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December 17, 2009

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Elimination of Flash Order Exception from Rule 602 of Regulation NMS; Release No. 34-60684; File Number S7-21-09

Dear Ms. Murphy:

I support the Securities and Exchange Commission's proposal to ban flash orders. The Commission must act to ensure that our capital markets are fair and transparent. As I have written to Chairman Mary Schapiro in the past, "fairness" may be an elusive and evolving concept in the securities market, but it must be defined and then vigorously defended by the regulators. I am pleased that the Commission is doing so with its proposed ban on flash orders.

Though they benefit some market participants, flash orders threaten the fairness and strength of the overall marketplace. It is my view that the costs of allowing flash order offerings, including the creation of a two-tiered market, impairment of the price discovery process and the potential for abuse of trading information, significantly outweigh the benefits.

Flash order offerings can create a two-tiered market by introducing information asymmetries. Because such orders allow select participants to access quote information that is not publicly-available through the consolidated quotation data streams, those who do subscribe to a particular market center's data feed might have superior access to the best prices and, thus, may be at a competitive advantage relative to average investors.

While anyone viewing a market's data feed can receive flashed order information, the Release points out that "only those who have invested in sophisticated trading systems are able to effectively access flash orders." Thus, while the opportunity to trade against flashed orders is open to all investors in theory, they are exclusive in reality. To the extent that flash orders permit a limited number of market participants to trade based on privileged information, they weaken the overall marketplace in perception as well as practice.

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Flash orders also weaken the marketplace by creating a disincentive for investors to post non-marketable limit orders, which are a critical piece of the price discovery process. Non-marketable limit, or resting, orders, "provide quotation information for investors and add liquidity and depth to the market," according to the Release. Flash orders might deprive resting orders of fast and total executions, and some resting orders may not be filled at all.

The Commission has previously maintained the importance of protecting investors who expose their trading interest to the public through non-marketable limit orders because such orders are a "public good" in that they promote an efficient and reliable price discovery process. Flash orders, however, are not consistent with this end.

Flash orders are also a potential source of information leakage, which can lead to frontrunning and other forms of market manipulation. The Release acknowledges that "today's sophisticated order handling and execution systems" enable the fastest market participants to trade ahead of flashed orders.

Some proponents have countered that flash orders are just an extension of trading practices that have existed in some form for years. Nevertheless, as I have asserted in the past, regulators will not be able to maintain a robustly regulated system if they simply apply precedent from obsolete business practices to a particular electronic order type or technological development. I am pleased the Release has taken a comprehensive view of the direct and indirect costs of flash orders to the broader marketplace, and I concur with the Release's assessment that they are "no longer necessary or appropriate in today's highly automated trading environment."

I am also pleased the Commission has agreed to undergo a comprehensive review of current market structure, which I requested in an August 21 letter to Chairman Schapiro. While the aforementioned flash order release, as well as the Commission's recently-published dark pool proposals, indicate the Commission is taking this review seriously, the Commission must take a holistic view of current market structure going forward in order to accurately assess the costs of other questionable practices to average investors.

Undoubtedly, the markets have changed dramatically over the last few years. Market fragmentation has spurred the rise of a number of questionable practices – flash orders, dark pools, co-location of servers at the exchanges, sponsored access, payment for order flow and liquidity rebates – all of which are at least partially a consequence of the intense competition for order flow. High frequency trading volume, which takes advantage of latency disparities across the many market centers, now comprises a large, and growing, majority of all trade volume.

While I commend the Commission for its flash order proposal, I am mindful that flash orders may only be a symptom of a much larger problem. Accordingly, it is imperative that the Commission quickly complete a broad review of current market structure to ensure these technological developments have not outpaced our regulatory understanding.

The Commission is expected to issue a concept release in early 2010 and possible rule proposals that summer. But, as I wrote to Chairman Schapiro on November 20th, I am concerned that, among other issues, "manipulative high frequency algorithms are almost certainly operating *today* and that sponsored access creates a systemic risk *today*. That is why the Commission must not let months go by without taking meaningful action."

In her response on December 3rd to me, Chairman Schapiro indicated the Commission would next month consider rule proposals to implement stricter reporting requirements for high frequency traders under the Commission's "large trader" reporting authority as well as address sponsored access arrangements.

These proposals are a welcome step in the right direction. In my view, fairness and transparency must continue to guide our regulatory efforts for investors to regain confidence in the markets. No less than the credibility of the United States financial markets is at stake.

Sincerely,

Edward E. Kaufman
United States Senator