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[redacted]

Oct. 5, 2009

By Email to rule-comments@sec.gov

The Commissioners
c/o Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F. St. NE
Washington, DC 20549

Re: Elimination of Flash Order Exception From Rule 602 of Regulation NMS, File No. S7-21-09

To the Commissioners:

I submit this comment letter concerning the Commission's proposed rule eliminating the "flash order" exception to Regulation NMS.[1] I write to make two points: (1) if the Commission is concerned about a "two-tiered" market for access to critical market data, then it should address the tremendous disparity between the quality of market data available to retail investors and that available to institutional investors; and (2) if the Commission is going to reexamine parts of Regulation NMS as part of a larger examination of market structure in the wake of the market dislocations of 2008, then it should review the "Trade-Through" provisions of Regulation NMS Rule 611.

The Commission Should Address the Real "Two-Tiered" Market for Information about Equity Securities Prices - the Difference Between Retail and Institutional Access to Market Data

The Commission's Proposing Release, Exch. Act Rel. No. 60,684 (Sept. 18, 2009), repeatedly expresses a concern that allowing flash orders permits a "two-tiered" market in terms of access to information about US equity market securities prices. See Proposing Release at pp. 5, 17, 28, 31, 32, 36 and 40. In fact, in the US there is and long has been a two-tiered market for access to market data. Institutional investors receive very high quality market data - real time, streaming market data with depth-of-book quotations on both sides of the market as well as transactions, and (with a few

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[1] I am a partner in the broker-dealer group at Bingham McCutchen LLP, where I advise broker-dealers, investment advisers and other financial services firms on compliance with the federal securities laws and rules. I was formerly General Counsel of Charles Schwab & Co., Inc., and previously was Assistant General Counsel for Market Regulation at the SEC. I am currently chair of the ABA Business Law Section's Subcommittee on Trading and Markets. I submit this comment solely in my personal capacity.

exceptions) they receive it for free, because they pay for it with client assets (soft dollars) pursuant to Section 28(e) of the Exchange Act. By contrast, retail investors receive very low quality market data: a static "snapshot" consisting of the national best bid, the national best offer, and the price of the last sale in the security at issue. Only a small handful of full-time professional individual investors can afford the cost (over a thousand dollars per year to access data for all national market system securities) to obtain the real-time, streaming, depth-of-book market data that most institutional investors receive at no cost to themselves.

The difference between institutional, real-time streaming depth-of-book market data and retail "snapshot" data is real and significant. Because prices for most actively-traded equity securities change on a second-to-second basis (in many instances multiple times per second), the "snapshot" information a retail investor sees generally is already outdated and inaccurate by the time the retail investor sees it on his or her computer, and almost certainly is outdated by the time the retail investor has had an opportunity to act on that information, for example by placing an order. Moreover, because so little volume is displayed at the inside quotes (often as little as 100 shares per side), even if those quotes have not changed by the time the retail investor places an order, that retail investor, if he or she places an order even for just 1,000 or 2,000 shares, is likely to have a portion of his or her order executed outside those quotes. An institutional investor with streaming, depth-of-book quotation information is far better informed about where liquidity may exist than is the retail investor trading the same security. As a result, retail investors know they are not on a level playing field with institutional investors when viewing market data. This failure to provide a level playing field is a powerful deterrent to retail investors having confidence in the US equity securities markets and providing liquidity to those markets.

The Proposing Release expresses concern about the "two-tiered" market as between an institutional investor who has subscribed to an ATS which offers "flash quotes" and an institutional investor who does not subscribe to that ATS and as a result, does not see those quotes in real time. I would submit this difference in access to information is trivial: all of the Arts that offer flash quotes allow any institutional investor to subscribe for free. Any institutional investor who wishes to see flash quotes need merely sign up to the ATSs that offer them, and then integrate the consolidated quotes with the ATS quotes. By contrast, even if the Commission adopts the proposed rule, virtually no individual investor (other than the atypical professional investor willing to spend thousands for institutional market data) will ever see a flash quote. The rare individual investor who requests a "snapshot" quote at exactly the same time a flash quote is displayed would have no way of knowing that the quote reflects a better price than was available immediately beforehand. And even if the Commission requires that all "fill or kill" orders be displayed, a retail investor receiving a "snapshot" quote will never be able to react to that "fill or kill" order in time to take advantage of the liquidity it offers.

I would suggest that the difference between stale "snapshot" retail investor market data and real-time, streaming, depth-of-book market data does create a real and important "two-tiered" market for access to information. And I would suggest it is well past time for the Commission to address the disparity. Moreover, the current disparate access to market data is codified in exactly the rules (Regulation NMS Rules 601-603) that the Commission is addressing in the Proposing Release. I suggest it would be arbitrary and capricious for the Commission to address "flash quotes" in the name of eliminating "two-tiered" access to market data without also addressing this larger and more important disparity in access to market data presented by the same set of rules.

I recognize that market data is not an entirely new issue for the Commission. The Commission created an advisory committee to study the issue a decade ago. In 1999, the Commission issued a concept release on market data, Exch. Act Rel. No. 42208 (Dec. 9, 1999), although in the succeeding decade it has never acted on any of the issues raised in that concept release. And currently an appeal is pending in the D.C. Circuit concerning the Commission's approval of an proposal by NYSE Arca (now an affiliate of the NYSE), to charge a high fee for streaming, depth-of-book market data that Arca, before it was acquired by the dominant exchange for listed securities trading, used to give away to all investors for free. The effect of this fee is effectively to preclude retail investors from receiving that information. *See* Exch. Act Rel. No. 59,039 (Dec. 2, 2008).

The last time the Commission comprehensively addressed the market data issue was in the 1999 concept release.[2] At that time, the Commission concluded that SROs needed the revenues from the current market data regime to fund their regulatory responsibilities, and this need justified the disparate pricing and access regime. However, much has changed since that time. Because of decimalization, quotation depth at the inside market has fallen, and the speed of quotation changes has accelerated, both by dramatic amounts. As a result, the "snapshot" quotation information available to retail investors is substantially less useful than it was ten years ago. Moreover, the major SROs have become for-profit, shareholder-owned entities with a duty to maximize their revenues and profits. The Commission recognized this fact in its 2004 concept release on SRO governance, Exch. Act Rel. No. 50,700 (Nov. 19, 2004), another release the Commission has failed to act upon for years despite its recognition of significant structural conflicts of interest. Moreover, the exchanges now have out-sourced the vast majority of their regulatory functions to FINRA, which does not rely on market data revenue at all to fund its operations. The basic conclusion of the 1999 market data concept release simply no longer is correct. Today market data is funding shareholder returns at privatized exchanges, not funding regulatory activities, and there is no longer a regulatory reason to

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[2] In the NYSE ARCA order, the Commission avoided the larger market data issues by noting that other SROs had adopted similar "depth-of-book" fees, and by making the questionable assertion that the market for such fees was subject to competition and thus was not in need of in-depth Commission review.

prevent individual investors from receiving market data of quality equal to that provided to institutional investors.

The path forward is clear. The Commission should amend Rules 601-603 of Regulation NMS to require that all investors, retail and institutional, receive high quality real-time, streaming, depth of book market data. Only in this way can the Commission assure that there is no “two-tiered” market for access to information about equity securities prices, and that retail investors can enter the equities markets on an equal footing with institutional and professional traders. It would be arbitrary and capricious for the Commission to address the comparatively unimportant “flash orders” issue without also addressing this larger, more important and inextricably inter-related issue of retail investor access to quality market data.

The Commission Should Review the Trade-Through Provisions of Regulation NMS

The Proposing Release reviews a portion of Regulation NMS, and the Commission has promised a wider review of market structure, in particular how the markets reacted to the stresses of the financial crisis of 2008. As part of this review, the Commission should review the trade-through provisions of Regulation NMS Rule 611,

The Commission adopted the trade-through provisions of Rule 611 in 2005 on a bitterly divided 3-2 vote. Prior to 2005, each major securities market would offer order execution guarantees matching the best price and volume offered by any market in a security. Thus, if a primary market (such as the NYSE) offered 1,000 shares at the best price for a given security, other markets trading the same security (including Nasdaq, Amex, CSX, NSX, Phlx, BSE and Arca, some with multiple market-makers in a given security) would match that price, so as to provide clients routing orders to that market with best execution of their orders. Thus, if a single exchange offered a 1,000 share quote on the inside market, the practical effect was that the markets as a group would offer at least 8,000 or more shares at that quote (and if the markets were not willing or able to route orders to “take out” the primary market quote, the result could be that 16,000 or 24,000 or more shares would be available, market-wide, at that quote). Regulation NMS changed this state of affairs - it required that any order routed to any market would be required to “take out” the first quote at the best price, wherever that quote had occurred. The Commission adopted this rule on the dubious assumption that it would encourage investors to post their liquidity and thereby make more volume available at the inside quote or better, because their orders could not be bypassed by other markets matching that quote.[3]

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[3] As discussed in the preceding section, retail investors would have substantially more incentive to provide liquidity if they were able to see market data of comparable quality to that seen by institutional investors. The current “snapshot” market data available to retail investors does not allow them to monitor effectively whether and how their orders

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However, the trade-off for this supposed benefit was that the entire order flow for a particular security, no matter to which market it was originally routed, would have to be routed to the single market which first posted the best price in that security. As a result, the fire-hose of orders in the US equity markets for any given security, instead of being directed simultaneously to eight (or now more) market centers, some with multiple market-makers, all now must be directed to a single market. Moreover, the entire fire-hose of orders must be re-directed from market to market, often multiple times per second, as the inside quotes at different markets are successively taken out.

The prediction on which the Commission based its adoption of Regulation NMS Rule 611 was that it would encourage investors to post their liquidity (particularly limit orders), and thus would increase the depth of the quotes at the inside market. There were those of us who hotly disputed this prediction. We instead predicted that the result of the rule would simply be to increase quote volatility without any corresponding increase in quote depth, and thereby degrade the quality of quotes in the US equity markets. Regulation NMS Rule 611 has now been in effect since early 2007, through both up and down markets, including the severe market dislocations of 2008. The Commission can and should review how the rule worked compared to the various predictions. I do not have access to data sufficient to perform this analysis - but it is certainly my perception that quote depth has not improved at all (if anything, it has deteriorated, especially in "down market" conditions), but that quote volatility has substantially increased. In other words, I believe the result of Regulation NMS Rule 611 has been to decrease the quality of markets, and that the rule exacerbated the market dislocations of 2008. While some commentators have blamed the repeal of the short sale uptick rule in 2007 for the market quality deterioration in 2008, the more compelling correlation is to the implementation of the trade-through rule, which also occurred in 2007.

In any event, if (as with the Proposing Release) the Commission is now reconsidering portions of Regulation NMS, and the Commission is promising a broader review of how our current market structure performed during the market crisis of 2008, then I strongly urge the Commission to review whether the trade-through rule helped or hurt during that market crisis. My belief is that if it reviews the relevant data, the Commission will conclude that the trade-through rule did not provided the benefits anticipated when the

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are being represented in the markets to which they are routed, or whether or when they are due executions of those orders. Moreover, many investors have understandably viewed posting public non-marketable limit orders as, in effect, giving other traders a free option on their liquidity. The reluctance of traders to provide counter-parties with such an uncompensated free option calls into question whether a regulatory strategy of encouraging such non-marketable limit orders can ever be successful.

rule was adopted in 2005, and the Commission will conclude that the rule is no longer worthwhile (if it ever was). The Commission should take the opportunity to perform this economic analysis now, and should provide the academic community, the trading community and the general public the opportunity to comment on that economic analysis. The risk of a new market dislocation like that of 2008 is too imminent and too severe to allow a regulatory provision that may have contributed to that dislocation to stay in place without thoughtful and critical analysis.

I would be happy to discuss either of these issues with the Commission or its Staff.

Sincerely yours,

W. Hardy Callcott