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April 29, 2010

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

Re: Concept Release on Equity Market Structure
<u>Release No. 34-61358; File No. S7-02-10</u>

Dear Ms. Murphy:

BNY ConvergEx Group, LLC ("ConvergEx") appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") Concept Release on Equity Market Structure, Release No. 34-61358 (Jan. 14, 2010), published at 75 FR 3594 (Jan. 21, 2010) ("Concept Release"). Through the Concept Release, the Commission seeks comment on a broad array of issues affecting the current U.S. equity market structure, including how market performance should be measured, issues surrounding high frequency trading, order routing, market data linkages and so-called dark liquidity. One of the recurring themes in the Concept Release is the effect of advances in technology and innovation on our equity markets.

ConvergEx Group offers a broad range of sophisticated technologies and innovative strategies designed to provide clients with the ability to gain access to liquidity while bringing value and cost efficiency to transactions. We offer some of the most advanced tools in the industry, specifically designed to help institutional investors have more choice and control over their execution strategies while addressing cost, timing, performance and market structure requirements. Key among these are our three proprietary Alternative Trading Systems ("ATSs"): ConvergEx Cross℠, VortEx℠, and Millennium ATS℠. ConvergEx Cross is a block trading venue for institutional customers, VortEx is a continuous midpoint crossing ATS for institutional customers, and Millennium ATS, which until recently was known as NYFIX Millennium, is a continuous crossing ATS for institutional and broker-dealer subscribers. All three ATSs leverage our sophisticated, proprietary technologies and are designed to provide reliable, anonymous sourcing of liquidity, enabling clients to remain competitive and flexible. Each of the ConvergEx ATSs executes orders on an agency cross basis, and ConvergEx does not act as a market maker in any NMS stock or trade with any of its institutional customers in any of its ATSs on a proprietary basis. ConvergEx also offers state-of-the-art smart-routing and algorithmic trading capabilities to its institutional clients. As a premier provider of investment technologies and global agency execution solutions to institutional clients worldwide, ConvergEx Group is well-placed to provide comments on the Concept Release based on our first-hand experience with many of the issues raised in it. ConvergEx Group appreciates the opportunity to comment on the issues raised in the Concept Release.

I. Introduction

A. General Overview

We are pleased that the Commission is looking at market structure broadly in an effort to enhance its regulatory mission. In our view, the summary of our current equity market structure provided by the Commission in the Concept Release is, by-and-large, accurate. Contrary to some of the suggestions in the Concept Release, however, we think that our current equity market structure generally works well. Thus, instead of resulting in a major overhaul and restructuring of our equity markets, we hope that this exercise will instead result in the right-sizing of regulation.

In this regard, we note that the Commission has already proposed several rules intended to restructure certain aspects of the equity markets, including rules relating to the treatment of dark liquidity in ATSs, flash orders, and market access.[1] Several of the issues discussed in the Concept Release relate to, and would be directly affected by proposed changes in current rules. We are reminded of the process undertaken in connection with Regulation NMS, in which numerous new rules and rule amendments were considered collectively at the same time. This enabled the Commission and its staff to analyze, with the help of comments received from market participants, how changes to one rule within the Regulation may impact the application of another rule within the Regulation, thereby decreasing the likelihood of unintended consequences. We believe that the same process of considering all major proposed structural changes collectively, rather than in a piece-meal fashion, should be extended to the Commission's current market structure initiatives.

For this reason, we agree with the statements made by Commissioner Casey at the Open Meeting at which the Commission considered the publication of the Concept Release:

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[1] ConvergEx and its affiliate Liquidpoint, LLC, which specializes in providing derivatives technology and execution solutions for U.S. listed options traders, have submitted comment letters on many of the pending and adopted market structure-related rule proposals and related SRO rule filings. See, e.g., Letter from Joseph M. Velli, Chairman and Chief Executive Officer of BNY ConvergEx Group, LLC, dated February 22, 2010 regarding the SEC's proposal for the regulation of non-public trading interest, which is available through the Commission's website at: http://www.sec.gov/comments/s7-27-09/s72709-51.pdf; Letter from Joseph M. Velli, Chairman and Chief Executive Officer of BNY ConvergEx Group, LLC, dated April 9, 2010 regarding the SEC's proposal to require Risk Management Controls for Brokers or Dealers with Market Access, available at: http://www.sec.gov/comments/s7-03-10/s70310-52.pdf; Letter from Anthony J. Saliba, CEO, LiquidPoint LLC, dated December 8, 2009, regarding the proposed elimination of the flash order exception from Rule 602 of Regulation NMS, available at: http://www.sec.gov/comments/s7-21-09/s72109-104.pdf; Letter from Anthony J. Saliba, CEO, LiquidPoint LLC, dated April 29, 2010, regarding the Commission's failure to adopt an options market maker exception to the recently adopted "modified uptick rule" under Regulation SHO, and Letter from Anthony J. Saliba, CEO, LiquidPoint LLC, dated October 7, 2009, re: CBOE's challenge to the SEC's approval of a new ISE rule permitting the crossing of option orders without prior exposure or the matched orders to the market or to interaction with customer orders, available at: http://www.sec.gov/comments/sr-ise-2009-35/ise200935-9.pdf. Many of the arguments made in those letters are equally applicable to the similar issues raised in the Concept Release.

> Sometimes we don't know what we don't know, and if we rush to regulate without a complete understanding of the extent to which complex and dynamic activities may be interrelated and interconnected, the specter of unintended consequences looms particularly large. We should strive to avoid playing a game of Whac-a-Mole in this area, where we solve one problem and inadvertently create a new one.
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> In my view, a comprehensive approach that includes reviewing public comments on the concept release from experts and practitioners, holding roundtables, and engaging in rigorous fact finding on advances in trading practices and technology prior to adopting any final trading rules would reduce the chances of such an outcome.[2]

For this reason, we believe that the Commission should forego taking final action on those pending proposals until the comments received in response to the Concept Release, including ours, can be reviewed and digested.

With that said, we turn our attention to the concepts discussed and questions asked by the Commission in the Concept Release.

B. The Commission Should Analyze Changes to the Current Equity Market Structure by Reference to a Set of Core Principles That Take Disparate Interests Into Account.

In considering whether to adopt changes to the current equity market structure, we believe that the Commission should not only adhere to the Exchange Act's strictures on balancing competing factors in approving market structure changes, but also to the concept of "do no harm" as espoused by several of the current Commissioners. We agree with these general principles and objectives, although we may differ with the Commission on which factors should be afforded more weight. Extending these principles and objectives farther, however, we would ask the Commission to apply additional principles that naturally flow from the stated objectives – allowing competition to help naturally structure our equity markets, refraining from stifling technological innovation that leads to greater efficiencies in the markets, and requiring market participants to take some personal responsibility for achieving their goals – in determining whether our equity markets are in need of restructuring. We believe that these various principles establish a core framework under which any proposed changes to our current market structure should be analyzed.

[2] See Statement by SEC Commissioner Kathleen L. Casey at the Open Meeting on January 13, 2010, available on the Commission's website at: http://www.sec.gov/news/speech/2010/spch011310klc-access.htm.

1. The Exchange Act Establishes Five Core Objectives.

The first set of principles that the Commission must consider are the Congressionally-mandated objectives for a national market system. As the Commission noted in the Concept Release, Congress has set forth five objectives that should govern and inform regulation of the securities markets. Those objectives are:

> (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 and transactions in securities;
> (iv) the practicability of brokers executing investors' orders in the best market; and
> (v) an opportunity, consistent with efficiency and best execution, for investors' orders to be executed without the participation of a dealer.[3]

Recognizing that these five objectives may conflict with each other in some instances, the Commission concluded that its job is to find the appropriate balance among these competing objectives when analyzing changes to our market structure.[4] Under these objectives, no single market participant or group of market participants, or particular end goal (such as market efficiency as opposed to fair competition), should take precedence over all others.

2. Rules Adopted by the Commission Should Not Do Harm to Our Markets.

The second principle to which the Commission should adhere when adopting rules that will change our equity market structure is to "do no harm." In our view, U.S. markets are running efficiently and have held up very well in times of market stress, as has been evident over the past few years. In an effort to "fix" perceived (but perhaps not actual) problems, the Commission should be careful not to institute new rules that make our markets less efficient and less competitive to the detriment of all market participants. As Commissioner Aguilar explicitly stated at the Open Meeting discussing the publication of the Concept Release:

> As the Commission proceeds, we need to be thoughtful and deliberative and we need to ensure that we preserve the fairness, transparency, and efficiency that have made our capital markets the

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[3] See Section 11A of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78k-1. See also Concept Release, 75 FR at 3596.

[4] Concept Release, 75 FR at 3597.

> largest and most effective in the world. We should observe the adage: "do no harm."[5]

We wholeheartedly concur with applying this principle to any proposed change to the current equity market structure. In addition to those principles, however, we further suggest that the Commission add the three additional principles described below, which follow naturally from the objectives and principles described above, to its analysis.

3. Additional Principles for the Commission to Consider.

a. "Fairness" does not require going to the lowest common denominator.

The first of these additional principles involves the concept of "fairness" and the creation of a "level playing field." We agree that fairness and having a level playing field are important for the markets so that investors and traders alike can realize the goals set forth by Congress. However, it is important to understand that fairness and the creation of a level playing field does not mean that everything must be the same for all market participants at the same time in all circumstances. While similarly-situated market participants should be treated similarly, persons performing different functions or representing different and often competing interests should not be, and should not expect to be, treated exactly the same.[6] Fairness and a level playing field must take account of the investments of time, money and resources made by market participants. Forcing those who make the investments to give away the fruits of their labors undermines all of the objectives/principles listed above. Competition, not regulation, is the proper determiner of how those resources should be allocated.

Requiring those market participants who have expended the resources needed to develop more successful trading strategies to relinquish those advantages by artificially "leveling the playing field" is reminiscent of the disturbing plot of Kurt Vonnegut's short story, "Harrison Bergeron." In that tale, society's goal was that no one feel inferior to anyone else. Instead of encouraging less fortunate members of society to strive to improve their lot, persons enjoying

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[5] See, e.g., "Assuring Securities Markets that are Fair, Transparent and Efficient," Speech by SEC Commissioner Luis A. Aguilar at the Open Meeting of the Commission held on January 13, 2010 at which the publication of the Concept Release was approved, available on the Commission's website at: http://www.sec.gov/news/speech/2010/spch011310laa.htm. See also Statement by SEC Commissioner Kathleen L. Casey at the Open Meeting of the Commission held on January 13, 2010, supra n. 1 ("I am pleased that our concept release embraces the "First, do no harm" principle.") Similarly, in advocating that the Commission not go overboard in reacting to the Enron scandal, Division Director Beller previously stated, "[W]e must be exceedingly careful not to over-react, not to regulate for the sake of regulating, and especially not to take steps that pose a significant risk of harming the system rather than improving it. The injunction to physicians, "First, do no harm!" applies equally to regulators." See Remarks before the Rocky Mountain Securities Conference by Alan L. Beller, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, Denver, Colorado, May 17, 2002).

[6] A simple example can be found in connection with sales transactions involving real goods. In that arena, a high-volume purchaser often will receive discounts and benefits that are not offered to purchasers of a single item. No one rationally suggests that the high-volume purchasers are being unfairly advantaged in that situation.

advantages not universally shared were brought down to the lowest common denominator. In effect, social equality was achieved by handicapping the more intelligent, athletic or attractive members of society.

The Commission should be careful that, through trying to establish a level playing field among market participants and create "fairness" in our markets, it does not sink to the lowest common denominator. Those market participants that expend the time, effort and resources to build the better mousetrap should be able to enjoy the fruits of their labor, as long as institutional obstacles do not prevent others from developing their own better mousetraps if they are willing to expend similar resources. Competition, and not the stifling of competition through unnecessary regulation, is the impetus for building the better mousetrap. Technological innovation should be rewarded, not handicapped.

b. Participating in Today's Markets Requires Taking on Personal Responsibility.

The second additional principle to consider is personal responsibility. Participants in today's equity markets have access to a wide array of investment and brokerage products and services. The marketplace has providers and solutions for every market participant and their unique objectives. Vendors, which may or may not be broker-dealers, offer order management and order routing systems and algorithmic trading programs to clients. Brokerage services offered by broker-dealers to their customers can range from full-service brokerage and investment advisory services to bare-bones fixed-fee execution services. Some broker-dealers have established access to a multitude of market centers to which they can route orders, while others offer more limited access to a variety of market centers. For every legitimate investment goal that a customer (whether retail or institutional) may have, there is a vendor or brokerage firm willing to provide it for an appropriate fee.

This requires, however, each market participant to bear some personal responsibility for achieving the results it seeks. In this regard, all market participants have a responsibility to shop around and figure out the best way to achieve their investing and trading goals. They must ask questions about their brokers' access to various market centers and the various products offered by those brokers that could be useful to them. Institutional investors and their brokers generally do this on a regular basis, and it is no less important for retail customers to do the same.

It is unrealistic to expect the same order execution and price improvement capabilities from all brokers for passive and active investors alike. For instance, a broker offering basic execution services for a minimal flat fee per trade may send those customers' market orders to a single market center for execution. Regulation NMS requires that the order receive a price at or within the NBBO at the time the order is executed, and the order should receive such a price. However, the actual price given to the execution depends on the availability of liquidity at the market center when the order arrives and, if not, whether that market center has access to other market centers to which it may route the order for execution. On the other hand, a full-service brokerage firm offering enhanced products and services to its customers (for a higher fee) likely will have access to various products to assist it in handling its customer orders and to myriad different market centers, both dark and light, to which it can send specialized order types on behalf of its customers. In both of these examples, the customer has made a choice regarding how to achieve its goals. Minimizing the brokerage fee paid is obviously a goal of the customer of the broker offering bare-bones execution services for a minimal flat fee per trade, while the customer of the full-service broker is looking for more personalized attention from its broker and is willing to pay for that higher level of service.

As discussed above, this disparity is not "unfair." There is no reason to punish those that take the time and effort to seek out or provide better execution capabilities in order to "protect" the persons who do not expend the effort to seek out, pay for, or provide an equivalent result or level of service. The market responds to customer needs, so that as new execution solutions become necessary in light of changing circumstances and goals, the market will create them. Regulation should not replace or remove each participant's responsibility to research and discern what is right for it and usurp the freedom to choose.

c. Rules Should Not Favor One Type of Market Participant Over Others Without a Careful Balancing

Finally, we urge the Commission to avoid taking any action that in effect unfairly benefits a particular group of market participants to the express detriment of another group of market participants without a careful balancing of the five core principles and additional considerations we have outlined above. As noted previously, the core principles call for fair competition among and between similar types of market participants as well as different types of market participants. Indeed, our current market structure is a diverse ecosystem, with many different types of business models, which in turn has led to more competition and innovation to the benefit of all. Each group of participants today, including long-term investors, short-term traders, exposed markets, dark markets, agency brokers, proprietary traders, institutional customers and retail customers, plays an important role in the successful operation of our equity markets. The products and services utilized by these and other groups of participants were developed in response to the needs of customers in order to achieve their goals within our current market structure. Regulation should be mindful of not unnecessarily driving any of these or other groups of participants out of the market, for fear of creating unintended consequences.

For instance, a particular group may be useful in unforeseen ways, including with the solutions it provides to customers or as a counter-balance to another group. If one group is regulated out of the market, under the rubric of "nature abhors a vacuum," the space previously occupied by that group will undoubtedly be filled by someone or something else – who or what that will be cannot be predicted. The end result could be an exacerbation of the problem the Commission intended to fix or even create a whole host of new problems. We believe it is far better to allow competitive forces to determine which entities succeed or fail in our markets than to regulate certain types of entities out of the market entirely.

C. The Importance of Agency Brokers to our Markets.

In deciding how to balance competing interests under the core and other principles described above, the Commission naturally makes judgments regarding the benefits that different types of market participants and the services they provide bring to the equity markets. As the Commission notes,

> [t]he Commission's task has been to facilitate an appropriately balanced market structure that promotes competition among markets, while minimizing the potentially adverse effects of fragmentation on efficiency, price transparency, best execution of investor orders, and order interaction. An appropriately balanced market structure also must provide for strong investor protection and enable businesses to raise the capital they need to grow and to benefit the overall economy.[7]

The Commission already has indicated that it generally favors the interests of long-term investors over the interests of short-term traders because, among other things, long-term investors "provide the capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time."[8] If protection of long-term investors is to be favored, the Commission should consider also favoring those market participants assisting those long-term investors and whose interests are aligned with them.

In this regard, as the Commission considers changing the structure of our equity markets, we urge the Commission to consider the impact of any such proposed changes on agency-only brokers, which include agency-only dark pools. Agency-only brokers play an important role in maintaining market equilibrium by providing an effective counterbalance to proprietary trading firms and full-service broker-dealers that conduct both agency and proprietary trading. Agency-only brokers play a key role in helping their investor clients figure out the right investment strategy for them by acting as the investors' advocate in the market. With an agency-only broker, a customer does not have to worry that its broker may be trading ahead of its orders and is better protected against information leakage relating to its orders. Agency brokers provide customers with the opportunity to have their orders executed without the participation of a dealer, one of the five main objectives of our national market system.

An agency-only broker is a neutral party that does not trade against its customers, and it therefore focuses its resources on working to enhance its best execution capabilities for those customers. Because it does not operate a proprietary trading business, its investments in technology developments and relationships with market centers are based on maximizing

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[7] Concept Release, 75 FR at 3597.

[8] Id., 75 FR at 3603.

customer satisfaction, and not on maximizing its own proprietary trading profits.[9] Its customers do not have to worry that the agency-only broker is using a better trading algorithm for its proprietary trading than it offers to them as a customer, because there is no proprietary trading. Similarly, the customer can be assured that the agency-only broker is not internalizing its order flow at a worse price than it could receive at another market center. At an agency-only broker, a customer is assured that its orders are crossed with other "natural" trading interest, not crossed at a potentially worse price against proprietary trading interest of the broker.

In our view, the unique position of agency-only brokers within our equity markets and differences between agency-only brokers and proprietary traders should be taken into account when weighing whether any proposed rules meet the national market system objectives listed above, particularly those relating to the promotion of fair competition between brokers and dealers and the provision of the opportunity for investors' orders to be executed without the participation of a dealer. The Commission has even noted that multi-service broker-dealer sponsors of ATSs, which execute the majority of dark pool volume, may be in direct competition with their subscribers, and questions whether such ATSs could apply objective fair access standards reasonably to prevent predatory trading, but without using such standards as a pretext to discriminate based on the competitive self interest of the sponsoring broker.[10] This conflict situation, as well as other situations caused by the fact that full-service broker-dealers and their customers are often in competition with each other, are not present for agency-only ATSs. Thus, to ensure that customers can continue to have their orders executed without the participation of an entity that is often in competition with those customers, the Commission should be careful not to take action that will disproportionately harm agency-only brokers and ATSs.

II. Comments on Specific Issues Raised in the Concept Release.

A. Our Current Market Structure

1. Overall Market Quality

We believe that the U.S. equity markets are the highest quality markets in the world. Consequently, although we may support some targeted regulatory changes to our market structure, overall, we do not believe that significant structural or regulatory changes are warranted. Notwithstanding stock performance over the past few years, which is a whole separate issue from market quality, the markets themselves have functioned extremely well during periods of market crisis. While there is little that could have prevented the overall loss in

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[9] For example, as we pointed out in our comment letter on the Commission's proposals relating to the Regulation of Non-Public Trading Interest (see SEC Release No. 34-60997 (Nov. 13, 2009), 74 FR 61208 (Nov. 23, 2009)), agency brokers have created dark pools where long-term investors can trade away from the high-frequency traders of proprietary trading firms and market makers. See BNY ConvergEx's Comment Letter dated February 22, 2010 regarding the Commission's Dark Liquidity Proposal, *supra* n. 1.

[10] See Concept Release, 75 FR at 3614.

value in investors' portfolios over the last couple of years, the markets themselves operated as they were supposed to operate. Even when they panicked, investors seeking to sell their stocks during the most volatile market days were able to do so in an orderly fashion.

In the Concept Release, the Commission has asked whether any of its current regulations have harmed market quality.[11] While current regulations have certainly changed market dynamics, we do not believe that overall market quality has decreased, primarily because of market participants' development of technologies to address obstacles to execution quality and to provide better linkages. Nevertheless, we believe that some of the Commission's recent rulemaking initiatives are or will be harmful to the markets. For example, we disagree with the Commission's determination to re-institute a short sale price restriction through the modified "up-tick" rule.[12] Although this measure may provide some investors and issuers with the illusion of security from rapid price declines in their stocks, we seriously question whether it is economically justified or will be remotely effective in times of market stress in preventing unwarranted downward price movements.[13] Instead, it is likely to have the opposite effect: when a stock price starts to fall, it is likely to drop down to the full 10% threshold level more often than not.[14] In addition, the lack of an options market maker exception from application of the rule is especially troublesome. We believe that options market makers can provide stability and liquidity in times of market stress, and their abilities should not be hindered by a placebo.

2. The Role of Technology

a. Competition in Technology Promotes Fairness

The Commission makes clear in the Concept Release its belief that it should uphold the interests of long term investors (not specifically defined) over those of short term traders.[15] It asks whether the current market structure is "fair" for long term investors and seeks input on how

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[11] See Concept Release, 75 FR at 3603.

[12] See Amendments to Regulation SHO, SEC Release No. 34-61595 (Feb. 26, 2010), 75 FR 11232 (Mar. 10, 2010).

[13] If the perceived problem is that some market participants are artificially attempting to depress a stock's value through short selling and false rumor-spreading in order to capitalize on the assured rebound of the stock price, that problem can be addressed to vigorous enforcement of current regulation, including the anti-fraud and price manipulation provisions of the Exchange Act. Reinstituting a form of regulation that the Commission's own economists, after study, determined was ineffective does not seem like the most effective means of solving that perceived problem. Furthermore, one must question the efficacy of such a rule in light of flickering quotes, which, if the Commission ultimately permits sub-penny quoting in lower-priced stocks, as is suggested as a possibility in the Concept Release (see 75 FR at 3613), will only become more prevalent.

[14] For instance, say that a stock has declined 8% from the prior day's close. An active trader, fearing he may be precluded from selling short later in the day except on an uptick, will be likely to short more and earlier in anticipation of the rule's application.

[15] See Concept Release, 75 FR at 3603. Although the Commission asks for input on how to define a "long term investor," we are not expressing an opinion on that issue. Unless otherwise indicated, our comments apply equally to all market participants, whether long term investors, short term traders, or something in between the two.

it should judge "fairness." In this connection, the Commission asks whether it is "unfair" that professional traders are likely to trade faster than long term investors, or that some market participants may gain a competitive advantage through investing in technology and human resources that enables them to make better trades.

As we discussed above, we do not believe that every benefit enjoyed by one market participant or group of participants because they have expended the time, effort and resources to position themselves to get a better result is "unfair" to other market participants. In our view, this is key to the success of our markets – participants are constantly developing new strategies and systems to trade better, faster and smarter, and those innovations often end up making the overall market more efficient. Persons unwilling to expend the same resources to develop their own strategies or systems cannot reasonably expect the same results. Innovation, such as the development of faster messaging and processing, smarter smart routers, and better trading algorithms, occurs because of keen competition among market participants. For instance, an institutional investor may ask its broker-dealer to create an algorithm for its trading that minimizes the likelihood that its potential counterparties (*e.g.*, proprietary traders) will be able to glean intelligence about the investor's interest in a particular stock. In response, the proprietary traders may then change their own trading programs in an effort to try to gain some information they can use to their respective advantages. While this can be a never-ending game of cat-and-mouse, that is not necessarily a bad thing. It is the nature of our capital markets that one party to a transaction is always looking for a better deal than his or her counterparty. In our capitalist system, those persons that figure out a legal way to provide that better deal for themselves and/or others generally should be rewarded.

In various areas of American life, certain persons or groups of persons have advantages that other persons or groups do not similarly enjoy and that fact is recognized, and sometimes even encouraged, in the law. For instance, at all levels of commerce, purchasers of larger quantities of goods and services may receive volume-based discounts in pricing. Even though this benefits larger, better capitalized purchasers, this is not considered anti-competitive under antitrust law concepts. Likewise, the inventor of a new or improved product may receive a patent on his invention. This patent rewards the inventor's expenditure of time, effort and resources by essentially providing him with a monopoly over the invention and its methods for a period of years. In this regard, the inventor can preclude others from using his invention for their own benefit without paying royalties to the inventor for a period of years. No one rationally argues that these areas of law are "unfair." Likewise, it is not "unfair" that a professional trader may be able to trade faster than a long term investor (or, most likely, its broker), or that some market participants may gain a competitive advantage through investing in technology and human resources that enables them to make better trades.

We believe that the smooth operation of our equity markets, even in times of market stress, is a testament to the role that innovation, and particularly technological innovation, plays in our markets. With every change to the regulatory landscape that occurs, or every problematic practice that develops, market participants find ways to solve those problems without more regulation. For every perceived problem, there is a market participant, or a number of market participants, ready and willing to help solve it. As we discuss above, it is every market participant's responsibility to determine its needs and goals, and retain the appropriate help to achieve those goals. Problems that are not unique to a single customer are likely to be addressed by numerous parties competing against each other to find the best solution and lure the greatest number of customers. As more market participants jump into the competition to provide a solution, the lower the cost of obtaining that solution becomes.

Innovation and technological advances can fix many perceived problems without the need for additional regulation. For example, we are aware that the Commission is concerned about market fragmentation, particularly since the advent of Regulation NMS, and we agree that liquidity is fragmented in our markets today. The Commission should not consider this to be a significant problem, however -- even if liquidity is fragmented, with enough investment by the private sector in creating linkages between markets, better systems communications techniques, greater messaging capabilities and the use of indications of interest to narrow down where the liquidity is residing, a fragmented market can essentially be put back together again. Because of these technological solutions, market quality has not been significantly diminished because of fragmentation. Eventually, competitive forces in the market will weed out those markets with insufficient market share to be sustained. That is how our system should work – vigorous competition should be the decider of who succeeds and fails, not regulation.[16]

b. Technology Is Not a Cure-All

While it is tempting to say that technology will easily handle changes in the markets, whether stemming from regulatory changes or from competing market forces, it is also important to remember a few things about technology:

First, technology cannot solve everything. There is still significant human involvement and judgment exercised in the trading markets, even though technology has decreased the need for human interaction in many areas. In addition, effective regulation still requires effective enforcement of regulations by market participants and regulators alike, and this necessarily involves people. For instance, a market can develop electronic surveillance reports to detect indications of problematic practices, but that data must be analyzed by a person so that false positives can be ruled out. Technology also cannot stop bad behavior by individuals; it can help detect violative behavior, but cannot change human nature.

Second, electronic systems cannot be changed instantly. Internal broker-dealer systems are not monolithic creatures to which a single programming tweak can be made and everything is suddenly new or compliant. Because the securities industry is so highly technology-driven, every time a change is made to a rule or regulation, market participants are required to expend a

[16] In this regard, Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact that any rule promulgated under the Exchange Act would have on competition and to justify any anti-competitive effects of a rule. Pursuant to this provision, the Commission "shall not adopt any ... rule or regulation which would impose a burden on competition necessary or appropriate in furtherance of the purposes of the Exchange Act." Section 3(f) of the Exchange Act further requires the Commission, when determining whether a rulemaking is necessary or appropriate in the public interest, also "to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

great amount of resources reprogramming all of their internal systems and testing the interactions among their various systems to ensure that no problems exist when the systems communicate with each other. Moreover, each market participant's multi-faceted systems interact with the multi-faceted systems of many other market participants. Broker-dealers and market centers must make sure that their systems changes do not affect the ability of their customers to reach them electronically (which could require changing customer front-end systems if necessary), and they must also make sure that their systems continue to communicate properly with other market centers. In short, there are ripple effects to each regulatory change.

Third, technology changes are not free. Changes in regulations do add considerable costs to the system, and those higher costs are often ultimately borne by investors. In this regard, we note that the Commission simultaneously has either proposed, has adopted or is otherwise considering numerous market structure-related rules, including rules relating to short sales, flash orders, dark liquidity, market access, co-location, and many more. As noted above, each of these regulatory changes would require market participants to revamp and test not only their own myriad internal systems but also to ensure that the systems of their customers and other market centers (*i.e.*, everyone up and down the chain) are compliant with those changes. Implementing a single rule change is almost always much more expensive than the Commission ever estimates in its cost-benefit analyses in its adopting releases in terms of time, money and employee resources needed to implement the change. These costs are compounded exponentially when disparate rule changes are implemented simultaneously because, among other reasons, the greater likelihood for programming conflicts when implementing more than one change at once. Consequently, if the Commission does adopt significant changes to our equity market structure, we urge the Commission to spread out the implementation of such rules to allow for a reasonable and managed approach to implementation to minimize the possibility of conflicts and the absorption of the implementation costs over a longer period of time.

B. The Metrics Used to Assess Market Quality

In the Concept Release, the Commission asks commenters to identify useful metrics for assessing current market structure.[17] It notes that it has previously used measures of spreads (quoted spreads, effective spreads and realized spreads) and speed of execution, generally on smaller-sized orders, but believes that these may not give a full picture of execution quality. The Commission asks whether metrics that focus on the execution of smaller orders are still useful.

In our view, the key metrics by which market quality for smaller-sized orders should be judged relate to execution quality. In fact, market makers and other executing firms are themselves judged by execution quality. Historically, execution quality has been calculated in the industry by dividing the effective spread by the quoted spread. The scores calculated through this formula are, in our view, immune from gaming by those seeking to improve their execution quality statistics through artificial means. Standard reports using this formula are issued monthly analyzing execution quality for retail order flow, and broker-dealers use those reports (and those metrics) when they make routing decisions. Algorithmic servers likewise utilize these metrics in

[17] Concept Release, 75 FR at 3604.

their order-routing decisions. We are aware of no other metric that is as consistent for this basic analysis.

The Commission believes that a significant number of individual investor orders are submitted after regular trading hours, and that these orders are therefore executed in the opening trade for that security the following trading day. It therefore asks what metrics can be applied to determine whether those orders are effected fairly and efficiently at the open.[18] While we cannot suggest any particular metric that can help evaluate the fairness of an opening price of a security, we do not believe that including metrics relating to prices given to trades at the open would be useful in determining overall execution quality. In fact, many market participants do not participate in the open because of the potential for temporary price dislocations in the opening trade. Using metrics that include opening price data would likely skew execution quality comparisons.

The Commission also asks for information as to how it can calculate transaction costs for institutional orders, including large orders that are split up into smaller child orders for execution.[19] In this regard, the Commission notes that certain trading analytics firms publish periodic analyses of institutional investor transaction costs, and asks for comment on those reports generally and on whether those reports accurately reflect institutional trade transaction costs.

As the Commission notes, there are firms that specialize in providing transaction cost analytics to institutional investors, including broker-dealers. The institutions receive monthly reports from the vendor that can be used by the institution, or a broker-dealer's best execution committee, to evaluate its trading activity. These measures, however, are hardly standardized. Each vendor's product relies on modeling based on a proprietary formula that gives various weights to different factors (*e.g.*, ranges of market capitalization for the stock, various price comparisons such as VWAPs over a period of time, etc.), and no two models are exactly alike. End users can even choose the inputs that are important to them. Because those cost models necessarily contain subjective choices, we believe it would be inappropriate for the Commission to try to establish a single "right" way to calculate transaction costs for institutional orders. In fact, we understand that there is no consensus, even among academics with no personal interest in the outcome, on the "right" way to calculate total transaction costs.

Similarly, judging overall execution quality for institutional orders is relative – where you stand depends on where you sit. Institutional clients have different needs and goals, different time horizons, trade under different trading conditions, and implement different trading styles. Attempting to create a standard one-size-fits-all measure of execution quality would be fruitless.

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[18] Id.

[19] Id., 75 FR at 3604-05.

C. Trading Tools

1. Use of Smart Routers and Algorithms

Among the questions asked by the Commission in the Concept Release is whether long term investors and their brokers have the tools they need to protect their interests.[20] We believe that they do. Numerous broker-dealers and third-party vendors offer smart routing capabilities and algorithms to institutional investors. Agency-only brokers like us view our job as helping our customers get the best executions possible, whether internally through our ATSs or in other markets. We have developed trading tools that meet this objective and offer those products to our customers.

As we noted above, brokers and vendors will even develop such tools at the request of particular institutional clients. Successful targeted tools may be modified and offered to a wide variety of other clients in order to recoup some of the development costs involved. As we also argued, however, market participants have the responsibility to figure out what tools will be useful to them and make the effort to find those tools. Broker-dealers and vendors are happy to explain their product offerings to their customers and prospective customers if they only ask.

The Commission wonders, however, whether broker-dealers offer their agency customers lesser tools than they use for their proprietary trading to the detriment of long term investors. While we cannot speak from personal experience on this issue since we do not engage in proprietary trading, we do not doubt that broker-dealers with both proprietary trading units and customer business use different trading tools for each function. It is difficult to know whether the trading tools offered to customers of these firms are equal to or lesser than the tools used by the firm's proprietary traders. It would not be surprising, however, if the proprietary arm of the firm does not share its most successful trading tools with anyone else, lest it lose or dilute any advantage afforded by those tools. This may be a result of the internal book-keeping rules and expense and profit allocations within the proprietary arm of the firm. Individual creators of trading tools within the firms may also retain intellectual property rights to the programs used by the tools, which may preclude the wide dissemination of the tools. Whether the tools used by the proprietary arm of a firm are made available to the firm's customers may depend on the willingness of the customers to pay an appropriate price for access to those same tools.

Nevertheless, we do not believe that it is necessary for the Commission to adopt rules to improve disclosure of the smart order routing services and order algorithms offered by brokers. Brokers already disclose the existence of such tools and their general capabilities to customers and prospective customers. Furthermore, these tools contain proprietary intellectual property that is highly valued and confidential. Mandating disclosure of the tools' methods and practices would destroy the value of the intellectual property contained therein, and could allow others, who did not expend the resources necessary to create such tools, to piggy-back on the efforts of those willing to expend the time and resources to develop them. As we stated above, innovation and competition should be encouraged, not penalized.

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[20] Concept Release, 75 FR at 3603.

2. Co-location

According to the Concept Release, co-location is a service offered by trading centers that operate their own data centers and by third parties that host the matching engines of trading centers. Because many proprietary firm strategies are highly dependent on speed, co-location provides the means by which they can implement those strategies. The Commission is concerned about potential unfairness of providing co-location to proprietary firms because they have greater resources to take advantage of the services. Specifically, it asks whether it is fair for some market participants to pay to obtain better access to the markets than others.[21]

We believe that, as long as market centers offer co-location services to all of their members/subscribers that want those services on the same terms, these services are "fair." Again, we reiterate our view that the fact that one party is willing to pay for a product or service that another party may not want or may not be able to afford does not make the market "unfair." Parties seeking co-location services have likely expended tremendous resources developing strategies and programs that depend on the advantages that co-location may offer, and they should not be precluded from profiting from their innovation and hard work because others may not have expended the resources to develop similar programs and strategies.

Co-location provides a benefit to those that have it because those persons receive information faster than others might, and they can react to it by sending in orders to the market center providing the co-location services more quickly than those who are not situated as close as the co-located person. Although the difference in timing may only be a matter of milliseconds, the timing of the receipt of an order at a market center often determines where in the queue that order sits for execution purposes. The faster an order can be sent in response to a market event, the greater likelihood that order will be executed first. This can reduce risk to those persons.

Latency problems between different market participants, however, will endure whether or not co-location exists. Although advances in technology have reduced the disparities in the length of time it takes messages to travel to distant locations over the internet, there is not now, nor will there ever be, absolute equality in terms of message delivery times. An order sent electronically from across the street from an exchange is likely to arrive at the exchange before an order sent from a neighboring state at the same moment, which is likely to arrive prior to an order sent from the other side of the country at the same moment. It is a law of physics that, all other things being equal, cannot be overcome.

One of the solutions suggested by the Commission – requiring trading centers to batch process all orders each second[22] – would <u>not</u> solve the latency issue. Orders received nano-seconds before the end of the second would still get priority over orders received nano-seconds into the next second. Even worse, however, is that such an action would violate the Commission's "do no harm" principle. Price/time priority is a staple in our markets and market

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[21] Concept Release, 75 FR at 3610-11.

[22] <u>Id.</u>, 75 FR at 3610.

center systems are programmed to ensure that trades are executed on that basis.[23] Lumping all orders received each second into a single batch would significantly interfere with the allocation of executions among those batched orders. We note that the Commission is concerned about the increased occurrence of odd-lot trades.[24] Requiring the batching of orders each second with no way to differentiate those orders by time received will surely increase the incidence of trades of less than round lots. Furthermore, batching orders within second periods adds risk to the system. For example, an IOC would no longer really be immediate.[25] Finally, a lot of market participants spend a lot of their time and resources to provide and develop faster and better messaging and processing capabilities for their clients, and most of that has nothing to do with co-location. Requiring batching each second in order to counter any advantage that co-location may provide would disincentivize these participants from investing in or developing advanced messaging and processing technologies to the benefit of investors.

The issue of the latency of consolidated market data versus individual trading center market data is the flip-side of the co-location issue. Just as the Commission should not institute a rule that requires trading centers to batch orders each second in an attempt to keep some participants from reacting more quickly to published information than others, the Commission also should not require individual markets to hold up the dissemination of their own market data until after the consolidated feed has been published. There will still be latency caused by geographic distance and this may just move any co-location from the trading centers to the securities information processors ("SIPs"). Such a delay also inhibits competition.

D. Dark Liquidity

1. Generally

In the Concept Release, the Commission broadly asks whether trading centers offering dark liquidity are subject to appropriate regulations for the type of business they conduct, and whether any aspects of ATS regulation should be enhanced for dark pools or for all ATSs.[26] We addressed this topic extensively in our comment letter on the Commission's Proposing Release on Dark Liquidity.[27] As we explained in that letter in more detail, we believe that dark pools provide a necessary and important service to institutional trading interest. They allow

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[23] We note, however, that some market centers execute orders purely on the basis of price and will equally share executions among all participants offering that same price without regard to time priority if sufficient liquidity exists. Even these market centers, however, will favor the orders with time priority if there is not sufficient liquidity to fill all orders on the same side of the market equally.

[24] Concept Release, 75 FR at 3611.

[25] This would seem to be counter to the Commission's recent proposals relating to flash orders. See SEC Release No. 34-60684 (Sept. 18, 2009), 74 FR 48632, 48635-36 (Sept. 23, 2009).

[26] Concept Release, 75 FR at 3614.

[27] See n. 6, supra.

institutional investors (and through them, holders of interests in pension plans, mutual funds and other collective investment vehicles) the possibility of receiving price improvement while minimizing the market impact that would otherwise occur if those investor's interests were required to be displayed, even in part. ATSs, including dark pools, incentivize light markets to narrow spreads and lower costs, and dark pools provide a competitive counter-balance to exchanges and market makers. Our response to the Concept Release's questioning of whether institutional investor orders receive quality executions in dark pools is a resounding "yes." We believe that the current system of ATS regulation works well and structural changes are not necessary.

2. Fair Access

In the Dark Liquidity Proposing Release, the Commission proposed, among other things, to lower the trading volume threshold required to be met by an ATS before it is required to include its best quotes in the public quote stream from 5% to 0.25%. (As we explained in our prior comment letter, we do not believe that lowering the display threshold is advisable for a host of reasons.) The Commission's stated reason for lowering that threshold was to reduce the potential for two-tiered markets and improve the quality of quotation data made available to the public. Along with the quoting obligations that would flow from this proposal, an ATS would also have to provide market participants with execution access to those displayed quotes. The Commission now asks whether the trading volume threshold for Fair Access under Regulation ATS[28] should similarly be lowered from the current 5% to a lower threshold, and if so, to what level.

The Commission appears to want to equate exchanges and ATSs and subject them to similar regulation, even though they are structurally quite different entities. While, as the Commission notes, an exchange is required to offer broad access to broker-dealers, this requirement in fact only applies to registered broker-dealers -- institutions that are not registered broker-dealers cannot become members of a national securities exchange.[29] ATSs, on the other hand, are operated by registered broker-dealers and can have any individual investors, institutional investors, and other broker-dealers as subscribers to the ATS.

Exchanges and ATSs also have very different financial responsibility regarding trades executed in their respective market centers. The broker-dealer sponsor of an ATS is responsible for the trades executed through its system, and it can be obligated to pay for and/or deliver the securities in connection with the trades it executes if its subscriber fails in its payment or delivery obligations. (This is particularly true where the executions through the ATS are agency cross

[28] See Rule 301(b)(5) of Regulation NMS.

[29] See Exchange Act Section 6(c)(1): "A national securities exchange shall deny membership to (A) any person, other than a natural person, which is not a registered broker or dealer or (B) any natural person who is not, or is not associated with, a registered broker or dealer." See also, "Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets" (February 2, 1972) ("as a general rule, the Commission believes that membership in the central market system should be open only to those who meet qualifying standards and who have the primary purpose of serving the public as brokers or market-makers").

transactions and the counterparties are not known to each other.) For this and other reasons, broker-dealers (including those sponsoring ATSs) are required to maintain minimum net capital and reserves. That is not the case with an exchange – the exchange itself bears no liability regarding the trades executed in its market, and in fact enjoys at least qualified immunity from suit. When a party to a trade on an exchange reneges on its agreement to deliver securities or funds to settle the trade, the exchange has no financial liability regarding that failed trade. Also, unlike broker-dealers, exchanges are not required to comply with customer protection rules, nor are they required to maintain minimum net capital (or frankly, maintain any capital at all under the federal securities laws and rules). We note, however, that exchanges have moved closer to a broker-dealer model, with most converting to for-profit entities in recent years. As such, they should not be given a structural advantage over ATSs.

Furthermore, exchanges have rules governing its members' behavior both on and off the exchange. For instance, an exchange may set rules relating to members' employee qualifications and even rules relating to office space. For violations of these and any other rules of the exchange, they can discipline members in any way permitted under their rules. For example, they can institute fines, order restitution, and suspend trading privileges. Contrarily, ATSs are expressly prohibited by Regulation ATS from setting rules governing the conduct of subscribers other than the conduct of such subscribers' trading on the ATS, and they can only discipline subscribers through exclusion from trading.[30] ATSs cannot impose fines designed to change their subscribers' activities.

All of these differences support the view that ATSs should not be required to broadly grant Fair Access to all comers. Since they are broker-dealers, and they have financial liability for the activities of their customers, broker-dealer sponsors of ATSs should have more leeway than exchanges to determine who their customers/subscribers should be. We believe that the current 5% threshold for Fair Access in Regulation ATS is the appropriate threshold. When an ATS has reached that level of transaction volume in a particular security, it may have become a significant enough market in that security to justify the requirement that it provide broader access to its system. We note that under the Commission's pending proposal on Dark Liquidity, an ATS that has quoting obligations under Regulation ATS because it has reached a threshold of 0.25% of share volume in a security also must provide execution access for those quotes. Whether or not that threshold remains at that low level (and we suggested a higher threshold in our comment letter on that proposal) in any adopted rule, the obligation to provide execution access to the ATS's displayed quotes should be sufficient. Requiring an ATS also to provide Fair Access at that same low threshold level would be unnecessarily burdensome.

Providing Fair Access to an ATS means that the broker-dealer sponsor would be required to enter into a customer relationship with anyone that meets objective, non-discriminatory criteria, no matter what the ATS's business model provides. For example, an ATS that currently caters solely to buy-side clients would be required to allow sell-side clients to participate in the ATS. This would make it much more difficult for institutional investors to trade in large size

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[30] See Rule 300(a)(2)(i) and (ii) of Regulation ATS.

with minimal market impact through an ATS. Furthermore, while an ATS could apply objective credit, other financial, and operational criteria when allowing access to the system, it could not refuse to do business with a particular customer/subscriber because of a general bad reputation in the industry or because of the type of order flow it would send to the ATS or because the strategies employed by that new subscriber would be antithetical to the strategies of its long-time subscribers. Its discretion to decide with whom it will do business – and to manage the risks that entails – will be severely curtailed.

As the Commission stated in the adopting release for Regulation ATS (when the Fair Access requirement had a 20% threshold),

> [a]ccess to alternative trading systems may not be critical when market participants are able to substitute the services of one alternative trading system with those of another. However, when an alternative trading system has a significantly large percentage of the volume of trading, unfairly discriminatory actions hurt investors lacking access to the system.[31]

Right now, according to the Commission, ATSs collectively have only 7.9% of the trading volume in NMS stocks in the entire U.S. equity markets, and the single largest ATS has 1.3% of the trading volume. We do not have, and the Commission has not published, any statistics on how many ATSs today would be subject to the Fair Access provisions of Regulation ATS at any particular suggested threshold level, but we suggest that if the Commission does decide to propose a lower Fair Access threshold than the current 5% threshold, the Fair Access requirement's application should be based on the actual significance of a particular ATS's trading in a particular security to the overall trading of that security in U.S. equity markets. While it is not unreasonable to conclude that a 5% share of the trading volume in a particular security is significant, a 0.25% share can hardly be considered significant, particularly in light of the large number of execution venues investors have to choose from for their executions.

Likewise, it may be appropriate to set a higher threshold for an ATS that executes orders at prices derived from prices disseminated by an effective transaction reporting plan. Regulation ATS currently exempts from the Fair Access requirements those ATSs that match customer orders for securities with other customer orders at prices for those same securities established outside the system and that do not display customer orders to any person, other than employees of the ATS.[32] This includes ATSs that match unpriced orders at the mid-point of the NBBO, which are exempted from the Fair Access requirements without regard to trade volume. Clearly, the Commission believed that more passive markets – like dark pools that do not publish their own quotes – did not need to guarantee Fair Access to all subscribers. We agree with that judgment. ATSs that choose to be dark and not publish quotes should, at the very least, have a higher threshold for Fair Access than those ATSs that operate much more like exchanges.

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[31] SEC Release No. 34-40760 (Dec. 8, 1998), 63 FR 70844, 70872 (Dec. 22, 1998) (emphasis added).

[32] See Rule 301(b)(5)(iii) of Regulation ATS.

We also note that Regulation NMS requires any trading center that displays quotes through an SRO display-only facility to provide a level and cost of access to such quotations that is "substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities in that stock."[33] Furthermore, Regulation NMS caps the fees that can be charged for execution of an order against a protected quote.[34] Extending this rule to ATSs, which could be the result of forcing ATSs to display quotes in the public quote stream and provide execution access to those quotes, would essentially impose a flat fee structure on ATSs. ATS fee structures vary greatly, and flexibility in pricing forms the basis of competition among ATSs. This would disproportionately harm ATSs, who, unlike exchanges, cannot charge their subscribers other types of regulatory or membership fees.

3. Dark Pool Transparency

The Commission also asks whether investors have enough information about dark pools to make informed decisions about whether they should seek access to them, and whether dark pools should be required to provide improved transparency on their trading services and the nature of their participants.[35] We believe that the institutions that utilize dark pools do have sufficient information to make informed decisions. Dark ATSs market their services to institutional customers and prospective customers on a continuous basis. Institutions know full well what types of customers each ATS caters to and the services they offer. While it may be true that some retail investors may not understand precisely how dark ATSs operate,[36] we are not aware of an ATS that permits retail investors to become direct subscribers. Instead, a retail investor would obtain access to a dark pool through its broker-dealer. Nevertheless, institutional and retail customers alike can research each ATS's execution quality and order routing statistics through an examination of the ATS's Rule 605 and 606 data, if they so desire. Any perceived lack of information for retail investors about an ATS's trading services would only become an issue if the ATS was to become subject to the Fair Access provisions of Regulation ATS and was thereby potentially required to provide direct access to retail investors to its system. However, because retail investors are unlikely to pass the objective credit and other financial standards that would be required under a Fair Access regime to become subscribers of the ATS, this may not be a real issue.

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[33] See Rule 610(b)(1) of Regulation NMS.

[34] See Rule 610(c) of Regulation NMS.

[35] Concept Release, 75 FR at 3614.

[36] This is likely no different for a customer of a non-ATS broker-dealer, who probably does not know in great detail precisely how the broker-dealer will execute the customer's orders and to which markets it sends orders under what circumstances.

4. Consolidated Market Surveillance

Finally, the Commission asks whether ATSs contribute appropriately to the costs of consolidated market surveillance.[37] The Commission bases this set of questions on what it refers to as the "significant volume" executed through ATSs. As noted above, however, ATSs collectively execute only 7.9% of total share volume in NMS stocks, and no single ATS has more than 1.3% of the share volume. Far more volume is executed in ECNs (10.8% total) and by broker-dealers through internalization (17.5% total share volume) than through ATSs. Furthermore, there likely are individual brokerage firms whose execution volumes throughout the whole market on various venues dwarf that of the most successful ATS. The Commission, however, does not suggest (and neither do we) that these internalizing broker-dealers, ECNs or large broker-dealers pay higher regulatory fees than anyone else to FINRA for purposes of consolidated market surveillance; that appears to be reserved solely for ATSs. As such regulatory fees are currently based on objective criteria such as gross income, trade volume, number of personnel and their registrations, and other factors denoting relative size and activity of the member firm, it would be unfair to single out ATSs from among all market centers and SRO members for increased regulatory fees for consolidated market surveillance.

We must address a large misperception held by the Commission, however. In its description of our current equity market structure, the Commission asserts that ATSs, unlike exchanges, do not have any market surveillance responsibilities.[38] This is simply not true.[39] An ATS is a market center operated by a broker-dealer, and broker-dealers have the obligation to monitor and supervise all of their trading activities, whether by their employees or on behalf of their clients.

In this regard, SRO rules require each broker-dealer firm to establish, maintain, and enforce written procedures that are reasonably designed to supervise the types of business in which it engages and to supervise the activities of its employees to achieve compliance with applicable securities laws and regulations, and with the applicable rules of the SRO.[40] Supervisory personnel within a broker-dealer are required to take reasonable precautions to prevent violations of applicable laws, regulations and SRO rules by employees under their

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[37] Concept Release, 75 FR at 3614.

[38] Id., 75 FR at 3599.

[39] This assertion appears to contradict the Commission's own statements in its recent proposal on market access, in which it recognized that broker-dealers do conduct surveillance activities. For example, it stated that, under those proposed rules, a broker dealer must have regulatory risk management controls and supervisory procedures that are reasonably designed, among other things, to "assure that appropriate surveillance personnel receive immediate post-trade execution reports." SEC Release No. 34-61379 (Jan. 19), 75 FR 4007, 4011 (Jan. 26, 2010). See also, id., 75 FR at 4012 ("any broker-dealers with ... direct access to trading on an exchange or ATS should establish effective risk management controls to protect against breaches of credit or capital limits, erroneous trades, violations of SEC or exchange trading rules and the like.")

[40] See, e.g., NASD Rule 3010(b)(1).

supervision.[41] In this connection, for example, Section 15(f) of the Exchange Act requires a broker-dealer to "establish, maintain, and enforce written policies and procedures reasonably designed ... to prevent" insider trading. In addition, a broker-dealer is required to monitor its and its customers' activities for other scienter-based violations, including market manipulation and wash trades.[42] Furthermore, under the Bank Secrecy Act, as amended by the USA Patriot Act of 2001, as well as SEC, SRO and Treasury regulations, broker-dealers are required to establish systems and controls to prevent and detect money laundering in the financial industry. These regulations require broker-dealer firms to monitor for and report unusual and suspicious activities with government regulators, including manipulative behavior.

ATSs in fact monitor the trading that occurs in their systems on a continuous basis, both manually and through the use of exception reports (just like exchanges). ATSs also take steps to try to prevent gaming through their systems. When bad or suspicious behavior by a subscriber is noticed, the ATS will investigate the matter, and where appropriate, it will submit a Suspicious Activity Report to anti-money laundering authorities. If problematic practices are occurring, the ATS will attempt to resolve the problem. If it cannot be resolved, the ATS can (and will) suspend trading privileges, just like an exchange. The difference between an exchange and an ATS in this regard is that an ATS is limited in what it can do to a wrongdoer from a disciplinary standpoint, while an exchange has a broad range of penalties it can impose.

The other primary difference between market surveillance conducted by ATSs and that conducted by FINRA is that an ATS is limited to surveilling the activity in its own market by its customers. An ATS has no ability or authority to access trading records relating to its customers' activities through other broker-dealers or through other market centers. (In this way, however, it is similar to an SRO – while an SRO has regulatory authority over its member firms, it does not have jurisdiction over the customers of those member firms unless they are also members.) In fact, only FINRA has the ability to surveil multiple market centers because all off-exchange transactions (like those executed by ATSs and ECNs) are reported to it by the broker-dealer members that sponsor those systems and because it has agreements with various exchanges to perform the regulatory surveillance function for those exchanges. (But for these agreements, FINRA would not have any legal authority to conduct market surveillance over those exchanges.

On a related point, the Commission notes that many dark pools execute orders with reference to the displayed prices in public markets, and asks whether such reference pricing creates opportunities for gaming to the detriment of institutional investors.[43] Although reference

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[41] In this regard, section 15(b)(4)(E) of the Exchange Act authorizes the Commission to impose sanctions on a broker-dealer and its employees who have "failed reasonably to supervise, with a view to preventing violations" of the securities laws by persons subject to the broker-dealer's supervision.

[42] For example, the Commission noted in the Appendix to its recent market access proposal that, under applicable SRO guidance, broker-dealers providing market access to customers are required to have controls to address, among other things, potentially manipulative activity by their customers. See Appendix to SEC Release No. 34-61379 (Jan. 19), 75 FR 4007, 4030 (Jan. 26, 2010).

[43] Concept Release, 75 FR at 3612-13.

pricing does lend itself to the possibility of gaming by unscrupulous participants, gaming behavior is possible in every market, and likely always will be. As noted, however, dark pools make every reasonable effort to monitor for and prevent it occurring through their systems. If an institutional investor subscriber of a dark pool believed that it was being victimized by the gaming activities of other subscribers in that ATS, that subscriber would be loath to submit additional orders to that ATS. Obviously, with numerous other market centers for subscribers to choose from, ATSs have a great incentive to detect and prevent gaming.

E. "Trade At" Proposal

The Commission asks whether, if the quality of public price discovery has been harmed by undisplayed liquidity, it should consider a "trade-at" rule that would prohibit any trading center from executing a trade at the price of the NBBO unless the trading center was displaying that price at the time it received the incoming contra-side order.[44] If a trading center is not displaying the NBBO at the time it received an incoming marketable order, it could either (1) execute the order with significant price improvement (such as the minimum allowable quoting increment, or \$0.01); or (2) route inter-market sweep orders (ISOs) to full displayed size of NBBO quotations and then execute the balance of the order at the NBBO price. Among the questions asked by the Commission regarding a "trade at" rule is whether such a rule would help promote pre-trade public price discovery by preventing the diversion of a significant volume of marketable order flow away from light markets and to dark trading centers, and whether such an increased routing of order flow to light markets create significantly great incentives for market participants to display quotations in greater size or with more aggressive prices.[45]

We believe that a "trade at" rule would be extremely harmful to our equity markets. Not only does it not accomplish any of Congress's objectives for national market system regulation, but it also is especially inimical to a couple of those objectives. First, it would not be economically efficient to force an execution at the NBB or the NBO when price improvement, even of half a penny, is available in a non-displayed venue. It will drive up trading costs because everyone will be required to pay higher exchange fees on all of the trades forced onto exchanges by such a rule. Moreover, it will reduce the incentives that exchanges have to lower their fees, since they will be, in effect, guaranteed the order flow.

Second, it would not promote competition between market participants and is especially inimical to competition between exchanges and non-exchange markets. It is pretty clear that market participants want as many trading venue choices as possible. In fact, such a rule would affect ATSs, and particularly dark pools, disproportionately, and could drive them wholly out of business. In connection with its pending Proposing Release on Dark Liquidity, the Commission has essentially given ATSs that utilize actionable IOIs a choice to either display those as quotes under the Firm Quote Rule (*i.e.*, become a lit market) or stop utilizing actionable IOIs (*i.e.*, go fully dark). Furthermore, as we pointed out in our comment letter on that Proposal, an ATS that

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[44] Id. , 75 FR at 3613.

[45] Id.

is a midpoint crossing network cannot possibly comply with the Firm Quote Rule, so those market centers have no choice but to remain dark. A "trade at" rule, however, would take that choice away from ATSs. If they choose to be dark, they could not execute any trades without offering penny price improvement or taking out all interest at the NBBO in every displayed market. Consequently, to compete with the lit markets, all ATSs would also be required to be lit.

Third, we do not see how a "trade at" rule would encourage greater size quotes or better priced quotes. Today, market participants are too scared to quote in size because of the information it reveals. This mind-set has resulted in the proliferation of dark pools, block crossing pools, algorithmic trading programs that slice off small pieces of larger orders and spread them around amongst dark and light markets alike to disguise overall interest, reserve order types, and hidden order types. A "trade at" rule will not change any of these things. Spreads today are already quite thin, so without the showing of more volume, there is little chance that quotes will become more aggressive.

For the same reasons, a "trade at" rule would not provide more or better information to the market, especially if it includes a block exemption like the Commission's dark pool proposals. Institutions actively seek to camouflage their interest, and ensuring that all interest in any market at the NBBO is protected is not likely to lessen their concerns regarding information leakage. NBBO protection in all markets does not benefit such institutions if the displaying of their interest causes significant changes in the NBBO when they are seeking to have their orders executed.

Fourth, such a rule would not assist in getting executions in the best market since many midpoint crosses would become unlawful. Today, spreads in some securities may be only a penny. Under a "trade at" rule, because the minimum price improvement required to avoid having to sweep all other markets at the NBBO would be a penny, market centers (whether dark or light) could not execute trades in those securities at the midpoint of the NBBO. It would make little sense, particularly for agency-only ATSs, to take out all displayed interest in every market at the NBBO in order to provide a half-cent price improvement to their customers.

Finally, contrary to the Exchange Act's defined objectives for market structure regulation, adopting such a rule would not better enable trades with no dealer involvement. A "trade at" rule can only be followed by broker-dealers with proprietary trading arms. For an ATS – a market center operated by a broker-dealer – to execute an order from a customer pursuant to such a rule, it must either offer a minimum penny price improvement or it must first take out the entirety of any displayed interest at the NBBO in any market. Neither choice is economically feasible for an agency-only broker operating an ATS. Before it executes any trade, an agency-only ATS will have received both a buy order and a sell order. Before matching those orders somewhere in the middle according to the rules of the ATS, the broker-dealer sponsor of the ATS would be required to take out the existing interest at both sides of the NBBO in all markets as principal. Agency-only ATSs are ill-equipped to do this. Since most agency-only ATSs cross subscriber orders somewhere in the middle of the NBBO, and this would either become prohibitively expensive or unlawful, such a rule would likely drive agency-only ATSs out of our markets and unduly benefit exchanges and ATSs sponsored by firms with proprietary trading arms.

F. Depth-of-Book Trade-Through Protection

In the Concept Release, the SEC asks whether current trade-through protection under Rule 611 of Regulation NMS (the "Trade-Through Rule") should be expanded to cover displayed depth-of-book quotations of a trading center.[46] It further wonders whether that would significantly promote the greater display of trading interest, or whether it even would be possible or economically feasible under current market conditions.[47]

Under the current Trade-Through Rule, a marketable order must receive at least the best displayed price, regardless of where the best price is displayed or where the order is executed. If a trading center that receives a marketable customer order does not want to match the NBB or NBO displayed on another market, it must either route that order out to that other market in order to obtain the best price or it can cancel and return the order if it does not have the best price. If it has an order of any significant size in hand, it can send an ISO to take out all better-priced displayed interest available in other market centers and execute the remainder at subsequent price levels. Today, the Trade-Through Rule only applies to top-of-book quotes.

In fact, market centers generally publish only top-of-book quotes[48] and only top-of-book quotes are required to be reported to SIPs for inclusion in the consolidated quote feed.[49] Some market centers charge additional fees for providing depth-of-book information for their markets to interested market participants. A consolidated quote feed with depth-of-book quotes is currently unavailable. Furthermore, market centers currently offer a multitude of non-displayed order types that are used by institutions to avoid the full display of their trading interest to minimize the market impact of those orders.

We believe that extending Trade-Through protection to depth-of-book would be harmful to our equity markets. Instead of taking the chance that their trading interest will be fully disclosed, institutional investors are likely to transfer their orders offshore to avoid publication of their trading information. In addition, mandatory depth-of-book protection will astronomically increase volatility. If all market makers and market participants are able to see all trading interest at price points worse than the NBBO, and they see significant interest just below or above the NBBO, depending on the side of the market, they are likely to immediately adjust their quotes upward or downward accordingly. Likewise, any change in any quote up and down the

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46 Concept Release, 75 FR at 3613.

47 Id.

48 For instance, the Limit Order Display Rule (Rule 604 of Regulation NMS) only requires the publication of limit orders that better, more than a *de minimis* amount, the specialist's or OTC market maker's quote price or increase the size available at the specialist's published quote. Customers may request, however, that their limit orders not be so displayed.

49 See Rule 602 of Regulation NMS.

book in any market will result in a change in the consolidated quote information disseminated throughout the market. Instead of worrying about flickering quotes only at top-of-book, one will have to worry about flickering quotes anywhere within the book and be prepared to take those into account in execution decisions.

Furthermore, as the Commission already notes in the Concept Release, there is an inherent latency between the publication of consolidated quote information and single-market quote data sold directly to market participants by market centers, and this is when only top-of-book information is required to be transmitted and consolidated.[50] Now imagine the latency that would occur when all displayed interest at every price point throughout each market center's book is required to be transmitted and consolidated by a SIP. This will exacerbate an already acknowledged problem. Likewise, market center routing systems and broker-dealer and investor trading systems will have to be modified to be able to analyze and react to a potentially exponential amount of market data that may not be particularly useful.

Finally, we note that many of the Commission's pending rule proposals are aimed at the protection of retail customers whose transactions are typically of smaller size. Extending Trade-Through protection to depth-of-book would offer little benefit to those investors, since they already have access to all important information on the light markets and they are fully protected as against all visible quotes. Ostensibly, the purpose of expanding the Trade-Through Rule to include depth-of-book would be to benefit institutions with larger-sized displayed orders, even if they are not at the top of book, from having any of their displayed interest traded through by an inferior-priced execution. But, as noted above, institutions will not want interest of any appreciable size to be published. Consequently, such a rule will have only limited, if any, utility, and could hardly justify the cost of developing a consolidated depth-of-book quotation feed.

G. Sub-penny Quoting Lower-priced Stocks

The Concept Release suggests the possibility for sub-penny quoting and trading increments for stocks valued at less than $10.00 in the lit exchanges.[51] We believe this would be a bad idea for numerous reasons. First, once the minimum increment is decreased, you will lose top-of-book liquidity, as no one will display any size at the price level when the next price point is only $0.001 lower. Second, markets would become less efficient as IOIs would become impractical in a sub-penny world. Third, volatility would increase within the penny with the addition of numerous price points within the penny. Fourth, quotes would likely constantly flicker in low-priced stocks such that trade-through protection may no longer be available in practical terms for the displayed top-of-book quotes in each market. In addition, sub-penny quoting would increase market data message traffic exponentially, and thereby the costs of receiving and processing market data.

Furthermore, such a rule also could be hard to implement, as a stock priced lower than $10.00 during some reference period (whether day, month or quarter) may not be priced lower

[50] Concept Release, 75 FR at 3610.

[51] Id., 75 FR at 3613.

than $10.00 during all reference periods. Would trading systems be required to be programmed so that market participants would have the ability to turn on and off sub-penny quoting and trading as the price of the stock fluctuates? Allowing sub-penny quoting and trading in the lit markets also may complicate the application of the new modified up-tick rule under Regulation SHO, making that rule essentially meaningless if a short sale after the 10% price decline threshold is met must only be $0.001 above the last sale. Finally, we note that allowing quoting in sub-pennies adds no particular benefits for long-term investors, and may actually benefit only short term traders, such as those utilizing a statistical arbitrage strategy, whose systems may be much faster than those of other market participants. In all, the problems that would result from sub-penny quoting in low-priced stocks far outweigh any purported benefit.

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ConvergEx sincerely appreciates the opportunity to shares its views on the Commission's Concept Release, and would welcome the opportunity to discuss our comments with the Commission. If you have any questions on our comment letter, please feel free to contact ConvergEx's General Counsel, Lee A. Schneider, directly at (212) 468-7767.

Sincerely,

Joseph M. Velli
Chairman & Chief Executive Officer

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
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