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April 20, 2010

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

www.CapitalMarketExperts.net

Via Email to rule-comments@sec.gov

Re: File Number S7-02-10
Concept Release on Equity Market Structure

Dear Ms. Murphy:

The International Stock Exchange Executives Emeriti ("ISEEE") is a global non-profit organization of current and former senior executives from stock and derivatives exchanges. We are incorporated in the State of New York. The purpose of the ISEEE is educational in nature, enabling our members to share insights and trends on developments in the World's financial markets in areas including organization, operations, listing, trading, disclosure, clearing and settlement, access to the market, technical infrastructure, risk management, surveillance and enforcement, investor protection and foreign investment.

We held our Annual Meeting over three days from March 28 to March 31 where we discussed equity market structure in the United States and abroad with an objective of commenting on the Commission's "Concept Release on Equity Market Structure."

Participants in this year's Annual Meeting included twenty-five exchange officials (many former CEOs) representing North America, Europe, Asia and South America. Our participants were split fairly evenly between executives with experience in the United States and Foreign markets. Present or past affiliations included the New York Stock Exchange, NASDAQ, American Stock Exchange and the Chicago Board of Options Exchange. Foreign participants had present or past affiliations with the Toronto Stock Exchange, Sao Paulo Stock Exchange (Bovespa), New Zealand Stock Exchange, Eurex, Deutsche Börse, Abu Dhabi Securities Exchange, Australian Securities Exchange, European Options Exchange and the Berlin Stock Exchange.

We appreciate this opportunity to comment on the state of equity market structure in the United States and to make recommendations as to how we believe it may be significantly improved. Given the timing of this Concept Release in the wake of the Credit Crisis, and coincident with financial reform initiatives underway in Congress, we note that the U.S. equities markets performed well during the

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Credit Crisis - a period of extreme stress. However, as with any other complex system, legislative, regulatory and technological changes have had many unintended consequences[1], not all of them good.

Our comments are divided into three categories, namely:

I. Capital Formation (The Detrimental Impact of Market Structure)
II. Market Regulation, Oversight and Transparency
III. Market Quality: Large vs. Small Capitalization Stocks and Investors (Worlds Apart)

I. CAPITAL FORMATION (THE DETRIMENTAL IMPACT OF MARKET STRUCTURE)

RECOMMENDATION (FOCUS ON CAPITAL FORMATION): We urge the SEC and Congress to focus on revitalizing the IPO market by improving the market structure to back support and liquidity for small and micro capitalization companies. Implicit in this notion is that current market structure:

- Has eroded liquidity for large investors in small capitalization and other "asymmetrical[2]" stocks.
- Has eroded the depth, breadth and quality of equity research coverage for small capitalization stocks.
- Has decimated the IPO market in the United States which in turn is likely to be hurting equity and debt investment in small business, jobs and US competitiveness.
- Has led to a steady decline in the number of publicly listed companies as support (liquidity) for investors has decayed and costs of listing have increased.

We note that this is a worldwide phenomenon (the impact from the way listed markets have developed on small and new company financing is also seen by our membership in such places as Canada, London, Brazil and Germany). We believe that the rush to embrace technology has disintermediated broker support for small capitalization stocks and cut transaction costs for the benefit of investors in large, naturally liquid stocks. Market responses to changing regulations are destroying the viability of markets in small capitalization stocks. As a result, the bridge from the private to public markets that supported economic growth has been severed. This has resulted in the

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[1] Examples of "unintended consequences" would include the concentration of the equity underwriting business into the "bulge bracket firms" and "universal banks" as a result of the repeal of Glass Steagall; the deterioration of Sell-Side research as a result of the Global Research Analyst Settlement; the emergence of traders as the primary institutional relationship focus of the Sell-Side and the deterioration in support for long-term investors as a result of changes including the Order Handling Rules, Decimalization (penny and sub penny trading) and Regulation NMS.
[2] An "asymmetrical" security in a trading sense is one where there is no buyer to pair off against a sell order or conversely no seller to pair off against a seller. Current market structure is really best applied to large capitalization stocks with large and deep "symmetrical" order books. When stocks become "asymmetrical" they require liquidity creation mechanisms – stock brokers, research analysts and capital commitment. If compensation potential (e.g., commissions and trading spreads) is so small that these market participants can not earn an adequate return, they turn their attention elsewhere (e.g., large company stocks or asset portfolio management compensation models) and liquidity creation and support for asymmetrical stocks (those in small companies or those with only relatively few or loyal shareholders/followers) dries up. This is the current state of the market for small public companies in the United States and a trend, which ISEEE's international membership believes is extending to many foreign markets.

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loss (or opportunity cost) of tens of millions of jobs and is adding risk to the system at a time when companies need to have greater access to equity and be less reliant on debt.

RECOMMENDATION (FOCUS ON COSTS BORNE BY ISSUERS): We urge the SEC and Congress to undertake a full analysis of the direct and indirect costs of going public and maintaining a public company in the United States and to ensure that the associated obligations are appropriate and reasonable for the size of the Company.

The initial and ongoing costs of going public in the United States are prohibitive for many small companies. This creates a barrier to accessing public markets. For small companies that do go public, high costs depress reportable earnings which in turn depress stock prices and may increase the number of delistings over time. Any review of cost should include an analysis of outside experts, civil liability (torts) and internal hiring. In addition, the SEC should undertake an examination of the implicit costs incurred where CFOs are hired for disclosure expertise and markets expertise is forgone and the fact that public company managements must necessarily shoulder a much higher investor relations burden.

II. MARKET REGULATION, OVERSIGHT AND TRANSPARENCY ("FIGURES DON'T LIE, BUT LIARS FIGURE")

In focusing on the detail of the NMS market system, the SEC risks losing sight of its broad mandate. As reiterated in the Concept Release:

> "Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure five objectives:
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> 1. Economically efficient execution of securities transactions;
> 2. Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchanges;
> 3. The availability to brokers, dealers and investors of information with respect to quotations and transactions in securities;
> 4. The practicability of brokers executing investor's orders in the best market; and
> 5. An opportunity, consistent with efficiency and best execution, for investor's orders to be executed without the participation of a dealer."

The implementation of the NMS system to achieve these objectives should reflect the four pillars of corporate governance on which the OECD Principles of Corporate Governance are based:

- Transparency
- Accountability
- Fairness; and
- Responsibility

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Our observation is that these governance pillars are not properly in place to support an integrated NMS and this is a task for the SEC. ("Corporate governance is essentially about leadership"[3])

Transparency: ("Sunlight is the best disinfectant") As long as sections of the market for public listed stocks are not visible and full tag information on all orders and trades is not uniformly distributed, there is no real Transparency. Concepts such as Indications of Interest (IOI), Flash orders and Dark Pools service a desire to avoid transparency in pursuit of a secret or manipulated better "deal". They do not provide or increase transparency.

Accountability: ("You can't manage what you can't measure") When participants can "game" the market with no consequence, there is no real accountability. Acceptance of settlement defaults invites and encourages "naked" orders placed with no intention to complete (as long as the expected cost of possible default is less than the expected benefit from placing a naked order). The absence of full transparency and the lack of integrated market surveillance and transparency means there is a lack of accountability.

Fairness: ("The fairness of markets is closely linked to investor protection and, in particular, by the prevention of improper trading practices, to confidence in the markets. Market structures should not unduly favor some market users over others."[4]) Public Markets were built on the concept of standardization of terms, and treating participants uniformly and equally. The idea of co-location to extract advantage, without any incremental responsibility to the marketplace[5], is a tacit acceptance of an old unfairness in electronic markets, where the ability to trade at faster than human speeds leads some to seek a trading advantage based on speed and location rather than price. Market fairness is essential to investor confidence and the requirement for equal access inherent in the NMS concept. It is unfair to allow any broker to "step ahead" of another order just because of proximity to the trading engine.

Responsibility: ("An effective system of corporate governance must strive to channel the self-interest of managers, directors and the advisors upon whom they rely into alignment with the corporate, shareholder, and public interest"[6]). Intermediaries have traditionally been the core of the capital market. Technology should be regulated to facilitate and improve the efficiency of what they do, not to indiscriminately eliminate both good and bad activities through application of a "one-size-fits-all" system. The conduct of brokers is essential to the integrity of the system and to socially responsible market behavior. Just as we argue for Corporate Responsibility at the corporate level, we need corporate responsibility in our markets to protect the contribution of these markets to the economy. In the same way, regulators need to adhere to a Code of Conduct for market structure and regulation that embodies concepts of broader respect for stakeholder interests. To do this well, regulators need

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[3] Mervyn King, King Report on Corporate Governance for South Africa (King II Report); IoDSA 2002 p18.
[4] From Principle 25; METHODOLOGY FOR ASSESSING IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION; IOSCO; Feb 2008
[5] Historically, specialists on exchanges were required to accept small capitalization stocks, where management of the exchanges expected them to lose money. In return, specialists were allowed to profit from their (and other) advantage in the trading of large capitalization stocks.
[6] Ira Milstein, Oversight Hearing on Accounting and Investor Protection Issues Raised by Enron and other Public Companies; US Senate Committee on Banking, Housing and Urban Affairs; Feb 27 2002.

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to collect data on market behavior and analyze it, as we recommend, and avoid the politicization of market regulation.

RECOMMENDATION: THE UNITED STATES MUST HAVE A NATIONAL (CENTRALIZED) TRADING SURVEILLANCE, DATA COLLECTION AND ENFORCEMENT SYSTEM

The United States has created a "national market system" that has driven innovation, venue fragmentation and interconnectivity, reduced spreads and stimulated liquidity for large cap stocks in public markets. However, trading venues are still generally responsible for their own surveillance. In essence, the U.S. now has a national market system for trading but a "Balkanized" system of surveillance which has not kept pace with the realities of the marketplace.

We urge the SEC to create a National Surveillance System. We believe that this system should be developed and run by either the SEC or FINRA (no one else has the cope or independence – see below). We believe that it should include the following basic components:

- Tag (identification) of all trades, quotes and messages (down to the microsecond and down to the venue and SEC registered investor)
- Audit capabilities (storage and surveillance)
- Real-time surveillance (analytics)
- Inclusivity (cross venue and cross market including across both cash and derivatives markets)
- Full Transparency – Delayed release of all information to the Public in a form that supports analysis and consistent with the words of Justice Brandeis, *"Sunlight is the greatest disinfectant."*

Such a system would help to definitively answer many of the questions posed by the SEC Concept Release on Equity Market Structure, including the relative merit, or lack thereof, of such practices as:

- High Frequency Trading
- Pennies and Sub-Pennies (which we believe may lead to increased gaming)
- Naked Access
- Naked Options
- Latency
- Dark Pools

RECOMMENDATION: THE UNITED STATES SHOULD SEPARATE ALL REGULATION AND ENFORCEMENT FROM FOR-PROFIT TRADING VENUES WHERE THERE IS A CLEAR CONFLICT OF INTEREST

Historically, exchanges were not-for-profit, member-owned organizations. This model is now, post Regulation NMS and demutualization, a highly competitive, multi-venue, for-profit marketplace. There is a significant conflict-of-interest for a for-profit enterprise to serve as its own regulator. In addition, this scheme has likely resulted in uneven regulation, cost of regulation and "jurisdiction shopping" across venues.

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Internationally markets are adjusting to the for-profit exchange model by shifting the responsibility for surveillance and enforcement to the regulator, in some instances initially to a third party surveillance entity. We believe the US needs to lead the trend of market development, not follow it, (as it has with the NMS concept) and separate the listing and surveillance functions completely from exchanges or other trading centers. Personal conflict of interest issues for regulatory staff in this model need to be addressed as we highlighted in our Declaration last year.

Principle I.C of the OECD Corporate Governance Principles recommends that "the division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served"

RECOMMENDATION: THE SEC SHOULD MOVE THE INDUSTRY TO A SHORTER SETTLEMENT PERIOD AND REQUIRE A "HARD LOCATE" SYSTEM TO MINIMIZE CERTAIN ABUSIVE PRACTICES, MINIMIZE SYSTEMIC RISK AND INCREASE INVESTOR CONFIDENCE.

Longer settlement periods increase risk to the financial system (e.g., failure to settle, counterparty failures with the failure of a major market participant) and create a greater window for abuses, including naked short selling. Some foreign countries have moved to T+0 which has become the de facto "best practice" standard. The United States is still at T+3. In addition, we believe that investors deserve to know that shares that are shorted by hedge funds and other investors are shares that really exist and are available for sale at the time the order is placed (i.e. are owned or have already been borrowed). We believe that the combination of a shorter settlement period, severe penalties for defaults, and an electronic system (which could be housed at DTCC) of "hard locates" would eliminate most abusive (naked) short selling. We believe that there should be a market maker exemption from these restrictions which itself will be tougher to abuse when coupled with a shorter settlement period, severe penalties for defaults, and a "hard locate" for short selling by investors.

RECOMMENDATION: WE URGE THE COMMISSION TO ADOPT FORMAL DEFINITIONS OF "LIQUIDITY" (that incorporate all three dimensions of "Liquidity" namely, a) tradable volume, over b) time, within c) a given stock price tolerance) **AND TO APPLY THESE DEFINITIONS TO DIFFERENT ORDER SIZES (NOT TRADERS) ACROSS COMPANIES OF ALL SIZES.** Market participants substitute various order or trade "Volume" data for "Liquidity" data. This substitution is used out of ignorance, or worse, with intent to mislead Regulators, Congress and the Public in general. The SEC must define "Liquidity" measures and require their use in lieu of much simpler, but misleading, "Volume" measures.

III. MARKET QUALITY: LARGE VS. SMALL CAPITALIZATION STOCKS AND INVESTORS (WORLDS APART)

RECOMMENDATION (BRING INSTITUTIONAL LIQUIDITY BACK TO SMALL CAP): WE COMMEND THE SEC ON THE PERFORMANCE OF LARGE CAPITALIZATION STOCKS DURING THE CREDIT CRISIS BUT WE URGE THE SEC TO ADDRESS THE EROSION OF SUPPORT FOR SMALL AND MICRO CAPITALIZATION STOCKS AND THEIR INVESTORS. IN ADDITION, OUR INTERNATIONAL MEMBERSHIP WOULD APPRECIATE THAT THE SEC WORK JOINTLY WITH THE AUTHORITIES OF OTHER IMPORTANT MARKETS AS THEY ARE CONCERNED THAT PRIMARY CAPITAL FORMATION AND ECONOMIC DEVELOPMENT MAY HAVE BEEN UNDERMINED IN MANY FOREIGN MARKETS FOR REASONS SIMILAR TO THOSE IN THE UNITED STATES

The electronic interconnectedness of markets that resulted from Regulation NMS has created redundancy and uninterrupted trading during times of market stress as seen in the wake of the Credit Crisis. This is in stark contrast to the experience of the stock markets during the Crash of 1987 when traders simply did not pick up phones and investors were unable to execute orders.

However, it is generally acknowledged that there has been a profound deterioration, within the small capitalization segment of the U.S. stock market, in institutional investor interest, liquidity and valuations. We attribute this to the cumulative effects of many changes in market structure. Current market structure does not provide adequate economic incentive for market participants to generate order flow, provide liquidity, and to provide quality equity research coverage – the components necessary to sustain investor interest, and efficient pricing - in small public companies. This failure lies in stark contrast to the relative success of electronic markets in supporting liquidity for large capitalization stocks and the performance of these markets in the wake of the Credit Crisis (they worked). The spectacular success of ETFs and Index and Mutual Funds that rely on or are measured by market-capitalization-weighted performance indicators (e.g., market indices) and the shift to more passive investment by large investors has had a multiplier effect on the dependence of (and interest in) public markets on high capitalization stocks and the shift away from small cap stocks (most of which are now just a tracking error in portfolios).

In addition, we note that the “ecosystem” of market participants that once supported small capitalization liquidity, capital formation and economic growth has been decimated:

- Equity research quality has declined.
- Equity research availability has declined.
- Many institutional investors in small capitalization companies have raised their minimum “float” requirements dramatically.
- Reduced commissions drive by lower margins on high cap stocks have reduced brokers’ ability to support new and growth companies.
- Retail brokerage has largely abandoned the stock brokerage model in favor of asset allocation (investment advisor) model.
- The small investment banks that supported the small capitalization cash equities business have in most instances disappeared.

As a result of the above, the natural public market advocates for small capitalization companies and their investors have largely disappeared and Wall Street (and Capitol Hill) has become dominated by big firms, supporting big companies and big investors. The SEC must compensate for the fact that large companies dominate discussion (lobbying) at the SEC and on Capitol Hill. The needs of small business and the firms that would support small public companies are overlooked. The end result has been damage to the economy.

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RECOMMENDATION: WE URGE THE SEC TO DEVELOP METRICS OF MARKET QUALITY FOR DIFFERENT MARKET CAPITALIZATION SEGMENTS AND TO AVOID THE TEMPTATION OF ASSUMING THAT MEASURES COMMON TO THE LARGE CAPILIZATION SEGMENT (E.G. VIX) ARE RELEVANT TO SMALL AND MICRO CAPITALIZATION STOCKS.

Spreads: Knight Securities has documented that trading spreads for the S&P 500 have tightened since 2003 while trading spreads in the Russell 2000 have not and still remain high. The Russell 2000 consists of stocks that are still *much* larger than the great majority of public companies and companies that would be candidates for an initial public offering.

Volatility: To the best of our knowledge, the VIX, a measure of large capitalization volatility (S&P 500) is the only measure of volatility generally available in the market place. We know of no measures of volatility for smaller capitalization indices (e.g. the Russell 2000 or even smaller stocks).

ETFs and Derivatives: The increased market volumes are in part due to the proliferation of derivative products including ETFs and associated arbitrage activity. There is a risk that this activity drains liquidity from small capitalization stocks (many ETFs that provide index and "composite index" performance do not invest in stocks below a certain size). In addition, there is a risk these activities are siphoning off support for infrastructure to support fundamental investment disciplines. The combination may be impacting the market's purpose of efficiently allocating capital and deserves further study.

Given the above, the SEC is seen to be lacking the necessary suite of market quality measurements to fully understand the impact on small and micro cap stocks. We urge the development of a suite of measurements for small and micro capitalization volatility, institutional and retail liquidity, sellside and buyside research coverage, primary and secondary capital formation and listing trends (numbers of companies listed).

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In order to proceed to develop legislative and regulatory solutions to the problems which small and medium sized companies worldwide are facing in raising equity capital to create and expand growth businesses, and thus to provide the jobs and economic benefits to finance the economy and generate the revenues to deal with the governmental fiscal deficits, the ISEEE is establishing a *Small Business Financing Crisis Task Force.* The Task Force will consist of representatives from capital markets throughout the world including members of the ISEEE as well as officials from small and medium sized enterprise plus legal and accounting experts. The ISEEE has appointed David Weild as chairman of the task force with Don Calvin, current Chairman of the ISEEE, appointed to serve as vice chairman. An announcement will be made in the near future.

We appreciate the opportunity to comment on the Commission's Concept Release on Equity Market Structure. We would appreciate the opportunity to visit the Commission and discuss our comments and concerns with you at greater length. Please feel free to contact David Weild, newly appointed Chairman of the ISEEE's *Small Business Financing Crisis Task Force* at david.weild@cmapartners.com.

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Sincerely,

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William Foster
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