical hypotheses, and we should not make policy changes that will raise trading costs for millions of households without appropriate data to support these hypotheses. For example, to demonstrate the first hypothesis, we would have to show not only that quoted spreads have widened, but also that the widening of quoted spreads has been caused by the increased use of order notifications by ATSs. As discussed above, the data appears to show that quoted spreads overall have narrowed, and we have not seen data evidencing the alleged effect of order notifications on quoted spreads.

7. Depth at the NBBO

The Commission writes in the proposing release that,

> "... actionable IOIs with prices (whether explicit or implicit) equal to the NBBO could substantially improve the quoted depth at the best prices for an NMS stock."[90]

Yet in an order issued by the Commission on December 2, 2008 relating to a market data fee proposal by NYSE Arca, the Commission asserts that there is substantial liquidity at the NBBO for

[88] Rule 605 data compiled by Thomson Transaction Analytics Reports, 2004 and 2009. 2009 data is through October 2009. Data is for market and marketable limit orders between 100 and 499 shares.
[89] Rule 605 data compiled by Thomson Transaction Analytics Reports, 2004 and 2009. 2009 data is through October 2009. Data is for market and marketable limit orders between 100 and 499 shares.
[90] Proposing Release, p. 13.

executing retail orders and cites "liquidity pools"[91] as a beneficial contributing factor. The Commission writes:

> "In particular, the SLCG Study fails to consider the very substantial availability of undisplayed liquidity for executing retail orders at non-exchange venues, particularly OTC market makers and liquidity pools sponsored by broker-dealers. This undisplayed liquidity enables retail investors to receive executions for most of their orders at prices equal to or better than the NBBO, regardless of the displayed size at the NBBO."[92]

The Commission restated this point as recently as October 26, 2009 in a court filing. According to the Commission:

> "... the average displayed depth of quotations at the NBBO is larger than the average retail order, making depth-of-book data unimportant for those investors .... Investors are able to trade so often at the NBBO or better due to the availability of substantial liquidity at exchanges, ECNs, non-exchange liquidity pools, and OTC market makers that is not displayed either in core data or depth-of-book data."[93]

The preceding passages illustrate two contradictions between the Commission's analysis in the proposing release and the Commission's analysis in the NYSE Arca order and court filing quoted above. First, in the proposing release the Commission concludes that the quoted depth for retail orders is not sufficient, but in the NYSE Arca order and the Commission's court filing the Commission concludes that there is sufficient quoted depth for retail orders. Second, in the proposing release the Commission concludes that non-displayed liquidity detracts from depth of liquidity, while in the NYSE Arca order and the Commission's court filing the Commission concludes that non-displayed liquidity adds to depth of liquidity.

We are unclear as to what events transpired during the intervening time period (between October 26, 2009 and November 13, 2009) to cause the Commission to modify its position on these two points.

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[91] Curiously, when the Commission wants to speak favorably about so-called "dark pools", it refers to them as "liquidity pools".
[92] NYSE Arca Order, p. 96.
[93] Brief of Respondent Securities and Exchange Commission, in the case of NetCoalition; Securities Industry and Financial Markets Association, Petitioners, Securities and Exchange Commission, Respondent, United States Court of Appeals for the District of Columbia Circuit, Appeal Nos. 09-1042 & 09-1045, October 26, 2009, p. 49. ("Commission Brief")

Consistent with the Commission's analysis in the NYSE Arca order and the Commission's recent court filing, TD Newcrest notes:

> "... rarely do retail orders outsize the prevailing bid-ask spread, especially in today's market in which high frequency liquidity providers tend to stack bids and offers at the National Best Bid or Offer (NBBO)."[94]

* * * * *

It is also important to note that there is no evidence that the Commission's rule proposal would lead to greater depth of liquidity. To the contrary, it could result in less depth of liquidity as institutions, with fewer choices for communicating their block orders, opt for order execution strategies that are more protective of their block order information.

8. Price improvement

Another important consideration is price improvement. One important advantage of block order pools, and dark pools in general, is that they can provide price improvement for individual investors, whether they invest through mutual funds or trade through retail brokerage accounts.

As an example, our H2O system provides price improvement to both parties to the trade on 100% of executions. If we look at Liquidnet's Rule 605 data for 2009 as compiled by Thomson Transaction Analytics Reports, we see that for orders transmitted by Liquidnet H2O participants and executed by Liquidnet H2O, Liquidnet provided average price improvement of 1.26 cents per share, or 91% of the quoted spread.[95] This price improvement of 91% is in contrast to the industry as whole which, according to the same Rule 605 data compiled by Thomson Transaction Analytics Reports, provided slightly negative price improvement (close to 0%).[96]

The Commission agrees that dark pools can provide price improvement for retail orders. According to the Commission:

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[94] TD Newcrest, p. 6.

[95] Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares. The average quoted spread in the market during this period, as compiled by Thomson Transaction Analytics Reports from Rule 605 data, was 1.39 cents. Liquidnet H2O's average effective spread during the period was .13 cents. The difference between the average quoted spread of 1.39 cents and Liquidnet's average effective spread of .13 cents (1.26 cents) represents the price improvement provided by Liquidnet. Liquidnet's price improvement (1.26 cents) relative to the average quoted spread (1.39 cents) represents Liquidnet's price improvement percentage (91%).

[96] Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares. The average quoted spread in the market during this period, as compiled by Thomson Transaction Analytics Reports from Rule 605 data, was 1.39 cents. The average effective spread for the industry during the period was 1.40 cents. The difference between the average quoted spread of 1.39 cents and average effective spread of 1.40 cents (-.01 cents) represents the negative price improvement provided by the industry (-1%).

> "Moreover, contrary to the claim that 'ascertaining the total price of an average retail trade requires depth of book data,' the inferior prices in depth-of-book data provide a poor basis to assess the quality of execution of retail orders. As discussed below, the availability of substantial undisplayed liquidity enables such orders to be executed on average at prices better than even the best displayed quotes in core data."[97]

The Commission restated this point as recently as October 26, 2009:

> "Investors are able to trade so often at the NBBO or better due to the availability of substantial liquidity at exchanges, ECNs, non-exchange liquidity pools, and OTC market makers that is not displayed either in core data or depth-of-book data."[98]

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In Annex D we put forth a proposal for enhanced disclosure of price improvement and other execution quality data to retail customers. We think this type of proposal could assist retail customers in reducing their trading costs by empowering them with more data, but without impeding competition.

We would contrast this to the Commission's proposal, which will increase trading costs for retail brokerage customers by reducing their opportunities for price improvement. As noted by the Commission,

> "... undisplayed liquidity enables retail investors to receive executions for most of their orders at prices equal to or better than the NBBO, regardless of the displayed size at the NBBO."[99]

9. Protecting displayed limit orders

The Commission writes in the release that:

> "... actionable IOIs at NBBO matching prices potentially deprive those who publicly display their interest at the best price from receiving a speedy execution at that price."[100]

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[97] NYSE Arca Order, p. 77.
[98] Commission Brief, p. 49.
[99] NYSE Arca Order, p. 96.
[100] Proposing Release, pp. 14-15.

With respect to the policy goal of protecting displayed limit orders, industry experts have concluded that, typically, it is the high-frequency trader or other market intermediary, not the retail or institutional investor, whose liquidity is posted at the NBBO. Accordingly, the primary beneficiary of any rule designed to favor posted liquidity is the market intermediary.

As noted by Rosenblatt Securities, high-frequency traders have "... such superior mathematical and technological prowess that they almost always beat traditional market participants to posting the best prices first."[101] Other investors, including institutions, typically "have to cross the spread and incur a take fee."[102] Tabb Group, a firm that conducts extensive research on trading and markets, similarly reports that "institutional investors are generally liquidity takers and not posters."[103] TD Newcrest similarly reports that "... orders are being forced more and more to cross spreads, as bids and offers are stacked with so many other market maker orders that it becomes difficult to passively buy or sell stock."[104] We can see from these comments that the primary beneficiaries of any rules designed specifically to protect displayed limit orders would be high-frequency traders and other market intermediaries, and not individual investors.

10. Access by individual investors

The Commission writes in the release that,

> "The vast majority of investors may not be aware that better prices are disseminated to alternative trading system subscribers and many do not qualify for direct access to these systems and do not have the ability to route their orders, directly or indirectly, to such systems. As a result, many customers, both institutional and retail, do not always obtain the benefit of the better prices entered into an alternative trading system."[105]

Our H2O system welcomes participation from retail brokers. In fact, our Liquidnet H2O system is specifically designed to facilitate interaction between institutional block orders and other liquidity in the market, including orders from retail investors. For Liquidnet H2O, any restrictions on access are solely for the purpose of protecting the confidentiality of our institutional customers' block orders from short-term traders seeking to take advantage of that block order information.

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[101] Rosenblatt Securities, p. 23.
[102] Rosenblatt Securities, pp. 23-24.
[103] The Tabb Group, LLC, "US Equity High Frequency Trading: Strategies, Sizing and Market Structure", September 2009, p. 22. ("Tabb Group")
[104] TD Newcrest, p. 7. "Passively" trading stock refers to posting bids and offers at the NBBO.
[105] Proposing Release, p. 26.

At the recent Senate subcommittee hearing on market structure issues, Senator Bunning asked why certain people would be excluded from dark pools. James Brigagliano, former co-head of the Commission's Division of Trading and Markets, responded:

> "Senator Bunning, you know, that's an excellent question. One reason could be, for example, if a dark pool caters to large-sized traders, to mutual funds, and pension funds, it may well want to monitor that more predatory traders, if you will, people who are going to try to front-run those large orders don't get in."[106]

Liquidnet is not unique in actively seeking to attract institutional and retail order flow. It is a general principal of trading systems that they seek to attract order flow, so we are not clear why trading systems would seek to limit access to order flow representing long-term institutional or retail investors, nor is there any evidence for this in the release. In fact, the Commission has emphasized in a recent Commission order the

> "... very substantial availability of undisplayed liquidity for executing retail orders at non-exchange venues, particularly OTC market makers and liquidity pools sponsored by broker-dealers."[107]

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The Commission specifically notes that many investors "do not qualify for direct access" to alternative trading systems. But retail investors also do not qualify for direct access to exchanges – that is because they access the market through retail brokerage firms. Is that a basis for placing new regulatory restrictions on exchanges? Since retail brokerage customers access the market through retail brokerage firms, the important question is whether retail brokerage firms have access to alternative trading venues. As noted above, our H2O system welcomes participation from retail brokers, and we believe that many other alternative trading systems have adopted a similar policy. We would be interested to know whether the Commission has received complaints from retail brokers regarding their ability to access alternative trading venues and how these complaints have been resolved.

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[106] Senate Subcommittee Hearing Transcript, p. 20.
[107] NYSE Arca Order, p. 96.

If we look at the Rule 606 reports of Charles Schwab, E*Trade and TD Ameritrade for the 3rd quarter of 2009, it appears that close to 100% of non-directed retail customer market orders are routed to proprietary trading firms for internalization.[108] E*Trade and TD Ameritrade route the majority of limit orders to DirectEdge, and Charles Schwab routes the majority of limit orders to UBS Securities.[109] DirectEdge and UBS are both participants in Liquidnet H2O, which provides price improvement for retail orders that DirectEdge and UBS route to Liquidnet H2O. More generally, the NYSE and BATS, two of the three largest exchanges, and DirectEdge, the leading ECN, participate in Liquidnet H2O, which includes access for their retail order flow.

If we examine the data in the Rule 606 reports, it is unclear how alternative trading venues harm retail brokerage customers and how restrictions on alternative trading venues would benefit retail brokerage customers. As indicated in the preceding paragraph, the three leading on-line retail brokers route a majority of limit orders to venues that have access to Liquidnet H2O. And with respect to market orders, if close to 100% of retail customer market orders are internalized by proprietary dealers trading for their own account, it would appear that restrictions on ATSs would not have any effect on how those orders are executed.

In fact, the way the Commission has designed its proposed block exemption, it would be harder for retail orders to interact with systems like Liquidnet H2O that provide price improvement for retail orders.[110] We believe this would be bad for retail customers. In Annex C we propose a modification to the Commission's proposed block exemption that would address this issue.

11. Fragmentation

In the Release the Commission notes that it "continues to have the same concerns about fragmentation ... potentially caused by ATSs as it did when adopting Regulation ATS."[111] We believe, to the contrary, that the market is less fragmented than ever because of advances in technology, including smart order routing functionality and advances in network speed and capacity. In fact, the Commission expressly notes in the proposing release that,

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[108] https://content.etrade.com/etrade/powerpage/pdf/OrderRouting11AC6.pdf. http://www.schwab.com/public/schwab/nn/legal_compliance/important_notices/order_routing_execution/order_routing.html?cmsid=P-1028624&lvl1=nn&lvl2=legal_compliance&. http://www.tdameritrade.com/forms/CLR2054.pdf (accessed December 18, 2009). ("Rule 606 Reports"). Rule 606 reports only provide data on the routing of non-directed orders, so we do not have information on the routing of directed orders.

[109] Rule 606 Reports.

[110] According to Rule 605 data for 2009 as compiled by Thomson Transaction Analytics Reports, for orders transmitted by Liquidnet H2O participants and executed by Liquidnet H2O, Liquidnet provided average price improvement of 1.26 cents per share, or 91% of the quoted spread. Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares.

[111] Proposing Release, p. 27.

> "... robust and extremely fast linkages that were not available at that time [the time of adoption of Regulation ATS] are now widely offered on commercially reasonable terms. It also appears that the market for these services is highly competitive, further reducing their cost."[112]

Block order pools contribute to the linkage of order flow by enabling institutional block orders to interact with other liquidity in the market in a manner that protects the confidentiality of the institution's block order information.

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The question of fragmentation has been considered by industry experts Aite Group in a research report on the equity markets. According to Aite Group,

> "Nothing in life stays static, and the dark pool market is no exception. What started out as an island, touting diversity of unique internal and customer flow and cost-effective, low-market-impact execution service has now evolved to something much larger and more connected, leading to the current market reality in which many of the dark pools are now connected with each other as well as with displayed markets."[113]

Aite further notes,

> "The non-displayed market is not a homogeneous one. One important note is that due to the variations in business models and target client base, dark pools do not necessarily compete against one another. A dark pool that focuses on facilitating buy-side block trading, for example, might link up with a dark pool that aggregates sell-side flow to add diversity in order flow. Similarly, broker-owned dark pools might link up with one another to increase overall fill rates for their collective clients. In fact, given the growing trend of dark pool linkages, coopetition (i.e., certain level of cooperation between entities that otherwise compete) has become more common in recent months."[114]

Dr. Sirri notes similarly:

> "Competitive forces, however, seem particularly apt to address the problem of fragmented dark pools. The ultimate users of dark pools – investors and traders – seem likely to pressure operators of the pools,

[112] Proposing Release, p. 30.
[113] Aite Group, LLC, "Dark Pools 2009: Not so Dark Anymore....", September 2009, p. 7. ("Aite Group")
[114] Aite Group, p. 5.

> particularly the less successful ones, either to consolidate with other pools or to cooperate with dark pool aggregators. These aggregators offer services that enable investors to check liquidity more efficiently at multiple dark pools. A key cost of fragmentation for traders is the opportunity cost of being out of the market on one venue when you search for a contraside on other venues. With latency dropping rapidly, such fragmentation costs are falling as well."[115]

Mr. Colby noted similarly at a recent webinar sponsor by the Investment Company Institute that "... even though there's a lot of them [trading venues], they've very tied together."[116]

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As noted by industry experts, restrictions on block order pools would mean fewer choices for institutional traders and lead to block orders having less interaction with other liquidity in the market, resulting in increased fragmentation. Raymond James points out in a research report on the proposed regulations:

> "Like most governmental regulations, we think it is likely that the three proposals will have unintended consequences. We think they will tend to make dark pools even more dark by forcing them to not share their information with other parties ...."[117]

12. Competition

In other industries, fragmentation is known as "competition". The Commission's rule proposal, by restricting how systems can operate to reduce trading costs for institutional block orders, will impede competition and innovation that benefits individual investors.

According to the Commission,

> "The Exchange Act and its legislative history strongly support the Commission's reliance on competition, whenever possible, in meeting its regulatory responsibilities for overseeing the SROs and the national market system. Indeed, competition among multiple markets and market participants trading the same products is the hallmark of the national market system."[118]

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[115] Sirri, p. 7.
[116] ICI Webinar.
[117] Raymond James, p. 1.
[118] NYSE Arca Order, pp. 46-47.

The Commission notes that Congress, when "directing the Commission to facilitate the establishment of a national market system", "emphasized the importance of allowing competitive forces to work."[119]

According to the Senate Report issued in connection with the Securities Act Amendments of 1975,

> "In 1936, this Committee pointed out that a major responsibility of the SEC in the administration of the securities laws is to 'create a fair field of competition'. This responsibility continues today. The bill would more clearly identify this responsibility and clarify and strengthen the SEC's authority to carry it out. The objective would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services. It would obviously be contrary to this purpose to compel elimination of differences between types of markets or types of firms that might be competition-enhancing."[120]

Dr. Sirri similarly notes:

> "The four categories of trading venue highlight a quite positive aspect of U.S. equity market structure. The U.S. has a wide range of trading venues, and the competition for order flow among them is exceptionally strong. This wide range of competing markets is the hallmark of the national market system approach to market structure that was mandated by Congress in the Exchange Act. Today, investors and traders have never had a wider range of choices of trading venues that compete to satisfy their particular trading needs, and the competition among these venues has never been stronger. Many dark ATSs exist, in large part, due to competitively-driven attempts to service the particular trading needs of different types of investors and traders.
>
> I believe that competition among diverse trading venues is a tremendous strength of U.S. equity market structure."[121]

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[119] NYSE Arca Order, p. 47.
[120] Senate Report, p. 8.
[121] Sirri, pp. 2-3.

13. Two-tiered markets

A common refrain of dark pool critics is that dark pools create a "two-tiered market",[122] but if dark pools provide access to institutional and retail investors, we do not understand how dark pools create a two-tiered market.

To support the claim of a two-tiered market, we would need to identify which specific investor group is on the preferred tier, and which specific investor group is on the non-preferred tier, but the proposing release does not provide this information. In fact, the Commission has specifically noted in a Commission order the

> "... very substantial availability of undisplayed liquidity for executing retail orders at non-exchange venues, particularly OTC market makers and liquidity pools sponsored by broker-dealers."[123]

If, as the Commission indicates, retail orders are interacting with liquidity pools that provide substantial liquidity, we would not agree with the conclusion that there is a two-tiered market.

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We would more accurately characterize the current market as a network structure. Different participants have different points of access to the system, but the overall structure is linked through advances in order routing practices. As discussed above, the current markets are more inter-connected than in the past because of innovations that make it easier for different types of liquidity to interact.

Would we have a better internet today if we prohibited corporations, governments and other groups from setting up their own internal networks? We would doubt it. Should we restrict the business of Amazon and other on-line retailers because certain people don't have computers? We don't think so. Institutional investors and retail brokers choose whether and how to participate in different alternative trading venues. How do we help them by restricting their choices?

14. The financial crisis

According to Chairman Schapiro and Richard Ketchum, Chairman and CEO of FINRA, the equity markets performed in an orderly manner during the recent financial crisis.

Chairman Schapiro has written recently,

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[122] Proposing Release, p. 27.
[123] NYSE Arca Order, p. 96.

> "The recent economic crisis has put tremendous stress on the U.S. securities markets. Trading volume and volatility have reached record highs. In the face of the sharp spikes in volume and volatility, however, investors have been able to benefit from markets for U.S.-listed securities that have continued to operate in an efficient and orderly manner."[124]

Mr. Ketchum similarly notes in this regard,

> "The story in the equity markets is a good one. Despite the turmoil of the past year, the markets structurally came through relatively unscathed, despite both historic market volatility and unprecedented regulatory volatility ...."[125]

The non-equity markets that contributed to last year's financial crisis lack post-trade transparency; this is different from the equity markets, where there is full post-trade transparency of all executions.

15. Costs

In evaluating the costs of the proposal, the Commission should give appropriate consideration to two significant costs that will result from the proposal. First, and most importantly, by restricting the choices that are available to institutions in executing block orders, the rule proposal will result in higher trading costs for individual investors, including the 42 U.S. million households that own mutual funds. Second, in response to the proposal market participants will spend tens of millions of dollars redesigning their systems to adapt to the new restrictions. For example, as discussed above, participants will move certain activity from their ATS to their trading desk or will transition from an order notification model to a pinging model.

We would expect to see a significant increase in pinging, which can achieve an equivalent result to an order notification but in a less efficient manner. When a smart order router interacts with multiple execution venues, order notifications can be more efficient than pinging. For example, if a block order pool has a match for 10% of orders on average, instead of the block order pool sending one order notification message to a smart order router, the smart order router could send ten pings to the block order pool. We fail to see any benefit for investors that would justify imposing this additional cost and incurring this additional message traffic and infrastructure investment.

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[124] Letter from Mary L. Schapiro, Chairman of the Securities and Exchange Commission, to Senator Edward E. Kaufman, September 10, 2009, p. 1.

[125] Richard Ketchum, Chairman and CEO, FINRA, speech at the SIFMA Annual Meeting, New York, NY, October 27, 2009, p. 5. ("Ketchum")

Annex C

The Commission can minimize the adverse impact of the pre-trade proposal on individual investors with appropriate modifications to the proposed block order exemption

We appreciate the Commission's recognition in the release that institutions face a challenge in executing block orders. According to the Commission:

> "In general, dark liquidity (that is, trading interest that is not included in the consolidated quotation data) is not a new phenomenon. Market participants that need to trade in large size, such as institutional investors, always have sought ways to minimize their transaction costs by completing their trades without prematurely revealing the full extent of their trading interest to the primary market."[126]

We also appreciate the Commission's proposal for an exemption to protect "institutional investors that need to trade efficiently in sizes much larger than those that are typically available in the public quoting markets."[127]

We support the Commission's proposal for a block exemption. Our concern is that the block exemption is too restrictive. We recommend three modifications to the proposed block order exemption to ensure that the proposed rule change does not increase trading costs for institutional investors and the 42 million households that invest in mutual funds. We believe all of these proposed changes are sufficiently limited that they do not affect the Commission's overall objectives in proceeding with the proposed rule changes.[128]

As the Commission recognizes in proposing the block exemption, we can't necessarily assume that the rules that are appropriate for 100-share orders also are appropriate for block orders. We note that in other industries wholesale buyers typically get better pricing than retail customers. This is the rare industry where wholesale customers (i.e., institutions) would be happy to get the same price as retail customers because it means they have eliminated their market impact costs. Our proposed modifications are aimed at assisting institutions to achieve this objective.

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[126] Proposing Release, pp. 4-5.

[127] Proposing Release, p. 19.

[128] We note our first preference is that the Commission not proceed with the proposed pre-trade proposal as we believe that the Commission's pre-trade proposal, even with a more flexible block exemption, would raise trading costs for investors. We would instead request that the Commission consider alternative rule proposals that we have proposed in Annex D below. However, if the Commission is to proceed with the proposed rule changes, we believe that the exemptions we propose in this Annex will be important to ensure that the adverse effects on millions of U.S. households are minimized.

In connection with the adoption of Regulation NMS,[129] the Commission issued a series of FAQs. These FAQs included a number of exemptions and interpretations relating to the order protection requirement.[130] We believe these exemptions and interpretations were important in facilitating the implementation of Regulation NMS, and we would recommend a similarly flexible approach with respect to the Commission's pre-trade proposal.

Block orders should be protected whether they are executed in one block execution or multiple non-block executions

The Commission recognizes in the proposing release the historical and current challenge faced by institutions in executing block orders.[131] In our view, this interest applies regardless of the method selected by the institution to execute a block order. Many industry analysts have noted that typically the lowest cost method for an institution to execute a block order is to execute directly against another institution with a contra-side block order. But in many cases, a contra-side block order is not available, and the institution will still want the ability to control how information is disseminated about its block order. We believe the institution's flexibility should be preserved in this situation because the objective is the same – executing a block order in a way that minimizes the institution's trading costs.

The Commission notes in the proposing release:

> "For many years, the manual trading floors of exchanges were a primary source of dark liquidity in the form of floor traders that 'worked' the large orders of their customers, executing each such order in a number of smaller transactions without revealing to counterparties the total size of the order."[132]

The Commission further notes in the proposing release that,

> "... Rule 604 of Regulation NMS, which imposes limit order display requirements, recognizes the need of large investors to control the public display of their trading interest. Rule 604(b)(4), for example, provides a general exception from the public display requirement for a block size order, unless the customer placing the order requests that the order be displayed."[133]

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[129] 17 CFR 242.601, et. seq.

[130] Securities and Exchange Commission, "Division of Market Regulation: Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS", http://www.sec.gov/divisions/marketreg/nmsfaq610-11.htm (accessed December 18, 2009), April 4, 2008.

[131] Proposing Release, pp. 4-6.

[132] Proposed Release, pp. 5-6.

[133] Proposing Release, p. 6.

Both of these examples illustrate that what is important to protect is the institution's block order, as opposed to a particular method for executing that block order. In other words, if we acknowledge that an institution has a valid interest in protecting its block order information, that interest should apply without discrimination as to the process chosen by the institution for executing the block order.

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We would propose a limited exemption where a block order would not be subject to a public display requirement if an institution commits a block order to a broker as a firm order and any notification transmitted by the broker for the block order is at least block size. This means that if a contra-order of block size is sent in response to the order notification, the institution's block order will be executed for the block amount.

Our proposed exemption would not cover the situation where an institution has a block order and transmits a non-block portion of that order to a broker. Instead, as a condition to the exemption in the preceding paragraph, the institution must send the broker an order of block size. In addition, it would not be sufficient that the order transmitted to the broker be of block size. Any order notification transmitted by the broker also must be of block size, which means that any counter-party submitting a contra-side order for block size would get a block execution.[134]

* * * * *

We would also propose one additional condition for this exemption if the Commission does not believe that our proposed exemption is sufficiently limited. Under this condition, the system would need to provide meaningful price improvement for both sides to the trade, defined either as a mid-point execution or minimum price improvement of one cent. This is sometimes described as a "trade at" requirement.

If we add this condition, we can identify four specific benefits from the proposed exemption:

- ***Reduced market impact costs.*** We know that this exemption will provide reduced market impact costs for block orders because institutions use systems that transmit order notifications for block orders, and they would not use these systems unless they determined that these systems could reduce their trading costs for certain block orders.

[134] As previously noted, our first preference would be that the Commission not proceed with the proposed pre-trade proposal. Our second preference would be a broader block exemption than the one we are proposing, but we are looking for how we could most narrowly tailor any proposed block order exemption.

- ***Price improvement for the institution.*** As discussed in detail in Annex B, it is typically the high-frequency traders and other market intermediaries who are represented at the best bid and offer and capture the spread, while the institutional order typically is required to cross the spread. A mid-point execution reduces the institution's trading costs by allowing the institutional order to capture half the spread.

- ***Price improvement for the contra-party.*** A mid-point execution also provides price improvement for the contra-party. If we look at Liquidnet H2O, the contra-parties include exchanges, ECNs, ATS and brokers representing different types of liquidity, including institutional and retail liquidity. Accordingly, the proposed exception would facilitate price improvement for market counter-parties, including retail customers.[135]

- ***Interaction of institutional and other liquidity.*** The proposed exception would facilitate interaction between an institution's liquidity and other liquidity in the market, including retail liquidity, but in a manner that protects the confidentiality of the institution's block order information. As a result, institutional liquidity that might not otherwise interact with the market would be made available to other market participants.[136]

In addition to providing these four specific benefits, the proposed exemption would not impact the stated intent of the proposed rule as all non-block order notifications would not be covered by the exemption.[137]

We also believe that a minimum time period for the order notification could be added as a further condition if there is a concern that market participants with slower systems would be disadvantaged. We do not believe this should be a concern because our H2O participants who represent retail liquidity have the same speed of transmission as other H2O participants.

* * * * *

[135] According to Rule 605 data for 2009 as compiled by Thomson Transaction Analytics Reports, for orders transmitted by Liquidnet H2O participants and executed by Liquidnet H2O, Liquidnet provided average price improvement of 1.26 cents per share, or 91% of the quoted spread. Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares.

[136] This result is consistent with Section 11A(a)(1)(C) of the Exchange Act which identifies as one of the policy objectives of the national market system, providing "an opportunity ... for investors orders to be executed without the participation of a dealer." 15 U.S.C. § 78k-1(a)(i)(C).

[137] As discussed in Annex B below, we do not believe there is a need to further restrict non-block order notifications, but our primary concern, as discussed in this Annex C, is to ensure appropriate protection for block order notifications.

Block exemption for mid, small and micro-cap stocks

The Commission's has proposed a market value threshold of $200,000 for the proposed block exemption. Several of our institutional customers have expressed the concern that $200,000 would be too high a threshold for mid-cap, small-cap and micro-cap stocks, as well as for less liquid large-cap stocks, and could impede their ability to achieve best execution for block orders in those stocks.

We would propose a modification to the Commission's definition of block order so that a block order is defined as an order that meets one of the following criteria:

- Market value of at least $200,000
- At least 10,000 shares
- At least 1% of ADV.[138]

We would propose that ADV be computed based on the average ADV in the relevant stock for the ten prior trading days.

We also would propose that the Commission, from time to time, could set the threshold for any or all of the 50 most actively traded stocks at $200,000. For these stocks, the alternative proposed thresholds of 10,000 shares and 1% of ADV would not apply.

* * * * *

The proposal for a 10,000-share threshold is consistent with the traditional definition of block order under various Commission rules, including Rule 604 of Regulation NMS, which references the block order definition in Rule 600(b)(9) of Regulation NMS.[139] We believe the 10,000-share threshold would facilitate execution of block orders for mid-cap, small-cap and micro-cap stocks as well as for less liquid large-cap stocks. For example, in Q3 2009 we received an order for 13,200 shares of VTNC. The price of the stock was $11.51. This order had a principal value of $151,932 and represented 72% of the ten-day trailing ADV.[140] We note that a 10,000-share threshold is still 37 times larger than the average execution size on the NYSE and 37 times larger than the average execution size on NASDAQ.[141]

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[138] We note that this percentage threshold is four times greater than the .25% order display threshold proposed by the Commission.

[139] 17 CFR 242.604. 17 CFR 242.600(b)(9).

[140] This is just one example. We could provide many similar examples at the Commission's request.

[141] http://www.nyxdata.com/nysedata/default.aspx?tabid=115 (January 1 to October 31) (accessed December 18, 2009). http://www.nasdaqtrader.com/Trader.aspx?id=DailyMarketFiles (January 1 to October 31) (accessed December 18, 2009).

Our proposed threshold with regard to ADV is to facilitate execution of orders in less liquid stocks. For example, in Q3 2009 we received an order for 7,289 shares of LULU.[142] The price of the stock was $19.73. This order had a principal value of $143,812 and represented 1.1% of the ten-day trailing ADV.

* * * * *

In determining the appropriate threshold, it is important to take into account that the exemption is based on the size of the order that the institution commits to the broker, not the size of the institution's order. For example, in our H2O system, the average size of an order that accesses our H2O system is 46,875 shares, yet the average size of the associated order record in the institution's order management system is 251,279, or 5.4 times the size of the order that the institution creates in Liquidnet. Based on this data we could roughly estimate that for a 10,000-share order committed by an institution to a broker, the institution's actual order size would be approximately 54,000 shares. Similarly, we could estimate that for an order committed by an institution to a broker representing 1% of ADV, the institution's actual order size would be approximately 5.4% of ADV.

* * * * *

Because we believe the Commission's rule proposal will raise trading costs for institutions if the block exemption is too narrowly drafted, we hope that the Commission will take a flexible view when setting the applicable thresholds.

As noted by Jeff Morgan, CEO of the National Investor Relations Institute,

> "Enabling institutional investors to trade a large block efficiently is important for all issuers. It's especially important for small and mid cap stocks that are typically less liquid and therefore more difficult to trade without moving the market. While this proposal appears to make sense for large block trading, the challenge for the SEC will be creating certainty that long term investors are not disadvantaged by market trading and front running at any level."[143]

Proposed exemption for large programs

We recommend an exemption for orders that are part of a qualifying program. We would define a qualifying program as a program that meets all of the following conditions:

- The program involves the related purchase or sale of a group of 15 or more stocks

[142] This is just one example. We could provide many similar examples at the Commission's request.
[143] Jeffrey Morgan, "President's Note", *IR Weekly,* December 1, 2009, p. 2.

- The program involves a coordinated trading strategy where execution of the individual orders in the program is linked
- The aggregate principal amount of the program is $3,000,000 or higher.

The proposed 15-stock threshold is taken from the definition of "program trading" in NYSE Rule 132B.10(b). The proposed $3,000,000 threshold is based on multiplying the 15-stock threshold in NYSE Rule 132B.10(b) by the Commission's proposed $200,000 principal value threshold. We believe such an exemption would be appropriate because restrictions on how the non-block portion of a program can be executed would likely impede execution of the block portion of the program. Ultimately, if there are systems and products available for institutions to reduce their execution costs for program trades, institutions should have the ability to utilize these systems and products.

Flexibility to issue additional exemptions

The Commission should reserve for itself the authority to issue additional exemptions in the future where the exemption is appropriate to facilitate execution of large orders by institutions. We envision that any such exemption, like the one we have proposed for large program orders, would be based on objective, quantifiable criteria and would be available to systems that meet these criteria, as opposed to exemptions that would apply for a specific system.

Annex D

Alternate proposals to address the challenges faced by individual investors that do not restrict competition or raise trading costs for tens of millions of investors

How do we help individual investors

Regulators should approach the issue of how to regulate markets with one simple question – how can we make the market better for individual investors. The largest group of individual investors is the 42 million American households that invest in mutual funds, pension funds and 401(k) accounts.[144]

Challenges faced by the institutions that trade for mutual fund investors

To understand how regulations can help individual investors, we need to understand the challenges faced by individual investors in today's markets. Let's start with the 42 million households who invest through mutual funds and other institutional investment vehicles.

First, let's look at the upside. According to Rosenblatt Securities, high-frequency trading has led to massive liquidity provision and has "... played a key role in narrowing spreads, which results in reduced transaction costs for all investors."[145] It also "fosters intense competition between market centers", leading to greater innovation and improvements in technology.[146] TD Newcrest similarly reports that "from the institutional perspective, narrower spreads are a positive."[147]

Dr. Sirri notes that market developments such as algorithms and block crossing systems have "... enabled large investors not merely to deal with highly active, automated markets, but to benefit from them."[148]

* * * * *

Now, let's look at the challenges. According to Rosenblatt Securities,

> "Another cost comes from the effect of HFT market makers having such superior mathematical and technological prowess that they almost always beat traditional market participants to posting the best prices

[144] According to the Tabb Group, buy-side institutional investors represent approximately 20% of market volume and retail brokerage trading represents approximately 3% of market volume. Tabb Group, p. 15.
[145] Rosenblatt Securities, p. 25.
[146] Rosenblatt Securities, p. 25.
[147] TD Newcrest, p. 6.
[148] Sirri, p. 5.

> first. This means that HFTs earn the vast majority of exchange rebates while others subsidize these rebates by paying exchange fees."[149]

A research report by TD Newcrest echoes this point:

> "From the institutional perspective, narrower spreads are a positive. However, for institutions that tend to like to work orders passively [i.e., institutions that like to post bids and offers at the NBBO], overall trade execution costs have gone up as they now have to compete more for passive executions. This is because most of the passive liquidity in the current market environment is provided by market makers (in other words, it is not natural)."[150]

* * * * *

Institutions also face the challenge of signaling their block intent to market intermediaries. According to Tabb Group,

> "... institutional investors tend to keep their trades quiet and not telegraph their intentions. Many investors feel that by placing limit orders or showing their hand, they will leak information into the market and invite other traders to take advantage of them."[151]

TD Newcrest similarly reports that institutional traders in Canada "... remain concerned over information leakage that results from sophisticated pattern recognition as well as aggressive strategies utilized by high frequency traders that are able to maneuver in the market much more nimbly than traditional traders."[152]

* * * * *

Greenwich Associates reports "a complete lack of consensus about high-frequency trading's role in equity markets".[153] According to Greenwich Associates,

> "The institutions participating in the survey interact with high-frequency traders on a near constant basis, and these institutions would be affected more than anyone else by any negative or positive influence from high-frequency trading strategies .... Yet these institutions are split between

[149] Rosenblatt Securities, p. 23.
[150] TD Newcrest, p. 11.
[151] Tabb Group, p. 22.
[152] TD Newcrest, p. 8.
[153] Greenwich Associates, "High-Frequency Trading: Lack of Data Means Regulators Should Move Slowly", October 2009, p. 1. ("Greenwich Associates")

> those that see high-frequency trading practices as malevolent or benign, as adding liquidity to global markets or preying on traditional stock investors."[154]

Greenwich Associates further reports,

> "Institutions do agree on one thing: They do not have enough information to make any final judgments about high-frequency trading."[155]

* * * * *

Regardless of their view as to whether high-frequency trading is harmful or benign for the market, institutional traders accept the challenge of executing block orders in a market where high-frequency trading is prevalent. As noted by Pete Driscoll, Senior Equity Trader at the Northern Trust Company, in his testimony at the recent Senate subcommittee hearing on market structure:

> "As far as people trying to take advantage of my orders, I can see – I don't need technology to show me that. I can see it and react as I need to, and that's my job. That's what we're sitting on these desks to do."[156]

* * * * *

Institutions also are challenged by the complexity and opaqueness of how their orders are handled. According to the Tabb Group:

> "... hedge funds and asset managers would like to see more transparency on dark pool executions, beginning with standard terminology and reporting for volume figures. Furthermore, they would like a better understanding of how their orders are handled. Without more empirical data on how orders are handled, it is very difficult for them to make intelligent decisions regarding with whom to trade and how to trade."[157]

The Tabb Group further notes:

> "Even many market participants believe the current market structure is too opaque. Dark pool reporting is voluntary, unverifiable and not necessarily standardized. Independent analysis comparing execution

[154] Greenwich Associates, p. 1.
[155] Greenwich Associates, p. 1.
[156] Senate Subcommittee Hearing Transcript, pp. 40-41.
[157] Tabb Group, p. 25.

> quality across dark pools is non-existent. Order handling has become so complex that even the most sophisticated institutional investors are not fully aware of what is or could happen to an order."[158]

Adam Sussman of the Tabb Group echoed this concern in his recent testimony before a U.S. Senate Subcommittee:

> "They [institutions] need to use these tools [trading systems] ... to efficiently interact with the marketplace, ... to efficiently distribute their orders ... trading against other institutional investors, trading against high-frequency traders. But the issue is how much do they really understand about the algorithms and the dark pools that they're handling.
>
> ... sometimes they feel overburdened by the amount of information that they have to keep track of in order to execute these orders. But I don't think that they would ... ask for anything else .... This is a challenge that they accept wholeheartedly as a part of their job, and they would rather have the responsibility of understanding these pieces ... rather than some regulatory framework force them to act one way or another.
>
> ... Freedom is obviously a responsibility as well as a right, and they accept that challenge."[159]

Challenges faced by retail brokerage customers

As discussed in Annex B above, retail brokerage customers have benefited from lower commissions, reduced spreads, reduced execution times and increased liquidity for retail-sized orders.

As far as challenges, according to TD Newcrest, retail orders (like institutional orders) "... are being forced more and more to cross spreads, as bids and offers are stacked with so many other market maker orders that it becomes very difficult to passively buy or sell stock."[160]

The Tabb Group reports that,

> "Individual investors are at the mercy of their brokers to manage their order flow with dexterity. Many retail brokers do not have access to the

[158] Tabb Group, p. 30.
[159] Senate Subcommittee Hearing Transcript, p. 18. Senator Corker, one of the Senators who attended the hearing, praised Mr. Sussman's testimony: "I do want to say, Mr. Sussman, ... I thought your presentation was outstanding and very easy to understand." Senate Subcommittee Hearing Transcript, p. 40.
[160] TD Newcrest, p. 7. Passively buying stock refers to posting a bid or offer at the NBBO.

same sophisticated technology as larger brokers or investors, and hence sell their flow to wholesalers who typically have better execution facilities."[161]

Proposals to help mutual fund and retail brokerage investors

We set forth below five sets of proposals to help mutual fund and retail brokerage investors. For the most part, these are not our proposals, but rather suggestions that we have heard from third-parties, including regulators, legislators, customers, market participants and industry experts. We think all of these suggestions are open to debate, but they are the types of proposals that should be up for discussion. You will note that none of these proposals involve restricting the business of our competitors.[162]

1. ***Mandate disclosure of specific order handling practices by institutional brokers***

As noted by Adam Sussman of Tabb Group in his testimony at the recent Senate subcommittee hearing on market structure:

> "The relationship between the trader and the floor broker was based on trust. It was based on a kinship that was built up over time.
>
> And in an electronic world, you know, how do we build that trust and confidence. At Tabb Group, we believe that's with more disclosure, more openness about the trading practices. That's why we believe that dark pools should be more public about their types of participants they have in their pools, the mechanisms the use to execute client orders."[163]

Addressing the concern noted above by the Tabb Group and other industry experts that order handling has become too complex even for the most sophisticated institutional investors, we support a regulation mandating disclosure by institutional brokers (including institutional ATSs) to their customers of specific order handling practices.

We think the details would need to be worked out, but some specific items of disclosure might include:

- Description of the broker's order handling process, including:
  - Identification of external venues to which the broker routes orders
  - Process for crossing orders with other orders received by the broker
  - Execution of orders as agent and principal
  - Use of IOIs, pinging and other messages

[161] Tabb Group, p. 24.
[162] See the section of Annex G below entitled "Another troubling Wall Street practice".
[163] Senate Subcommittee Hearing Transcript, p. 17.

- Detailed description of the operation and function of each ATS or trading desk operated by the broker
- Percentage of executed shares executed at each external venue
- Percentage of executed shares executed internally, including:
    - Percentage executed as principal and agent
    - For agency executions, percentage of shares executed by each specific trading desk or ATS operated by the broker
    - For principal executions, percentage of shares executed by each specific trading desk operated by the broker
- Clear and detailed description of each algorithm and order type offered by the broker
- Categories of participant and admission criteria for each ATS or trading desk with which the customer's order can interact
- Detailed disclosure of any dissemination of the institution's order and trade information.
- Internal processes and policies to control dissemination of the institution's order and trade information and other confidential information.
- Fees received or paid by the broker in connection with routing to other venues.
- Ownership and other affiliations between the broker and any venues to which the broker routes orders.

These are suggested disclosure items. It would make sense to solicit input from institutional investors and other market participants on the types of disclosures that would be appropriate.

These disclosures should be kept current and updated on a monthly basis. They should be made available by institutional brokers to their customers through the broker's customer website. Disclosures should be filed with the Commission and FINRA, with an opportunity for the regulators to provide input if they believe the disclosure is incomplete, unclear or inaccurate.

2. *Improve execution disclosure for retail brokerage customers*

The primary concerns for retail brokerage customers include commissions, quoted spreads, price improvement and speed of execution. Commissions are expressly disclosed to customers. Spreads are a function of the overall market. We think enhanced disclosure of quoted spreads, price improvement and speed of execution data could potentially benefit retail brokerage customers.

In a letter to Chairman Schapiro, Senator Edward Kaufman has suggested amendments to Rule 606 that would provide "better and usable execution quality statistics in Rule 606."[164] In the current Rule 606 report, retail brokers are required to disclose payment for order flow

[164] Letter dated August 21, 2009 from Senator Edward I. Kaufman to The Honorable Mary L. Schapiro, p. 2. ("Kaufman Letter")

arrangements. This is an appropriate disclosure, but ultimately retail brokerage customers would be more directly concerned with price improvement (relative to the market at the time of order receipt) and speed of execution.

A number of questions would have to be considered as to how this disclosure could be most helpful for individual investors. For example: should disclosure be based on aggregate data for the broker or broken out across order types or security types?; should the disclosure be limited to market orders and orders below a certain size (for example, 200 shares or less)?; what should be the frequency and format of the disclosure?

We also could consider enhanced trade-by-trade disclosure through the Rule 10b-10 confirmation process. For example, would it be helpful if a retail investor could see on a confirmation the NBBO at the time of order receipt, the price improvement per share and the price improvement as a percentage of the quoted spread? This could allow the retail investor to compare his or her execution price against the NBBO. Similarly, would it be helpful if the investor could see on the confirmation the time lag between order receipt and order execution?

The following principles should guide any disclosure obligation:

- ***Simplicity.*** It is important to ensure that any mandated report provides data that can be readily understood by the retail brokerage customer.
- ***Relevancy.*** The data should be relevant for a retail brokerage customer in determining how to trade and facilitate comparison of execution performance across brokers.
- ***Efficiency.*** It is important that any disclosure obligation not impose an undue obligation on brokers in collecting and making the data available. A proposal would only be advisable if the potential benefits of the proposal outweighed the potential costs.

The limitation with the current Rule 605 report is that the execution quality data in the report relates to the execution venue, rather than the routing broker, and provides information to the routing broker, rather than the retail brokerage customer. The limitation with the current Rule 606 report is that it does not provide data on execution quality. The proposals in this section could potentially fill a gap between the two rules, but it would be important to ensure that the data in the report would be useful and meaningful for the retail brokerage customer and that we minimize any increased disclosure burden on the retail broker.

3. Mandate immediate reporting of all electronic executions

In a letter from Senator Charles Schumer to Chairman Schapiro, Senator Schumer recommends that the Commission end 90-second reporting for trades.[165] In his letter to Chairman Schapiro,

[165] Letter dated July 24, 2009 from Senator Charles E. Schumer to The Honorable Mary L. Schapiro, p. 3.

Senator Kaufman similarly asks: "When trades are executed in milliseconds, why do we permit a 90-second delay in reporting trades to the tape...."[166] We think it is time to do away with 90-second reporting for electronic executions. Any trade executed electronically should be reported to the tape immediately.

FINRA has recently proposed reducing the 90-second trade reporting period to 30 seconds.[167] FINRA writes in its rule proposal:

> "Although members would have 30 seconds to report, FINRA reiterates that – as is the case today – members must reports trades as soon as practicable and cannot withhold trade reports, e.g., by programming their systems to delay reporting until the last permissible second."[168]

Consistent with FINRA's statement, we would support a rule requiring immediate reporting of all electronic executions. We understand that some time period, whether 30 or 90 seconds, is required for input of trades executed manually. For these manual trades, once the trade has been input into the reporting system within the applicable time period, the trade should be immediately transmitted to the tape.

We also would support a tag that would publicly identify manually reported trades. With this tag market participants would know which trades are being reported in real-time and which trades are being reported on a delayed basis.

4. *Market surveillance*

On July 26, 2007 the Commission approved an order for transferring the member firm regulation and enforcement functions and employees of NYSE Regulation to an expanded NASD. During this time period the NASD was renamed the Financial Industry Regulatory Authority (or "FINRA") to reflect its recent independence from NASDAQ. The Commission wrote in the order that,

> "The consolidation is intended to streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single

[166] Kaufman Letter, p. 5.

[167] Securities and Exchange Commission, Release No. 34-60960, "Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change, and Amendment No. 1 Thereto, to Require Members to Report OTC Transactions in Equity Securities Within 30 Seconds of Execution", File No. SR-FINRA-2009-061, November 6, 2009. ("FINRA Trade Reporting Release")

[168] FINRA Trade Reporting Release, p. 3.

> set of rules and a single set of examiners with complementary areas of expertise within a single SRO."[169]

This consolidation was, in part, a result of the demutualization of the exchanges. The Commission wrote:

> "SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from self-regulation. For instance, shareholder-owned SROs may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable."[170]

Another contributing factor to the consolidation was events at the NYSE earlier in the decade. According to a paper by Nan Ellis, Lisa Fairchild and Harold Fletcher,

> "... the NYSE was rocked by allegations of trading irregularities in the early 2000's. Specifically, seven specialist firms admitted to violating stock trading rules and to engaging in practices of inter-positioning, front-running and freezing. Prodded by the threat of an investigation by the Securities and Exchange Commission (SEC), the NYSE investigated the allegations and concluded that there was specialist misconduct. In response, the NYSE fined five specialist firms a total of $150 million; in addition, a settlement was reached with the specialist firms agreeing to pay over $240 million. Following these disclosures, the NYSE itself was accused of being complicit in the trading schemes, of publishing misleading representations of regulatory oversight and of failure to oversee the specialist system."[171]

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At the time, the decision was made not to consolidate regulation of market surveillance. We think this decision should be reconsidered.

According to Richard Ketchum, Chairman and CEO of FINRA,

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[169] Securities and Exchange Commission, Release No. 34-56148, "Program for Allocation of Regulatory Responsibilities Pursuant to Rule 17d-2; Notice of Filing and Order Approving and Declaring Effective a Plan for the Allocation of Regulatory Responsibilities Between the National Association of Securities Dealers, Inc., New York Stock Exchange LLC, and NYSE Regulation, Inc.", File No. 4-544, July 26, 2007, p.4.

[170] Securities and Exchange Commission, Release No. 34-50700, "Concept Release Concerning Self-Regulation", File No. S7-40-04, December 8, 2004, p. 34.

[171] Nan S. Ellis, Lisa M. Fairchild, Harold D. Fletcher, "The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation", pp. 1-2.

> "The decline of the primary market concept, where there was a single price discovery market whose on-site regulator saw 90-plus percent of the trading activity, has obviously become a reality. In its place are now two or three or maybe four regulators, all looking at an incomplete picture of the market and knowing full well that this fractured approach does not work. This is especially true given how easy it is for market participants to move volume on a second-by-second basis between venues.
>
> ....
>
> Today, there are multiple regulators attempting to respond in a timely way to market changes, using scarce resources to try to simultaneously develop similar systems and processes. A stronger, single regulator would be equipped to meet market surveillance more effectively, and with less expense, than multiple regulators."[172]

At the same time, we recognize that current market surveillance personnel at the NYSE and NASDAQ have a detailed understanding of how their respective markets operate. We would recommend continuing to take advantage of the current infrastructure for market surveillance while consolidating this infrastructure under FINRA. This will help to address the potential conflicts that market surveillance personnel currently face in performing their supervisory responsibilities.

Senator Schumer noted at the recent Senate subcommittee hearing on market structure:

> "... the proliferation of alternative trading venues has significantly altered the trading landscape. Many of these changes have been largely for the better. The competition provided by alternative trading systems brought significant benefits to retail investors and that's been discussed by many of our witnesses. But these benefits have come at a cost, because our capital markets have become increasingly fragmented and market surveillance has not kept pace, making it increasingly difficult – especially in light of the technological developments that facilitate large volumes trading at high speeds – to conduct adequate market surveillance across the markets.
>
> ....
>
> So I proposed to the SEC that market surveillance should be consolidated across all trading venues to eliminate the information gaps and

[172] Ketchum, p. 5.

coordination problems that make surveillance across all markets today."[173]

We believe that consolidation of market surveillance under FINRA would help address the issues raised by Senator Schumer, Mr. Ketchum and others.

5. *Changes to Regulation ATS*

We would propose the following three amendments to Regulation ATS.

Enhance the review process for new ATSs and material business changes by ATSs

Under Rule 301(b)(2) of Regulation ATS, an ATS must file an initial operation report on Form ATS at least 20 days prior to commencing operation as an alternative trading system. In addition, an ATS must file an amendment on Form ATS at least 20 calendar days prior to implementing a material change to the operation of the ATS.

We would propose amending Regulation ATS to permit the Commission to delay the effective date of a new ATS commencing operation or of an existing ATS implementing a material business change if the Commission believes that information in the ATS filing is unclear or incomplete or raises an issue of potential non-compliance with applicable law or regulation. Under this proposal, the effective date of the new ATS or material change in ATS business would be delayed until the information in the filing has been amended to the satisfaction of the Commission and any issues of potential non-compliance have been addressed to the Commission's satisfaction.

We would propose that FINRA have the same right as the Commission to delay the effective date of a new ATS or a material business change of an existing ATS on the same basis as noted in the preceding paragraph.

Transparent dark pool registration

As suggested by Senator Kaufman in a letter to Chairman Schapiro, registration of alternative trading systems with the Commission should be transparent to the public.[174]

Expand the capacity, integrity and security obligations to all ATSs

Under Rule 301(b)(6) of Regulation ATS, ATSs that exceed certain volume thresholds are subject to specific capacity, integrity and security obligations. As suggested by Senator Schumer, this

[173] Senate Subcommittee Hearing Transcript, p. 25-26.
[174] Kaufman Letter, p. 6.

obligation could be expanded to all ATSs.[175]

[175] Schumer Letter, p. 3.

Annex E

Post-trade proposal

With regard to post-trade transparency, we support the principle of identifying where trades in a stock are executed (we refer to this as the "identification requirement"). We agree that reporting of this information to the Commission and FINRA should be done on a real-time basis. We also support public identification of the venue where trades are executed; our only concern relates to the timing of this disclosure.

Our concern with immediate public identification of the specific venue where a trade has been executed is that market intermediaries could use this information to detect a large institutional buy or sell order in a stock and then trade against that order to the disadvantage of the institution.

According to a research report by Raymond James,

> "... we do think this proposal has the potential to create more trading opportunities for the much-maligned high frequency trader by mandating real-time posting. Delayed posting (such as at the end of the day) would still allow market participants to see exactly how much trading occurred on each dark pool, but real-time posting will allow sophisticated high-frequency traders to take advantage of this information."[176]

We understand the Commission has proposed an exemption for reporting of block executions, but this exemption would not cover non-block executions at venues that are known for handling large block orders.

To address the concern of protecting institutional block orders, we propose applying the public identification requirement on a delayed basis. Some of our institutional customers would not object to end-of-day public identification of this information. Other institutional customers that we have spoken with are concerned that even end-of-day public identification could be problematic for block orders that are executed over multiple days. We think it is important for the Commission to have a dialogue with institutional traders about this issue to help determine the appropriate solution.

* * * * *

It is important to ensure consistency in application of the identification requirement. The rule as proposed unfairly discriminates against electronic trading versus manual trading and unfairly discriminates against agency trading versus principal (or proprietary) trading.

[176] Raymond James, p. 2.

The following table highlights our concern on this point:[177]

	Agency crossing	Principal (proprietary) trading
Electronic trading	ATSs	High-frequency traders; market makers; block trading desks
Manual trading	Block trading desks	Block trading desks

If, as we understand, the purpose of the rule proposal is to assist market participants to identify where to find liquidity in a specific stock, we are unclear as to why this requirement would apply only for electronic, agency trading but would not apply to the other three categories of trading. As an example, under our proposal, if a broker has a proprietary trading desk and also operates two ATSs, any trade executed in one of the two ATSs would identify the specific ATS where the trade was executed, and any trade executed by the broker as principal (or crossed by the broker as agent) outside of the ATSs would identify the broker.

The right solution is not specific to ATSs but would apply to all market intermediaries making liquidity available, whether as agent or principal and whether electronically or manually. If an identification requirement is adopted, it should apply for all of the scenarios identified in the table, with identification of the block trading desk, high-frequency trading firm or market maker, as applicable.

* * * * *

In addition to the specific proposal put forth in the release, it also is important to consider more generally the need to ensure accurate and consistent disclosure of trade volume by exchanges, ATSs and other market participants. According to Aite Group,

> "Dark pools are not currently required to publicly share any volume data. Certain dark pools double-count all of their volume, even if the order was actually executed externally. Other dark pools double-count what they

[177] Note that we are discussing where a trade is executed, not where a trade is reported. Since the purpose of the rule proposal is to assist market participants in identifying where to find liquidity in a specific stock, the focus should be on where a trade is executed, not where it is reported. In the table above, a trade executed by a market maker against a customer order and reported to an exchange's trade reporting facility would be classified as a market maker trade. Similarly, a trade crossed by a block trading desk and reported to an exchange's trade reporting facility would be classified as a trade by the block trading desk. In these situations, reporting the exchange does not provide any information as to where liquidity can be found in that stock.

> cross on their own platform, and single-count volume that they route out. Standardizing reporting standards should provide a much better view into the actual size of the non-displayed marketplace."[178]

We would support any guidelines that would ensure consistent reporting of trade volume by market participants.

* * * * *

While on the subject of post-trade reporting, we note a recent comment by Richard Ketchum:

> "It is also becoming easier to hide the identity of the actual participant in a trade in the trade report, further frustrating our efforts. It often takes days, not minutes, to understand who traded and where, and that is not the standard we want for a well-regulated and modern market."[179]

We are not clear what specific data needs to be added to the trade reports to address this issue, but Mr. Ketchum's concern should be addressed promptly to ensure that regulators have immediate access to all necessary trade information.

[178] Aite Group, p. 10.
[179] Ketchum, p. 5.

Annex F

Legislative history

Securities Acts Amendments of 1975 – emphasis on competition

The Commission writes in the proposing release that:

> "Congress in 1975 endorsed the development of a national market system and granted the Commission broad authority to implement it. Chief among the objectives of the national market system are coordinating markets, reducing fragmentation, and limiting the possibility of tiered markets where the best trading opportunities are available only to selected market participants."[180]

As noted by the Commission, creation of a national market system was the primary objective of the Securities Acts Amendments of 1975.[181] The legislative history demonstrates that Congress viewed competition as an essential component for a national market system. According to the Senate Report accompanying the Securities Acts Amendments of 1975:

> "The objective [of the Act] would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services. It would obviously be contrary to this purpose to compel elimination of differences between types of markets or types of firms that might be competition-enhancing."[182]

The Senate Report further provides that the Commission's basic role would be "to remove burdens on competition which would unjustifiably hinder the market's natural evolution" and that the Commission should act only after determining that "competitive market forces ... cannot be relied upon."[183] According to the Senate Report:

> "This is not to suggest that under S.249 the SEC would have either the responsibility or the power to operate as an 'economic czar' for the development of a national market system. Quite the contrary, for a fundamental premise of the bill is that the initiative for the development of the facilities of a national market system must come from private interests and will depend upon the vigor of competition within the securities industry as broadly defined. Although the SEC's basic role

[180] Proposing Release, p. 80.
[181] Securities Acts Amendments of 1975, P.L. 94-29.
[182] Senate Report, p. 8.
[183] Senate Report, p. 12.

> would be to remove burdens on competition which would unjustifiably hinder the market's natural economic evolution and to assure that there is a fair field of competition consistent with investor protection, in situations in which natural competitive forces cannot, for whatever reason, be relied upon, the SEC must assume a special oversight and regulatory role."[184]

The Senate Report further noted:

> "As the Subcommittee on Securities concluded in its Securities Industry Study, the ability of individual firms as well as the various exchange and over-the-counter markets to compete with one another will be a critical element in the successful functioning of the national market system. Unfortunately, because of excessive and unnecessary regulatory restraints, competition in the securities industry has not been as vigorous and as effective in advancing the public interest as it could be. The Committee concluded, however, that rather than amending the Exchange Act to eliminate particular, enumerated barriers to competition, the most effective way to foster competition would be to charge the Commission with an explicit obligation to eliminate all present and future competitive restraints that cannot be justified by the purposes of the Exchange Act."[185]

Of course, competition must be balanced against other regulatory objectives:

> "Under all of these Sections, the Commission's responsibility would be to balance the perceived anti-competitive effects of the regulatory policy or decision at issue against the purposes of the Exchange Act that would be advanced thereby and the costs of doing so."[186]

The Senate Report is clear that Congress did not intend to force all markets into a "single mold":

> "This is not to say that it is the goal of the legislation to ignore or eliminate distinctions between exchange markets and over-the-counter markets or other inherent differences or variations in components of a national market system. Some present distinctions may tend to disappear in a national market system, but it is not the intention of the bill to force all markets for all securities into a single mold. Therefore, in implementing the bill's objectives, the SEC would have the power to

[184] Senate Report, p. 12.
[185] Senate Report, p. 12.
[186] Senate Report, pp. 13-14.

> classify markets, firms, and securities in any manner it deems necessary or appropriate in the public interest or for the protection of investors and to facilitate the development of subsystems within the national market system."[187]

The Commission similarly has emphasized the importance of competition and innovation:

> "Section 11A of the Exchange Act charges the Commission with maintaining and strengthening a national market system for securities. In fulfilling this responsibility, the Commission has not attempted to dictate the ultimate structure of the securities markets. Instead, it has sought to establish, monitor, and strengthen a framework that gives the forces of competition sufficient room to flourish and that allows the markets to develop according to their own genius. The Commission remains committed to allowing the forces of competition to shape market structure in the first instance."[188]

The Commission's proposal runs contrary to the objectives identified in the legislative history

According to the Senate Report, "Section 11A(a)(1) of the Securities Acts Amendments of 1975 sets forth the goals and objectives of a national market system."[189] Section 11A(a)(1)(C) provides:

> "(C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure:
>
> (i) Economically efficient execution of securities transactions;
>
> (ii) Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
>
> (iii) The availability to brokers, dealers and investors of information with respect to quotations for and transactions in securities;
>
> (iv) The practicability of brokers executing investors' orders in the best market; and

[187] Senate Report, p. 7.
[188] Rule 390 Proposal, p. 16.
[189] Senate Report, p. 8.

(v) An opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors orders to be executed without the participation of a dealer."[190]

We are concerned that the Commission's rule proposal runs contrary to these objectives.

- ***Efficient execution.*** By restricting the choices available for institutions to executed block orders efficiently, the rule proposal will raise trading costs for institutions, resulting in less efficient executions.

- ***Fair competition.*** The rule proposal applies restrictions on ATSs and their customers that do not apply to agency trading desks, principal trading desks and floor brokers performing the equivalent function. This runs contrary to the principle of fair competition.

- ***Availability of information with respect to quotations and transactions.*** The Senate Report makes clear that in the Securities Acts Amendments of 1975 Congress was concerned with providing information about transactions and quotations. The term "transactions" refers to post-trade transparency; the term "quotations" refers to quotations by market makers and specialists.[191] References to institutional and retail orders in the Senate Report clearly refer to them as customer orders or public orders, and not quotes. The Senate Report focuses on providing protections for public orders; it does not propose imposing obligations and restrictions on institutions and retail investors as to how they communicate their orders.[192]

- ***Best execution.*** The Commission's rule proposal would run contrary to the principle of best execution by restricting the ability of institutions to use block order systems that reduce their market impact costs and provide price improvement on many orders. The rule proposal also would deny retail brokerage customers opportunities for price improvement.

- ***Opportunity for investor orders to execute without dealer participation.*** The rule proposal would impede opportunities for institutional orders to interact directly with other institutional orders and with other retail customer orders. To the contrary, the rule propose would mean less interaction between institutional order flow and other non-dealer liquidity in the market. The rule proposal also could drive institutional order

[190] 15 U.S.C. § 78k-1(a)(i)(C).
[191] Even with respect to quotes by market makers the Senate Report notes that "the competitive structure and incentives to participation thus provided should supplement, and ultimately may be able to replace, most affirmative requirements to deal imposed by regulation." Senate Report, p. 14.
[192] See, for example, Senate Report, p. 18.

flow to markets where market intermediaries with the fastest computer systems will have the first opportunity to interact with, and take advantage of, this order flow.

Order execution rules

Consistent with the analysis above, the Commission's order execution rules, adopted in 1996, imposed additional quoting obligations on market makers, but not on institutional and retail customers.[193] As part of the order execution release, the Commission adopted Rule 11Ac1-4 relating to display of customer limit orders.[194] The limit order display rule is intended for the benefit of customers and does not impose a display obligation on customers; to the contrary, the limit order display rules provides full discretion to the customer as to whether or not to display an order.[195]

Regulation ATS

Regulation ATS presents the first example of which we are aware where the Commission has imposed a display obligation on customer orders.[196] During the Regulation ATS comment period, a number of institutions expressed concern about the display obligation proposed by the Commission.[197]

The Commission writes in the adopting release for Regulation ATS:

> "Finally, a large number of institutional subscribers to alternative trading systems submitted comments within the last two weeks. These commenters expressed a number of concerns about the public display requirement. Among the concerns voiced by these commenters was a concern about decreasing liquidity, limiting a potentially advantageous trading strategy, being able to provide best execution for their clients, and increasing costs to execute trades."[198]

In the same release, the Commission responds:

> "Retail investors are not currently alternative trading system subscribers. To avoid market impact, institutions try to avoid signaling other institutions and market professionals, not retail investors. Almost all market professionals and a significant number of institutions already

[193] Order Execution Adopting Release.
[194] The Commission has re-designated Rule 11Ac-4 as Rule 604 of Regulation NMS.
[195] Rule 604 of Regulation NMS. 17 CFR 242.604.
[196] ATS Adopting Release. Technically, the display obligation falls on the ATS, but since ATS's trade as agent, in reality the display obligation falls on the institution using the ATS.
[197] ATS Adopting Release, p. 38.
[198] ATS Adopting Release, p. 38.

> subscribe to alternative trading systems. Thus, the Commission believes that the additional exposure to the market should not affect institutions' use of alternative trading systems."[199]

The Commission reaches an interesting conclusion - if market intermediaries can already view an institution's order information in the alternative trading systems that are used by the institution, the order display obligation does not harm the institution. But based on developments subsequent to the Commission's adoption of Regulation ATS, the Commission's conclusion on this point would no longer seem applicable. Since 1998, competitors (including Liquidnet) have developed and made available to institutions products and systems that enable them to trade block orders directly with other institutions without revealing their block order information to market intermediaries who can take advantage of this information. More recently, competitors (including Liquidnet) have developed and made available products and systems that enable direct interaction between institutional block orders and retail orders. With the development of these systems, the Commission's point would no longer seem applicable. In addition, the assumption that retail order flow does not interact with alternative trading venues is no longer accurate.

In the Regulation ATS adopting release the Commission cited the 5% order display threshold proposed by the Commission as providing flexibility for the institution:

> "Nonetheless, assuming institutions do have a preference for showing their sized orders to other alternative trading subscribers but not the public market, there may be two reactions. First, institutions could choose to move their orders to more opaque venues, such as block trading desks .... While block trading desks would benefit from the increased business, it likely would increase institutions' transaction costs. For this reason, as well as those discussed above, the Commission believes it unlikely for institutions to react this way. Second, because the public display requirement only applies to alternative trading systems with five percent or more of the volume in a particular security, there is a possibility that institutions may move their order flow to smaller alternative trading systems in order to avoid the public display requirement."[200]

The Commission provided flexibility for institutions by setting the order display threshold at 5%. The proposed reduction of the ATS threshold in the proposing release would take away this flexibility to the detriment of institutional investors, unless adequate flexibility is provided in the Commission's proposed block exemption.

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[199] ATS Adopting Release, p. 44.
[200] ATS Adopting Release, p. 44.

Annex G

Some final thoughts on the pre-trade proposal

Mid-peg orders

The benefits of mid-peg executions should not be lost in this discussion.[201] One of the unique characteristics of a mid-peg order is that there is no fixed price associated with the order, so the sender cannot display a quote, yet mid-peg executions provide price improvement to individual investors. Accordingly, restrictions on mid-peg orders run counter to the notion of best execution.

Protecting long-term investors

In the recent flash orders rule proposal, the Commission highlights "... its clear responsibility ... to uphold the interests of long-term investors."[202] The Commission writes:

> "If ... the interests of long-term investors and professional short-term traders conflict, the Commission previously has emphasized that 'its clear responsibility is to uphold the interests of long-term investors.'"[203]

The Commission writes further, citing to the proposing release for Regulation NMS, that,

> "... giving priority to the interests of long-term investors is consistent with both the legislative history of the Exchange Act and the strong policy goal to reduce the cost of capital for U.S.-listed companies."[204]

The Commission's rule proposal will raise trading costs for long-term investors. Our proposed modifications to the Commission's block exemption proposal will provide greater flexibility for institutional traders in executing block orders for their customers, for the express benefit of long-term investors.

Another troubling Wall Street practice

Regulators should be skeptical of any proposal by a Wall Street firm to restrict the operations of its competitors. For example, a firm engaged in institutional equity trading has proposed

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[201] According to Rule 605 data for 2009 as compiled by Thomson Transaction Analytics Reports, for orders transmitted by Liquidnet H2O participants and executed by Liquidnet H2O, Liquidnet provided average price improvement of 1.26 cents per share, or 91% of the quoted spread. Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares.

[202] Flash Orders Proposing Release, p. 16.

[203] Flash Orders Proposing Release, p. 16.

[204] Flash Orders Proposing Release, p. 16.

requiring high frequency traders to expose all orders for at least one second.[205] Like this firm, we are engaged in institutional equity trading, and we believe they make certain valid points about the challenges that high frequency trading presents for institutions. But we do not believe their proposal would help end investors. Rather than restricting how high-frequency traders operate, we think the better approach is for institutional brokers to provide the appropriate systems and products for institutions to navigate within the current market environment.

In this regard, we must ensure that institutions have the flexibility to use systems and products that they believe will help them navigate within the current market environment to achieve the most efficient execution of their block orders. Regulations should not impede this flexibility.

* * * * *

We also have seen exchanges propose limitations on off-exchange trading. We have seen agency-only firms propose limitations on internalization by investment banks. Other industry participants have proposed banning payment for order flow. While all reasonable suggestions should be considered, we would be suspicious of these and similar types of anti-competitive proposals put forth by industry competitors. We should instead always look first for regulatory solutions that do not impede competition.

* * * * *

We note, in particular, that the NYSE and NASDAQ recently have spent time in Washington, D.C. lobbying against dark pools. Yet the NYSE and NASDAQ have not always been so opposed to dark pools. Bob Greifeld, CEO of NASDAQ, had this to say about dark pools last year:

> "So the term 'internalization' has been around for a long period of time. What's new is the term 'dark pools'. So a dark pool is really a – just a form of internalization. We at NASDAQ have been a believer in internalization and in dark pools. Our exchange application was held up for five years because we fundamentally believed that dark pools internalization could add value to the market place."[206]

NYSE Euronext wrote similarly about dark pools early this year:

> "The trend towards smaller execution sizes in central 'lit' order books boosts the demand for alternative trading models. Dark pools respond to this demand by offering the industry a place for trading large orders with minimal impact on prices and allow professional investors to search

[205] Sal L. Arnuk and Joseph Saluzzi, "Toxic Equity Trading Order Flow on Wall Street – The Real Force Behind the Explosion in Volume and Volatility", p. 5.
[206] "View from the Top Transcript: Bob Greifeld", *Financial Times*, March 11, 2008.

> counterparty. Therefore, we strongly believe that there are benefits in offering services complementary to order books."[207]

The NYSE also is lobbying against so-called "IOIs", yet the NYSE posted the following on its website as recently as April 2009:

> "In March of 2008, NYSE Arca began offering clients access to undisplayed liquidity using the Indication of Interest (IOI) functionality which sources liquidity from twenty-six (26) participating broker dealers and Alternative Trading Systems (ATS).
>
> The result has been a resounding success. In the last six months the percentage of volume routed to the IOI participants has doubled to 22% and the average number of shares that receive price improvement has jumped to 11% of orders executed.
>
> The IOI is a great way for NYSE Arca customers to generate interest for large orders, across multiple markets, in an anonymous environment while minimizing their impact."[208]

* * * * *

None of the proposals we have put forth in Annex D limit the operation of our competitors. Instead, they all focus on how to address the challenges faced by individual investors in the current market environment, which is what all of us should be focused on.

As noted by the Tabb Group:

> "The challenge is to honestly assess the efficiency of the market for all participants, but avoid the noise of political rabble-rousers, Luddites of liquidity, regulatory appeasement and industry marketing and lobbying spiel. This is only possible if there is even a basic agreement on the goals of market structure and how we ought to measure it."[209]

Looking to the future

No one can predict the future, but there are some trends that seem likely to continue. One trend is the increasing sophistication of high-frequency traders and other market intermediaries in detecting and profiting from the order flow of institutional investors. As the sophistication of

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[207] "Comments from NYSE Euronext in Response to CESR's Call for Evidence on the Impact of MiFID on Secondary Markets Functioning (CESR/08-872)", January 2009.
[208] NYSE Euronext, *U.S. Equities News,* April 2009.
[209] Tabb Group, p. 30.

market intermediaries continues to grow, institutions will need appropriate products and systems to interact with the market in a manner that protects the institution's block order information. It is important that the Commission provide appropriate flexibility in any final rule to ensure that the Commission does not unduly restrict institutions in their ability to efficiently execute block orders in an environment of increasingly sophisticated market intermediaries.

The need for prudent and careful regulation

The Commission's recent rule proposal on flash orders underscores the potential risk of unintended consequences and the need for prudent and careful regulation. Since we do not participate in flash order trading, the Commission's rule proposal on flash orders has no effect on our business. But NYSE Euronext recently submitted a comment letter on the flash orders rule proposal noting that the Commission's rule proposal could mean the end not only of floor trading, but also an end to immediate-or-cancel ("IOC") orders and all forms of non-displayed liquidity on exchanges.[210]

Clearly, the Commission will look to address this issue, and even itself identified the potential issue in the proposing release,[211] but the solution to differentiate between activities might not be that simple. We think this underscores three points – first, market structure issues are complex; second, careful and patient deliberation is needed; and third, market structure must be considered on a holistic, as opposed to a piecemeal, basis.

We believe a concept release is the most appropriate forum to address proposals like the Commission's proposal on non-displayed liquidity that, at first glance, appear to be discrete, but upon further consideration, are recognized to be intertwined with the entire market structure.

* * * * *

The Commission has always understood the need to act in a prudent and deliberate matter for rule changes involving material changes to market structure. In the end, the prudent and thoughtful approach taken by the Commission has resulted in higher quality rulemaking as it has afforded the Commission the opportunity to carefully consider comments from the public, including comments relating to potential unintended consequences of the Commission's rule proposals.

On September 6, 1996 the Commission adopted amendments to the quote rule and a new limit order display rule,[212] but the process that led up to this rulemaking started well before September 1996. In January 1994 the Commission issued its Market 2000 examination of the

[210] NYSE Euronext Comment Letter, pp. 11-12.
[211] Flash Orders Proposing Release, p. 27.
[212] Order Execution Adopting Release.

equity markets.[213] Conclusions from the Market 2000 study were reflected in the Commission's rule proposal, issued on September 29, 1995.[214] The Commission issued its final rule on September 6, 1996. The final rule reflected modifications to certain proposals from the proposing release, including removal of a proposal for a market-wide price improvement rule for customer market orders.

On December 8, 1998 the Commission adopted the rule that is now known as "Regulation ATS".[215] Again, the process leading up to the final rule was deliberate and thoughtful, allowing time for an open and reasoned debate of the issues and the ability to address potential unintended consequences. The process started when the Commission issued a Concept Release on the "Regulation of Exchanges" on May 23, 1997.[216] The Commission issued a proposing release on the "Regulation of Exchanges and Alternative Trading Systems" on April 17, 1998[217] and the final rule on December 8, 1998. Again, the final rule reflected modifications to certain proposals from the proposing release.

Don't limit institutions to shouting or whispering

We have attempted throughout this letter to provide third-party validation for the points we are making and to take into account the views of industry experts. We conclude with the following quote by Adam Sussman of Tabb Group from his testimony at the recent Senate subcommittee hearing on market structure, which we believe provides a well-considered analysis of the issues:

> "This is about the proper handling of orders. And in some cases, you have an order that you need to get executed right away. If you need to get that order executed right away, you're going to broadcast to as many folks as possible in order to attract willing counterparties.
>
> However, if the order is sensitive to price, you need to keep that order tighter – you know, you need to play those cards a little bit tighter. Any information that leaks out about that order could cause the price of the stock to move against you and, thus harm you investors.
>
> So they've always had to make these choices, and it's never as clear as just shouting from the hilltops or make barely a whisper. There's a lot of degrees in between. And so for price-sensitive orders, they've always

[213] Securities and Exchange Commission, Release 34-30920, "Market 2000: An Examination of Current Equity Market Developments", January 1994. ("Market 2000 Study")
[214] Securities and Exchange Commission, Release No. 34-36310, "Order Execution Obligations", File No. S7-30-95, September 29, 2005.
[215] ATS Adopting Release.
[216] Securities and Exchange Commission, Release No. 34-38672, "Regulation of Exchanges", File No. S7-16-97, May 23, 1997.
[217] ATS Proposing Release.

used dark liquidity. Now, in the past, that dark liquidity may have been calling up a floor broker at the New York Stock Exchange. They would discuss the parameters of these orders; size, price, how urgently does it need to get done.

And then that floor broker, on behalf of that trader, would go out to the floor and seek that liquidity out. Nowadays, those same instructions are encoded in electronic messages and sent to the various marketplaces that are available. But the intention is the same.

The challenge is that there was always a value in that floor broker. The relationship between the trader and the floor broker was based on trust. It was based on a kinship that was built up over time.

And in an electronic world, you know, how do we build that trust and confidence. At Tabb Group, we believe that's with more disclosure, more openness about the trading practices. That's why we believe that dark pools should be more public about their types of participants they have in their pools, the mechanisms they use to execute client orders."[218]

[218] Senate Subcommittee Hearing Transcript, p. 17.