MODERN MARKETS INITIATIVE

April 14, 2016

VIA E-MAIL

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C., 20549-1090

Re: Notice of Proposed Commission Interpretation Regarding Automated Quotations Under Regulation NMS (Release No. 34-77407; File No. S7-03-16)

Dear Mr. Fields:

Modern Markets Initiative ("MMI"), the industry association dedicated to education and advocacy in support of the benefits of high frequency trading (HFT), appreciates the opportunity to provide written comments in connection with the Proposed Commission Interpretation Regarding Automated Quotations Under Regulation NMS.

This letter addresses question one in the "Solicitation of Comment" section of the proposed interpretation: "Would delays of less than a millisecond in quotation response times impair a market participant's ability to access a quote or impair efficient compliance with Rule 611?"

MMI believes an exemption to the definition of an automated quotation to allow delays of up to 1,000 microseconds in quotation response times, "whether intentional or not," will create a trading environment that violates Section 11A of Rule 611 in both letter and spirit.[1] Namely, "economically efficient execution of securities transactions, fair competition among broker-dealers, among exchange markets, and between exchange markets and non-exchange markets; price transparency; (and) best execution of investor orders."

Natural delays apply to all market participants, but intentional delays can be applied selectively. Consider an exchange that is meeting the current standards of immediate execution. That exchange, and its members, are equally subject to natural latency, such as that which accompanies a trading order traveling from New York to the exchange's data center in Chicago. Upon that order's arrival and display, exchange and members alike can choose to immediately update their orders to reflect a new view of the market. However, through selective application of even a short delay, an exchange could update certain orders before allowing members to update theirs, creating an un-level playing field.

[1] See SEC Division of Trading and Markets memorandum April 30, 2015 "Rule 611 of Regulation NMS"

An exchange such as IEX, leveraging a selective delay could create order types that systemically disadvantage investors such as in the following example[2]:

1. At 12:00 PM, with the National Best Bid and Offer (NBBO) 10.10 – 10.14, a sophisticated investor sends a buy order to IEX using a "D-Peg" or similar order type. The exchange has no existing contra interest at the midpoint, so the order is placed on the exchange's book at the National Best Bid price of 10.10.
2. At 12:01:00 PM a non-professional investor gives her broker an order to sell at the market. The broker immediately routes it to IEX without delay.
3. Upon arrival at IEX's Point of Presence, the market order is slowed down by 350 µs by transmitting it through a long coil of cable. This is an example of one way IEX applies its delay to orders in its care.
4. During the time the non-professional order is "stuck" in the IEX delay coil, the NBBO changes to 10.09 – 10.14.
5. At 12:01:00 PM (the exact same time the non-professional investor sent her order, in 2, above) IEX notes the change in the bid price and immediately lowers the sophisticated investor's D-Peg order price to 10.09. This operation—equivalent to a cancel/replace order--is not subject to the delay and takes effect immediately. As such, it is an example of a different way IEX selectively applies its delay to the sophisticated investor order.
6. Because IEX applies the delay to the non-professional order and not to the sophisticated investor order, the former ends up selling at 10.09 rather than 10.10.

In effect, the pegged order always trades with superior market information and has the ability to exploit a latency arbitrage opportunity by trading against investors with stale prices. This is particularly disturbing when the market orders often represent the trading interest of retail investors who would never be fast enough to manage their orders against the exchange's superior speed.

The delay also confers a de facto 'last look' on those pegged orders by giving them exclusive access to the latest bid and offer information. In 2011, the Commission assessed fines of $228 million[3] and $160 million[4] on two firms for employing 'last look' tactics to undermine the competitive bidding process in the municipal bond market. We believe the same principles of fairness are applicable here.

Together, delayed quotation response times, systemic latency arbitrage and order types with 'last look' capabilities will create an environment in which investors receive a sub-optimal trading experience. The Commission has stated that best execution is a function of "the opportunity to get a better price than what is currently quoted, the speed of execution, and the likelihood that the trade will be executed."[5] All of these are compromised when a broker is obligated to pursue protected quotes at venues to which access is intentionally delayed and updates selectively applied.

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[2] We use the term "sophisticated" and "non-professional" investors purposefully here. We are not aware of any retail brokerage firm that supports the sending of "D-Peg" orders to any exchange or ATS so we are assuming that only the most sophisticated institutions and principal trading firms use these order types, either directly or through their brokers.

[3] See SEC Charges J. P. Morgan Securities with Fraudulent Bidding Practices Involving Investment of Municipal Bond Proceeds

[4] See SEC Charges UBS with Fraudulent Bidding Practices Involving Investment of Municipal Bond Proceeds

[5] See SEC website, Fast Answers, Best Execution.

Further, we believe the proposed interpretation will distort order execution and routing practices reports mandated by Rule 605.[6] When there are impediments to quick and cost-effective trading, judging best execution is more difficult and potentially more misleading. As our pegged order example shows, delayed orders interacting with immediately updated quotes in the same venue can create unpredictable outcomes, including executions outside the NBBO as it existed at the time of order transmission. We expect that brokers' best execution statistics will continue to suffer as a result of voluntarily routing orders to IEX, as has been documented by other commenters. However, if IEX is granted protected quote status as an exchange, brokers may be forced to involuntarily route there, with a corresponding decrease in best execution compliance. Does the Commission intend to exempt brokers from their best execution requirements in that event?

Canadian regulators recently enacted policy that we believe should be examined by the Commission. In its April 7, 2016 "Amendments to National Instrument 23-101 Trading Rules and Companion Policy 23-101CP to National Instrument 23-101 Trading Rules" the Ontario Securities Commission (OSC) states:

> "With respect to the application of sections 6.1 and 6.4, Canadian securities regulatory authorities are of the view that where a marketplace has introduced functionality that imposes an intentional order processing delay ***that is not applied in the same way to all orders***, that marketplace does not provide the ability for an immediate execution against the displayed volume and therefore, does not offer "automated trading functionality". As a result, an order on that marketplace would not be a "protected order" as defined in the Instrument."[7]

As described above, IEX applies a delay to incoming orders but not to pegged orders resting on their book, and so it would appear that it would not pass this test. As the OSC has promulgated, investors should have the right, subject to best execution requirements, to bypass markets that apply selective, intentional delays that adversely impact the trading ecosystem, and introduce great uncertainty into whether they will honor their advertised quotation.

We recommend the Commission reject the proposed interpretation of automated quotations in favor of a holistic and data-driven analysis of Regulation NMS. This will elevate deliberations on necessary reforms to our market system from a series of interpretive renderings to a comprehensive public policy debate.

Thank you for your consideration.

Very truly yours,

William R. Harts, CEO
Modern Markets Initiative

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[6] See SEC Final Rule: Disclosure of Order Execution and Routing Practices

[7] See: Amendments to National Instrument 23-101 Trading Rules and Companion Policy 23-101CP to National Instrument 23-101 Trading Rules - http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20160407_23-101_noa-amendments-trading-rules.pdf

cc: Mary Jo White, Chairman
Kara M. Stein, Commissioner
Michael S. Piwowar, Commissioner
Stephen Luparello, Director, Division of Trading & Markets