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22 February 2010

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Ms. Murphy,

First, we would like to take this opportunity to thank the Commission for its efforts in drafting this proposal and providing this open forum in which ideas and thoughts may be shared. It is a hallmark of our society that differing opinions can be voiced without fear of retribution and in the sincere hopes that they may contribute to the discussion. Although it is in the SEC's remit to do so, it is has done well and the US equity markets are better for it. We applaud the serious nature with which you take this task and the contribution of the several dozen comments.

Second, SpreadZero would further like to express its determination to assist in making the evolution of our market centers as beneficial as possible to all. We agree with the ultimate goal of the SEC to promote transparency, fairness, and efficiency and see this proposal as a brave first step. Additionally, SpreadZero understands and appreciates the complexity of the markets, competing interests of all participants, and difficulty in addressing this issue. We welcome this forum for open discussion so that the US markets are made more robust and hope that together a rational discussion may take place to achieve such ends.

Finally, in our comment, we will assume the major points of the SEC are well known and understood and will therefore only briefly describe them. Our response will address six topics: an explanation of the genesis of dark pools, two tiere markets, redefining bid and offer, display obligations, post trade reporting, and block exemptions.

**An Explanation of Why Dark Pools Exist: Information Leakage**

There are two general costs to trading: explicit and implicit.

Explicit costs, as its name suggests, are easily identified. They include commissions, taxes, and fees. The dramatic reduction in explicit costs is a testament to the robustness of our markets and the fierce competition among agents. The traditional largest component, commissions, have become negligible. As a consequence, money managers are now more focused on implicit costs.

Implicit costs are much more difficult to measure. They include ideas such as opportunity costs, delay costs, and information leakage. Information leakage is the

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reason why dark pools exist. Unintended communication of order flow can be costly. The SEC recognizes information leakage as a real concern and one that is positively addressed by the ATS community. It is a cornerstone on which Reg ATS is founded.

In offering this proposal, the SEC demonstrates its acknowledgment that information leakage is a legitimate concern to holders of large positions. It would make sense that the SEC would not want such investors to be disadvantaged. SpreadZero submits that the game of cat and mouse which gave rise to dark pools is both natural and necessary for efficient and fair markets.

**Two Tier Markets**

The SEC spends a significant portion of its argument addressing its concern over "two tiered" access to information. Its concern rests in part to an extrapolation of trends in the market share of ATSs but also in the belief that ATSs and exchanges are mutually exclusive, which is to say, an order placed on an ATS is one that is not necessarily represented on an exchange. These arguments should not be taken as foregone conclusions.

The proposal acknowledges that it is common practice for institutional traders to split "parent" orders into multiple "child" orders. It is standard practice to access more than one pool of liquidity through these child orders. When a trader finds the liquidity they are looking for, it makes sense that they migrate their order to that venue. Thus, removing posting from one venue does not necessarily increase posting at another.

To the point of market share, as suggested in the proposal, over 90% of the trading volume takes place away from dark pools. Also, it appears that the market shares have tended to stabilize to a fairly equal distribution with no one exchange achieving more than 19% market share.[1] The SEC uses these statistics to argue the point that 7.2% of *collective* dark pool market share as significant when compared to individual exchange market share. The problem with this comparison is that the exchanges should be taken collectively and the dark pools should be taken individually. The NBBO is defined by the SEC in terms of reporting market centers, which is to say, registered exchanges.[2] Since Reg NMS came into force, the quotes of the exchanges are linked and therefore the NBBO is being determined by the 90%+ of trading interest which is linked. Some might argue that the true market share of venues establishing the NBBO is closer to 80%. Were that the case, 80% is still a significant proportion of market share that determines price discovery.

The trend in ATS market share is remarkable. However, ATSs are dependent on the price discovery provided by the exchanges. It is improbable to assume that users of the exchanges will abandon their life blood to their own disadvantage for several reasons:

1. Lowest hanging fruit has been plucked: the most obvious and lucrative areas have been exploited;
2. Exchanges are not static: the exchanges have reacted and will continue to innovate to provide traders with a more appealing environment;

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3. Lower Growth: the niches left to dark pools are the less liquid issues. Thus, increasing market share in less liquid areas will provide diminishing incremental increases in market share.

The SECs proposal goes into great detail in many areas but unfortunately it does not articulate well what constitutes a two tiered market. Presumably, the proposal suggests a two tiered market is one in which one set of market participants has access to liquidity that another does not. The opposite side of that coin might be that one set of market participants has access to technology that another does not and such technology has a negative impact on their ability to execute orders. Thus, dark pools were set up to even the playing field in a technologically two tiered market. This creates a dilemma for the SEC. Either way the decision can be construed as favoring a two tiered market. We politely remind the SEC that in the past, their stance has been to favor what is best for long term investors over short term investors and offering an advantage to a trading strategy whose holding period is measured in seconds or smaller would be inconsistent with its mission.

On a more abstract note, efforts to constrain the development or continuation of a two tiered market, though admirable, are essentially futile. Any broad market, with multiple competing interests and strategies will evolve into a spectrum of tiers. The current equity market is hardly one of black and white but rather a continuum of shades of grey.

**Redefining "bid" and "offer"**

The first proposal addressed by the SEC, redefining "bid" and "offer" to include actionable IOIs, has garnered quite a bit of attention. We agree that a definition that takes into account the realities of today's trading technology and environment is necessary. We are a little concerned with the practical application of the proposed criteria for displaying bids and offers to include actionable IOIs. For example, Liquidnet offered 5 ways to get around this recommendation[3] all of which maintain legality yet effectively skirt the intention of the SEC. The Alliance of Floor Brokers offered a definition[4] that would encompass more than what the SEC requests. Understanding that their aim was to simplify the definition, their suggestion might take into account floor conversations and discussions by "upstairs" sell side efforts to seek contra sides to trades. These two comments demonstrate the inherent difficulty in the SEC's task.

The logical path in the debate over actionable IOIs is that participants either post their interest for public dissemination or refrain from participating in outgoing IOIs. Presumably, the intention of restricting dark pools from sending outgoing IOIs would be to encourage more public posting on exchanges. The unintended consequence would be less transparency as firms migrate toward alternatives such as those described by Liquidnet.

SpreadZero supports what ever decision the SEC makes in this regard but believes forcing actionable IOIs to be part of the NBBO will not assist the SEC in its goals of transparency (as dark pools become darker), fairness (advantage to short term trading strategies), nor efficiency (forcing searches for liquidity to experience additional barriers).

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## ATS Display Obligations

"The proposed amendments are designed to create a more level playing field with respect to order display and execution access for all market participants that receive and attempt to execute orders, including exchanges, ATSs, and OTC market makers."[5]

In regard to ATS display obligations SpreadZero asks two questions:

1. Is the current market structure failing?
2. Will the proposal achieve the stated goal?

We do not believe the current market structure is actually failing. Rather, it is in a state of flux and therefore can appear inefficient. Trading has always been an evolution of gaining advantage over other participants and will continue to be one regardless of the rules put in place to stop it. Of course, this argument could have been made numerous times in the past to justify doing nothing. We are not suggesting doing nothing but instead calling for moderation. A reduction by 95% of any threshold seems an extreme move and for all intents and purposes might as well be a reduction by 100%. It appears a more measured approach might be less disruptive and allow the SEC the opportunity to monitor the change. There were several calls for a reduction of the threshold to 1%. We would be interested in seeing a pilot program that starts with a reduction by half the current threshold to 2.5%.

More importantly, we are not sure this specific proposal will achieve its intended goal. If traders prefer using dark pools, they will find a way to use them. As soon as one dark pool must display quotes, the order flow will most likely migrate to another dark pool. It was proffered by Matthew Samelson[6] that a threshold for consolidated dark pool volume to be the rubric with which to obligate all ATSs to display quotes in a particular issue. Although this sounds like a decent compromise, it takes away a valuable tool at exactly the point when the tool is needed. An extraordinary increase in trading in a stock may require greater efforts to control information leakage. Forcing an ATS to display its quotes may not create a level playing field but instead further entrench an unlevel playing field.

## Post Trade Reporting

It is important to note that the proposal merely wishes to add the identity of which ATS arranged the trade in real-time and that 99% of dark pool trades are reported to the tape withing 30 seconds.[7] It is clear that there is a misunderstanding among many commentators (not just respondents to the SEC request for comment) that ATS trades go unreported. SpreadZero would benefit from this proposal as it would be free advertising and possibly draw more liquidity towards its matching engine. That said, it is hard to fathom the value the average trader would gain. One can not send orders to a dark pool on a whim. Dark pools are broker/dealers and have an account opening process which must be satisfied. If a trader already is a subscriber to a dark pool, it does not take much effort to discover if there is activity in an issue of interest. In fact, most trading desks perform this function automatically.

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**Block Exemption**

We agree and appreciate the Commission's steadfast acceptance of the need for block exemptions. Here, as well, the Commission is faced with a task of defining "block." The more simple and broad the definition, the more fitting it becomes in the aggregate. Suggestions have been offered such as delineating among capitalization, ADV, number of shares, a lower dollar threshold ($100,000 as opposed to $200,000) and various combinations of these ideas. The more specific the criteria, the more questions are raised:

- How would market cap be defined?
- What happens if an intra-day move changes the classification of market cap?
- Is market cap necessarily a good proxy for liquidity and therefore is one flawed system replacing another flawed system while only adding complexity?
- If ADV is used, what happens when volume spikes?
- There are several definitions of "block" existent in the rules and guidelines in the industry. Which is most appropriate?

The list of questions can go on. SpreadZero sympathizes with the Commission and is of the opinion that simplicity is most appropriate in this instance. Therefore, we agree with the commission basing its block exemption on a dollar threshold for the reasons outlined in the proposal. We acknowledge other comments recommending a $100,000 threshold and see the logic in the lower amount and defer to the SEC as to where the exact threshold amount should be placed.

* * * * *

The financial markets are large, intricate, sophisticated environments with a myriad of self interested parties all attempting to represent their constituencies as best they can. In an ideal world, all interested investors would amicably commune and divulge all information and make investment decisions based on risk preferences from agreed upon risk/reward perceptions. But this ideal flies in the face of human nature. One merely need to draw an analogy to a personal experience of negotiating whether it be for a car, a house, a job, or a classic guitar. There is always the belief that one side or the other has an informational advantage. And so it goes with the equity markets. Thus begins a series of defenses and machinations to protect what one believes is rightfully theirs to protect. As well they should. Admittedly, the analogy is not perfect. However, in the next negotiation to buy a car, in the interest of transparency, fairness and efficiency, try bidding the highest price you are willing to pay and see how that works out.

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Again, we applaud the Commission for taking on this burden and giving all interested parties a chance to voice their opinion and we look forward to participating in this dialogue going forward.

Respectfully Submitted,

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notes

[1] SEC Proposal File No. S7-27-09 page 7

[2] With respect to quotations for a reported security, the highest bid or lowest offer for that security made available by any reporting market center pursuant to § 240.11Ac1-1

[3] Liquidnet response to request for comment File No. S7-27-09 pp B8-B9.

[4] "An Actionable IOI is a bid or offer that can be accessed by one set of market participants that is not publicly disseminated at the risk of the market." (response to request for comment to File No. S7-27-09, p2)

[5] SEC Proposal File No. S7-27-09 page 31

[6] Woodbine Associatesresponse to request for comment page 2

[7] SEC Release No. 34-60960; File No. SR-FINRA-2009-061 page 3