INTRODUCTION

This Comment Letter is being submitted in response to the SEC's Concept Release on Equity Market Structure.[1] It has been drafted by four University at Buffalo Law School students studying equity market structure in the University's *UB in NYC Program: A Semester in Finance & Law*. The *UB in NYC Program* is a semester-long program that immerses students in the study of the financial markets.[2] The ideas and opinions expressed herein are the personal reflections of the student authors and do not reflect the ideas or opinions of the University at Buffalo Law School or its faculty or staff. As independent observers, we feel we offer a uniquely unbiased view of equity market structure, free of both government and private interests.

Thirty-five years ago, Congress passed legislation establishing the National Market System ("NMS").[3] The purpose was to encourage the competition of markets and market systems, and to ensure fair access for all market participants. The legislation boasted five fundamental principles of the NMS:

> (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 the transactions in securities;
> (iv) the practicability of brokers executing investors' orders in the best market; and
> (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.[4]

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[1] SEC Concept Release on Equity Market Structure, Release No. 34-61,358 (Jan. 14, 2010), *available at* http://www.sec.gov/rules/concept/2010/34-61358.pdf.

[2] For more information, please see http://www.law.buffalo.edu/UBinNYC/index.asp.

[3] Securities Exchange Act of 1934, Pub. L. No. 94-29, § 7, 89 Stat. 111 (codified at 15 U.S.C. 78k-l(a)(2)(2006)).

[4] Securities Exchange Act of 1934 § 11A(a)(1), 15 U.S.C. § 78k-l(a)(2) (2006).

In 2005, the SEC updated and codified the principles of the NMS through the publication of Regulation NMS ("Reg NMS"). Three pillars provide overriding themes regarding the structure of equity markets and will thus be used to provide a framework for our discussion below: transparency, fair access, and efficiency.

I. TRANSPARENCY

In order to properly monitor the equity markets there needs to be increased transparency in terms of data collection and analysis. Transparency in the markets allows the SEC to perform its surveillance function and also allows investors to get a detailed and accurate picture of market trends and movements. We suggest the following changes to improve transparency: the creation of a Consolidated Audit Trail, amendments to specific definitions for both large traders and high frequency traders, increased disclosure by dark pools, and decreased reporting thresholds for large traders and transactions on Alternative Trading Systems.

A. CONSOLIDATED AUDIT TRAIL

Pursuant to Section 11A of the Securities Exchange Act and the National Market Plan in Reg NMS, the SEC should create a Consolidated Audit Trail ("CAUD"). A CAUD will allow traders to report all trades into one uniform filing system, instead of reporting to numerous Self-Regulatory Organizations ("SROs") with varying reporting requirements. The SEC should require that all SROs report all transaction data to the CAUD until such time that trades can be directly reported to the CAUD, thus bypassing reporting through SROs. The audit trail should be expanded to include more data, show both sides of the trade, and all reporting should be done in the English language.

One data field we recommend adding is the Market Participant Identifier ("MPID"), an identifier specific to each individual trader, but also containing a prefix that designates the trader's firm. The information collected should also include the time of transaction, type of transaction (whether it is a traditional buy/sell, short, dark, etc.), type of trader (institutional or individual), and the location of the trade (NYSE, Nasdaq, ECN, ATS, etc.). Further, all trades executed in dark pools should be reported to the CAUD by the close of business in order to ensure post-trade transparency by all market participants.

B. LARGE TRADER REPORTING

The definition of a large trader needs to be amended in order to increase transparency in the market and to incentivize traders (including transactions in dark pools) to use block transactions instead of breaking up large transactions to avoid increased reporting requirements. Currently the industry definition of a large trader is a single volume transaction totaling $200,000 or 10,000 shares. Under Section 13(h)(4) of the Securities Exchange Act, the SEC has the authority to aggregate transactions and accounts for the purpose of defining a large trader and thereby increasing reporting thresholds. The SEC should therefore amend the definition of large traders to include aggregate total transactions that equal the reporting threshold requirements for single transactions. The thresholds should also be lowered from 10,000 shares to 5,000 shares based on evidence that the number of block trades over 10,000 shares has significantly decreased, therefore making 10,000 shares an antiquated and arbitrary number.[5]

[5] *See, e.g.*, Tarun Chordia, Richard Roll, & Avanidhar Subrahmanyam, *Recent Trends in Trading Activity* 52-53 (Am. Fin. Ass'n 2010 Atlanta Meetings Paper), *available at* http://subra.x10hosting.com/volumechg24.pdf; *but see* SEC Rule Proposal on Large Trader Reporting System, Release No. 34-61,908 (April 14, 2010), *available at* http://www.sec.gov/rules/proposed/2010/34-61908.pdf (defining a "large trader" as person who trades two million shares or $20 million of NMS stock in any calendar day, or 20 million shares or $200 million of NMS stock in any calendar month) [hereinafter *Large Trader Reporting Rule Proposal*].

C. Dark Pools

In an effort to keep the market open and transparent, we propose that dark pool activity should be limited to large block transactions, and that all small orders should be completed in the fully disclosed, or "lit" market. We also propose that a minimal operational fee or tax be levied on all dark pool transactions. This would incentivize traders to not break up large orders into smaller blocks and to perform transactions in the lit markets as opposed to dark pools. The operational fee would serve as a value added tax traders pay to execute their transactions in the dark. So long as the fee is properly priced, it will not eliminate dark pools. Additionally, we propose that all transactions executed on dark pools be reported to the CAUD daily, at the close of business. The reported data should be similar to that required for transactions performed on an ATS and should include the MPID, generic "dark pool" label for transaction location, along with the already reported volume and price.

D. ATS Thresholds

We believe that the current 5% threshold that triggers public display of quotation information for Alternative Trading Systems ("ATSs") or dark pools is ineffective because it is too high.[6] The current threshold requires ATSs to report bid and ask prices on executed orders and the size of those orders if the ATS has traded in 5% or more of the aggregate daily volume of a given National Market System stock ("NMS stock") during at least four out of the previous six months. Additionally, the reporting requirement is only triggered if the ATS displays those subscriber orders to at least one person other than an employee of the ATS.

While the SEC suggests lowering the threshold to .25%, we assert that this is too low. Lowering the threshold to .25% would be functionally equivalent to setting the bar to 0% and

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[6] *See* SEC Rule Proposal on Regulation of Non-Public Trading Interest, Release No. 34-60,997 (Nov. 13, 2009), *available at* http://www.sec.gov/rules/proposed/2009/34-60997.pdf (discussing the SEC's original initiative to lower the ATS public reporting requirement from 5% to .25%) [hereinafter *Non-Public Trading Interest Rule Proposal*].

requiring public reporting for all executed trades, therefore significantly debilitating the useful aspects of the dark pool venue. We suggest the threshold would be best set at a more modest level, somewhere between 1-3%. This level would ultimately achieve the transparency and surveillance aims of the SEC, while maintaining the efficiency and utility of ATS and dark pool systems. [7]

E. Post-Trade Transparency

We support the SEC's desire to increase post-trade transparency of executed transactions in ATSs. While dark pools and other ATSs perform an important function for the equity markets by providing a platform on which institutional investors can trade block orders without unduly moving the market, there is still a legitimate need to monitor these systems. Currently, the SEC has insufficient means by which to analyze these trading platforms and must gain a better understanding of the volume, pricing, and market participants.

Specifically, we support the proposed requirement to include information that would identify the specific ATS on the CAUD, as opposed to the current system that uses the generic "OTC" label. We also support the increase in reporting requirements to include detailed trade-by-trade disclosure, as opposed to the current system of requiring simple summary statistics. We do, however, urge the SEC to consider whether the proposed $200,000 block order exemption could be more effectively achieved in a share volume based metric. Share volume may be a more accurate indicator of block trades, thereby better protecting the most important function of the ATS or dark pool – efficiently executing large institutional orders while causing the least amount of initial market price change.

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[7] *See Non-Public Trading Interest Rule* Proposal, *supra* note 6.

Finally, in an effort to ensure transparency in the markets, small trades should be required to be completed on the traditional exchanges. Dark pools and ATSs should only be used for block orders in order to allow trades to be completed at a fair market price without moving the market too drastically. Based on the proposed change in definition of a large trader to aggregate daily total transactions there is no incentive to break up large orders into smaller transactions to avoid increased reporting requirements. Further, with the proposed increases to post-trade transparency in dark pools and ATSs there is no incentive for small trades to be executed outside of traditional exchanges.

II. FAIR ACCESS

Fundamental to the fair and efficient markets contemplated by the original 1975 Amendments to the Securities Exchange Act and Reg NMS is the idea of fair access. In order to avoid a two-tiered and thus inherently inefficient market, *all* investors must have reasonable access to markets and to the tools necessary to transact in those markets. Two services that provide such access include co-location and sponsored access.

A. CO-LOCATION

Co-location can be broken into two separate categories: (1) actual "co-location" where users are wired into exchange owned and operated data centers, and (2) "proximity hosting" where third parties operate data facilities within close physical proximity to an exchange. Currently, only true co-locators are regulated by the SEC. We urge the SEC to bring independent third parties offering proximity hosting services under their regulatory purview. Proximity hosts should be required to file with the SEC, as well as receive SEC approval for any proposed rule changes affecting the offering of proximity hosting services.

The SEC must regulate both co-location and proximity hosting in a similar manner. The rules and regulations set by the SEC for both services must include fair access and reasonable fees. We also suggest that the SEC set a hard and fast line for proximity hosting services. Whether that line is 100 feet, 1000 feet, or a mile from an exchange, a barrier needs to be put in place. Although market participants will work right up to that line, and perhaps even on it, a line needs to be drawn beyond which users can enjoy equal footing and fair access.

B. SPONSORED ACCESS

Although the SEC has proposed to ban naked access, sponsored access still poses problems of its own.[8] In order to decrease the risks involved with sponsored access, we suggest the SEC clearly define the liability of both sponsors and traders who engage in such transactions. We argue against strict liability for sponsors on the basis of unreasonableness. Instead, we advocate for regulations that will ensure both reasonable and practicable supervision of traders by their sponsors.

We urge the SEC to look at NASDAQ Rule 4611(d) for an example of regulation that balances the risks involved with sponsored access, while still allowing access to the service. The SEC should propose a similar rule that requires increased due diligence by sponsors, including a standardized checklist of requirements that all traders must meet before being granted sponsored access. Examples of such requirements include a thorough inspection of the trader's internal risk management systems and making sure the trader meets certain financial thresholds. Sponsors may also set credit limits, size or price parameters, and require post-trade execution reports from traders.

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[8] *See* SEC Rule Proposal on Risk Management Controls for Brokers or Dealers with Market Access, Release No. 34-61,379 (Jan. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/34-61379.pdf.

C. Individual Access

While the individual investor himself may not have a direct link to an exchange through co-location or sponsored access, or access to high speed or algorithmic trading programs, they can invest through in intermediary that uses some or all of these techniques. For example, the individual investor's broker-dealer likely employs algorithmic execution of electronic limit orders, and smart routing technologies that have access to dark pools. Generally, these are not tools necessary for long-term investing, and the long-term investor should not be harmed even if they have no access to these tools at all. Even if electronic or dark pool trading were to distort the value of an NMS stock, there is nothing stopping traditional long-term, or value investors, from taking advantage of the distortion and thereby correcting or checking the value. It follows then, that as long as we maintain good quality of markets, the participants within the market, both large and small are adequately protected. The more relevant discussion then, is one of efficiency.

III. Efficiency

The SEC must walk a fine line between increasing transparency and decreasing efficiency in the markets. Increasing transparency increases efficiency in two ways: (1) for regulators in tracking and surveying market participants, practices, and trends, and (2) for market participants attempting to execute the best trades, such as the retail investor. When changing reporting requirements, thresholds, and transaction locations, the SEC must be careful to continue to maintain efficient markets. Regulations cannot be too onerous on market participants.

A. High Frequency Trading

Generally, the US equities market is considered the most efficient and effective market in the world. Technological innovations have benefitted investors in terms of reduced spreads, lower execution costs, and increased liquidity. In order to ensure the continued viability of those innovations, regulators need to obtain trading data that is sufficient to quantify and qualify the effects of high frequency trading ("HFT"), dark liquidity, and location advantages on the market. Specifically, the SEC needs this data to understand the quality of liquidity in today's market and to identify the existence of any signs of systemic risk associated with such liquidity (i.e. in the form of HFT). Additionally, the SEC must be able to gather information to determine whether new technologies are allowing the proliferation of inefficient and egregious predatory trading strategies. Ultimately, the SEC must be able to gain a clearer picture of whether the equity market is fair and efficient in line with the goals of Reg NMS.

In order to begin an empirical analysis of the effects of HFT, we propose that the SEC more effectively monitor transactions using consolidated market data. In Section I.A, we proposed adding more information onto the CAUD including MPID, transaction location, and time of transaction. Together, with the information already included in the CAUD, these three identifiers will help the SEC determine the levels of algorithmic and HFT, as well as the appropriate metrics to define HFT. Usually, HFT is defined by high cancellation rates, although no specific threshold exists. By examining the trading activity of an individual MPID, the SEC could determine that participant's trading history and strategy, including whether or not they engaged in HFT, market-making, or predatory trading strategies. The SEC could also determine if a particular MPID is using HFT as a proprietary trading strategy (i.e. flat to start and end the day) or as a customer-based speed of execution strategy. By using this same distinction, the SEC could use the CAUD to track traders with high cancellation rates and perform a cost benefit analysis to determine at what point, if any, their activity ceases to provide meaningful liquidity and begins to add costs to the market.

B. LARGE TRADER REPORTING

In a separate SEC release the Commission recommends creating a large trader identification ("LTID") number.[9] The release states that this will help track high frequency traders and help the SEC quantify and qualify the effects of high frequency trading. The proposed LTID number would essentially perform the same function as the MPID approach we have proposed, however only for individuals who exceed certain value or volume requirements in NMS stocks. In order for the SEC to accurately and meaningfully determine who is a large trader, we propose the SEC first examine the CAUD using a MPID analysis. This will allow the SEC to consider the market history of all actors, not just the largest firms. Based on analytical results, a more meaningful definition of large trader will surface, and firms who meet that designation can be monitored and regulated accordingly. Thus, we propose to expand the scope of LTID to a more robust MPID system. This system will be able to identify the use of dangerous or illegal trading strategies, and more accurately describe the quality and costs of liquidity provided by HFT.

CONCLUSION

The oversight and regulation of equity market structure is a complex task. It is important to remember the interconnectedness of the market and the large impact that one small change may have. We have asserted many ideas in this Comment Letter and urge the SEC to consider our recommendations both individually, and in the aggregate.

Overall, we propose policy and regulation that (1) increases disclosure requirements, (2) provides guidance as to the appropriate role of dark pools, and (3) reduces any potential systemic

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[9] *Large Trader Reporting Rule Proposal*, *supra* note 5.

risk. We are careful to note that transparency must be increased, but not at the expense of overall market efficiency. When making new policy, we urge the SEC to return to the ideals of Reg NMS and keep in mind not just transparency and fair access, but to continue to watch out for the efficiency of our equity markets. A market structure sufficiently aligned with the principles of transparency, fair access, and efficiency reflects the long-standing goals of the SEC and the attributes of an equity market that will best serve market participants and the national and global economy as a whole.

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