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Bright Trading, LLC appreciates the opportunity to respond to the round table discussion held on June 2, 2010. This letter will serve as a supplemental letter to our comments on March 24, 2010.[1]

We have chosen to focus our concerns on Undisplayed Liquidity. In the roundtable discussion, Larry Leibowitz, COO, NYSE Euronext mentioned the increasing "toxicity" of the order flow in the displayed markets.[2] Bright Trading would like to take this opportunity to expand on Mr. Leibowitz' comments, and give our views on why we feel the order flow in the publicly displayed markets is becoming more "toxic".

There are a number of concepts which we would first like to explain.

Informed vs Uninformed order flow

When we discuss informed order flow, we are not referring to market participants with inside information, we are referring to market participant's orders that are on the right side of the market in the short-term. Alternatively, when we discuss uninformed order flow we are referring to market participant's orders that are on the wrong side of the market in the short-term.

Uninformed order flow can take on a number of forms, but by far, the most common type of uninformed order flow are orders that are on the wrong side of the market with regards to the bid-ask spread and basic market making mechanics.

For example, consider a stock with an NBBO of 15.55 x 15.85. A customer sending an order to buy at 15.83, could be considered "uninformed" as they are not mindful of the current bid-ask spread. A market participant could sell short to this 15.83 buy order, risking only 2 cents (in the short-run) as there is an offer to lean on at 15.85.

The most common type of uninformed order flow with regards to the bid-ask spread is the market order. A great majority of retail traders place market orders. Historically, these types of orders would typically pay the spread, with marketable buy orders being executed on the offer, and marketable sell orders being executed on the bid. This marketable order flow gives great incentive to displayed market making participants, as it allows these participants to get executed on the bid or offer, and gives them a greater chance of capturing the displayed spread.

Broker-Dealer Internalization

However, when broker-dealers are allowed to intercept this marketable order flow, and provide their "nominal" price improvement, there is less chance for displayed market makers to capture

[1] http://www.sec.gov/comments/s7-02-10/s70210-63.pdf
[2] http://www.sec.gov/news/otherwebcasts/2010/060210marketstructure-3.shtml, time 1:15:00

the spread. This discourages the displayed market making participants and they begin to display less orders.

Consider the following scenario:

Stock symbol: XYZ
Displayed NBBO: 24.90 x 25.00

A market participant from broker-dealer ABC sends a market buy order for stock XYZ.

Barrier 1: Broker-dealer of the customer placing the market order

The first market-participant with the chance to trade against this uninformed market order is broker-dealer ABC. If they are an internalizing broker, and feel they can make money by taking the opposite side, they will execute directly against the market order. They can execute against this order as long as they match or beat the displayed offer which is $25.00. Often broker-dealers will offer some type of "nominal" price improvement to justify the practice. For example, broker-dealer ABC may execute the marketable buy order at $24.9999, a $0.0001 sub-penny price improvement over the displayed NBO.

Barrier 2: Internalization pool

If broker-dealer ABC is not an internalizing broker-dealer, or if it chooses not to trade against the order, then this market buy order may be routed to a number of internalization pools, where other broker-dealers, OTC market makers, and some high frequency trading firms will have the ability to trade against this order. Typically the firm with the lowest latency will win the right to trade against this order. Broker-dealer ABC which routed the order to the pool, will often receive a payment for the order flow, that the internalizing participant pays for the privilege of executing against the market order.

Barrier 3: Other Dark pools of liquidity

If no market participant in the internalization pool wants to trade against the order, the order continues through a number of dark pools, where it could be executed against any participant hiding an order inside the NBBO.

Final Destination: The Displayed NBBO

If there are no orders inside the NBBO, this market order finally makes it to the displayed marketplace where it can be publicly executed against the displayed offer.

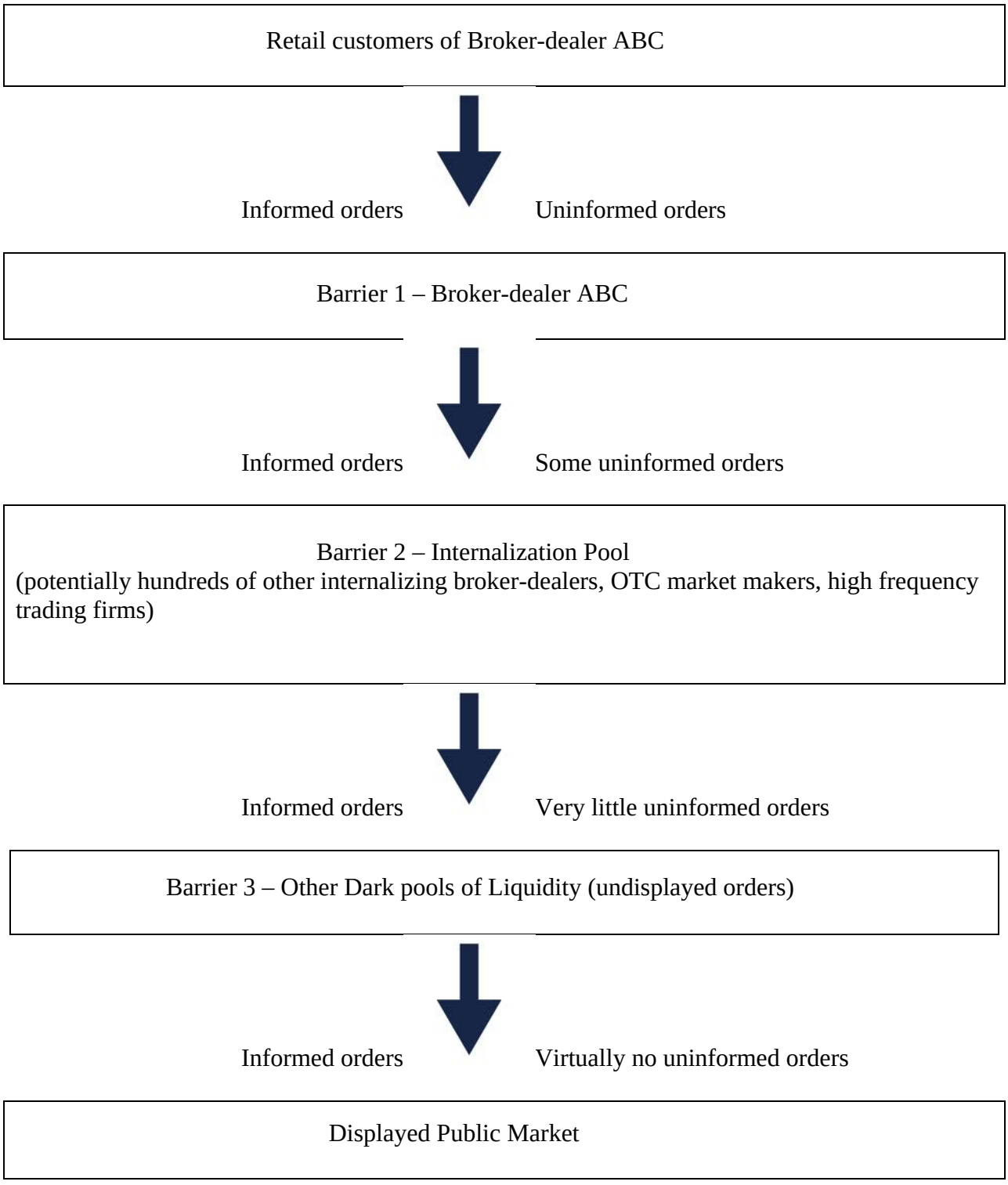
This entire process takes only a few milliseconds to execute.

The end result is that there are a significant number of undisplayed market participants having the first opportunity to trade against this uninformed flow. This creates a two-tiered market structure, where you have participants with the ability to internalize flow on the first tier, and the rest of the investing/trading public on the second tier. The ability of the internalizer's algorithmic systems to separate informed vs. uninformed flow gives the internalizing firm a substantial advantage over those firms that cannot internalize order flow.

Toxicity of Order Flow in Displayed Market

Now consider the following figure, where market participants from broker-dealer ABC send both informed and uninformed orders.

Figure 1: Toxicity of Order flow in Displayed Public Markets



As more and more participants internalize uninformed order flow, there is less uninformed order flow getting to the displayed market. This makes the displayed market more "toxic" to displayed market makers as the marketable order flow is executed before it reaches the displayed market, leaving only informed order flow to trade against. This discourages market making participants from displaying liquidity.

As Terrence Hendershott, discussed on panel two on High Frequency Trading, "a limit order is a free option for somebody to trade against" [3] Displayed bids act like a short-term put option to the market, giving participants the right to sell to it. Alternatively, displayed offers act like a short-term call option, giving participants the right to buy from it. There is a risk involved in displaying these bids and offers. If the return does not justify the risks, market making participants will not display these bids and offers.

Of greater concern is that participants in these internalization pools, do not have to display any liquidity, yet they reap the rewards of getting the execution. This reward comes at the expense of the displayed liquidity provider's risk. As displayed liquidity providers receive fewer executions, they will seek out other trading venues. The most logical venues to seek out are the ones getting the executions against this uninformed flow, which in many cases are these internalization pools. In essence, these internalization practices are driving our displayed liquidity providers into the undisplayed trading centers, leaving us with less and less displayed liquidity.

Proponents of these internalization practices argue that spreads have never been narrower, and liquidity has never been deeper. This may be true of the very liquid, most highly traded NMS stocks, but it is not true of the majority of thinly traded, more illiquid issues. We would argue that these spreads are not narrowing, but are in fact widening due to these predatory internalization practices.

If internalization practices are allowed to continue, and internalizers simply have to match the NBBO, eventually the majority of market makers, and participants acting as market makers, will move their trading businesses to these undisplayed pools, as they seek out the uninformed flow.

The fundamental flaw with this movement, is that the prices internalizers give to the uninformed flow are derived from the publicly displayed market. The current market structure encourages competition in the undisplayed trading centers, while deriving their prices from the displayed trading centers. We should be fostering competition in the displayed trading centers, as they are the source of public price discovery. If we continue to push displayed market participants into the undisplayed trading centers, displayed spreads will widen, and the executions that internalizing firms give to this uninformed flow will become more subjective as a result of the widening displayed spreads.

It is important for the Commission in its regulatory framework to provide incentive for the public display of liquidity, by regulating these internalization practices. It is our recommendation that an internalizing firm be required to provide "meaningful" price improvement over the displayed NBBO.

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[3] http://www.sec.gov/news/otherwebcasts/2010/060210marketstructure-2.shtml, time 1:13:00

Knight Capital Group, Inc. recently discussed their concerns with the concept of the minimum price variation (MPV), being lowered to a sub-penny increment.

Knight says, *"One concern revolves around the opportunities this opens up for traders to "micro-penny" orders. Currently, in order to "step in front" of a competing limit order on an exchange, a trader needs to post another order for 100 shares a full penny better than the existing order. This offers a full dollar of price improvement to the liquidity taker (providing some meaningful economic value) while requiring the new provider to risk at least that one dollar (assuming that they could potentially liquidate that position at the price of the previous limit order) in order to be first in line for incoming market orders. If the MPV were lowered to .001, the improvement to the incoming market order (and correspondingly the amount risked by the new provider) would only be 10 cents. We believe that this is insufficient improvement to the market to force the prior quote to yield priority.*[4]

We agree with Knight that this .001 improvement is insufficient improvement to the displayed quotation to force the prior quote to yield priority. But this is exactly what is allowed to happen when an internalizing broker-dealer steps in front of a displayed quotation, and provides only nominal price improvement. Sometimes this price improvement is even smaller than .001, in some cases as little as .0001. Why should Knight's concerns not apply to the undisplayed trading centers? Currently, market participants with internalizing capabilities can offer no price improvement at all, as they simply have to match the displayed quote, forcing the displayed quotation to yield priority.

By forcing internalizers to provide "meaningful" price improvement over the NBBO, it will push market making participants out of the undisplayed pools and back onto the displayed market. This will increase competition and tighten spreads.

<u>Quantifying "meaningful" price improvement</u>

Reiterating our comments from our previous letter, we believe that meaningful price improvement should be at least the minimum quotable price variation (MPV) of one cent.

In some cases, where illiquid securities typically have very wide spreads, it may be necessary to increase this amount of meaningful price improvement, or we risk turning the "sub-pennying" problem we previously discussed, into a "pennying" problem.

We therefore believe the mimimum price improvement amount for an internalizing broker-dealer should be a function of the average bid-ask spread in the security.

A general guideline could be a minimum of 10% of the average bid-ask spread. For example, if a stock has an average bid-ask spread of 50 cents, then the minimum price improvement for a broker-dealer to internalize would be 5 cents. If a stock has a 10 cent spread or less, than 1 cent price improvement may suffice.

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[4] *http://www.sec.gov/comments/s7-02-10/s70210-156.pdf, page6*

Conclusion

It is our recommendation that the Commission take note of the increasing "toxicity" of the order flow in the publicly displayed market, and regulate broker-dealer internalization practices, requiring an internalizing dealer to provide "meaningful" price improvement over the displayed NBBO. This will help to increase the amount of valuable marketable order flow reaching the displayed market, and encourage market making participants to display bids and offers more aggressively, helping to solve our declining displayed liquidity problems.

Sincerely,

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