

March 26, 2010

By e-mail

Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: File Number S7-02-10
Concept Release on Equity Market Structure
Release No. 34-61358

Ladies and Gentlemen,

Liquidnet, Inc. appreciates the opportunity to comment on the Securities and Exchange Commission's Concept Release on Equity Market Structure.¹

We appreciate the Commission's decision to issue the Concept Release as we believe that market structure issues are best considered and addressed in a comprehensive manner. The Concept Release addresses, and requests comment on, a series of issues affecting the current market structure. We commend the Commission for identifying these issues and requesting public comment.

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If we had to sum up our comments on the proposal in one sentence, we would say the following:

If we provide institutional traders with the appropriate disclosures regarding how their customer block orders are handled and we give institutional traders the choice of how to execute their customer block orders, they will make the best decisions for their customers, resulting in reduced trading costs, and higher investment returns, for the tens of millions of U.S. households that invest in mutual funds, pension funds and other collective investment vehicles.

¹Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010), <http://sec.gov/rules/concept/2010/34-61358.pdf> (accessed March 22, 2010). ("Concept Release")

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We write this letter following detailed discussions over the past few months with more than 50 head traders at buy-side institutions. We do not claim that our buy-side customers endorse all of our specific positions. In fact, not all buy-side traders agree with each other on every issue. But as a firm whose primary customer base is large mutual funds and other long-term investors, we determine our positions based on extensive discussions with buy-side traders and based on what we believe will most benefit our institutional customers, and we believe our views are generally consistent with those of our buy-side customers. If there is one theme that we hear from the institutional traders who are our primary customer base, it is that they are in the best position to determine how to handle their customer orders.

It is extremely important in connection with any rule proposals relating to market structure that the Commission carefully considers the views of the buy-side institutions that trade on behalf of tens of millions of American households, including mutual fund and pension fund beneficiaries.

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In Annex A we discuss the importance of ensuring that the market structure best supports the interests of long-term investors. Long-term investors include the 42 million U.S. households that invest in mutual funds² and millions of other households that are the beneficiaries of public-sector and private-sector employee retirement accounts.³

In Annex B we present commentary from industry experts on the current market structure. These industry experts generally take the view that competition and innovation in equity trading have been beneficial for long-term investors. We agree with this view.

While taking a generally favorable view of competition, industry experts identify a concern regarding the lack of clarity in order handling practices. In particular, institutional and retail investors do not have sufficient information regarding how their orders are handled. If market intermediaries are obligated to provide accurate and detailed disclosure to customers regarding order handling practices and execution quality, this will enable long-term investors to make better and more informed decisions regarding the handling of their orders. This ultimately will result in

² Investment Company Institute, *2009 Investment Company Fact Book*, 49th Edition, Section 6, www.icifactbook.org (accessed March 22, 2010).

³ As an example, the Teacher Retirement System of Texas notes in its recent comment letter on the Commission's rule proposal on "Regulation of Non-Public Trading Interest" that TRS serves more than 1,273,582 participants, including public and higher education members and retirement recipients. Letter from Britt Harris, Chief Investment Officer, Teacher Retirement System of Texas, February 22, 2010, commenting on the Commission's rule proposal on "Regulation of Non-Public Trading Interest", Securities Exchange Act Release No. 60997, <http://sec.gov/comments/s7-27-09/s72709-54.pdf> (accessed March 22, 2010). ("TRS Letter")

better execution of customer orders. In Annex F we discuss in detail our recommendations for providing improved disclosure to long-term investors.

While we support and encourage proposals that improve disclosure to customers, we generally are skeptical of proposals that seek to limit competition and innovation. Often, these types of proposals, which restrict investor choice, are put forth by industry competitors to support their competitive positions. We are particularly concerned with restrictions on competition and innovation that benefit short-term traders at the expense of long-term investors. We categorize these types of regulations as “regulatory subsidies” because they restrict the choices of long-term investors through regulations that primarily benefit short-term traders. We define a “regulatory subsidy” as a regulatory restriction on a class of market participants that primarily benefits another class of market participants.

In Annexes C, D and E we discuss three types of restrictions on long-term investors. In each case, the primary beneficiary of the restriction is short-term traders. The three categories of restriction are:

- ***Order protection obligations without an opt-out provision (discussed in Annex C).*** In Annex C we explain how the order protection rule without an opt-out provision is a regulatory subsidy that benefits short-term traders at the expense of long-term investors because short-term traders who “step-ahead” of long-term investors secure the benefits of the order protection rule. This would become a very serious issue if sub-penny quoting were reintroduced as it would make it less costly for short-term traders to step-ahead of long-term investor orders, taking advantage of the order protection rule to the detriment of long-term investors.
- ***Fair access restrictions (discussed in Annex D).*** An institutional trader with a block order should decide how to execute that order. If a trader wants to interact with short-term traders on a block order, she should have that choice. If she only wants to interact with other long-term investors on a block order, she also should have that choice. In certain cases, it will be beneficial for an institutional trader to interact with short-term traders; in other cases, it will not be beneficial. Forcing institutional traders to interact with short-term traders in those instances where they would have chosen otherwise will mean higher trading costs for institutions and the beneficiaries of the accounts that they manage.
- ***Restrictions on undisplayed liquidity (discussed in Annex E).*** An institutional trader should decide how he wants or does not want to display his customer’s block order. In certain cases, it will be beneficial for an institutional trader to display his customer order to short-term traders; in other cases, it will not be beneficial. Forcing institutional traders to display their orders to short-term traders in those instances

where they would have chosen otherwise will mean higher trading costs for institutions and the beneficiaries of the accounts that they manage.

In each of these areas, the current regulations provide sufficient flexibility for long-term investors, such that the adverse impact on long-term investors has been limited. However, the imposition of additional restrictions in the future relating to order protection, fair access or undisplayed liquidity would be problematic for long-term investors. We discuss this concern in detail in Annexes C, D and E.

In Annex F we discuss five proposals relating to market structure that will specifically benefit long-term investors:

- Mandate disclosure of specific order handling practices by institutional brokers
- Improve execution disclosure for retail brokerage customers
- Mandate immediate reporting of all electronic executions
- Consolidate market surveillance
- Enhance the review process for new ATSS and material changes by ATSS; provide transparent ATS registration; expand the capacity, integrity and security obligations to all ATSS.

Consistent with our discussion above, the first two proposals are aimed at providing greater transparency regarding order handling practices and order execution quality. The five sets of proposals that we discuss are a preferable alternative to regulatory proposals that restrict the choices of long-term investors.

In Annex G we discuss various other issues presented in the Concept Release, including high-frequency trading strategies, co-location, internalization, sub-penny trading, hidden orders, venues for undisplayed liquidity, depth-of-book order protection, fragmentation, anti-gaming tools and systemic risk.

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We would like to thank the Commission for the opportunity to comment on this proposal, and we look forward to participating in a thoughtful and reasoned analysis of the current market structure issues. This process has been extremely beneficial so far in creating greater awareness of how the equity markets operate, and we look forward to the ongoing discussion of market structure issues.

Very truly yours,



Seth Merrin, Chief Executive Officer



Howard Meyerson, General Counsel



Vlad Khandros, Corporate Strategy

Annex A

The importance of protecting long-term investors***Long-term investors***

In the Concept Release, the Commission emphasizes the importance of protecting long-term investors. The Commission writes:

“In assessing the performance of the current equity market structure and whether it is meeting the relevant Exchange Act objectives, the Commission is particularly focused on the interests of long-term investors. These are the market participants who provide capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time.

....

Given the difference in time horizons ... the trading needs of long-term investors and short-term professional traders often may diverge. Professional trading is a highly competitive endeavor in which success or failure may depend on employing the fastest systems and the most sophisticated trading strategies that require major expenditures to develop and operate. Such systems and strategies may not be particularly useful, in contrast, for investors seeking to establish a long-term position rather than profit from fleeting price movements. Where the interests of long-term investors and short-term professional traders diverge, the Commission repeatedly has emphasized that its duty is to uphold the interests of long-term investors.”⁴

We appreciate the Commission’s focus in this passage on protecting the interests of long-term investors. According to the Investment Company Institute (ICI), 42 million American households invest in equity mutual funds.⁵ It is essential that any proposals relating to market structure take into account the challenges faced by institutional investors in the current market environment when they trade on behalf of the 42 million American households that invest in mutual funds and millions of other households that are pension and retirement fund beneficiaries .

Liquidnet is an agency-only firm. Our primary customer base is the large asset managers who manage investments on behalf of tens of millions of American households. Our objective since we

⁴ Concept Release, pp. 33-34.

⁵ Investment Company Institute, *2009 Investment Company Fact Book*, 49th Edition, Section 6, www.icifactbook.org (accessed March 22, 2010).

commenced trading in April 2001 has been to provide the most efficient execution of institutional block orders. For calendar year 2008, BrokerEdge™ ranked Liquidnet as the #1 broker overall for equity trade cost performance across global trading firms. In this survey, Liquidnet also ranked #1 in 23 of 37 execution performance categories.⁶ For calendar year 2009, Liquidnet again ranked #1 in execution performance across all global brokers in the annual BrokerEdge™ report.⁷

Based on our experience, the most important thing the Commission can do from a market structure standpoint to protect these tens of millions of households is to ensure that institutional traders have the ability to decide how to execute their customer orders without being subject to regulatory restrictions that force long-term investors to interact with short-term traders on terms that are disadvantageous to the long-term investor, thereby subsidizing short-term traders.

Restrictions on investor choice vs. providing improved disclosure to investors

In evaluating different regulatory proposals, we make an important distinction between regulatory proposals that restrict investor choice and regulatory proposals that empower investors by providing them better information. We support proposals that better disclosure to investors regarding order handling practices and execution quality. We generally are skeptical of proposals from industry competitors that restrict investor choice.

Long-term investors should have the choice to decide how their orders are executed. This will facilitate long-term investors achieving best execution for their customer orders.

Distinguishing between short-term traders and long-term investors

In the Concept Release, the Commission requests comments “on the practicality of distinguishing the interests of long-term investors from those of short-term professional traders when assessing market structure issues.”⁸

The key distinction between short-term traders and long-term investors is the average time period for which they hold positions, sometimes referred to as “turnover” or “portfolio turnover”. This is a well-understood concept. For example, as part of Form N-1A, the Commission requires mutual funds to disclose their “Portfolio Turnover”.⁹

⁶ Investment Technology Group “ITG Broker Edge™ Core Broker Report” for U.S. trades for the four quarters ended December 31, 2008, cited in April 30, 2009 press release, “Liquidnet Ranked #1 in 62% of all Execution Categories According to ITG Broker Edge™ Core Broker Report”.

⁷ Tradewatch, *Pensions & Investments*, March 8, 2010, <http://www.pionline.com/apps/pbcs.dll/article?AID=/20100308/CHART/100309924&crit=liquidnet&template=printart> (accessed March 22, 2010).

⁸ Concept Release, p. 34.

⁹ See Instruction 5 to Item 3 of Commission Form N-1A, <http://www.sec.gov/about/forms/formn-1a.pdf> (accessed March 22, 2010).

There is no bright line that separates short-term traders and long-term investors; rather, it is a continuum where certain investors may fall somewhere in between the short-term trader and long-term investor paradigms, yet the average short-term trading firm can clearly be distinguished from the average long-term investor. For example, we can easily distinguish between a traditional mutual fund with a 1X or 2X turnover¹⁰ and a high-frequency trading firm engaged in a passive market making, liquidity rebate or order anticipation strategy where positions are opened and closed multiple times within the same day.

Because there is no bright line that separates short-term traders and long-term investors, it is not practical to draft regulations specifically aimed at short-term traders. For example, it would not be practical to draft a regulation that defines “short-term traders” and imposes specific restrictions on them, nor would that be our recommended approach.

Our main concern, as discussed in this letter, is that certain current regulatory provisions restrict the choices of long-term investors, and the primary beneficiaries of these restrictions are short-term traders. As a general matter, we should be skeptical of restrictions on investor choice. More particularly, we should be skeptical of restrictions that benefit short-term traders at the expense of long-term investors.

¹⁰ A firm with a 1X turnover refers to a firm that holds its average position for 12 months; a firm with a 2X turnover refers to a firm that holds its average position for 6 months.

Annex B

The current market structure for long-term investors

Challenges faced by the institutions that trade for mutual fund investors

To understand how regulations can help or harm long-term investors, we need to understand the challenges faced by long-term investors in today’s markets. Let’s start with the 42 million households who invest through mutual funds and the millions of other households that are pension fund beneficiaries.

First, let’s look at the upside. According to Rosenblatt Securities, an institutional brokerage firm that provides research on the operation of the US equity markets, high-frequency trading has led to massive liquidity provision and has “... played a key role in narrowing spreads, which results in reduced transaction costs for all investors.”¹¹ It also “fosters intense competition between market centers”, leading to greater innovation and improvements in technology.¹² TD Newcrest, a Canadian broker that issues research reports on the equity markets, similarly reports that “from the institutional perspective, narrower spreads are a positive.”¹³

Dr. Erik Sirri, former Director of the Commission’s Division of Trading and Markets, notes that market developments such as algorithms and block crossing systems have “... enabled large investors not merely to deal with highly active, automated markets, but to benefit from them.”¹⁴

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Now, let’s look at the challenges. According to Rosenblatt Securities,

“Another cost comes from the effect of HFT market makers having such superior mathematical and technological prowess that they almost always beat traditional market participants to posting the best prices first. This means that HFTs earn the vast majority of exchange rebates while others subsidize these rebates by paying exchange fees.”¹⁵

A research report by TD Newcrest echoes this point:

¹¹ Rosenblatt Securities Inc., “Trading Talk – An In-Depth Look at High-Frequency Trading”, September 30, 2009, p. 25. (“Rosenblatt Securities”)

¹² Rosenblatt Securities, p. 25.

¹³ The Equity Division of TD Securities, “High Frequency Trading Strikes a Chord with Politicians, Regulations and Market Participants”, *S&P/TSX Bulletin*, p. 6. (“TD Newcrest”)

¹⁴ Erik Sirri, Director, Division of Trading and Markets, Securities and Exchange Commission, “Keynote Speech at the SIFMA 2008 Dark Pools Symposium”, February 1, 2008, p. 5. (“Sirri”)

¹⁵ Rosenblatt Securities, p. 23.

“From the institutional perspective, narrower spreads are a positive. However, for institutions that tend to like to work orders passively [i.e., institutions that like to post bids and offers at the NBBO], overall trade execution costs have gone up as they now have to compete more for passive executions. This is because most of the passive liquidity in the current market environment is provided by market makers (in other words, it is not natural).”¹⁶

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Institutions also face the challenge of signaling their block intent to market intermediaries. According to TABB Group, a research and consulting firm that conducts extensive research on trading and markets,

“... institutional investors tend to keep their trades quiet and not telegraph their intentions. Many investors feel that by placing limit orders or showing their hand, they will leak information into the market and invite other traders to take advantage of them.”¹⁷

TD Newcrest similarly reports that institutional traders in Canada “... remain concerned over information leakage that results from sophisticated pattern recognition as well as aggressive strategies utilized by high frequency traders that are able to maneuver in the market much more nimbly than traditional traders.”¹⁸

Quantitative Services Group, a provider of advanced trading analytics and investment consulting services, notes similarly in a recent report:

“It’s well known that sophisticated stat-arb models routinely monitor market data and the depth of limit order books to detect asymmetries in trading interests. The goal is to exploit and profit from them before the flows reverse and larger traders have a chance to finish their orders. These HFT strategies increase the costs of completing institutional trades and often introduce ‘adverse selection’ as orders are completed in names that are moving contrary to the institutional trader’s investment goals.”¹⁹

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¹⁶ TD Newcrest, p. 11.

¹⁷ The TABB Group, LLC, “US Equity High Frequency Trading: Strategies, Sizing and Market Structure”, September 2009, p. 22. (“TABB Group”)

¹⁸ TD Newcrest, p. 8.

¹⁹ Quantitative Research Group LLC, “Beware of the VWAP Trap”, *Research Note*, November 2009, p. 3.

Greenwich Associates, a firm that provides market research and analysis in the financial services industry, reports “a complete lack of consensus” among institutions “about high-frequency trading’s role in equity markets”.²⁰ According to Greenwich Associates,

“The institutions participating in the survey interact with high-frequency traders on a near constant basis, and these institutions would be affected more than anyone else by any negative or positive influence from high-frequency trading strategies Yet these institutions are split between those that see high-frequency trading practices as malevolent or benign, as adding liquidity to global markets or preying on traditional stock investors.”²¹

Greenwich Associates further reports,

“Institutions do agree on one thing: They do not have enough information to make any final judgments about high-frequency trading.”²²

TABB Group reports that most traders do not see high-frequency trading as something that is either inherently good or inherently bad:

“Because it moves at lightning speed, is high frequency flow even liquidity at all? When asked if high frequency flow is ‘good’ for their own firm’s trading style or ‘bad,’ or if they’re just indifferent about it, over half of the head traders we spoke to expressed the view that high frequency flow is neither good nor bad, it’s just a fact of the marketplace today, neither inherently an impediment nor an advantage.”²³

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Regardless of their view as to whether high-frequency trading is harmful or benign for the market, institutional traders accept the challenge of executing block orders in a market where high-frequency trading is prevalent. As noted by TABB Group in a recent report:

“In the meantime, head traders at buy-side firms have a job to do, choices to make, and alpha to capture. And they have made changes in their trading behavior to adjust to the shifting landscape. The landscape has some fast-growing players in the game, most recently high frequency

²⁰ Greenwich Associates, “High-Frequency Trading: Lack of Data Means Regulators Should Move Slowly”, October 2009, p. 1. (“Greenwich Associates”)

²¹ Greenwich Associates, p. 1.

²² Greenwich Associates, p. 1.

²³ Laurie Berke, TABB Group, “Institutional Equity Trading 2009/10: Dark Pools, Transparency and Consequences”, November 18, 2009, p. 8. (“TABB Group Institutional Equity Trading”)

traders Buy-side traders are continually challenged to adapt and adjust their trading behavior in the face of this constant wave of market evolution. They are increasingly sophisticated, increasingly knowledgeable, and want to decide their own fate.²⁴

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Institutions also are challenged by the complexity and opaqueness of how their orders are handled. According to TABB Group:

“... hedge funds and asset managers would like to see more transparency on dark pool executions, beginning with standard terminology and reporting for volume figures. Furthermore, they would like a better understanding of how their orders are handled. Without more empirical data on how orders are handled, it is very difficult for them to make intelligent decisions regarding with whom to trade and how to trade.”²⁵

TABB Group further notes:

“Even many market participants believe the current market structure is too opaque. Dark pool reporting is voluntary, unverifiable and not necessarily standardized.²⁶ Independent analysis comparing execution quality across dark pools is non-existent. Order handling has become so complex that even the most sophisticated institutional investors are not fully aware of what is or could happen to an order.”²⁷

Adam Sussman of TABB Group echoed this concern in his recent testimony before a U.S. Senate Subcommittee:

“They [institutions] need to use these tools [trading systems] ... to efficiently interact with the marketplace, ... to efficiently distribute their orders ... trading against other institutional investors, trading against high-frequency traders. But the issue is how much do they really understand about the algorithms and the dark pools that they’re handling.

... sometimes they feel overburdened by the amount of information that they have to keep track of in order to execute these orders. But I don’t

²⁴ TABB Group Institutional Equity Trading, p. 6.

²⁵ TABB Group, p. 25.

²⁶ The authors are not referring here to reporting of specific trades because all trades in dark pools are publicly reported. The authors are referring to the fact that reporting of aggregated dark pool volume is voluntary and not standardized.

²⁷ TABB Group, p. 30.

think that they would ... ask for anything else This is a challenge that they accept wholeheartedly as a part of their job, and they would rather have the responsibility of understanding these pieces ... rather than some regulatory framework force them to act one way or another.

... Freedom is obviously a responsibility as well as a right, and they accept that challenge.”²⁸

Challenges faced by retail brokerage customers

Retail brokerage customers have benefited from lower commissions, reduced spreads, reduced execution times and increased liquidity for retail-sized orders. Robert Colby, former Deputy Director of the Commission’s Division of Trading and Markets, recently noted at a webinar sponsored by the Investment Company Institute that “the retail investor has never had better trading conditions than it has today.”²⁹ He noted specifically that there are “brokers that are willing to trade at very low commission rates and you can get both a narrow spread and a low commission rate.”³⁰ The Commission has noted the “very substantial availability of undisplayed liquidity for executing retail orders at non-exchange venues, particularly OTC market makers and liquidity pools sponsored by broker-dealers.”³¹ The Commission further notes that “this undisplayed liquidity enables retail investors to receive executions for most of their orders at prices equal to or better than the NBBO, regardless of the displayed size at the NBBO.”³²

Finally, execution times continue to improve. According to data from Rule 605 reports compiled by Thomson Transaction Analytics Reports, the average execution time for NYSE-listed securities decreased from 10.5 seconds in 2004 to 1.2 seconds in 2009, and the average execution time for NASDAQ-listed securities decreased from 2.8 seconds in 2004 to 1.6 seconds in 2009.³³

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²⁸ Transcript of the Hearing of the Securities, Insurance and Investment Subcommittee of The Senate Banking, Housing and Urban Affairs Committee on “Dark Pools, Flash Orders, High Frequency Trading and Other Market Structure Issues”, October 28, 2009, p. 18. (“Senate Subcommittee Hearing Transcript”). Senator Bob Corker, one of the Senators who attended the hearing, praised Mr. Sussman’s testimony: “I do want to say, Mr. Sussman, ... I thought your presentation was outstanding and very easy to understand.” Senate Subcommittee Hearing Transcript, p. 40.

²⁹ “Trading 101: Webinar on the Basic Elements of Securities Trading and Market Structure for Funds”, sponsored by the Investment Company Institute, November 16, 2009. (“ICI Webinar”)

³⁰ ICI Webinar.

³¹ Securities Exchange Act Release No. 59039, “Self-Regulatory Organizations; NYSE Arca, Inc.; Order Setting Aside Action by Delegated Authority and Approving Proposed Rule Change Relating to NYSE Arca Data”, December 2, 2008, <http://sec.gov/rules/sro/nysearca/2008/34-59039.pdf> (accessed March 22, 2010), p. 96. (“NYSE Arca Order”)

³² NYSE Arca Order, p. 96.

³³ Rule 605 data compiled by Thomson Transaction Analytics Reports, 2004 and 2009. 2009 data is through October 2009. Data is for market and marketable limit orders between 100 and 499 shares.

As far as challenges, according to TD Newcrest, retail orders (like institutional orders) "... are being forced more and more to cross spreads, as bids and offers are stacked with so many other market maker orders that it becomes very difficult to passively buy or sell stock."³⁴

The TABB Group reports that,

"Individual investors are at the mercy of their brokers to manage their order flow with dexterity. Many retail brokers do not have access to the same sophisticated technology as larger brokers or investors, and hence sell their flow to wholesalers who typically have better execution facilities."³⁵

Another potential challenge for retail investors is price improvement. Rule 605 data for 2009 as compiled by Thomson Transaction Analytics Reports, shows that the industry as a whole provided slightly negative price improvement (close to 0%).³⁶

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Any regulatory proposals to change the current market structure should specifically address the challenges faced by long-term investors and take into account the current realities of the equity markets. For example, industry reports indicate that short-term traders typically are represented at the best bid and offer. This means that short-term traders are the primary beneficiaries of rules, such as the order protection rule without an opt-out provision, specifically designed to protect displayed liquidity. This must be taken into account as we consider proposals, such as sub-penny quoting, that would make it easier for short-term traders to utilize the order protection rule to step-ahead of long-term investors.

³⁴ TD Newcrest, p. 7. Passively buying stock refers to posting a bid or offer at the NBBO.

³⁵ TABB Group, p. 24.

³⁶ Rule 605 data compiled by Thomson Transaction Analytics Reports, January to December 2009. Data is for market and marketable limit orders between 100 and 499 shares. The average quoted spread in the market during this period, as compiled by Thomson Transaction Analytics Reports from Rule 605 data, was 1.39 cents. The average effective spread for the industry during the period was 1.40 cents. The difference between the average quoted spread of 1.39 cents and average effective spread of 1.40 cents (-.01 cents) represents the negative price improvement provided by the industry (-1%). We note that certain orders are exempt from Rule 605 reporting, so we would be interested to see if other market participants have data showing that the Thomson data is not representative of the overall market.

Annex C

Order protection rule

Customer protection vs. liquidity display protection

As noted by the Commission in the Concept Release there are two primary policy justifications for the order protection rule:

- ***Customer protection.*** Customers should be protected from executions outside the national best bid and offer (“NBBO”) without their express consent.
- ***Liquidity display protection.*** Customers who display limit orders should be protected.³⁷

We agree with the first justification for the order protection rule; we disagree with the second justification. Accordingly, we support the order protection rule, subject to an opt-out right for investors.

Customer protection is an important policy goal of the order protection rule

Regarding customer protection, every customer absolutely should have the right to insist on an execution within the NBBO if that is what the customer wants. This should be the customer’s choice. We note the specific concern that retail brokers could secure opt-out consent from retail customers without providing appropriate disclosure, and we would support any reasonable regulatory controls to address this concern and ensure that any opt-out is specific, voluntary and made after all the facts have been clearly presented to the customer.

Liquidity display protection primarily benefits short-term traders

Liquidity display protection, on the other hand, is a regulatory subsidy primarily for the benefit of short-term traders and is not an appropriate policy justification for the order protection rule.

Rosenblatt Securities writes that high-frequency traders have “... such superior mathematical and technological prowess that they almost always beat traditional market participants to posting the best prices first.”³⁸ According to Rosenblatt, other investors, including institutions, often “have to cross the spread and incur a take fee.”³⁹ TABB Group similarly reports that “institutional investors are generally liquidity takers and not posters.”⁴⁰ TD Newcrest, similarly reports that “... orders are

³⁷ See, for example, p. 27 of the Concept Release.

³⁸ Rosenblatt Securities, p. 23.

³⁹ Rosenblatt Securities, pp. 23-24.

⁴⁰ TABB Group, p. 22.

being forced more and more to cross spreads, as bids and offers are stacked with so many other market maker orders that it becomes difficult to passively buy or sell stock.”⁴¹

We can see from the analysis of industry experts that the primary beneficiaries of any rules designed specifically to protect displayed limit orders are high-frequency traders and other market intermediaries, and not long-term investors.

Do we need to subsidize short-term traders who provide liquidity?

It could be argued that even though short-term traders are the primary beneficiary of rules designed to protect displayed limit orders, we still need those rules to ensure sufficient displayed liquidity in the market. We disagree with this argument because all the evidence shows that market forces incentivize the display of liquidity.

Market forces incentivize markets to provide display facilities

First, we have to understand that market forces incentivize market providers to provide facilities for the posting of displayed bids and offers because this attracts order flow to the markets that they operate.

As recently explained by the NYSE and NASDAQ in a brief that they filed jointly, market forces incentivize markets to provide facilities for displayed liquidity:

“Wide distribution of an exchange’s market data, including depth-of-book order data, increases market participants’ knowledge of all displayed orders that are available on that exchange. This means that buyers interested in purchasing securities at particular prices have better chances of locating on that exchange sellers willing to meet those prices, resulting in more trades executed on that exchange and more revenue from transaction fees.”⁴²

In support of their argument, the NYSE and NASDAQ cite “the real-world example of Island ECN”. According to the NYSE and NASDAQ:

⁴¹ TD Newcrest, p. 7. “Passively” buying or selling stock refers to posting bids and offers at the NBBO.

⁴² Initial Brief of Intervenors NYSE ARCA, Inc. and NASDAQ Stock Market, LLC, in the case of NetCoalition; Securities Industry and Financial Markets Association, Petitioners, Securities and Exchange Commission, Respondent, United States Court of Appeals for the District of Columbia Circuit, Appeal Nos. 09-1042 & 09-1045, November 16, 2009, p. 17. (“NYSE and NASDAQ Joint Brief”)

“After Island ceased displaying its order book to the public in three very active exchange-traded funds ... in which it enjoyed a substantial market share, Island experienced a 50% drop in its market share in those funds.”⁴³

A second important benefit for market providers in providing facilities for displayed liquidity is the ability to charge for market data. For display markets that are registered as exchanges, this includes the ability to share in the fees that are paid to exchanges for contributing to the consolidated quote and last sale data feeds.⁴⁴ It also includes the ability for all display markets, whether or not they are registered as exchanges, to charge directly for access to their market data.⁴⁵

The benefits for market providers in providing display facilities are evidenced by the recent successes of BATS and Direct Edge, both of which operate markets that display quotes.⁴⁶ The advantages of this business model also are evident globally with the success of Chi-X in Europe and Canada.⁴⁷

Market forces incentivize market participants to display liquidity

Market forces also incentivize market participants to display liquidity. Market participants who display liquidity benefit from the ability to capture market spreads. They also benefit from other financial incentives provided by markets to participants who display liquidity.

Displayed liquidity and quoted spreads

The data on quoted spreads clearly supports the conclusion that market forces incentivize market participants to display liquidity. If market forces were not incentivizing the display of liquidity, the premium charged by short-term traders to quote would increase, resulting in wider spreads. But this is not consistent with the data. To the contrary, quoted spreads continue to narrow.

According to Rule 605 data compiled by Thomson Transaction Analytics Reports, the average quoted spread for NYSE-listed securities decreased from 5.60 cents in 2004 to 1.35 cents in 2009,

⁴³ NYSE and NASDAQ Joint Brief, p. 18.

⁴⁴ See CTA Plan: Second Restatement of Plan Submitted to the Securities and Exchange Commission Pursuant to Rule 11Aa3-1 Under the Securities Exchange Act of 1934, http://www.nyxdata.com/nysedata/CTA/tabid/227/DMXModule/1515/EntryId/29533/Command/Core_Download/Default.aspx (accessed March 22, 2010).

⁴⁵ Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004), section V, <http://sec.gov/rules/proposed/34-50870.htm> (accessed March 22, 2010).

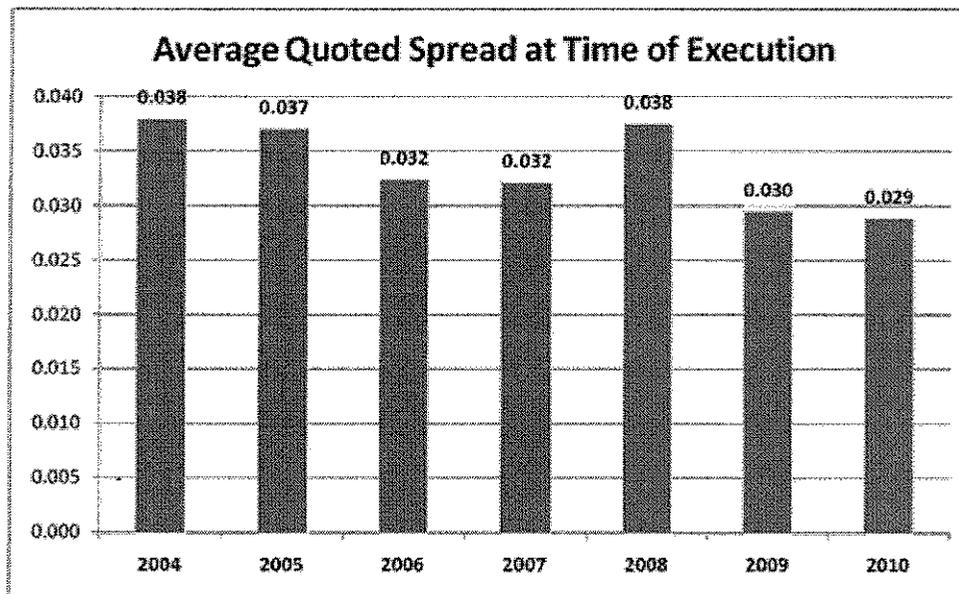
⁴⁶ See, for example, Alexandra Zendrian, “Direct Edge: Exchange in 2009,” *Forbes.com*, May 19, 2009, <http://www.forbes.com/2009/05/19/stocks-exchanges-direct-markets-economy-sec-equities.html> (accessed March 22, 2010); and Jonathan Stempel, “BATS Trading wins SEC approval for exchange status,” *Reuters*, August 19, 2008, <http://www.reuters.com/article/idUSN1845653320080819> (accessed March 22, 2010).

⁴⁷ See, for example, “Chi-X Europe Wins ‘Best MTF’ in Waters EuroFIT Awards”, <http://www.chi-x.com/chi-x-press-releases/chi-x-europe-waters-eurofit-awards.pdf> (accessed March 22, 2010).

and the average quoted spread for NASDAQ-listed securities has decreased from 12.36 cents in 2004 to 1.82 cents in 2009.⁴⁸

We also look at our own internal data, which shows the same trend.⁴⁹ For the years 2004 through 2009 we computed the weighted average quoted spread in the market at the time of execution for all executions in our negotiation system. If you consider the sample size (the total number of negotiated executions in our system over the six-year period), there is a high statistical probability that this data reflects overall market trends.⁵⁰

Liquidnet trade data (2004 through 2010)



As demonstrated by the table above, there is a consistent trend towards narrowing of quoted spreads, excluding 2008, when heightened market volatility caused a temporary widening of quoted spreads. In 2009 and 2010 the historical trend towards narrowing spreads has continued, and any temporary effects of 2008 have been fully reversed. This data shows that market forces are incentivizing the display of liquidity. The data directly contradicts the assertion that venues for undisplayed liquidity are adversely affecting the display markets.

⁴⁸ Rule 605 data compiled by Thomson Transaction Analytics Reports, 2004 and 2009. Data is for market and marketable limit orders between 100 and 499 shares.

⁴⁹ We believe the Thomson data, compiled from Rule 605 reports, is important to consider. We are aware that certain order types are excluded from Rule 605 reporting and we would be interested to see if other market participants have evidence that this data is not representative of the overall market. Ultimately, we look to our internal data, which shows a clear and consistent trend towards narrowing of spreads.

⁵⁰ Liquidnet tends to execute a higher percentage of shares in mid and small-cap stocks relative to the overall market, which would explain why Liquidnet's spread numbers show a wider spread than the overall market numbers compiled by Thomson, but the trend towards narrowing of spreads evidenced by the Liquidnet data should be consistent with the overall market trend.

Fairness of protecting displayed limit orders

One of the justifications for protecting displayed limit orders is the fairness argument. Let's assume that the best displayed bid in the market is \$10.01 and the best displayed offer is \$10.03. It would seem unfair to the trader who has posted the best bid at \$10.01 if another market participant with a buy order at \$10.00 is executed in a different venue ahead of the buyer who has posted at \$10.01.

But we should consider the fairness argument from the other perspective. Let's assume that an institution with a buy order for 100,000 shares posts a bid for 500 shares at \$10.00. Let's further assume that a short-term trader is able to detect the large buy order and posts a bid at \$10.01 to purchase ahead of the institution.⁵¹ The short-term trader continues to buy ahead of the institution and can later sell back to the institution at a higher price. In this scenario, is the order protection rule without an opt-out provision fair to the institution?

This example illustrates our point that the order protection rule without an opt-out provision effectively is a regulatory subsidy by long-term investors primarily for the benefit of short-term traders.

Impact of order protection rule without an opt-out provision

While we identify certain concerns with the current version of the order protection rule that does not provide an opt-out, we believe the Commission has taken certain steps to minimize the adverse impact on long-term investors. For example, in connection with the adoption of Regulation NMS, the Commission issued a series of FAQs providing interpretive guidance on various aspects of Regulation NMS.⁵² In FAQ 3.23, the Commission provided an interpretation to facilitate execution of negotiated block orders by institutional brokers in compliance with the order protection rule.⁵³ This is an example of an action by the Commission that has helped minimize the adverse impact of the order protection rule on long-term investors.

Nevertheless, we believe the order protection rule without an opt-out provision could become a concern as markets continue to evolve, for example, as a result of the increasing sophistication of high-frequency trading strategies. In addition, potential future regulatory changes, such as the introduction of sub-penny quoting, would be problematic given the current order protection rule.

Order protection rule without an opt-out provision and speed of access to markets

⁵¹ See, for example, the Commission's discussion of order anticipation strategies on pages 54-56 of the Concept Release.

⁵² "Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS", <http://sec.gov/divisions/marketreg/nmsfaq610-11.htm> (accessed March 22, 2010).

⁵³ "Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS", Question 3.23: Agency Block Transactions with Non-Trade-Through Prices that are Individually Negotiated, <http://sec.gov/divisions/marketreg/nmsfaq610-11.htm> (accessed March 22, 2010).

In the Concept Release, the Commission identifies the fairness of co-location services as a potential concern for market participants. For example, the Commission asks whether co-location provides “proprietary firms an unfair advantage because they generally will have greater resources and sophistication to take advantage of co-location services than other market participants, including long-term investors.”⁵⁴ The Commission asks whether exchanges and other trading centers could “batch process all orders each second and, if so, what would be the effect of such a policy on market quality?”⁵⁵

In his comment letter on the Commission’s rule proposal on non-displayed trading interest, Robert Schwartz, Professor of Finance at the Zicklin School of Business, Baruch College, CUNY, identifies the issue of “temporal fragmentation”. He defines “temporal fragmentation” as the “problem of how orders meet each other in time in a continuous trading environment.”⁵⁶ He suggests that continuous trading can increase intra-day volatility and cites a study that volatility in trading of Nasdaq stocks after the market open and prior to the market close decreased after Nasdaq introduced electronic call auctions to open and close the Nasdaq market.⁵⁷

We do not support regulatory proposals to mandate batch execution by trading centers, nor do we believe that Professor Schwartz is specifically recommending this, but what if a trading center believed that a market that batched orders every second, every five seconds, every ten seconds or at some other time interval could better serve the interests of investors? Or what if a market wanted to offer both discrete and continuous order types? The order protection rule would effectively prohibit this type of system. We do not know whether such a system would be feasible or would benefit investors, but we would suggest that a more flexible approach to market structure regulation could foster innovation that ultimately benefits long-term investors. As an example, the Commission could consider on a pilot basis an opt-out provision for participation in a system that proposes to execute orders at discrete time intervals.

Order protection rule without an opt-out provision and sub-penny quoting

In the Concept Release, the Commission requests comment on the advisability of reducing the minimum quoting increments to permit sub-penny quoting.⁵⁸ Allowing markets to determine their pricing increments should lead to optimal pricing for different investor groups, but this is in a world where there is no order protection obligation. When you have an order protection rule

⁵⁴ Concept Release, p. 60.

⁵⁵ Concept Release, p. 61.

⁵⁶ Letter from Robert A. Schwartz, Marvin M. Speiser Professor of Finance, Zicklin School of Business, Baruch College, CUNY, New York, NY, commenting on the Commission’s rule proposal on “Regulation of Non-Public Trading Interest”, Securities Exchange Act Release No. 60997, February 22, 2010, <http://sec.gov/comments/s7-27-09/s72709-52.pdf> (accessed March 22, 2010), p. 3. (“Schwartz Letter”)

⁵⁷ Schwartz Letter, p. 7, citing Michael S. Pagano, Lin Peng and Robert A Schwartz, “The Quality of Market Opening and Closing Prices: Evidence from the Nasdaq Stock Market”, 2010, working paper.

⁵⁸ Concept Release, p. 72.

without an opt-out provision, sub-penny quoting becomes problematic because it exacerbates the regulatory subsidy that the order protection rule provides to short-term traders.

Let's consider the example above where an institution with a buy order for 100,000 shares posts a bid for 500 shares at \$10.00. Let's assume again that a short-term trader is able to detect the large buy order. In the example above, the short-term trader was able to buy ahead of the institution and sell back to the institution at a higher price. When you introduce sub-penny quoting into the equation, the short-term trader can still buy ahead of the institution, but he can do so at a lower cost. Assuming that quoting in tenths of a cent is permitted, the short-term trader can buy ahead of the institution while only improving the posted bid by $1/10^{\text{th}}$ of a cent. Since the cost of trading ahead is reduced, the prevalence of trading ahead would likely increase, to the detriment of long-term investors.

As noted above, the order protection rule without an opt-out provision is a regulatory subsidy provided by long-term investors, and the primary beneficiary of this regulatory subsidy is short-term traders. The flexibility of the current regulatory structure has minimized the adverse impact on institutions. The introduction of sub-penny quoting could change this for the worse.

Order protection rule without an opt-out provision and access fees

Another concern relates to the interaction between the order protection rule and access fees. When access fees are taken into account, the order protection rule sometimes forces investors to buy or sell at an inferior price. We use the example of a flea market to illustrate this point.

Let's assume that there are two flea markets across the street from each other. Each has various stalls operated by independent vendors, and there is a stall at each flea market that sells fruits and vegetables. Let's assume that an apple at the fruit and vegetable stall at the 1st flea market costs \$1.00, while an apple at the stall at the 2nd flea market costs \$1.25. The owner of the 1st flea market charges a 50% service fee on any purchases at the flea market. The owner of the 2nd flea market does not charge a fee. Let's assume for purposes of this example that the apples are of comparable quality.

Assuming that the order protection rule applied to flea markets and apples, customers would be obligated to buy their apples at the 1st flea market because the independent vendor at the 1st flea market is offering a lower sale price. The flea market regulators would justify this policy on the grounds that it would not be fair to the independent vendor at the 1st flea market to permit the customer to buy his apples at the 2nd flea market. However, the total cost to the customer in purchasing at the 1st flea market is \$1.50, while the total cost to the customer in purchasing at the 2nd flea market is \$1.25. It would seem unfair to the customer in this instance to require him to purchase his apples at the 1st flea market.

Now it is true that when a broker acts as agent for a customer access fees are paid by the broker and not by the customer, but ultimately the total cost to the customer and his agent is the relevant benchmark. Considering the flea market example, if the purchaser of the apple is a child,

and the flea market rules require that parents pay the 50% service fee to the flea market on behalf of the child, the total cost to the child and his parents (the all-in cost to the family) is still \$1.50.

Mandating order protection at venues that charge access fees is a regulatory subsidy for the venue that charges the access fee. This is in addition to the regulatory subsidy already provided to the party that posts liquidity. Of course, the primary subsidy still rests with the party that posts the liquidity because most of the access fee charged by a market goes towards paying the liquidity rebate to the liquidity poster.

As in the case with sub-penny quoting and sub-second trading, access fees should not be problematic in themselves,⁵⁹ but the order protection rule, when combined with access fees, creates a situation where long-term investors can be forced into a worse execution, taking into account the execution price and access fee.

⁵⁹ The assertion that access fees should not be problematic in themselves assumes that access fees are properly disclosed to the end-customer and that principal-agency issues are properly addressed. These are separate issues to consider. Our proposals in Annex F seek to improve disclosure to customers.

Annex D

Fair Access

Retail order flow has access to dark pools and other ATSs

Under Regulation ATS, alternative trading systems that exceed certain volume thresholds become subject to the Regulation ATS “fair access” obligation.⁶⁰ An ATS that is subject to the fair access obligation cannot “unreasonably prohibit or limit any person in respect to access to services offered by such alternative trading system by applying” its access standards “in an unfair or discriminatory manner.”⁶¹ The Commission asks whether “all types of dark pools can comply with this fair access requirement, yet still achieve the objective of enabling institutional investors to trade in large size with minimal price impact?”⁶²

We consider the Regulation ATS fair access obligation to be another regulatory restriction on long-term investors that primarily benefits short-term traders. We have read every page of every comment letter submitted in response to the Commission’s rule proposal on regulation of non-public trading interest,⁶³ and we did not see one claim, or even suggestion, that a retail broker was being excluded from a dark pool or other ATS.⁶⁴

As we noted in our December comment letter on this rule proposal,⁶⁵ our Liquidnet H2O system welcomes participation by retail brokers and other market intermediaries who represent retail orders. As we noted in that letter, publicly-filed Rule 606 reports provide evidence that retail order flow accesses Liquidnet H2O. If we look at the Rule 606 reports filed by E*Trade and TD Ameritrade for the 3rd quarter of 2009, it appears that E*Trade and TD Ameritrade route the majority of their customer limit orders to DirectEdge.⁶⁶ DirectEdge is a participant in Liquidnet H2O, which provides price improvement for retail orders that DirectEdge routes to Liquidnet H2O. More generally, the NYSE and BATS, two of the three largest exchange groups, and DirectEdge, the leading ECN, participate in Liquidnet H2O, which includes access for their retail order flow.

⁶⁰ Rule 301(b)(5) of Regulation ATS. 17 CFR 242.301(b)(5).

⁶¹ Rule 301(b)(5) of Regulation ATS. 17 CFR 242.301(b)(5).

⁶² Concept Release, p. 73.

⁶³ Securities Exchange Act Release No. 60997 (November 13, 2009), 74 FR 61208 (November 23, 2009), <http://sec.gov/rules/proposed/2009/34-60997.pdf> (accessed March 22, 2010). (“Rule Proposal on Regulation of Non-Public Trading Interest”)

⁶⁴ Comment letters on the Rule Proposal on Regulation of Non-Public Trading Interest are posted on <http://sec.gov/comments/s7-27-09/s72709.shtml> (last accessed March 22, 2010).

⁶⁵ Letter from Seth Merrin, Chief Executive Officer, Anthony Barchetto, Head of Trading Strategy, Jay Biancamano, Global Head of Marketplace, Vlad Khandros, Market Structure Analyst and Howard Meyerson, General Counsel, December 21, 2009, commenting on the Commission’s Rule Proposal on Regulation of Non-Public Trading Interest, <http://sec.gov/comments/s7-27-09/s72709-25.pdf> (accessed March 22, 2010), pages B-21 to B-23. (“Liquidnet Letter”)

⁶⁶ Rule 606 Reports.

It is clear from the discussion above that retail brokers are not excluded from Liquidnet and other dark pools. In addition, to the extent that retail brokers effectively outsource their routing process to other market participants such as DirectEdge, those market participants have access to dark pools such as Liquidnet H2O for executing retail order flow.

Institutional investors participate in dark pools

We also know that institutional investors participate in, and benefit from, dark pools.⁶⁷ The Investment Company Institute wrote as follows in its comment letter on the Commission’s rule proposal on regulation of non-public trading interest:

“Much of the current debate over the structure of the U.S. securities markets have centered on the proliferation of non-public trading interest and the venues that provide such interest, particularly ‘dark pools’. Mutual funds are significant users of these trading venues, which provide a mechanism for transactions to interact without displaying the full scale of a fund’s trading interest, thereby lessening the cost of implementing trading ideas and mitigating the risk of information leakage. These venues also allow funds to shelter their large block size trading interest from market participants who seek to profit from the impact of the public display of large orders to the detriment of funds and their shareholders. As we have stated in several letters to the Commission, the confidentiality of information regarding mutual fund trades is of significant concern to Institute members. Any premature or improper disclosure of this information can lead to frontrunning of a fund’s trades, adversely impacting the price of the stock that the fund is buying or selling.”⁶⁸

The primary beneficiaries of fair access requirements are short-term traders

If institutional investors, retail brokers and other market participants representing retail order flow all have the opportunity to participate in dark pools, who benefits from fair access obligations imposed on dark pools? The clear answer is that fair access mandates benefit short-term traders at the expense of long-term investors.

⁶⁷ If retail and institutional investors both have access to dark pools, this directly contradicts the false assertion that dark pools create a “two-tiered” market.

⁶⁸ Letter from Karrie McMillan, General Counsel, Investment Company Institute, February 22, 2010, commenting on the Commission’s rule proposal on “Regulation of Non-Public Trading Interest”, <http://sec.gov/comments/s7-27-09/s72709-58.pdf> (accessed March 22, 2010). (“ICI Letter”). As noted in footnote 1 to the ICI Letter, the ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs) and unit investment trusts (UITs). Members of ICI manage total assets of \$11.82 trillion and serve almost 90 million shareholders.

As noted above, we do not support regulatory restrictions on how short-term traders conduct their business. But we also do not support regulatory restrictions that force institutions to reveal their block order information to short-term traders. As an example, if there were a mandate for Liquidnet to admit short-term traders to participate directly in our negotiation system, this would be harmful for the large institutions that participate on our negotiation system and would impede their ability to achieve cost savings for their investors.

Practical aspects of a fair access requirement

In the past, Liquidnet has discussed with the staff of the Division of Trading and Markets the application of the fair access requirement to Liquidnet's negotiation system. In connection with these discussions, we discussed internally at Liquidnet various alternatives for addressing fair access. For example, we could provide a customer list to all of our customers and allow customers to choose which customers they wanted to interact with. But many of our customers consider their participation on Liquidnet to be confidential, so providing this type of list was not feasible. At the end of the day, we determined there was no feasible way for us to address this issue without adversely impacting our system and our customers.⁶⁹

We acknowledge there could be potential abuses if ATSS restrict access in an arbitrary or unreasonable manner, but any solution we can think of to address this potential concern creates more problems for long-term investors than it solves. Since any solution will generate new problems, we need to consider and evaluate the scope of the existing problem.

We note that our H2O system provides access to brokers; however, we seek to do so in a manner that protects the confidentiality of our customers' block order information. We also note that many dark pools and other ATSS welcome participation from short-term traders and other brokers. It is important to keep in mind that brokers, ATSS and other market participants seek to attract liquidity because more liquidity typically means more business.

Absent evidence that retail and institutional customers are being excluded from dark pools, we would oppose the expansion of fair access obligations, as it would result in higher trading costs for institutional investors, and we do not see any countervailing benefit for long-term investors in imposing new obligations in this area.

⁶⁹ The Commission also recognized the potential adverse impact on long-term investors that could result if institutions participating in our negotiation system were required to expose their orders to short-term traders. Our discussions with the Commission resulted in the issuance by the Commission of an exemptive order exempting Liquidnet from the reduction of the Regulation ATS fair access threshold that was adopted as part of Regulation NMS. Securities Exchange Act Release No. 52514 (September 27, 2005), "Order Granting Exemption to Liquidnet, Inc. from Certain Provisions of Regulation ATS under the Securities Exchange Act of 1934", <http://sec.gov/rules/exorders/34-52514.pdf> (accessed March 22, 2010).

Annex E

Undisplayed liquidity

Dark pools - order execution quality, public price discovery and fair access

In the Concept Release “the Commission requests comment on all forms of undisplayed liquidity in the current market structure.”⁷⁰ In particular, the Commission requests comment on “the effect of undisplayed liquidity on order execution quality, the effect of undisplayed liquidity on public price discovery, and fair access to sources of undisplayed liquidity.”⁷¹

With regard to order execution quality, we agree with the Investment Company Institute’s position that venues that provide non-public trading interest, including dark pools, “provide a mechanism for transactions to interact without displaying the full scale of a fund’s trading interest, thereby lessening the cost of implementing trading ideas and mitigating the risk of information leakage.”⁷² We note, for example, that BrokerEdge ranked Liquidnet #1 in execution performance across all global brokers in its annual reports for 2008 and 2009.⁷³

We also believe, as discussed in more detail below, that dark pools can reduce execution costs for retail brokerage customers by providing significant price improvement for retail orders. If we look at Liquidnet’s Rule 605 data for 2009 as compiled by Thomson Transaction Analytics Reports, we see that for orders transmitted by Liquidnet H2O participants and executed by Liquidnet H2O, Liquidnet provided average price improvement of 1.26 cents per share, or 91% of the quoted spread.⁷⁴ This price improvement of 91% is in contrast to the industry as a whole which, according to the same Rule 605 data compiled by Thomson Transaction Analytics Reports, provided slightly negative price improvement (close to 0%).⁷⁵

⁷⁰ Concept Release, p. 66.

⁷¹ Concept Release, pp. 66-67.

⁷² ICI Letter, pp. 3-4.

⁷³ Investment Technology Group “ITG Broker Edge™ Core Broker Report” for U.S. trades for the four quarters ended December 31, 2008, cited in April 30, 2009 press release, “Liquidnet Ranked #1 in 62% of all Execution Categories According to ITG Broker Edge™ Core Broker Report”. Tradewatch, *Pensions & Investments*, March 8, 2010,

<http://www.pionline.com/apps/pbcs.dll/article?AID=/20100308/CHART/100309924&crit=liquidnet&template=print> (accessed March 22, 2010).

⁷⁴ Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares. The average quoted spread in the market during this period, as compiled by Thomson Transaction Analytics Reports from Rule 605 data, was 1.39 cents. Liquidnet H2O’s average effective spread during the period was .13 cents. The difference between the average quoted spread of 1.39 cents and Liquidnet’s average effective spread of .13 cents (1.26 cents) represents the price improvement provided by Liquidnet. Liquidnet’s price improvement (1.26 cents) relative to the average quoted spread (1.39 cents) represents Liquidnet’s price improvement percentage (91%).

⁷⁵ Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares. The average quoted spread in the market during this

With regard to public price discovery, we have shown in Annex C that quoted spreads continue to narrow, directly contradicting the assertion that dark pools have adversely affected public price discovery. As discussed in Annex C, market forces incentivize the display of liquidity, and rules that mandate the public display of liquidity by long-term investors can result in a regulatory subsidy that benefits short-term traders at the expense of long-term investors.

Please see Annex D for our views on fair access to undisplayed liquidity.

Commission rule proposal on actionable IOIs

An important issue relating to undisplayed liquidity is the use of so-called “actionable IOIs”. This was a major area of focus in the Commission’s recent rule proposal on “Regulation of Non-Public Trading Interest”. In the rule proposal, the Commission proposed a reduction in the threshold at which ATSs become subject to the order display requirement, with the intent of such change being to reduce the use of actionable IOIs by ATSs.

In the rule proposal the Commission proposes an exemption from the ATS order display requirement for certain block orders. In our December comment letter on the rule proposal, we proposed three modifications to the Commission’s proposed block exemption⁷⁶:

- **Definition of a block.** We proposed that the definition of block order be expanded to facilitate efficient execution of block orders for mid, small and micro-cap stocks. We proposed that a block order be defined as an order with a principal value of \$200,000, an order for 10,000 shares or more, or an order that represents 1% or more of a stock’s average daily trading volume (ADV).⁷⁷ We also proposed providing flexibility to the Commission at any time to set the block threshold at \$200,000 for any or all of the 50-most actively traded stocks in the market.
- **Flexibility for execution of a block order.** In proposing the block exemption, the Commission recognized the institution’s legitimate interest in protecting its customers’ block order information. This interest should apply regardless of whether the institution’s block order is executed in one large execution or in multiple smaller executions. We proposed that the block exception should apply as long as the order notification sent by the broker or ATS is of block size.

period, as compiled by Thomson Transaction Analytics Reports from Rule 605 data, was 1.39 cents. The average effective spread for the industry during the period was 1.40 cents. The difference between the average quoted spread of 1.39 cents and average effective spread of 1.40 cents (-.01 cents) represents the negative price improvement provided by the industry (-1%). Negative price improvement results when the average effective spread exceeds the average quoted spread.

⁷⁶ We also proposed in our December comment letter that public identification of the ATS where a trade is executed should be on an end-of-day or other delayed basis.

⁷⁷ We proposed measuring ADV based on a 10-day trailing average.

- **Program trades.** We recommended that the Commission provide an exemption for program trades where the principal amount of the program is \$3,000,000 or higher.

Actionable IOIs vs. order notifications

You will note in our December comment letter that we use the phrase “order notification” rather than the phrase “actionable IOI”. In the adopting release for Regulation ATS,⁷⁸ the Commission sets forth a clear distinction between orders and indications of interest (or IOIs). The Commission states that the term “order” is defined as “any firm indication of a willingness to buy or sell a security.”⁷⁹ The Commission goes on further to say that “[a]t a minimum, an indication of interest will be considered firm if it can be executed without the further agreement of the person entering the indication.”⁸⁰ In Regulation ATS, the Commission sets forth a clear distinction between orders and IOIs: an order can be executed without a further affirmative action by the party providing the order; an IOI requires a further affirmative action by the party providing the IOI before an execution can occur.

The term “actionable IOI” appears somewhat confusing from our perspective because, according to the Commission’s guidance, an intention to trade can be firm, in which case it is an order, or an intention to trade can be non-firm, in which case it is an indication or IOI. The term “actionable IOI” appears to combine two contradictory terms into one expression. We prefer to use the term “order notification” for clarity, but our analysis is the same regardless of the terminology used.

Actionable IOIs have been used since the dawn of trading and are used today by many types of market participants other than ATSS

“Actionable IOIs” as defined by the Commission (or order notifications, as we refer to them) have been used since the dawn of trading, and they are used today by many equity market participants other than ATSS. Let’s consider some of the other market participants that use “actionable IOIs”:

- **Block trading desks use actionable IOIs.** A block trading desk can facilitate the negotiation and execution of a block order between two institutions. The institutions can start the negotiation by communicating non-binding indications to each other through the broker, but at some point during the negotiation the two institutions must communicate firm orders (i.e., actionable IOIs) to each other through the broker. This must occur prior to the trade execution.
- **Floor brokers use actionable IOIs.** Floor brokers can communicate non-binding indications to each other as part of a negotiation process, but for an execution to occur the floor

⁷⁸ Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998), <http://sec.gov/rules/final/34-40760.txt> (accessed March 22, 2010). (“ATS Adopting Release”)

⁷⁹ ATS Adopting Release, p. 16.

⁸⁰ ATS Adopting Release, p. 15.

brokers must communicate firm orders (i.e., actionable IOIs) to each other at some point prior to the point of execution.

- ***Principal trading desks use actionable IOIs.*** When a trading desk receives and executes a customer order, the trading desk is executing an actionable IOI. Let's assume that the NBBO in a stock is \$10.00-\$10.04 and a market sell order is routed to a dealer. The dealer has the opportunity to execute the market sell order at \$10.00. The internalizing dealer might or might not be a market maker in the stock and might or might not have a posted quote in that stock that is the best displayed bid in the market. The internalizing dealer is able to execute that order for \$10.00, and no one else in the market has the opportunity to view or execute against that order. That sell order is an "actionable IOI".
- ***Firms that communicate to internal smart order routers use actionable IOIs.*** A number of market participants commenting on the rule proposal on regulation of non-public trading interest raised the issue of an ATS disclosing ATS order information in real-time to smart order routers used by the broker that operates the ATS. When an ATS communicates order information to a smart order router, it is communicating an actionable IOI to that order router.

Level of detail in an actionable IOI

Applying the Commission's guidance from the Regulation ATS adopting release, there is an underlying order in Liquidnet H2O that can be executed without a further affirmation action from the customer. We define this as an order, and we define the notification that we send out relating to that order as an "order notification". There might be a question as to what level of detail in the notification must be provided before the notification rises to the level of a "displayed" order. Certain market participants commenting on the rule proposal noted the ambiguities in defining what would constitute an "actionable IOI" or, using our terminology, what would constitute a "displayed" order notification. This is less of a concern for us; our primary concern is that for block orders, each institutional trader should have the right to decide how to display or not display those orders.⁸¹

Comment letters on the Commission's proposed block exemption

We were pleased to see that most industry participants commenting on the proposal, including the Alliance of Floor Brokers, Bank of America, BIDS Trading, Bloomberg, Fidelity Investments, the Investment Company Institute, Investment Technology Group, NYSE Euronext, Pipeline Trading,

⁸¹ We understand the logic in the Commission's approach of moving from a volume threshold focus to an order-size focus. From a policy perspective, we do not believe there is sufficient data to support the Commission's proposal to restrict the use of order notifications, whether block or non-block. From a business perspective, our only concern is that institutions have sufficient flexibility to execute block orders efficiently.

the Securities Industry and Financial Markets Association, the Security Traders Association, the Security Traders Association of New York, and the Teacher Retirement System of Texas, expressly supported the Commission's proposal for a block exemption from the proposed restriction on so-called "actionable IOIs".⁸²

While not expressly addressing the Commission's proposal for a block exemption, the National Investor Relations Institute, the largest professional investor relations association in the world representing 2,000 publicly held companies,⁸³ wrote in support of the rationale for such an exemption,

"In today's market structure, dark pools provide an important function for investors by allowing large block trading with efficiency and anonymity. NIRI urges the SEC to proceed with a thorough understanding of dark pools' price discovery role. If, for example, the proposed changes result in advantages to short term traders at the expense of long term investors, this does not foster fair, free markets for all participants in keeping with the SEC's mission and investor protection role. We appreciate the SEC's focus on large block orders by considering appropriate exceptions to facilitate execution of these large block orders. We also recommend the SEC continue to provide sufficient market flexibility to enable efficient execution of these types of orders."⁸⁴

Comment letters on defining a block

⁸² See the following letters commenting on the Commission's rule proposal on "Regulation of Non-Public Trading Interest", available at <http://sec.gov/comments/s7-27-09/s72709.shtml> (accessed March 22, 2010): Letter from Patrick D. Armstrong, Co-President, Alliance of Floor Brokers, January 29, 2010, ("AFB Letter"); Letter from Gegory A. Baer, Deputy General Counsel, Corporate Law, Bank of America, February 22, 2010 ("Bank of America Letter"); Letter from Vivian A. Maese, Esq., General Counsel and Corporate Secretary, BIDS Trading, LP, February 18, 2010 ("BIDS Trading Letter"); Letter from Scott C. Goebel, Senior Vice President, General Counsel, FMR Co., Fidelity Investments, February 23, 2010 ("Fidelity Investments Letter"); ICI Letter; Letter from P. Mats Goebels, Managing Director and General Counsel, Investment Technology Group, Inc., February 22, 2010, ("ITG Letter"); Letter from Janet M. Kissane, Senior Vice President – Legal & Corporate Secretary Office of the General Counsel, NYSE Euronext, February 22, 2010 ("NYSE Euronext Letter"); Letter from Richard L. West, General Counsel, Pipeline Trading Systems LLC, February 22, 2010, ("Pipeline Trading Letter"); Letter from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, February 18, 2010 ("SIFMA Letter"); Letter from Brett F. Mock, Chairman and John C. Giesea, President & CEO, Security Traders Association, February 22, 2010 ("STA Letter"); Letter from Kimberly Unger, Esq., Executive Director, Security Traders Association of New York, Inc., February 17, 2010 ("STANY Letter"); and TRS Letter. Of the minority of market participants who opposed the Commission's proposal for a block exemption, all of them were firms that represent short-term trading interest.

⁸³ <http://www.niri.org/FunctionalMenu/About.aspx> (accessed March 22, 2010).

⁸⁴ Letter from Jeffrey D. Morgan, CAE, President and CEO, National Investor Relations Institute, February 16, 2010, commenting on the Commission's rule proposal on "Regulation of Non-Public Trading Interest", <http://sec.gov/comments/s7-27-09/s72709-42.pdf> (accessed March 22, 2010).

We also were pleased that many commenting parties, including the Alliance of Floor Brokers, Bank of America, BIDS Trading, Bloomberg, Fidelity Investments, the Investment Company Institute, Investment Technology Group, Pipeline Trading, the Securities Industry and Financial Markets Association, the Security Traders Association, the Securities Traders Association of New York, and the Teacher Retirement System of Texas, proposed modifications to the Commission's proposed definition of a "block order" to provide greater flexibility for institutions in executing large orders for small and mid-cap stocks.⁸⁵ We continue to support the proposal in our December comment letter to define a block as an order with a principal value of \$200,000, an order for 10,000 shares or more or an order that represents 1% or more of a stock's average daily trading volume, subject to providing flexibility to the Commission to set the block threshold at \$200,000 for the most actively traded stocks in the market. We believe that a number of other commenting parties made sensible recommendations on this issue and we would support alternative proposals that provide similar flexibility for execution of institutional orders for less-liquid stocks.

Academic study on "Equity Trading in the 21st Century"

We also were pleased that James Angel, Lawrence Harris and Chester Spatt, three distinguished finance and business professors,⁸⁶ recently issued a report on "Equity Trading in the 21st Century".⁸⁷

This report steps back from the hype and misinformation currently surrounding many equity market structure issues and provides the most thoughtful and comprehensive analysis of market structure regulation issues that we have seen for a very long time. With respect to indications of interest, the authors write:

"Traders sometimes can attract contra-side interest by showing that a trading opportunity is available. Traders thus have an interest in displaying their orders because such displays may attract other orders. However, as noted above, order display can often lead to front-running and quote-matching problems.

An IOI represents a middle strategy in the search for liquidity between displaying an order and hiding an order. Since IOIs are not firm, traders

⁸⁵ See AFB Letter, Bank of America Letter, BIDS Trading Letter, Fidelity Investments Letter, ICI Letter, ITG Letter, Pipeline Trading Letter, SIFMA Letter, STA Letter, STANY Letter and TRS Letter.

⁸⁶ Mr. Angel, Associate Professor at the McDonough School of Business, Georgetown University, specializes in the structure and regulation of financial markets globally and has visited over 50 financial exchanges. Mr. Harris, Professor of Finance at the Marshall School of Business, University of Southern California, served as the Chief Economist of the Commission from July 2002 through June 2004. Mr. Spatt, Professor of Finance at the Tepper School of Business, Carnegie Mellon University, served as Chief Economist of the Commission and Director of its Office of Economic Analysis from July 2004 through July 2007.

⁸⁷ James J. Angel, Lawrence E. Harris, Chester S. Spatt, "Equity Trading in the 21st Century", February 23, 2010. ("Angel, Harris and Spatt")

who might try to exploit the information in them may find that the order is not available to them.

IOIs are most valuable when they are displayed by traders widely recognized to be reliable, and when they are received only by traders who will not engage in exploitive trading strategies. When an IOI truly represents a real opportunity to trade, and when the recipient can be trusted not to exploit the information, both traders have an interest in ensuring that they can act upon the IOI at minimum cost to produce a trade.

To this end, many dark pools have systems for disseminating actionable IOIs to trustworthy entities. These actionable IOIs inform the entity that a trade is possible. For example, a retail broker may receive an IOI from a dark pool. If the broker has an order that would help fill the interest, the broker then could route to the dark pool and obtain a better execution at lower cost for its client.

Without actionable IOIs, the broker would have to use an IOC order to probe the dark pool for liquidity when looking to fill an order. Since such probes usually produce fruitless results and thereby waste time while in flight, brokers may choose not to probe the dark pool when trying to fill their orders. Alternatively, they may only probe the pool late in their sweep sequences so that they can probe first other trading venues that generally produce better results.”⁸⁸

In a recent report, TowerGroup reached similar conclusions to those reached by Professors Angel, Harris and Spatt in their report:

“TowerGroup believes the regulators should allow competitive market forces to determine if market participants want to interact with ATSS that send actionable IOIs rather than imposing an artificially low limit that potentially reduces the choices institutional investors have in seeking liquidity.”⁸⁹

Block order notifications communicated to non-block contras

We would like to focus on one specific issue relating to the Commission’s proposed block exemption - the Commission’s proposal to condition the proposed block exemption on “the IOI

⁸⁸ Angel, Harris and Spatt, pp. 36-37.

⁸⁹ Dushyant Shahrawat, CFA, William Butterfield and Stephen Bruel, TowerGroup, “The Changing Electronic Trading Landscape: Assessing the Drivers for 2010 and Beyond”, January 18, 2010, p. 4. (“TowerGroup”)

being communicated only to those who are reasonably believed to represent current contra-side trading interest of at least \$200,000.”

There are several approaches the Commission could take in drafting this provision. A broader approach would be to set the exemption based on the institution’s total order size since that is the order we are seeking to protect,⁹⁰ or based on the size of the order committed by the institution to the broker. A narrower approach would be the one proposed by the Commission in the rule proposal on non-public trading interest. We would support a compromise where the exemption is based on the size of the order notification communicated by the ATS, but without requiring as a condition that the contra be reasonably believed to represent current contra-side trading interest of at least block size. We note that this should not require the sending ATS to communicate block size, as this could be disadvantageous to the sender, but rather it should require that the order at the ATS underlying the order notification be executed for block size if a block size order is received in response to the order notification. In other words, the ATS is committed to a block execution if a block sized order is received in response to the order notification.

Our proposed modification to the proposed block order exemption

The Commission’s proposed block exemption with our proposed modification would provide six specific benefits for investors:

- Reduced market impact costs for institutions
- Price improvement for the institution
- Price improvement for the contra-party, including retail orders
- Interaction of institutional and other liquidity
- Reduced message traffic and latency
- Clear and verifiable standard.

These six benefits are discussed in more detail below. While providing these six specific benefits, the proposed modification to the Commission’s proposed block order exemption would not

⁹⁰ For example, the American Bar Association writes in its comment letter on the rule proposal: “Some members of the drafting committee have suggested that there may be similar reasons for including ‘child’ orders of ‘size-discovery’ orders in the ‘size-discovery’ exception. They note that institutional clients often split their orders into smaller ‘child’ orders to avoid information leakage and to improve the quality of their executions, which are the same considerations that led the Commission to propose excluding ‘size-discovery’ orders from the display requirement in the first place.” Letter from Jeffrey W. Rubin, Chair of the Committee of Federal Regulation of Securities, American Bar Association, February 25, 2010, commenting on the Commission’s rule proposal on “Regulation of Non-Public Trading Interest”, <http://sec.gov/comments/s7-27-09/s72709-42.pdf> (accessed March 22, 2010), p. 3.

impact the stated intent of the Commission's proposed rule as all non-block order notifications would not be covered by the exemption.⁹¹

Block order notifications – benefits of having a clear and verifiable standard

As noted by BIDS Trading, L.P. in its comment letter to the Commission, the Commission's proposed approach involves a certain level of ambiguity in determining when a "reasonable belief" exists.⁹² This could result in certain market participants taking a more aggressive interpretation than other market participants. It also could require the Commission to provide future ongoing interpretive guidance regarding compliance with this condition without being able to provide definitive guidance. It also could present challenges for regulators and firms in setting standards and monitoring for compliance. We believe a more straightforward approach, and one that would still achieve the purposes of the proposed block exemption without impacting the purposes of the Commission's rule proposal, would be to set the exemption based on the size of the order notification. This would be a standard that is clearly defined, and compliance or non-compliance with the condition for the exemption would be readily verifiable by internal compliance personnel and by regulatory personnel conducting an audit.

Price improvement benefits of block order notifications

As noted in our December comment letter, we would be agreeable to an additional condition for a block exemption that any execution resulting from the sending of a block IOI be executed with significant price improvement for both sides to the trade, defined as a mid-point execution (where the quoted spread is one cent) or minimum price improvement of one cent (where the quoted spread is two cents or greater).

With or without this additional condition, our Liquidnet H2O system will continue to execute all orders with significant price improvement for both sides to the trade, regardless of whether the order represents institutional, retail or dealer liquidity.

Allowing sufficient flexibility for the block exemption, as we have proposed, will be beneficial for retail investors because it will provide them greater opportunities for price improvement. In support of this point, we first review data on price improvement provided by Liquidnet H2O; we then discuss how the Commission's proposed block exemption with our proposed modification would make it easier for retail order flow to achieve this price improvement in different systems, including Liquidnet H2O.

⁹¹ From a policy perspective, we do not believe that additional restrictions of order notifications are necessary at this time, either for block or non-block order notifications. From a business perspective, since we only use order notifications to facilitate efficient execution of large institutional orders, our only concern is that the Commission provide sufficient flexibility for institutions through our requested modification to the Commission's proposed block exemption.

⁹² BIDS Trading Letter, p. 2.

If we look at Liquidnet's Rule 605 data for 2009 as compiled by Thomson Transaction Analytics Reports, we see that for orders transmitted by Liquidnet H2O participants and executed by Liquidnet H2O, Liquidnet provided average price improvement of 1.26 cents per share, or 91% of the quoted spread.⁹³ This price improvement of 91% is in contrast to the industry as a whole which, according to the same Rule 605 data compiled by Thomson Transaction Analytics Reports, provided slightly negative price improvement (close to 0%).⁹⁴

The order notifications that our H2O system sends out make it easier for other liquidity in the market to interact with our institutional block liquidity. Let's assume that for every 20 orders received by a retail broker⁹⁵ Liquidnet H2O has one matching block order in its system. Instead of the retail broker sending 20 immediate-or-cancel orders (IOC's) to Liquidnet H2O, Liquidnet H2O can send one order notification to the retail broker's smart order router. This reduces latency and message traffic and allows for direct and mutually beneficial interaction between two sources of long-term trading interest, when this interaction might not be available absent the availability of these order notifications.⁹⁶

Benefits of reduced latency and reduced message traffic

Professors Angel, Harris and Spatt highlight the benefits that IOIs can provide with respect to reduced latency and reduced message traffic:

" To this end, many dark pools have systems for disseminating actionable IOIs to trustworthy entities. These actionable IOIs inform the entity that a trade is possible. For example, a retail broker may receive an IOI from a dark pool. If the broker has an order that would help fill the interest, the broker then could route to the dark pool and obtain a better execution at lower cost for its client.

⁹³ Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares. The average quoted spread in the market during this period, as compiled by Thomson Transaction Analytics Reports from Rule 605 data, was 1.39 cents. Liquidnet H2O's average effective spread during the period was .13 cents. The difference between the average quoted spread of 1.39 cents and Liquidnet's average effective spread of .13 cents (1.26 cents) represents the price improvement provided by Liquidnet. Liquidnet's price improvement (1.26 cents) relative to the average quoted spread (1.39 cents) represents Liquidnet's price improvement percentage (91%).

⁹⁴ Rule 605 data compiled by Thomson Transaction Analytics Reports, January to October 2009. Data is for market and marketable limit orders between 100 and 499 shares. The average quoted spread in the market during this period, as compiled by Thomson Transaction Analytics Reports from Rule 605 data, was 1.39 cents. The average effective spread for the industry during the period was 1.40 cents. The difference between the average quoted spread of 1.39 cents and average effective spread of 1.40 cents (-.01 cents) represents the negative price improvement provided by the industry (-1%). Negative price improvement results when the average effective spread exceeds the average quoted spread.

⁹⁵ This could be a retail broker or a broker or trading venue, such as DirectEdge, to which the retail broker outsources some portion of its routing function.

⁹⁶ See, also, Angel, Harris and Spatt, p. 37.

Without actionable IOIs, the broker would have to use an IOC order to probe the dark pool for liquidity when looking to fill an order. Since such probes usually produce fruitless results and thereby waste time while in flight, brokers may choose not to probe the dark pool when trying to fill their orders. Alternatively, they may only probe the pool late in their sweep sequences so that they can probe first other trading venues that generally produce better results.”

Senator Edward Kaufman recently identified potential concerns arising from the growth in message traffic in the equity markets.⁹⁷ Our primary goal in designing our H2O system was to facilitate interaction between institutional and other liquidity by reducing message traffic and latency, while at the same time protecting the confidentiality of our customers’ block order information from certain intermediaries who could take advantage of that information to the detriment of our customers. Competitive solutions that seek to facilitate cost-efficient interaction of investor order flow with reduced message traffic should be supported and not restricted by regulation.

⁹⁷ Release by Office of Senator Edward E. Kaufman, “Kaufman Cites Rising Concern over High Frequency Trading among Regulatory Agencies, Market Participants”, March 3, 2010.

Annex F

Proposals to help long-term investors

In Annex D of our December comment letter we identified five sets of proposals to help address the challenges faced by individual investors in the current market environment. We discuss each of them in this section. Please refer to Annex D of our December comment letter for more detail.⁹⁸

Mandate disclosure of specific order routing practices by institutional brokers

TABB Group reports that institutional traders,

“... would like a better understanding of how their orders are handled. Without more empirical data on how orders are handled, it is very difficult for them to make intelligent decisions regarding with whom to trade and how to trade.”⁹⁹

TowerGroup makes the same point in a recent report on the changing electronic landscape:

“The buy-side trade desk must have a strong knowledge of the operating and business models of the various execution venues and the way algorithms work with dark pools, exchanges and ECNs. A lack of understanding of which types of participants (other buy-side firms, hedge funds, or high-frequency-trading firms) dominate which trading venues, for example, could limit a buy-side desk’s ability to trade effectively and cause it to risk being picked off by other market participants.”¹⁰⁰

Consistent with the points raised by these industry experts, we support a regulation mandating disclosure by institutional brokers (including institutional ATs) to their customers of specific order handling practices.

Some specific items of disclosure might include:

- Description of the broker’s order handling process, including:
 - Identification of external venues to which the broker routes orders
 - Process for crossing orders with other orders received by the broker
 - Execution of orders as agent and principal
 - Use of IOIs, pinging and other messages
- Detailed description of the operation and function of each ATS or trading desk operated by the broker

⁹⁸ Liquidnet Letter, Annex D.

⁹⁹ TABB Group, p. 25.

¹⁰⁰ TowerGroup, p. 6.

- Percentage of executed shares executed at each external venue
- Percentage of executed shares executed internally, including:
 - Percentage executed as principal and agent
 - For agency executions, percentage of shares executed by each specific trading desk or ATS operated by the broker
 - For principal executions, percentage of shares executed by each specific trading desk operated by the broker
- Clear and detailed description of each algorithm and order type offered by the broker
- Categories of participant and admission criteria for each ATS or trading desk with which the customer’s order can interact
- Detailed disclosure of any dissemination of the institution’s order and trade information.
- Internal processes and policies to control dissemination of the institution’s order and trade information and other confidential information.
- Ownership and other affiliations between the broker and any venues to which the broker routes orders.

These are just suggested disclosure items, and we would recommend that regulators consult with buy-side institutions to determine the specific types of disclosures that would be appropriate and helpful for safely sourcing liquidity. It would be worthwhile to consider whether the disclosure mandates need to be as specific as we have proposed or whether it might be more appropriate to have more high-level guidance from the regulators on subject areas where disclosure would be appropriate and possibly guidance from the regulators regarding best practices.

Improve execution disclosure for retail brokerage customers

As noted in our December comment letter, enhanced disclosure of price improvement and speed of execution data could potentially benefit retail brokerage customers. We can think of two methods for providing this disclosure: Rule 10b-10, which provides disclosure for individual executions; and Rule 606, which provides aggregated disclosure for individual brokers on a quarterly basis.

For Rule 10b-10, the Commission could consider whether it would be helpful for retail customers to include the following information on customer confirmations:

- Time of order receipt
- Time of order execution
- Best posted bid and offer in the market at the time of order receipt
- Execution price
- Price improvement amount
- Price improvement percentage
- Net cost per share.

Price improvement amount would be the difference between the execution price and the highest posted bid (in the case of a sell order) or the lowest posted offer (in the case of a buy order) at the time of order receipt. Price improvement amount could be positive, zero or negative. Price improvement percentage would be the price improvement amount as a percentage of the difference between the best bid (or offer, as applicable) at the time of order receipt and the mid-point between the NBBO at the time of order receipt. Net cost per share would be the commission per share less any price improvement per share (or plus any negative price improvement per share).

As noted in the preceding section, these are suggested disclosure items, and it is not clear whether these or other disclosure items would be most appropriate. A number of issues would need to be considered in connection with this proposal. For example, this disclosure might be most appropriate for market orders but other types of disclosure might be more appropriate for limit orders. The costs for reporting this data also must be considered and evaluated relative to the benefits that this disclosure could provide to investors.

In contrast to Rule 10b-10, which mandates disclosure on a trade-by-trade basis, Rule 606 requires routing brokers to provide details regarding routing practices on a quarterly basis. At present, the 606 report does not provide data on execution quality. The Commission should consider whether it would be worthwhile to modify the requirements for Rule 606 reports to include data on execution quality for orders received and handled by the routing broker – in particular, data regarding execution time and price improvement.

Mandate immediate reporting of all electronic executions

As noted in our December comment letter, we would support a rule requiring immediate reporting of all electronic executions.¹⁰¹ We understand that some time period, whether 30 or 90 seconds, is required for input of trades executed manually. For these manual trades, once the trade has been input into the reporting system within the applicable time period, the trade should be immediately transmitted to the tape.

Consistent with our recommendations in the preceding paragraph, we also would support a tag to publicly identify manually reported trades. With this tag market participants would know which trades are being reported in real-time and which trades are being reported on a delayed basis. If these recommendations were implemented, market participants would have a real-time view of executions in the market.

Consolidate market surveillance

¹⁰¹ Our proposal relates to immediate public reporting of all execution prices. As noted in our December comment letter, we support public identification of the ATS that executes a trade on an end-of-day or other delayed basis. We would defer to the views of buy-side institutions regarding the appropriate delay period.

As discussed in detail in our December comment letter, we would recommend continuing to take advantage of the current infrastructure for market surveillance at the various exchanges while consolidating ultimate supervisory responsibility for this infrastructure under FINRA.

There are at least three benefits that would result from consolidating market surveillance. Most importantly, consolidating market surveillance will eliminate information gaps and coordination problems.

As Senator Charles Schumer noted at a Senate subcommittee hearing on market structure:

“... the proliferation of alternative trading venues has significantly altered the trading landscape. Many of these changes have been largely for the better. The competition provided by alternative trading systems brought significant benefits to retail investors and that’s been discussed by many of our witnesses. But these benefits have come at a cost, because our capital markets have become increasingly fragmented and market surveillance has not kept pace, making it increasingly difficult – especially in light of the technological developments that facilitate large volumes trading at high speeds – to conduct adequate market surveillance across the markets.

....

So I proposed to the SEC that market surveillance should be consolidated across all trading venues to eliminate the information gaps and coordination problems that make surveillance across all markets today.”¹⁰²

Richard Ketchum, Chairman and CEO of FINRA, notes similarly:

“The decline of the primary market concept, where there was a single price discovery market whose on-site regulator saw 90-plus percent of the trading activity, has obviously become a reality. In its place are now two or three or maybe four regulators, all looking at an incomplete picture of the market and knowing full well that this fractured approach does not work. This is especially true given how easy it is for market participants to move volume on a second-by-second basis between venues.

....

Today, there are multiple regulators attempting to respond in a timely way to market changes, using scarce resources to try to simultaneously develop similar systems and processes. A stronger, single regulator would be

¹⁰² Senate Subcommittee Hearing Transcript, p. 25-26.

equipped to meet market surveillance more effectively, and with less expense, than multiple regulators.”¹⁰³

We also support consolidation of market surveillance because it will remove the potential conflicts that can result when a for-profit market operator is responsible for regulating its own market. As noted by the Commission:

“SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from self-regulation. For instance, shareholder-owned SROs may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable.”¹⁰⁴

The legislative history prior to passage of the Securities Acts Amendments of 1975 reflects a similarly skeptical view of self-regulation by Congress:

“The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a façade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.”¹⁰⁵

Finally, we support consolidation of market surveillance because we believe that the cost for market surveillance should be shared equitably among market participants.

Based on these considerations, we recommend that market surveillance functions be transferred from the individual exchanges to a self-regulatory entity such as FINRA that is not affiliated with a for-profit entity and can consolidate the market surveillance function. This consolidation can occur while leaving in place the current exchange-based infrastructure for market surveillance by consolidating ultimate supervisory responsibility for this infrastructure under FINRA.

¹⁰³ Richard Ketchum, Chairman and CEO, FINRA, speech at the SIFMA Annual Meeting, New York, NY, October 27, 2009, p. 5.

¹⁰⁴ Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004), <http://sec.gov/rules/concept/34-50700.htm> (accessed March 22, 2010), p. 34.

¹⁰⁵ Securities Industry Study, Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs, S. Doc. No. 93-13, 93rd Congress, 1st Session 137-204 (1973).

We note that in Canada, market surveillance functions previously performed by the Toronto Stock Exchange are now performed by the Investment Industry Regulatory Organization of Canada (IIROC), an entity that otherwise performs similar functions to FINRA in the United States.¹⁰⁶ In Australia, the Parliament recently passed a bill to transfer responsibility for market supervision from the Australian Stock Exchange, which is currently the sole marketplace for executing Australian securities, to the Australian Securities and Investments Commission (ASIC), an entity that performs similar functions to the Commission and FINRA in the United States. The transfer of supervision to ASIC will come into effect in the third quarter of 2010, removing the obligation on Australian market licensees to supervise their markets and providing ASIC with the function of supervising domestic Australian market licensees.¹⁰⁷

* * * * *

If the regulators proceed with consolidation of market surveillance, the concept of an exchange as a “self-regulatory organization” (or SRO) should be reconsidered.

We would identify at least six features of an exchange:

- An important feature of an exchange is that it provides facilities for crossing of participant orders. In this aspect an exchange is similar to an ATS. It also is similar to a block trading desk or any other broker that crosses customer orders.
- A second feature of an exchange is that it provides a facility for market makers to display quotes and for market participants to execute against those quotes. In this feature it is similar to an “electronic communications network” (or ECN).
- A third feature of an exchange is the ability to make available and sell a data feed for its quotes. This feature follows from the second feature and also would apply to ECNs.
- A fourth feature of an exchange is the ability to share in consolidated tape revenues.¹⁰⁸

¹⁰⁶ Pursuant to Section 7.1(2) of National Instrument 23-101, a recognized exchange in Canada can monitor the conduct of its members and enforce the requirements governing the conduct of its members either directly or indirectly through a regulation services provider. http://www.osc.gov.on.ca/documents/en/Securities-Category2/rule_20080905_21-101_unofficial-consolidated.pdf (accessed March 22, 2010).

The Toronto Stock Exchange has chosen to engage IIROC as its regulation services provider. Ontario and most other provinces in Canada have adopted National Instrument 23-101.

¹⁰⁷ Parliament of Australia, “Corporations Amendment (Financial Market Supervision) Bill 2010”, <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=ld:legislation/billhome/R4302> (accessed March 22, 2010).

¹⁰⁸ See CTA Plan: Second Restatement of Plan Submitted to the Securities and Exchange Commission Pursuant to Rule 11Aa3-1 Under the Securities Exchange Act of 1934, http://www.nyxdata.com/nyxedata/CTA/tabid/227/DMXModule/1515/EntryId/29533/Command/Core_Download/Default.aspx (accessed March 22, 2010).

- A fifth feature of an exchange is the ability to list securities on its market.
- A sixth feature of an exchange is its SRO status and its associated market surveillance obligations.

The appropriate level of exchange regulation must be considered in light of these features. To the extent that an exchange conducts the equivalent business function as a broker or an ATS, regulators should ensure that levels of regulation are consistent. Of course, the regulators should not impose unnecessary burdens on ATSS and brokers, but rather should remove unnecessary regulatory burdens from exchanges, to the extent that they exist.

When we refer to “regulatory burdens” we do not mean rules designed to prevent market manipulation, insider trading and similar fraudulent conduct. These types of rules are essential for investor protection. We instead refer to regulatory burdens that inhibit or delay the introduction of new products or functionality by exchanges notwithstanding that the products or functionality comply with all legal and regulatory requirements.

* * * * *

Despite Congressional reservations about self-regulation by exchanges, the Securities Acts Amendments of 1975 did not consolidate the market surveillance function of exchanges and instead added new requirements for Commission approval of changes to certain exchange rules.¹⁰⁹

If market surveillance functions are centralized with FINRA, as we suggest, we should consider whether exchanges would need to continue as self-regulatory organizations and whether Section 19(b) of the Exchange Act, which requires exchanges to obtain written approval from the Commission for certain rule changes, would still be necessary.¹¹⁰

Our understanding of the Section 19(b) approval process as applied to exchanges is that it can be a cumbersome and bureaucratic process. It also appears that the significant volume of Section 19(b) filings requires significant Commission resources that could be reallocated towards other projects that are more directly related to investor protection.

We believe the Commission should receive notice of all rule changes by exchanges, but we question the value of having such a formal process as currently provided under Section 19(b). It would seem to us that the Commission could still review all rule changes and, if the rule changes do not comply with the applicable regulatory requirements, the Commission could demand that the exchange cease the activity and also take other remedial action, where appropriate. Effective

¹⁰⁹ 15 U.S.C. § 78s(b).

¹¹⁰ We refer only to an exchange’s SRO status relating to its trading function. We do not consider an exchange’s SRO status relating to its listing function.

Commission review of rule changes by exchanges could take place without a formal Section 19(b)-type process.

* * * * *

If market surveillance is consolidated, allocation of costs for consolidated market surveillance is an important issue that would need to be addressed. One way to allocate costs equitably is to consider the regulatory risk presented by different types of trading activity and to allocate costs on that basis. This would be similar to how an insurance company might determine fees for issuing a life insurance policy, with a higher premium for higher risk policy owners. For example, as an agency-only firm with a primary focus on the largest buy-side institutions, we believe that our business model presents a relatively lower level of regulatory and control risk when compared to the business models of other market participants.

An alternative, and probably more practical, approach would be to allocate costs across the industry so that fees for market surveillance would be included within the general fees charged by FINRA. It is typically not markets themselves that present the risk of improper trading activity but rather the participants on the market or third-parties who interact with the market through such participants, and fees for market surveillance should be allocated accordingly. If exchanges are no longer regulated as SRO's, they could become members of FINRA and share the cost of market surveillance with other market participants through such membership.

Clearly, the proposals in this section are not simple and implicate various provisions of the securities laws. Yet the issue of effective market surveillance is paramount, and it is important to consider potential solutions to address the current issues surrounding market surveillance.

Changes to Regulation ATS

In our December comment letter we proposed the following changes to Regulation ATS, which we continue to support:

- Amend Regulation ATS to permit the Commission to delay the effective date of a new ATS commencing operation or of an existing ATS implementing a material business change if the Commission believes that information in the ATS filing is unclear or incomplete or raises an issue of potential non-compliance with applicable law or regulation.
- Make registration of ATS's with the Commission transparent to the public.
- Apply the capacity, integrity and security obligations of Regulation ATS to all ATS's, not just to ATS's that exceed the specific volume thresholds.

Annex G

Other issues raised in the Concept Release

High-frequency trading strategies

In the Concept Release, the Commission discusses the various strategies used by high-frequency trading firms, including passive market making, arbitrage, structural and directional strategies. The Commission identifies two categories of directional strategies - order anticipation strategies; and momentum ignition strategies.

The Commission writes as follows regarding order anticipation strategies:

“Order anticipation is not a new strategy. Indeed, a 2003 treatise on market structure described order anticipation as follows: ‘Order anticipators are parasitic traders. They profit only when they can prey on other traders. They do not make prices more informative, and they do not make markets more liquid... Large traders are especially vulnerable to order anticipators.’”¹¹¹

Order anticipation strategies, though they seek to detect and take advantage of large orders of institutional investors, are legitimate and perfectly legal strategies. This is subject, of course, to the caveat noted by the Commission that the party implementing the strategy does not have a fiduciary or other agency-type relationship with the institution whose order is being anticipated that would restrict this activity. While order momentum strategies are legitimate and legal strategies, we caution against regulatory restrictions imposed on long-term investors that impede their ability to protect their order information from short-term traders using order anticipation strategies.

Momentum ignition strategies, on the other hand, are problematic. In the terms described by the Commission,¹¹² we would not consider momentum ignition strategies to be legitimate or legal trading strategies. We are not suggesting that short-term traders engage in these types of strategies. We are instead suggesting that if they did engage in these types of strategies it would be problematic.

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More generally, consolidation of market surveillance is an important element in addressing trading activity that could be considered manipulative. To detect market manipulation, regulators must consider all trading activity by a firm and a partial view of the market often is not sufficient.

¹¹¹ Concept Release, p. 55, citing Larry Harris, *Trading and Exchanges: Market Microstructure for Practitioners* (2003), p. 251.

¹¹² Concept Release, pp. 56-57.

A related concern would be the use by a market participant of multiple asset classes to implement a manipulative trading strategy. Commissioner Luis Aguilar in the past has expressed his concern regarding the Commission's limited jurisdiction over certain derivative instruments. For example, at a recent open meeting of the Commission, Commissioner Aguilar noted that "the Commission's oversight of the capital markets is severely undermined by gaping holes in our authority over swaps."¹¹³ This limitation presents a challenge for the Commission in addressing manipulative activity involving multiple asset classes and could only be addressed through appropriate legislation.¹¹⁴

Co-location

The Commission asks for comment on whether co-location services create unfair access to trading. We believe the issue of co-location is best addressed by competition as markets compete to provide the lowest latency access to the greatest number of customers. Aite Group, a firm that provides strategic advice on IT, business and regulatory issues in the financial services industry, discussed co-location in a report that it issued last year:

"Colocation provides users with the lowest possible latency to particular execution venues, as well as a certain level of resiliency from occupying the same physical location as the execution venue, thereby eliminating potential failure points such as various external connectivity and networks."¹¹⁵

In terms of unfairness, there is an element of unfairness in rules that require long-term investors to participate in markets where short-term trading predominates. As an analogy, it would be similar to a requirement that an athlete run in a 100-meter race when the athlete could have a greater chance of success in a one-mile run. From our perspective, this comes down to the choice of the institutional trader – when the institutional trader wants to interact with the market that emphasizes short-term trading, he should have that choice; when the institutional trader believes there is a more efficient alternative for executing a block order, he also should have that choice.

Internalization

¹¹³ "Speech by Commissioner Luis A. Aguilar at Securities Exchange Commission Open Meeting", February 24, 2010, <http://www.sec.gov/news/speech/2010/spch022410laa-shortsales.htm> (accessed March 22, 2010).

¹¹⁴ A recent bill introduced by Senator Christopher Dodd seeks to address this issue to some degree. See "Restoring American Financial Stability Act of 2010, Title VII – Improvements to Regulation of Over-the-Counter Derivatives Markets", http://banking.senate.gov/public/files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf (accessed March 22, 2010).

¹¹⁵ Sang Lee, Aite Group, "New World Order: The High Frequency Trading Community and Its Impact on Market Structure", February 2009, p. 15.

The Commission asks whether 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.”¹¹⁶

We do not support a trade-at rule for the same reasons that we do not support an order protection rule without an opt-out right. Trade-at is sometimes discussed with respect to internalization by market makers and other principal trading firms (dealer internalization). We do not favor trade-at or other restrictions on dealer internalization, but we want to point out the inconsistency of commenters who support dealer internalization but oppose so-called IOIs (which we refer to as order notifications).

Let’s assume that the NBBO in a stock is \$10.00-\$10.04 and a market buy order is routed to a dealer. The dealer has the opportunity to execute the market buy order at \$10.04. The internalizing dealer might or might not be a market maker in the stock and might or might not have a posted quote in that stock that is the best displayed offer in the market. The internalizing dealer is able to execute that order for \$10.04, and no one else in the market has the opportunity to view or execute against that order. We do not see a difference between this activity and an ATS sending out order notifications. For that matter, we do not see a difference between an ATS sending our order notifications and two or more traders negotiating a trade on the floor of the NYSE or a block trading desk facilitating a negotiation between two or more institutional customers.

A number of market participants commenting on the rule proposal on non-public trading interest raised the issue of an ATS disclosing ATS order information in real-time to smart order routers used by the broker that operates the ATS. These commenters expressed the view that this activity should be permitted under Regulation ATS. While we do not engage in this activity, we presume that this activity would be permitted under Regulation ATS because the order is only communicated to one recipient. That recipient is the broker that operates the ATS. But ironically, this broker could be communicating the order information to internal order routers handling dozens of customer orders in the stock and order routers being used by multiple internal proprietary trading desks. This would be permitted because the order is only being communicated to “one” recipient (the broker) even though multiple customer and proprietary smart order routers can benefit from this information. Yet a similar order notification communicated by an ATS to two brokers, each of whom might only have one contra order in that stock, would be prohibited.

Certain industry participants have argued that notifications to internal order routers do not present the same level of regulatory concern as notifications to third parties. We could not disagree more. Both types of notifications have advantages, including reduced message traffic, reduced latency and the ability to execute block orders (either in one or multiple executions)

¹¹⁶ Concept Release, pp. 70-71.

while limiting disclosure of block order information. Both type of notifications also present certain risks. For example, a broker could program its smart order router algorithms to take advantage of order notifications sent from an ATS that the broker operates. It is a mistake to argue that one type of order notification is good and should be permitted, while the other type of order notification is bad and should be outlawed. Instead, we should let the customer make that decision, and we should ensure that the customer has the necessary information to make an informed decision.

Clearly, lines have to be drawn somewhere, and we could accept a restriction on order notifications sent to multiple parties if a sufficiently flexible block exemption is provided. However, it is very important to understand conceptually that the order notifications sent by an ATS are no different than the communication of a customer order to an internalizing dealer, communication of orders by floor brokers to other floor brokers, communication of customer orders by a block trading desk to other customers of the desk and communication of ATS orders by a broker operating an ATS to smart order routers operated by the broker.

Internalization and sub-penny trading

Several comment letters submitted to date in response to the Concept Release have expressed concern about sub-penny trading in dark pools, specifically trading in small increments (for example, 1/100th of one cent) above the best posted bid or below the best posted offer.

We note that our negotiation and H2O systems only execute orders in whole-penny increments or at the mid-point between the highest displayed bid and lowest displayed offer in the market at the time of execution. We do not execute trades at small increments from the NBBO. In fact, our understanding is that this activity would be contrary to the provisions of Regulation NMS.¹¹⁷

We believe that at least some of this activity can be explained as dealer internalization. For example, the market is \$10.00-\$10.04, and a dealer buys from a customer at \$10.0001. This has nothing to do with dark pools. It instead has to do with a dealer's option to match or beat any posted bid or offer when internalizing a trade with a customer. As discussed above, we do not support restrictions on this activity, but we note that dealer internalization is similar to the IOIs that many dealers criticize, as most clearly illustrated by the discussion above on smart order routers. As discussed in Annex F, we support improved disclosure as a means to address potential concerns raised by dealer internalization.

High-frequency trading and "hidden orders"; is there such thing as a hidden block order?

One interesting question to consider in light of the increasing sophistication of high-frequency trading is whether there is such a thing as an "undisplayed" or "hidden" order type for an

¹¹⁷ Rule 612 of Regulation NMS. 17 CFR 242.612.

institutional block order. If high-frequency traders can use pinging and other tactics to discover hidden liquidity on exchange, ECN and dark pool order books, can an institution really have a “fully dark” block order in these markets? What is sometimes considered a “hidden” block order is, in many cases, a block order that can be detected by short-term traders but not by other market participants.

In fact, an institution might preserve greater confidentiality for its block order in an agency-only dark pool that sends notifications to a limited number of trusted counter-parties relative to a hidden order on an exchange, ECN or dark pool that is accessible to all short-term traders. As noted by ITG in a recent research report on execution quality in dark pools, “once a trader exposes an order to a dark pool, it is important that he try to avoid exposure to any toxic liquidity within that pool.”¹¹⁸ ITG further notes in the report that, “IOIs do not cause adverse selection but rather, interaction with toxic counterparties [causes adverse selection].”¹¹⁹

Comparing the different types of venues for undisplayed liquidity

The Commission asks in the Concept Release:

“Finally, are institutional investors able to trade more efficiently using undisplayed liquidity at dark pools and broker-dealers than they are using the undisplayed liquidity at exchanges and ECNs? What are the advantages and disadvantages of each form of undisplayed liquidity? If the use of undisplayed liquidity at dark pools and broker-dealers were curtailed in any way, could institutional investors adjust by using undisplayed liquidity on exchanges and ECNs without incurring higher transaction costs?”

The most important point to make in response to this series of questions is that in some cases it will be most advantageous for an institution to use undisplayed liquidity at a broker-dealer, in some cases it will be most advantageous for an institution to use undisplayed liquidity at a dark pool, in some cases it will be most advantageous for an institution to use undisplayed liquidity at an ECN, and in some cases it will be most advantageous for an institution to use undisplayed liquidity at an exchange. For example, an exchange might provide the advantage of having the largest amount of liquidity with which to interact, while a dark pool that is limited to institutional investors might provide the advantage of protection against pinging from short-term traders.

Ultimately, in each case, the institutional trader must decide the best method for executing a particular order. If we take any of these options away from the institutional trader, the result will be higher trading costs for long-term investors.

¹¹⁸ Nigam Saraiya and Hitesh Mittal, Investment Technology Group, “Understanding and Avoiding Adverse Selection in Dark Pools”, November 2009, p. 18. (“ITG Dark Pools Report”)

¹¹⁹ ITG Dark Pools Report, p. 18.

Depth-of-book order protection

In the Concept Release, the Commission requests comment on whether “Rule 611 of Regulation NMS should be expanded to provide trade-through protections to the displayed ‘depth-of-book’ quotations of a trading center?”¹²⁰ We would not support this proposal.

As discussed above, there are two primary policy objectives for an order protection mandate: customer protection; and order display protection. We fully support the customer protection rationale for the order protection rule, which can be achieved through an order protection rule subject to an opt-out provision. In other words, any customer who does not opt-out of order protection will be assured of an execution at the NBBO.

We do not support the order display protection rationale for the order protection rule because it is a regulatory mandate where the primary beneficiaries are short-term traders. We do not support regulatory mandates specifically for the benefit of short-term traders. Depth-of-book order protection provides an additional regulatory subsidy to short-term traders at the expense of long-term investors.

Fragmentation

In the Concept Release, the Commission requests comment on fragmentation and linkages. The Commission writes:

“Given the dispersal of liquidity across a large number of trading centers of different types, an important question is whether trading centers are sufficiently linked together in a unified national market system.... Whether fragmentation is in fact a problem in the current market structure is a critically important issue on which comment is requested....”¹²¹

The question of fragmentation has been considered by industry experts Aite Group in a research report on dark pools. According to Aite Group,

“Nothing in life stays static, and the dark pool market is no exception. What started out as an island, touting diversity of unique internal and customer flow and cost-effective, low-market-impact execution service has now evolved to something much larger and more connected, leading to the current market reality in which many of the dark pools are now connected with each other as well as with displayed markets.”¹²²

¹²⁰ Concept Release, pp. 71-72.

¹²¹ Concept Release, pp. 21-22.

¹²² Aite Group, LLC, “Dark Pools 2009: Not so Dark Anymore...”, September 2009, p. 7. (“Aite Group Dark Pools”)

Aite Group further notes,

“The non-displayed market is not a homogeneous one. One important note is that due to the variations in business models and target client base, dark pools do not necessarily compete against one another. A dark pool that focuses on facilitating buy-side block trading, for example, might link up with a dark pool that aggregates sell-side flow to add diversity in order flow. Similarly, broker-owned dark pools might link up with one another to increase overall fill rates for their collective clients. In fact, given the growing trend of dark pool linkages, coopetition (i.e., certain level of cooperation between entities that otherwise compete) has become more common in recent months.”¹²³

Dr. Sirri notes similarly:

“Competitive forces, however, seem particularly apt to address the problem of fragmented dark pools. The ultimate users of dark pools – investors and traders – seem likely to pressure operators of the pools, particularly the less successful ones, either to consolidate with other pools or to cooperate with dark pool aggregators. These aggregators offer services that enable investors to check liquidity more efficiently at multiple dark pools. A key cost of fragmentation for traders is the opportunity cost of being out of the market on one venue when you search for a contraside on other venues. With latency dropping rapidly, such fragmentation costs are falling as well.”¹²⁴

Mr. Colby noted similarly at a recent webinar sponsored by the Investment Company Institute that “... even though there’s a lot of them [trading venues], they’ve very tied together.”¹²⁵

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One concern is that regulations intended to reduce fragmentation could, in fact, result in greater fragmentation. For example, if we limit the options for long-term investors to interact directly with trusted counter-parties, the end result could be less interaction of institutional order flow with the rest of the market, as more liquidity remains at the institution’s trading desk unavailable to interact with other liquidity in the market. Raymond James points out in a research report on the proposals in the Commission’s recent rule proposal on regulation of non-public trading interest:

¹²³ Aite Group Dark Pools, p. 5.

¹²⁴ Sirri, p. 7.

¹²⁵ ICI Webinar.

“Like most governmental regulations, we think it is likely that the three proposals will have unintended consequences. We think they will tend to make dark pools even more dark by forcing them to not share their information with other parties....”¹²⁶

Anti-gaming tools

In the Concept Release the Commission requests comment on anti-gaming tools used by dark pools. As the strategies of high-frequency traders continue to increase in sophistication, the emphasis placed by institutional brokers and institutional ATs on anti-gaming tools will increase. Typically, anti-gaming tools are not directed at illegal activity; rather, they are directed at activity on a trading venue that is disadvantageous for long-term investors participating on that venue. The purpose of anti-gaming tools is to reduce trading costs for long-term investors, thereby increasing their investment returns.

Systemic risk

We support the Commission’s recent rule proposal on “Risk Management Controls for Brokers or Dealers with Market Access” to help address the issue of systemic risk.¹²⁷ Ultimately, while a broker can set and enforce credit limits on a particular customer that is a high-frequency trading firm, a broker cannot ascertain the risk exposure that the high-frequency trading firm has with other brokers. In light of this consideration, a narrowly tailored form of registration category for proprietary trading firms that focuses on capital requirements would be the most appropriate means to address this credit issue.

¹²⁶ Raymond James, U.S. Research, Financial Services Industry Brief, October 22, 2009, p. 1.

¹²⁷ Securities Exchange Act Release No. 61358 (January 19, 2010), FR 75 4007 (January 26, 2010), <http://sec.gov/rules/proposed/2010/34-61379.pdf> (accessed March 22, 2010).