

MEMORANDUM

TO: File No. S7-02-10

FROM: Arisa Tinaves
Division of Trading and Markets

DATE: May 22, 2013

RE: Meeting with Representatives of Morgan Stanley

On May 22, 2013, James Burns, David Shillman, Heather Seidel, Victoria Crane, Daniel Gray, John Roeser, David Dimitriou, Theodore Venuti, Kathleen Gross, Ilya Fradkin, Charles Sommers, Jasmin Sethi, Stephanie Mumford, Dhawal Sharma, Tyler Raimo, and Arisa Tinaves met with Andrew Silverman (Managing Director and Global Co-Head of Electronic Trading), Bill Neuberger (Managing Director and Global Co-Head of Electronic Trading), Sapna Patel (Executive Director and Head of Americas Market Structure and Liquidity Strategy) and Anthony Cicia (Managing Director and Counsel, Legal and Compliance Division) to discuss market structure issues, including the attached presentation.

Attachment

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Update on Equity Market Structure

May 2013

Agenda

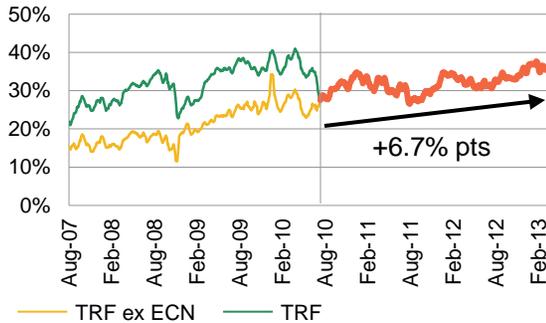
- Public Transparency of Dark Volume Statistics
- How to Measure Market Quality?
- Trade-At is an Over-Reaction
- Addressing Aggressive Order Handling Practices
- Revisiting the Role of a Self-Regulatory Organization
- Small Exchange and Dark Pool Market Share
- Revisiting the “Block” in Today’s Electronic Market
- Summary / Suggested Actions

Public Transparency of Dark Volume Statistics

No one truly knows what % of US Consolidated Volume consists of “dark” liquidity

TRF Market Share

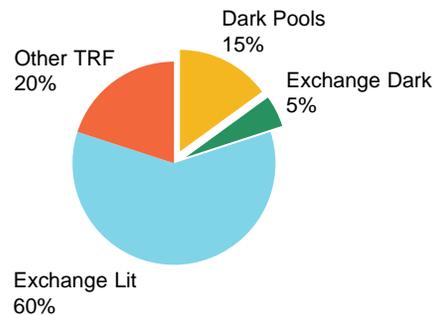
10 day Moving Average



Source BATS Global Markets, Morgan Stanley

Estimated US “Dark” Volume 1Q 2013

% of US Consolidated Volume



Source Tab Group, NYSE, NASDAQ, BATS, Direct Edge, Morgan Stanley (“Dark” volume is based on self-reported volume by dark pools and exchanges.)

Current State

- On / off exchange volume split is easy to determine. Nearly impossible to measure “lit” v “dark” – both forms of liquidity exist on and off exchange.
 - Exchange “dark” – zero display orders. How do you categorize reserve quantity?
 - TRF “dark” – dark pool, capital commitment, agency cross, retail wholesaler, institutional electronic market maker executions

Key Considerations

- Need transparency around the composition of TRF volume – breakdown of different forms of liquidity
 - Conversely, need transparency around the “dark” portion of exchange volumes
- **Post-trade** execution information should be collected by SEC / FINRA and **select** volume statistics made publically available in manner that does not harm customers

Recommendations

- Public breakdown of aggregate dark pool and exchange dark volume statistics, produced by regulators (not third parties)
- Trade modifier on TRF and exchange prints to provide real-time public transparency as to “style” of execution (e.g., “.DP”, “.ECN”, “.EXD”)
 - Preserves customer anonymity when using a specific dark pool
 - SEC’s 2009 Proposal on Regulation of Non-Public Trading Interest should be revisited to facilitate this type of transparency

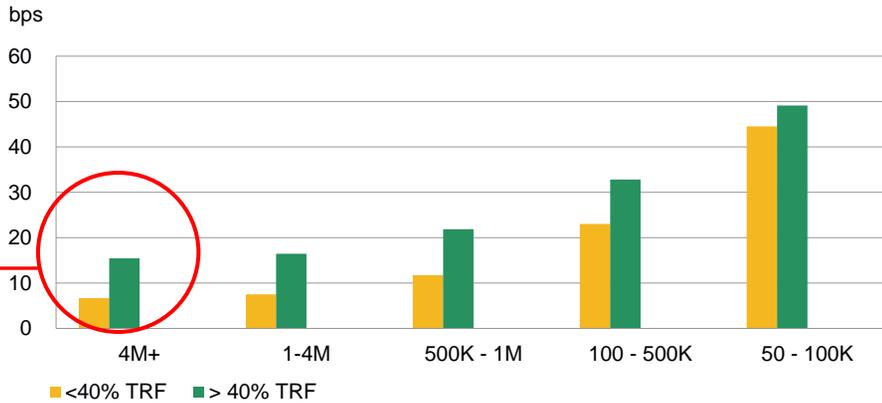
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How to Measure Market Quality?

It's in the Eye of the Beholder

On Exchange Spread Varies for Stocks with %TRF above 40%

MS Reproduction of Exchange CEO analysis from SEC Presentation

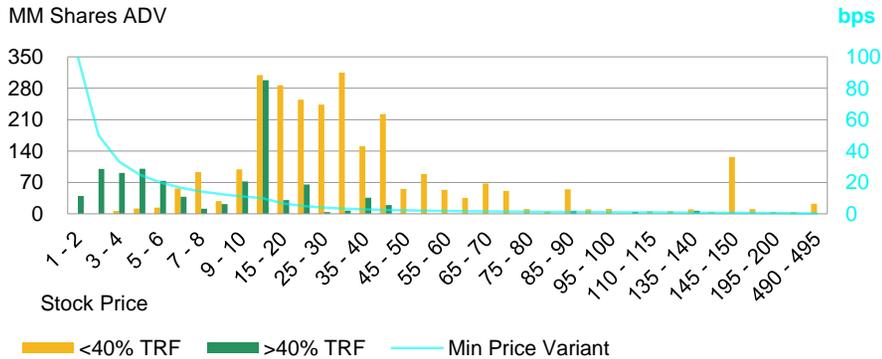


Source Morgan Stanley, TAQ – Jan 2013 data

Bps Spread is a Function of Stock Price

4M+ ADV stocks

MM Shares ADV



Source Morgan Stanley, TAQ

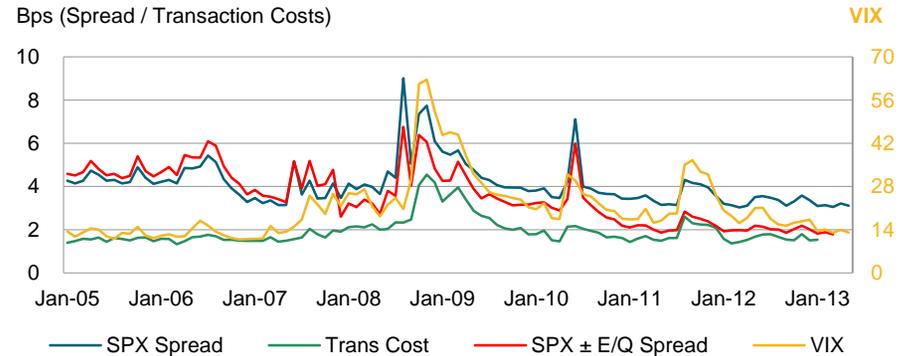
Market Quality Factors Vary for Different Participants

- Retail: Effective / quoted spread, speed of execution
- Institutional: Transaction costs, Slippage v Arrival Price
- Market Maker: Profitability of flow / execution
- Broker: Fair & stable market, best execution, execution costs
- Exchange: Consolidated volume, market share, capture
- Overall: Continuously available liquidity / size at price, certainty of execution

Need to balance competing interests for a healthy marketplace

Sample Market Quality Measures

Bps (Spread / Transaction Costs)



Source Morgan Stanley, Reuters

Trade-At is an Over-Reaction

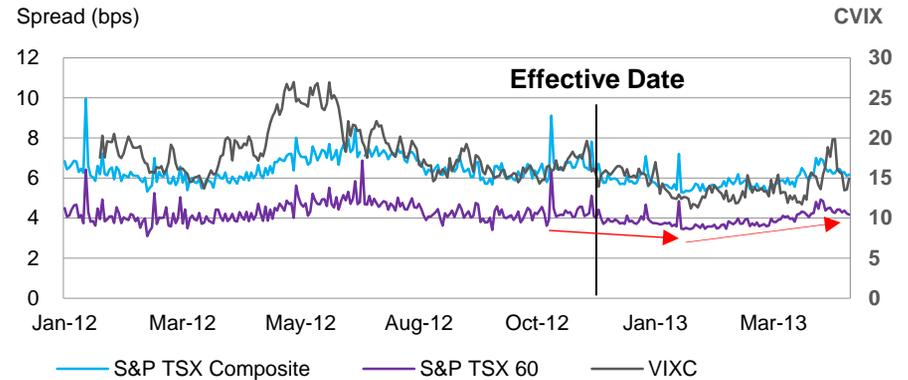
Driven by Competitive Forces Trying to Regain Market Share

Potential Implications

- Customers have always valued dark liquidity. Liquidity will **not all** go back to the exchanges – naïve to think otherwise
 - Retail Investors will bear increased transaction costs
 - Some institutional flow will leave the market and return to PM / traders desk
- Not all dark liquidity is the same
 - Broker-dealer role is to find or be the other side for our customer – in **any** size in which the customer wants to interact
 - Broker internal liquidity pools are an automation of long established manual order handling practices
 - Qualitatively different from “pinging” of external liquidity providers by broker-dealers and exchanges in lieu of transacting in the public market
- Real possibility exists for lower market volumes and higher spreads

Impact of Canadian Dark Regulations

Spreads have reduced ... and then increased – remain correlated to volatility



Source Morgan Stanley, Reuters, S&P

Key Equity Market Structure Differences: Canada

Regulations must account for different US market structure

- OTC / off exchange market is nonexistent
- ~ 10% of the size of the US equity market by volume
- Earlier stage of dark liquidity evolution – < 7%; 4 dark venues
- Inter-market linkage in infancy stage
- Inter-listed market allows avoidance of Canada requirements

Maker-Taker Pricing – Is There a Better Alternative? No One has Proposed a Better Solution.

- A return to oligopolies of either exchanges or “specialists” is wrong for the market
- Market access economics should be revisited, but a competitive, transparent liquidity provision model benefits all participants

Addressing Aggressive Order Handling Practices

Open Issue Being Discussed Since 2008

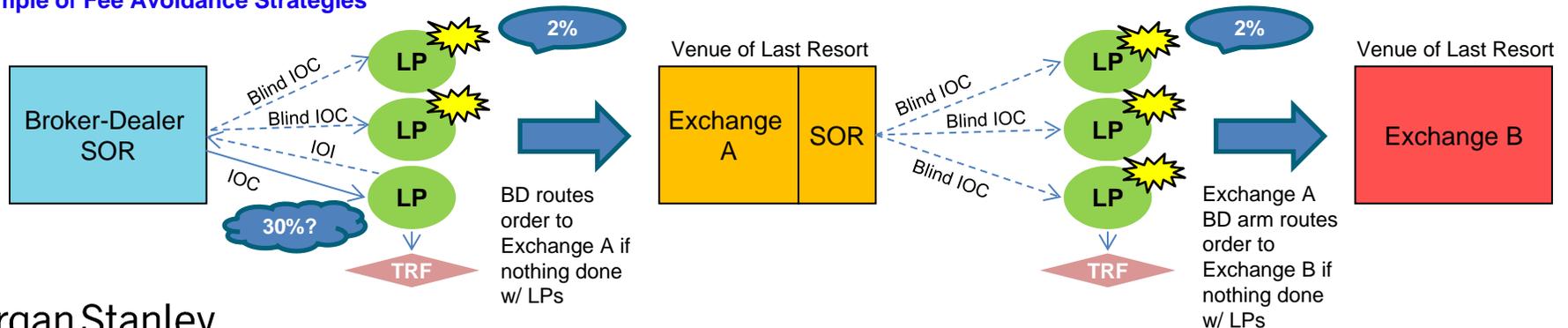
Current State

- Order Handling & Execution Disclosure Rules **have not been updated** to address technological advances and economic driven behaviors that emerged post Reg NMS
- **Broker dealers** and **exchanges** engage in economically driven routing of orders to external dark liquidity providers to reduce expense – **how much of TRF does this represent?**
 - Solicitation of order flow / actionable IOIs
 - Blind pinging of external dark venues for orders otherwise en route to the lit market, resulting in relatively low fill rates
- Customers trying to obtain full audit trail of their orders – where routed / shown / touched and ultimately executed
 - “Swing and miss” reports – no industry standard
 - Detailed questionnaires about order handling practices due to concerns about **information leakage**

Recommendations

- Finalize ban on actionable IOIs from 2009 SEC Proposal
- Address fiscal, external “blind pinging” practices for orders that would otherwise interact with the lit market and participate in public price discovery
- Mandate real-time disclosure of actual execution venue on fill
- Consider impact of outdated Rule 605 / 606 requirements on current routing of order flow
 - Require standardized reports providing an order life cycle audit trail, not just ultimate execution or first route venue
 - Mandate an exchange’s own routing broker to provide the same transparency as all other BDs – to the end customer
- Accurate, regulator-mandated disclosure of dark liquidity volume – for any execution venue, even if not an ATS

Example of Fee Avoidance Strategies

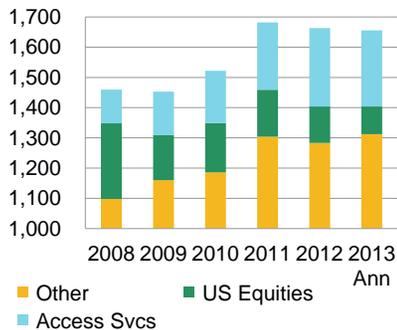


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- Unrealistic balancing act exists in a world with “For-Profit” Exchanges
 - Fiduciary / profit maximizing outcomes for shareholders
 - Regulatory obligations to maintain fair and orderly markets

Exchange Revenues

Nasdaq: Equities under pressure
MM USD



Source: Company Filings

Revisiting the Role of a Self-Regulatory Organization

Can't be a referee and a player at the same time!

Current State

- All Equity Exchanges are “for-profit”
- Most traditional SRO functions are outsourced to FINRA
- Exchanges continue to enjoy most SRO benefits
 - Assumed Immunity from Liability
 - Market data tape plan revenue share
 - Protected quotations in NMS
- Revenue generation sources include:
 - Proprietary market data products
 - Port fees
 - Co-location / cross-connect
 - Surveillance tools
- New market-wide obligations could result in new fees for members / customers

Focus Areas

- For-Profit entities generally have liability for their commercial actions
 - **Unlimited liability** for Fraud, Gross Negligence, Willful Misconduct
 - Caps for negligent acts / omissions should be related to likely harm
 - **Why should exchanges be different?**
- Protected quote status should be **earned** – not an entitlement
- Exchanges routing to non-exchanges – was this really the intent in replacing ITS?
- Access fees – ports, co-location, direct data feeds, other services – should continue to be reviewed holistically
- Reduce number of order types – will reduce market complexity
- Market data tape revenue pool needs to be revisited – grossly exceeds costs

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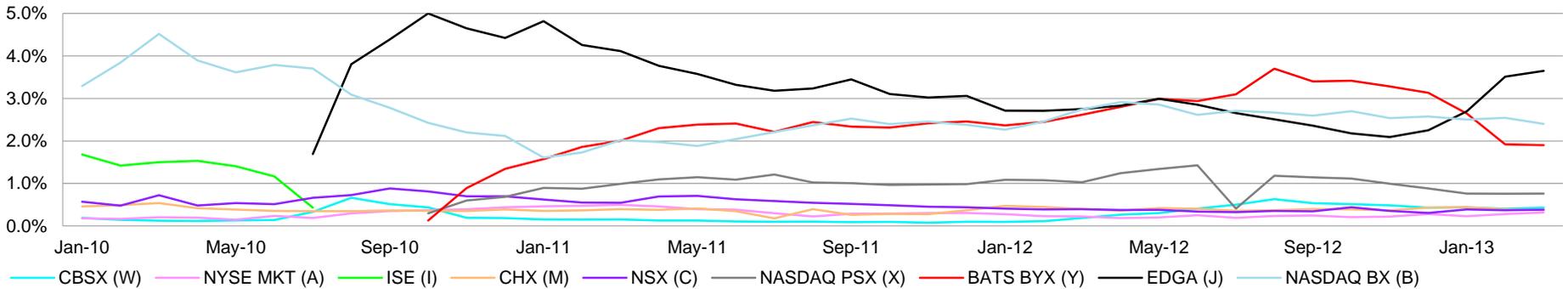
Small Exchange and Dark Pool Market Share

Forced to Connect – should there be a % threshold to “earn” protected quote status?

Small Exchange Market Share – (13 Equity Exchanges – Required to Access All)

8 exchanges w/ <5% market share individually / <10% in total; 5 exchanges with <1% market share individually / <2.1% in total in April 2013

% of TCV

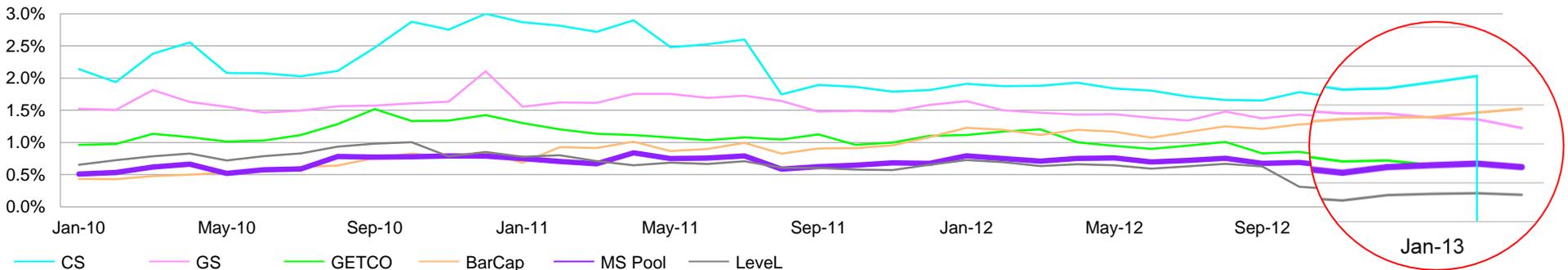


Source BATS Global Markets

Dark Pool Market Share – (No Requirement to Access Any)

No ATSs with >2% market share in 2013

% of TCV



Source Tabb Group

Sudden increases and decreases in volume should be questioned

Notes

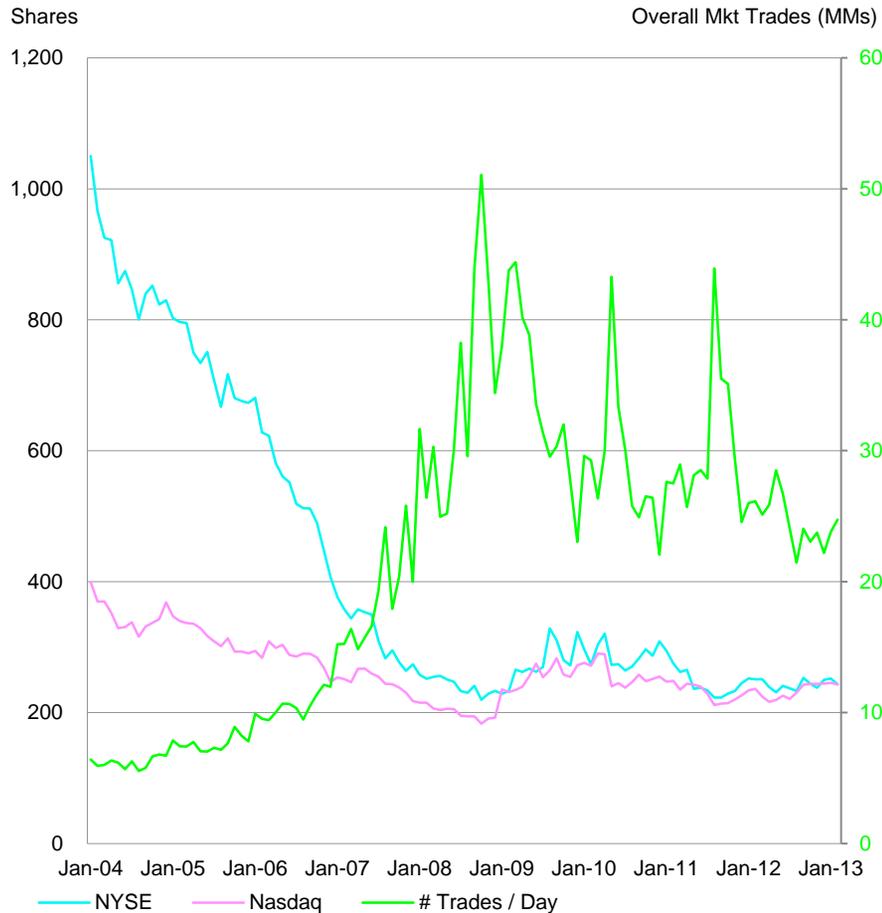
1. EDGX / EDGA data unavailable prior to exchange status conversion in July 2010 due to lack of identifier on the TRF

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Revisiting the “Block” in Today’s Electronic Market

Is 10,000 shares / \$200,000 still appropriate? Maybe, if you consider the Parent Order.

Decline of Average Trade Size



Source NYSE (Consolidated Avg Trade Size in NYSE Listings), Nasdaq (Nasdaq Group Avg Trade Size in Nasdaq Listings), TAQ, Morgan Stanley

Current State

- Continued institutional investor interest in blocks
- Finding contra-side block size liquidity has never been harder – reality of a fragmented, electronic and automated environment
- Forced to “shred” orders – combination of growing use of algorithms, Reg NMS OPR requirements and the ever expanding number of exchanges with protected quote status
- Market participants trying to recreate block dynamics
 - Prisoner’s dilemma – Everyone wants to see info, but nobody wants to give it up

Recommendations

- Apply current block definition at the Parent Order level, or
- Alternatively, redefine “block” to a lower amount based on current trade sizes

Summary / Suggested Actions

Trade At is a Draconian Response to Addressing Aggressive Order Handling Practices that Impact Public Price Discovery

- Limit the ability of order handlers to excessively and fiscally solicit the other side of a trade from external liquidity providers rather than routing the order to the public market for execution

Improve Transparency – TRF and Dark Volume Statistics and Update Order Handling Practice Disclosures

- Provide breakdown of aggregate dark pool and exchange dark volume statistics, produced by regulators (not third parties)
- Trade Modifier on TRF and exchange prints to provide real-time public transparency as to “style” of execution (e.g., “.DP”, “.ECN”, “.EXD”)
- Update Rule 605 / 606 disclosure requirements; require reporting of the entire order lifecycle, including swings and misses, fill rates, etc.

Address For-Profit Exchanges

- Clarify / impose appropriate liability for commercial decisions
- Have exchanges earn protected status / market data revenue
- Can’t be a referee and a player at the same time!

Consider Applying Current Block Definition at the Parent Order Level

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Prior Morgan Stanley Presentations / Comment Letters on Equity Market Structure Topics

Nasdaq / BATS “Flash Orders”	http://www.sec.gov/comments/sr-nasdaq-2009-043/nasdaq2009043-5.pdf	2009
Dark Pool / IOI Proposal	http://www.sec.gov/comments/s7-27-09/s72709-74.pdf	2010
Market Structure Roundtable	http://www.sec.gov/comments/4-602/4602-7.pdf	2010
Order Handling Practices & Disclosure	http://www.sec.gov/comments/s7-02-10/s70210-328.pdf	2011
Canada Dark Liquidity Regulation	http://www.iiroc.ca/Documents/2011/833b54b5-51fd-4f83-b224-17ccb0e8c6e2_en.pdf	2011

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