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Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549-1090

Re: Concept Release on Equity Market Structure
File No. S7-02-10

Dear Ms. Murphy:

UBS Securities LLC ("UBS") respectfully submits this letter in response to the US Securities and Exchange Commission's (the "Commission's") request for comment in its "Concept Release on Equity Market Structure")[1]. We appreciate the rigor being demonstrated by the Commission in its pursuit of analysis, and in seeking input from market participants across the equity investment spectrum. We also appreciate the opportunity to express our view of issues that currently and potentially impact the US equity markets. Please note that our comments do not seek to address every topic and question posed by the Commission in the Concept Release, but focus on the following issues, which we believe are among the most critical to the US equity market structure:

- Fragmentation, Competition & Market Efficiency
- Short-Term Liquidity & High Frequency Trading
- The Costs of Trading: The Maker/Taker Model & Gross vs. Net Trading Costs
- The "Trade-At" Proposal
- Reg ATS Fair Access Rule

Introduction

Theories about market structure are evolving with the advent of alternative and dark liquidity, and advanced technology. The Street used to believe a central, displayed market—where all orders interact—was best. But changes to market regulation going back to Order Handling Rules and Regulation ATS, combined with thinning spreads, escalating competition and the immediacy of information, have made that model less efficient for investors of all types. Today's technology and the proliferation of real-time information improved market mechanics and gives traders new ways to quickly and/or quietly capture elusive liquidity.

Fragmentation, Competition & Market Efficiency

In this Concept Release, the Commission reviews the concept of market fragmentation, also referred to as "dispersed liquidity." The release seems to express a view that one centralized market would be a more efficient structure and better for investor performance, but that the

[1] Exchange Act Release No. 34-61358, available at http://www.sec.gov/news/press/2010/2010-8.htm.

Commission has resisted a forced return to such a model in recognition that competition among markets and orders offers distinct, but equally vital benefits.[2]

Industry participants would assert that competition, non-displayed and alternative liquidity, and the availability of advanced technology—rather than detracting from investor performance—have all actually increased market efficiency and liquidity. Prior to non-displayed pools, traders would not put their orders into the market but would hold their orders on their desks to manage the risk of information leakage. Now, traders can use non-displayed pools to seek liquidity without their orders becoming known to the market. Price discovery has not been hindered, because most non-displayed venues establish spreads based on the NBBO, and trades done within dark pools have immediate post-trade transparency. This information is available to everyone.

The existence of market de-centralization is the natural result of competition, which is a catalyst for innovation that has enhanced efficiency and lowered transaction costs for investors. While it is true that the proliferation of alternative trading venues – both displayed and non-displayed – is essentially the definition of fragmentation, it does not automatically follow that fragmentation is a bad thing for investors or for the marketplace's efficiency. A simple, completely displayed model would be easier to regulate, but it does not mean investors would experience better performance, or that the market would experience the volume levels and orderly efficiency that the US equities markets currently demonstrate. Consider that during the most volatile periods during the fall of 2008, the markets still functioned in a comparatively orderly fashion and market data/price discovery was still available. We believe this is indicative of the balance that natural market forces have created in the US equities trading arena. Dramatic reform is not required, and would likely be detrimental to the long-term investor.

Short-Term Liquidity & High Frequency Trading

Another major subject of the Commission's analysis is the impact of short-term versus long-term liquidity. As the Commission accurately states, defining this category is a challenge. Short-term and "high frequency trading" are loosely defined, but generally include traders who are not undertaking traditional fundamental research-based investment strategies, but rather, are implementing quantitative electronic model-based or statistical analysis-based trading intended to capture gains from short-term price fluctuations and statistical arbitrage opportunities. These traders, in most cases, are doing a form of pure market making—they are taking risk by committing capital in order to try to capture a portion of the spread. Because potential gains at the order level are small and fleeting, the trader must use advanced, high speed electronic trading models to manage thousands of short duration orders over the course of a trading session.

These types of investing strategies are actively implemented in many different kinds of firms, both large and small, either as a primary investment strategy or as part of a multi-strategy program. This poses an important question: In defining short-term investing, does the definition apply at the firm level (clearly not in every case), the trader level (in some cases the same traders implement both long- and short-term strategies), or is short-term trading defined at the individual order level?

[2] *See* Regulation NMS Adopting Release, Exchange Act Release No. 34-51808 at 13 ("Since Congress mandated the establishment of an NMS in 1975, the Commission frequently has resisted suggestions that it adopt an approach focusing on a single form of competition that, while perhaps easier to administer, would forfeit the distinct, but equally vital, benefits associated with both competition among markets and competition among orders").

There is a market misperception that this investor type is predatory, and operates by manipulating the markets or by seeking to game other orders. We believe this is a sweeping mischaracterization of the vast majority of short-term traders. Certainly, instances of “nefarious” or manipulative practices can be found among all kinds of market participants. Such behavior is addressed by existing regulation. The key, as in all regulatory initiatives, is to aggressively enforce existing rules, and to root out the specific factors that motivate or create opportunities for negative behavior. Better to remove the factors that prompt inappropriate activity, than to create wide ranging regulations aimed at participant types or trading strategies – which in most cases play an important role in the investment spectrum.

If long-term investors are the gasoline that fuels the US market’s economic engine, then short-term investors are the oil that ensures the engine runs smoothly and efficiently. Both types of investing serve an important purpose, and while they are not based on the same objectives, they are very interdependent. High frequency traders and market makers are in and out of positions numerous times intraday. This means they actually dampen intraday volatility and narrow spreads, which benefits both the investors and the issuer companies, and serves an important market making/liquidity provision function.

Our recommendation is to focus on the gaps or issues that prompt or create the opportunity for concerning activity (such as Flash Orders). The Commission should not seek to marginalize specific categories of traders or strategies.

The Costs of Trading: The Maker/Taker Model & Gross vs. Net Trading Costs

The maker/taker model rewards, through rebates, market participants who add or post liquidity to a market center’s book and “penalizes,” through access fees, market participants who remove or take liquidity. The rebates are designed to attract liquidity providers into the market center, which, in turn, attracts liquidity takers (who must pay access fees). The market center retains as revenue the difference between rebate paid and the access fee charged. The model emerged in response to the Order Handling Rules of 1997. We believe that the maker/taker model should be examined for its impact on market efficiency.

The maker/taker model creates a wide disparity in the overall cost of trading between market participants who are net liquidity providers versus those who are net liquidity takers. This disparity creates incentives to access liquidity using alternative means that are designed to earn rebates while avoiding access fees, for example: flash orders and actionable indications of interest—practices that the Commission has proposed to change or eliminate. Practices such as these may not have arisen in a marketplace that did not support such wide differences in the cost of trading between participants.

The effect of the maker/taker model is particularly sensitive with respect to stocks that are quotable in sub-pennies, where the rebates frequently exceed the bid increments of the stocks being traded. This often results in a situation called “rebate arbitrage,” where market participants post quotes on both sides of the NBBO and attempt to earn the rebate on each side. This practice also results in synthetically “locking” or crossing the stock because the combined rebates on the bid and offer exceed the spread in the security.

In addition, certain market participants send inter-market sweep orders as day orders at all price points, allowing the recipient market center to post an order that locks the best bid or offer. This can result in meaningful time periods during which market quote updates are locked[3].

As a result of latency between a direct market data feed and the SIP in quotation dissemination, these orders may cause the market participant to be a liquidity provider instead of a liquidity taker, thus earning a rebate instead of paying an access fee. This situation essentially subverts the objectives of Regulation NMS[4].

The "Trade-At" Proposal
The Concept Release questions whether a "trade-at " rule is necessary to prevent damage to the price discovery process in the lit marketplace due to the growth of non-displayed liquidity within ATSs and broker crossing networks. We believe that non-displayed liquidity does not harm the process of price formation. Executions in non-displayed liquidity are immediately reported to the tape – which then impacts the NBBO just as in displayed trades. So based purely on a price discovery quality basis, a Trade-At rule is not necessary. Non-displayed liquidity can present challenges to market participants who seek to assess supply/demand at the venue level, but a "trade-at" rule would not necessarily aid in the process of price formation and will likely harm investors. It is unlikely that driving market participants out of non-displayed pools will result in their orders finding their way to the displayed markets.

While alternative trading pools and broker crossing networks frequently offer the opportunity for price improvement, investors are drawn to non-displayed venues for more than just price improvement. Investors access non-displayed pools of liquidity for the opportunity to interact with unique or scarce liquidity that is price sensitive, and in order to protect themselves from pre-trade information leakage. The "absence" of pre-trade price impact for retail client and institutional client flow executed in broker networks and non-displayed pools is a significant benefit that yields an unknown level of performance improvement (or lack of slippage) to these orders.

The Commission suggests that a "trade at" rule might require a broker dealer with an order in a non-displayed network to facilitate the order only if by executing it within that network it gets a price improvement of a minimum quotation increment or a penny (.01), or else they must route ISOs against the displayed orders at the NBBO and facilitate the balance at the NBBO. This approach would be harmful to investors of all types for several reasons. This will often result in detriment to the "long-term" investor and benefit the "short-term" investor, as rebate-motivated trading strategies will increase. The ISOs create the pre-trade information leakage that these investors were seeking to avoid by sending their orders to non-displayed venues.

Market makers currently provide price improvement to retail orders in amounts less than a penny. A "trade at" rule would harm the retail investor by taking away this opportunity for price improvement. Since May 2007, wholesale market makers[5] have provided predominantly retail clients with over $650million in price improvement on orders eligible for Rule 605 reporting. On

[3] For example: During the April 27, 2010 trading day, UBS conducted market data analysis between 10:00AM and 4:00PM. Tape A: NYSE Listed Securities quote updates were locked (bid = offer) 2.4% of the time. Tape B: ARCA/AMEX/Regional Listed Securities quote updates were locked 1.5% of the time. Tape C: NASDAQ Listed Securities quote updates were locked a full 5.0% of the time.
[4] *See, e.g.,* Regulation NMS Adopting Release, Exchange Act Release No. 34-51808 at 193 (July 2004), *describing* the obligations of SROs to establish and enforce rules "prohibiting their members from engaging in a pattern or practice of locking or crossing quotations."
[5] 605 Reports analyzed include reports from wholesale market makers UBS, Citadel, E*Trade, ATD, and Knight.

average, these market makers price improved 59% of total shares executed, at an average of $0.43 cents per improved share, representing 20% of the quoted spread. Access fees that are borne by these market makers who aggressively take liquidity to provide best execution on held market orders generally range between 0.28 - 0.30 cents per share, and total an estimated $737.8mm over the same time period[6].

Why should regulation dictate that no price improvement is better than a ½ cent or a ¼ of a cent? This is real improvement that benefits retail investors, and is consistent with the spirit of a broker's best execution obligations. How could we not tell an investor that "any price improvement is good?"

In addition, broker dealers often compete with the inside market and facilitate their clients' orders. If a broker is required to route to the best quote prior to facilitating the client's orders, the broker will be locked into paying an access fee for all of their clients' marketable orders. Where the retail order might have been price improved a fraction of a penny, the retail client now must pay the offer price for the security and the executing broker must pay an additional 3/10s of a cent access fee. This will result in higher trading costs for all investors, especially retail investors, as these costs are quite likely to be passed along. Price improvement analysis must factor in the costs of trading – including market access fees. In this context, an order that is facilitated at the inside market today is by definition price improved, because the retail client is not paying the access fee.

A "trade-at" rule also would be harmful to clients whose objective in accessing non-displayed liquidity is to manage price impact. By forcing every order to first trade in the lit market (unless it can be facilitated at a full penny better off-Exchange), large orders would be required to set stocks in motion, exposing clients to adverse execution quality and increasing volatility as stock prices move on an order by order basis. Order information would also be leaked every time an institution with a large order accesses the lit markets, increasing the likelihood of gaming.

The Commission acknowledges in its Concept Release that broker dealers have done a good job of innovating new technologies to address dispersion. A "trade at" rule would undermine important NMS objectives and stifle innovation, compromising the important role that non-displayed liquidity plays in the marketplace. Execution algorithms have evolved to aid investors to seamlessly interact with multiple market centers at the same time, as well as access non-displayed venues. This allows clients to place orders simultaneously in several non displayed venues, including the executing broker dealer-owned ATSs. A "trade-at" rule would severely undermine this "liquidity discovery process" in the hope (with no guarantee) of fortifying the "price formation" process. Therefore, a "Trade At" Rule would severely negate investor choice regarding the manner in which to implement their investment decisions, protect themselves from information leakage, and obtain the best possible price.

Reg ATS Fair Access Rule

In this Concept Release, the Commission also raises a variety of questions related to non-displayed liquidity and its impact on the market. Many of these concepts were addressed by UBS in our comment letter on proposed Regulation of Non-Public Trading Interest (File No. S7-27-09). We will not reiterate those views, but rather refer the Commission back to this original

[6] Source: Thompson MSI, Rule 605 Public data.

letter[7] with regard to our views on the benefits of non-displayed liquidity. We will comment here, however, on whether the original Reg ATS Fair Access Rules should be altered.

With respect to the Fair Access Rule, the Commission requests the industry to comment on whether the 5% trading volume threshold should be lowered. The Fair Access Rule provides, *inter alia*, that if during at least four of the preceding six calendar months, an ATS had 5% or more of the average daily volume in a security, the ATS: (1) must establish written standards for granting access on its system, and must not unreasonably prohibit or limit any person in respect to services offered by the ATS by applying its access standards in an unfair or discriminatory manner.[8]

Over the past several years, competition among markets for institutional order flow has resulted in the formation of dozens of alternative trading systems that actively trade NMS stocks. Fair access to alternative trading systems is a good and appropriate standard. It is important, however, to ensure that the definition of "fair" is not stretched to mean absolutely ubiquitous. Alternative trading systems exist in order to provide competitive alternatives to the displayed markets. The evolution of these venues was spurred on by investor demand for wider alternatives in how they interact with liquidity.

Buy side clients appreciate the ability to choose where and how they route their orders. If every ATS needed to be open to absolutely every possible participant, then there would be little to no variation of business model or types of flow available in these pools. If, for example, the non-displayed exemption were changed and the volume threshold triggering Fair Access rules were lowered to such an extent that all ATSs had to be open to all participants, investors would lose the ability they currently have to strategically make decisions (based on their orders) about the nature of the liquidity with which they'd like to interact. This would remove another important aspect of investor choice – and ultimately would result in a far less competitive marketplace.

Conclusion

The market has not demonstrated a desire to regress back to a fully centralized, fully lit order book approach. The US Equities Market's evolution over the last decade, and the efficiencies we've gained, have been the result of greater competition, which has stimulated innovation, pushed down the costs of trading, and broadened the equity investor's range of choice. Economic progress and market performance would not be served by the elimination of these important benefits. We congratulate the Commission on their measured approach to their analysis of US market structure issues, and would encourage further study that incorporates empirical analysis and ongoing, open dialogue.

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[7] See UBS's commentary on the proposed Regulation of Non-Public Trading Interest, available at http://www.sec.gov/comments/s7-27-09/s72709-71.pdf

[8] Regulation ATS, 17 CFR 242.301(b)(5)(ii)(C) – (D). The Fair Access Rule also requires an ATS to make and keep records of all grants, denials, and limitations of access and to report that information on FORM ATS-R. 17 CFR 242.301(b)(5)(ii)(C) – (D). *id.*

Thank you again for the opportunity to provide our perspective on this critical set of subjects. We welcome the opportunity to respond to any questions from the Commission or staff members relating to the views expressed in this letter.

Sincerely,

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CC:
Hon. Mary L. Shapiro, Chairman
Hon. Kathleen L. Casey, Commissioner
Hon. Elisse B. Walter, Commissioner
Hon. Luis A. Aguilar, Commissioner
Hon. Troy A. Paredes, Commissioner
Robert W. Cook, Director, Division of Trading and Markets
Arisa Tinaves, Special Counsel, Division of Trading and Markets
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