Organization of Independent Floor Brokers

11 Wall Street
New York, NY 10005

April 21, 2010

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

Re: Securities and Exchange Commission Release No. 34-61358 (File No. S7-02-10) – Equity Market Structure

Dear Ms. Murphy:

The Organization of Independent Floor Brokers (OIFB) represents the interests of 450 independent brokers working on the NYSE Euronext (NYSE) trading floor. We would like to take this opportunity to comment on the above-mentioned Securities and Exchange Commission ("SEC" or "Commission") review of the Equity Market Structure. We agree with the initial Congressional findings that "…the securities markets are an important national asset that must be preserved and strengthened."[1]

However, like the SEC, we are concerned whether the market structure rules have kept pace with, among other things, changes in trading technologies and practices. We believe that with the many market structure changes that have taken place in recent years, a holistic review of the U.S. equity market structure is timely, relevant and needed. Our comments are focused in namely two areas: (1) payment for order flow; and (2) market fragmentation that has resulted from dark pools and alternative trading systems.

I. Payment for order flow

The fourth objective cited by Congress, the practicability of brokers executing investors' orders in the best market, strikes a chord with our organization.[2] Despite the fact that members of the OIFB are, like most other brokers, beneficiaries of the current practice of payment for order flow (also commonly known as "rebates" and referred to herein as "POF"), we question the existing inherent conflicts in the POF practice and whether disclosure requirements under existing Rule 606 (formerly SEC 11Ac 1-6) is even legally sufficient? Alternatively, and duty to the duties under the broker-customer relationship, we believe an outright ban on POF is warranted.

When a broker agrees to execute a customer's order, the broker has a fiduciary duty of "best execution" – to not place his interest before the clients and to execute the order at the best available price in the marketplace. [3] This duty is derived from the common-law agency duty of loyalty which requires an agent to act in the best interest of the principal. The SEC itself has explained

[1] Securities and Exchange Act Release No. 34-61358 (Jan. 14, 2010) at 10.
[2] *Id.*
[3] For the purposes of this comment letter it is clear that the best execution does not necessarily imply best price.

that “a broker’s duty to seek to obtain the best execution of customer orders, which derives from the common-law agency duty of loyalty, obligates the broker as an agent to exercise reasonable care to obtain the most advantageous terms for the customer”[4] For the most part, a broker’s handling of an order violates the duty of best execution when the broker fails to obtain the best available prices for an order. Payment for order flow can prevent customers from receiving the best execution of their orders. In an order flow payment, the order is not exposed to other orders in the marketplace for a better price. Rather, it is executed at the National Best Bid and Offer (“NBBO”) resulting in a lost customer opportunity for price improvement over the NBBO. Until POF is banned, brokers and customers will never know what best execution prices might be achieved absent POF.

A broker must be required to exercise his professional judgment in the interest of the customer; both at the time the broker selects a market to execute orders as well as subsequently when he executes the order. However, the self-interest in obtaining an order flow payment clouds a broker’s professional judgment. As a fiduciary, failure to exercise reasonable diligence to obtain best execution undermines the broker’s duty of loyalty and goes against basic legal principles.

Despite the existence of the disclosure requirements that currently exist that is required by Rule 606, the disclosed information does not shed light on fiduciary duties. As argued in a number of cases, it should also not be a valid defense to an alleged violation of the fiduciary duties for a broker to claim that disclosure printed on a confirmation slip permitted an inference of consent by the customer.

Based on the foregoing, we believe that a broker’s acceptance of order flow payments breaches the fiduciary relationship between them and their customers under common-law agency principles. A fiduciary is defined in law as one who has the legal duty to act in the best interest of another. A fiduciary relationship exists whenever trust and confidence is reposed by one person in the integrity and fidelity of another. A stock broker executing a customer’s purchase or sale order acts as an *agent* for that customer, and thereby assumes certain duties in the eyes of the law. As such, they owe their customers a duty of utmost good faith, integrity and loyalty. Under Section 388 of the Restatement (Second) of Agency, ‘‘(u)nless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal.’’ The broker is conclusively the agent of the purchaser or seller, and the payment for order flow is, without a doubt, profit. Accordingly, the acceptance of payment for order flow should be actionable under the basic fiduciary principles of agency. To find otherwise is legally troubling.

II. <u>Dark pools and their impact on market fragmentation & price discovery</u>

In the above-mentioned concept release, the SEC has stated that there is a concern that dark pools rely on the public quotations to price and execute indications of interest (IOIs), but do not contribute to price discovery in the public markets. Among other wide range of issues, the SEC has expressed interest in receiving public comment on the effects that the growth of dark pools have had on trading patterns. As stock markets evolve, investors continue to shift trading from the more traditional public exchanges to private networks – called dark pools. They enable institutional investors to buy or sell large blocks of stocks while not subjecting such block trades to price improvement.

While we are willing to compete with other trading venues on price and execution quality, we do believe that current treatment of dark pools and alternative trading systems is problematic for the

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[4] MARKET 2000, *Best Execution*, Study V, p.1. "Best execution," as used in this comment letter, as in the Market 2000 study, refers to the full set of legal duties whether derived from the common law agency duty of loyalty or general fiduciary principles.

marketplace on the whole. Specifically, we believe current practices are going down a path of eroding adequate price discovery.

A primary purpose of exchanges is to put together buyers and sellers to help realize true pricing – i.e., to gain proper price discovery. As the volume leader in equity trading, dark pools, alternative trading systems and others turn to the NYSE to help set their own prices. However, we believe that, at the minimum, they must help contribute to price discovery. Without such a contribution,
dark pools and other alternative trading systems exploit information from the traditional market place thus avoiding the costs associated with price discovery and affecting the price discovery function. In other words, dark pools ride free off of the NYSE price discovery, and actually impair the quality of price discovery by allowing large traders to execute orders at prices derived from the exchanges where the price discovery actually takes place.

If dark pools and alternative trading systems are allowed to continue to consummate transactions outside of the price discovery process then the marketplace runs a risk that, eventually, the markets will reach the tipping point where volume away from exchanges will result in an increased market fragmentation that, in turn, will mean an inability to gain proper price discovery. In addition, as their market share grows, what effect will this have as this market trickles down to retail investors?

Market price quotations belong to all market participants who provide the pricing mechanism for listing securities and maintaining a fair and orderly market. In our opinion, dark pools disrupt this balance by free-riding on market prices. Investors who choose to trade outside of the price discovery system give priority to factors like, among others, costs of the transaction. We cannot blame them for legally transacting business at a lower cost when it is made legally available.

The current reporting mechanism for dark pools and other alternative trading systems is problematic as well. Currently, market centers (i.e., exchanges) are required to report their trade activity to the Consolidated Trade System (CTS); but, unlike dark pools, regulated exchanges are required to publish the name of the venue on which the trade took place. Dark pools, on the other hand, are required to report their trades within 90 seconds to the TRF operated by either NYSE or by NASDAQ or to FINRA's ADF. What remains murky is whether these reported trades were executed in the broker's dark pool or via its market maker desk? As a result, the dark pools have not only taken a free ride off of exchange price discovery but also had its volumes lumped in with the broker's transactions - thereby avoiding transaction costs and bypassing the more stringent post-trade reporting. Last but not least, paying for NYSE exchange pricing is insufficient. Money alone will not help contribute to price discovery. Instead, the focus should be on enhanced regulatory oversight that will "leveling the playing field." In part, this means a payment of regulatory fees by all that are contributing to market trading.

The NYSE performs an important function in the National Market System by providing the primary market with the pricing mechanism. Nonetheless, it is necessary to address practices that do not foster price improvement and impede fair competition and transparency. We consider that dark pools play a passive role in the price discovery process and urge the SEC to fashion an approach that does not stifle the already existent price discovery system yet also addresses the need for dark pools to contribute a certain percentage of their trades to NYSE in order for them to pay a part of the cost of price setting and to contribute to ongoing price discovery.

Conclusion

The Organization of Independent Floor Brokers commends the Commission on its initiative to review the equity market structure. We understand and appreciate the difficulties that the Commission faces in attempting to address the current flaws in an otherwise healthy U.S. equities market structure. We are concerned however, that the present payment for order system fails to address sufficiently the underlying fiduciary duty of the broker owed to its customer. As reflected in our comments above, despite the existence of the disclosure requirements, the disclosed information does not shed light on fiduciary duties. A broker must be required to exercise his professional judgment in the interest of the customer. We therefore, urge the Commission to focus its attention on the current disclosure requirements and shed some light on the broker-client fiduciary duties.

We have also highlighted the need for the Commission to fashion an approach that address the need for the dark pools to contribute percentage of their trades to the NYSE in order for them to also pay, along with other market participants, the cost of price setting. We continue to believe that each participant in the NMS should be expected to assume a fair share of the regulatory burden, in our case, the price for using the NYSE listing services and sharing in the resulting regulatory fees.

Thank you for consideration of these matters.

On behalf of the Organization of Independent Floor Brokers,

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