

November 20, 2009



Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File No. S7-21-09
Elimination of Flash Order Exception from Rule 602 of Regulation NMS

Dear Ms. Murphy:

Direct Edge Holdings, LLC¹ (“Direct Edge”) appreciates the opportunity to comment on the recent rule release² (the “Release”) to eliminate the flash order exception from Rule 602 of Regulation NMS. For the past three years, Direct Edge has utilized flash technology as part of its “Enhanced Liquidity Provider” program for the benefit of market participants on *both* sides of the transaction. While approved by the Commission in various forms over the years,³ flash technology gained little media, regulatory or political attention until earlier this year. At that time, certain sub-groups of market centers, market participants, and market practices started becoming subject to a variety of suspicions, allegations and accusations. With the vilification of “Wall Street” generating populist disdain, flash technology received a disproportionate amount of passion and scrutiny.

While a ban may appear to be a convenient response to populist sentiment, Direct Edge respectfully requests that the Commission carefully consider why and how such technology is used, how it can help investors achieve their objectives of accessing market-wide liquidity through a single market center, and whether any credible evidence of its impact on overall market integrity dictates an abolition of the practice as the only alternative. To date, the positive aspects of flash technology have been understated, the concerns have been generally overstated and under-supported, and less restrictive and comprehensive solutions to address such concerns have been ignored.

As discussed below, enabling market participants to simultaneously display trading interest to multiple parties during the execution process is beneficial to both long and short term investors, particularly in volatile markets. Data presented herein shows that usage of such technologies can result in investors receiving a greater incidence of price improvement and lower instances of price disimprovement, and that limit orders displayed on other markets are not materially impacted as a result. Simply put, the prohibition of this technology will not promote efficient execution of investor transactions, and thus investor confidence, over the long term.

A deliberative, data driven approach to additional regulation is warranted. In the words of the Honorable Commissioner Troy A. Paredes:

“There always is room for improvement; but it also is possible that regulatory changes that constrict market operations and trading activities may do more harm than good by denying markets needed flexibility. One way to reduce the likelihood that regulation will be

¹ Direct Edge currently operates the third-largest stock market for the trading of U.S. equity securities, behind only NYSE Euronext and NASDAQ OMX. More information about Direct Edge is available at <http://www.directedge.com>.

² See Securities Act Release No. 60684, 74 FR 48632 (September 23, 2009)(the “Flash Release”).

³ See, e.g., CBSX Rule 52.6(a); BOX Rules, ch. 5, § 16(b); ISE Rule 803.



counterproductive is to focus on data. It is one thing to posit that a problem exists; it is another to demonstrate it empirically. Data has a way of disciplining decision making and can help channel regulatory efforts to where they are most productive.”⁴

Fortunately, the Commission followed such an approach in publishing the Release and soliciting a broad range of industry comment. We respectfully request the Commission incorporate this feedback in a manner that produces a measured approach that preserves the benefits of flash technology for investors.

I. Distinctions

Any analysis of flash technology needs to account for its different uses and forms. For example, after a flashed order has removed marketable liquidity from the originating market center’s order book, its instructions may direct the order to either be cancelled, posted (but not at a price that would lock the market) or routed to one or more external market centers. While a ban is not warranted in any of these cases, if a user chooses to only remove marketable liquidity from the originating market center’s book and cancel or post the balance of the order, then flashing the order will have no impact on that order’s interaction with liquidity then displayed in the market. In such circumstances, the flash technology concerns that have been raised, further discussed in Section III of this letter, would not be implicated.

There are also important distinctions in flash technology dissemination methods. For example, both flash technology products offered by NASDAQ OMX and the BATS Exchange, for which each exchange filed immediately effective rules,⁵ disseminated flash orders to their users via their order book data feed. Such a method was non-targeted, exposing the relevant order to widespread information leakage, subjecting customers with no discernible interest in interacting with the order to receiving and disregarding the data, and forcing market data vendors to filter information out of the data feed so as to avoid the appearance of a locked or crossed market. On the other hand, Direct Edge’s “Enhanced Liquidity Provider” (“ELP”) program deploys a separate data feed for order data flashed to designated ELP recipients that, while available to any Direct Edge subscriber, requires affirmative action on the part of the subscriber to receive, reflecting a conscious willingness to participate in the program. Targeted usage of flash technology limits disclosure of the user’s interest to those parties most likely to execute against it. The Commission has recently acknowledged the appropriateness of “communicat[ing] only to those who are reasonably believed to represent current contra-side trading interest.”⁶ This is the approach that has been employed by Direct Edge to date for all order sizes.

⁴ Commissioner Troy A. Paredes, Remarks Before SIFMA’s 14th Annual Fixed Income Legal & Compliance Conference (September 24, 2009) (available at <http://www.sec.gov/news/speech/2009/spch092409tap-sifma.htm>) (“Commissioner Paredes Remarks”)

⁵ See Securities Exchange Act Release No. 59875 (May 6, 2009), 74 FR 22794 (May 14, 2009) (SR–NASDAQ–2009–043)(the “NASDAQ Rule Filing”); Securities Exchange Act Release No. 60040 (June 3, 2009) 74 FR 27577 (June 10, 2009) (SR–BATS–2009–014) (the “BATS Rule Filing”). In these filings, both BATS and NASDAQ stated that their flash technology offering would “promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest.” NASDAQ Rule Filing at 22795; BATS Rule Filing at 27578. BATS elaborated on their belief that “Users may receive more efficient executions by briefly displaying their marketable orders to BATS Users for potential execution.” BATS Rule Filing at 27578.

⁶ See Securities Exchange Act Release No. 60997 (November 13, 2009) at 21 (the “Dark Pools Release”).



An ELP user that chooses to simultaneously display its order information to ELP recipients avoids the latency associated with sequentially routing “Immediate or Cancel” (“IOC”) orders to multiple potential contra parties. While working an order in this manner has typically been associated with block order sizes, technology has enabled even smaller sized orders to be worked using a wider variety of mechanisms and parameters. Many such smaller sized orders originate from larger or block trading interest and seek to avoid the risks of large executions while endeavoring to gain the optimal time, price or size distributed execution of the underlying order. We believe that investors should not be limited to sequentially routing their orders to non-displayed providers to achieve such execution goals.

Other flash technology distinctions include whether the usage of flash technology is rewarded through rebates. For example, NASDAQ OMX and BATS Exchange paid subscribers to flash their orders⁷ while Direct Edge provided no incentive other than the potential for superior execution quality. Lastly, while flash technology has typically enabled the first responder to a flashed order to receive an execution, such technology could easily be adapted to grant the execution to the responder with the greatest price or size improvement. We urge the Commission not to adopt an approach that could limit innovative approaches to offering such price or size improvement.

II. Benefits of Flash Technology

As discussed above, Direct Edge subscribers who choose to utilize flash technology-based products benefit from the ability to easily interact with displayed and non-displayed liquidity in a consolidated manner designed to maximize execution potential, reduce implicit and explicit transaction costs and improve execution quality. While off-exchange liquidity has always existed and will continue to do so in some form, the ability to simultaneously display orders to these liquidity sources during the execution process empowers users to interact with such liquidity on their own terms while having the certitude of an exchange execution. In this way, flash technology serves the Congressional mandate to assure economically efficient execution of securities transactions, fair competition between exchange markets and markets other than exchange markets, and removes impediments and perfects the mechanism of a free and open market.⁸

a. Greater Price Improvement

Order execution products that use flash technology can provide meaningful price improvement opportunities for investors and help brokers to satisfy their best execution obligations. It is an established tenet of market regulation that “the duty of best execution requires broker-dealers to execute customers’ trades at the . . . best reasonably available price.”⁹ In assessing price improvement opportunities for their customers to ensure “the most beneficial terms for their customer orders . . . broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.”¹⁰ In this regard, our preliminary data suggests that flash technology should be part of this consideration.

⁷ Supra note 5.

⁸ 15 U.S.C. § 78k-1.

⁹ See Securities Exchange Act Release No. 51808, 70 FR 37496 (June 29, 2005) (“NMS Release”) at 37538.

¹⁰ Id.



In an effort to measure the price improvement benefits of flash technology, Direct Edge examined the incidence of price improvement experienced by orders routed out of Direct Edge’s order book that were “flash eligible” compared to those that were not, during June and July 2009. Improvement was measured based on the NBBO at time of receipt, the industry standard metric under Exchange Act Rule 605. Pursuant the data below, orders eligible to be executed through flash technology received price improvement at a rate approximately *three times* higher than the price improvement rates for orders that were not:

*Table 1:
 Price Improvement Comparison: Flash vs. Non-Flash Eligible Orders – June/July 2009*

	Total Shares	Shares Price Improved	% Price Improved
Flash-eligible orders (June)	2,377,861,922	186,025,856	7.82%
Non flash-eligible orders (June)	5,956,429,249	156,025,723	2.62%
Flash-eligible orders (July)	2,009,621,238	177,628,298	8.84%
Non flash-eligible orders (July)	5,230,697,176	139,817,929	2.67%

The existence of greater price improvement for orders utilizing flash technology is not surprising, as flash technology broadens the pool of eligible liquidity to encompass orders resident on both primarily displayed or “lit” and non-displayed or “dark” trading venues.

b. Size Improvement / Reduced Market Impact

An over-looked benefit of flash technology is the availability of additional liquidity and the resulting reduction in market impact. These benefits accrue to short and long term investors alike. As stated by the Commission staff in Regulation NMS, “deep and liquid markets that minimize volatility are of most benefit to long-term investors. Such markets help reduce transaction costs by furthering the ability of investors to establish and unwind positions in a stock at prices that are as close to previously prevailing prices as possible.”¹¹ Indeed, as cited in Regulation NMS, the 1975 Senate Report on the national market system emphasized that one of the “paramount” objectives for the national market system is “the maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements.”¹² Our data suggests that by providing interaction with additional liquidity sources as part of the execution process, these objectives are met.

One method of measuring these benefits is to examine the incidence of price disimprovement at the time of execution, as it provides an indication of how frequently an order type causes a user to receive a fill at her limit order price. Such a statistic also provides an indication of whether the solicitation of additional liquidity caused the user to “miss the market” because of the latency introduced. Direct Edge’s data, based on the NBBO at time of receipt, indicates that routed orders eligible for execution using flash technology were approximately *three to four times* less likely to experience price disimprovement versus orders types that were not eligible.

¹¹ NMS Release at 37500.

¹² S. Rep. No. 94-75, 94th Cong., 1st Sess. 7 (1975).



Table 2:
Price Disimprovement Comparison: Flash vs. Non-Flash Eligible Orders – June/July 2009

	Total Shares	Shares Price Disimproved	% Price Disimproved
Flash-eligible orders (June)	2,377,861,922	90,183,766	3.79%
Non-flash eligible orders (June)	5,956,429,249	736,613,106	12.37%
Flash-eligible orders (July)	2,009,621,238	60,453,956	3.01%
Non-flash eligible orders (July)	5,230,697,176	609,452,813	11.65%

Thus, while the Release raises the concern that flash technology may increase the risk of missing market liquidity,¹³ the data indicates that the availability of a broader pool of contra-side liquidity more than offsets this risk. Rather, flash technology *reduces* the likelihood of an investor missing the market and increases the likelihood of the flashed order being executed at its full size.

c. *Cost and Latency Reduction*

In addition to price and size improvement, flash technology can save transaction costs associated with accessing another market center, as well as reduce latency associated with the order not being routed out to an away market center. As noted in Section I hereof, to the extent that a market participant seeks to interact with passive liquidity, flash technology minimizes latency by permitting the participant to access numerous sources of such liquidity simultaneously without having to route orders to each of them in seriatim. Recipients of the flashed data can save on potential costs of transacting with an away market center by maximizing the likelihood of identifying a natural cross within their order book. In addition, recipients minimize market impact associated with displaying such interest.

III. Other Factors To Consider

a. *Choice and Availability.*

As recognized by the Commission in the Release, subscribers to the Direct Edge platform have complete control over whether their orders utilize flash technology.¹⁴ Recipients of flash orders choose whether or not to interact with such orders. Furthermore, any Direct Edge subscriber who is a broker can be a recipient or sender of flash orders and if a subscriber chooses not to be, it does not have any impact on their usage of other Direct Edge products, services and information. Order types utilizing this technology are a mere subset of numerous other order types offered by Direct Edge and others with respect to execution quality. Providing this choice to the broker in a competitive environment for such order flow is, as noted by Commissioner Paredes, “fundamental.”¹⁵

¹³ Flash Release at 48637 (“the delay in routing during a flash period may further decrease the likelihood of an execution in the displayed market for the flash order because prices at the displayed market may move away from the flash order during the flash process”).

¹⁴ Flash Release at 48633.

¹⁵ Supra note 4.



Brokers are best suited to decide when and how to use the tools exchanges and other markets provide in executing customer orders. Delegation of the responsibility to manage execution quality by an investor to a broker is, for all but the more sophisticated investor, a critical concept in how markets operate. The research, perspectives and execution strategies that brokers bring to the marketplace are subject to the rigors of competition, as investors use a range of criteria and information to choose among scores of reputable, experienced providers of execution services. A broker failing to deploy flash technology for the benefit of its customers puts its business at risk. Ultimately, we believe that the surest indication of an investor's preference is reflected in the products that they choose to use. In the words of Commissioner Paredes:

“Exchanges and other trading venues need flexibility to innovate new products, services, and trading opportunities that advance the varied interests of market participants by affording them choice. Investors are the ultimate beneficiaries when innovation spurs robust competition among different trading venues. Markets become more efficient, execution improves, and trading costs fall.”¹⁶

If a product benefits investors and promises to continue to do so, then we believe that it is the Commission's role to ensure that the proper regulation applies to that product's continued use.

b. Fosters Competition and Innovation

Recipients of flash orders have an instant to interact with a flashed order, forcing a competitive decision with respect to their non-displayed interest. Much like the displayed market, recipients must compete to be the first to interact as there is no guarantee of the flashed order's continued availability. In this manner, flash technology aggregates the benefits of both aggressive and passive liquidity for the benefit of the order sender and, consistent with the principles of Regulation NMS, such integrated competition among orders promotes the more efficient pricing of individual stocks.¹⁷ Furthermore, as flash technology is still in its early stages of development, its continued evolution as a product has the potential to drive vigorous competition across market centers to create more efficient and innovative variations of it.

IV. Criticisms of Flash Technology

Any financial product in hands of the unscrupulous is subject to abuse. Because of its audit trail and sub-second exposure time, however, flash technology is less prone to abuse than other financial products lacking a similar audit trail or latency. Nonetheless, restoring greater confidence to the use of the product requires an examination of the existence of and response to address perceived inequities. We note that the primary criticisms of flash technology are that it: (i) creates the potential for information leakage; (ii) could lead to a two tiered market in which the public does not have access to information about the best available prices for securities; (iii) discourages the display of orders and harms quote competition; and (iv) undermines Rule 610(d) of Regulation NMS respecting locked and crossed markets.

¹⁶ *Supra* note 4.

¹⁷ NMS Release at 37498-99 (“Vigorous competition among markets promotes more efficient and innovative trading services, while integrated competition among orders promotes more efficient pricing of individual stocks for all types of orders, large and small. Together, they produce markets that offer the greatest benefits for investors and listed companies.”)



a. Potential for Information Leakage

The potential for information leakage exists throughout an order's life cycle and even more so when a broker is working an order. To the extent a broker working a customer order knows that a customer's interest has not been fully executed upon, the broker is in a position to violate its fiduciary duty with regards to that customer. While trading ahead and front running rules (most notably NYSE Rule 92 and FINRA Manning rules) prohibit a broker from trading in front of a customer order, the risk always exists with respect to order exposure to those having no fiduciary or regulatory obligation. This is not to suggest that bad actors or practices should not be pursued vigorously, but rather that the risks associated with information leakage are not unique to flash technology products.

In certain respects, flash technology mitigates this risk as opposed to manual means of working an order. If an order is flashed to multiple recipients simultaneously and each recipient has an opportunity to interact with the order before it is routed to another destination, then a party seeking to trade based on that order's information cannot be certain whether or not the flashed order is going to be executed by another recipient, thereby substantially reducing the value of the information. If another recipient of flashed order data executes the order there is no informational advantage. Further, users of flash technology understand that their order is being distributed to multiple recipients and can adjust their activity accordingly. They do so by adjusting the size of their order and by not sending thinly traded securities through the process. The average order size entered through the ELP product is less than 500 shares, which is not a size capable of moving the price of most equity securities. A user of the ELP product can also reduce the exposure time that its order is flashed to recipients from the default flash time of 75 milliseconds down to as low as 5 milliseconds. The ability to shorten duration allows users to balance information leakage risks against the possibility of a better execution. We generally support addressing any concerns regarding cross-market trading activity, due to information leakage or otherwise, through more coordinated surveillance and enforcement mechanisms that are not narrowly focused on flash technology. To the extent that the Commission determines that such a risk requires additional regulation, we believe that such regulation should not be specific to flash technology due to the short duration of exposure, small average sizes of flashed orders and the inability to determine whether information received will result in an open order being sent to the displayed market.

b. Two-Tiered Market

The Release notes that flash orders *may* create a two-tier market "where the public does not have access, through the consolidated quotation data streams, to information about the best available prices for listed securities."¹⁸ First, it is difficult to address concerns that *may* result, particularly when there is no empirical data to support such a result. Furthermore, we do not view technology that instantaneously aggregates passive and aggressive liquidity as creating a two-tier market. Rather, flash technology democratizes access to the non-displayed market and in this regard, *removes* different "tiers" in market access. A primary reason certain investors and traders choose to use non-displayed markets is to segregate their trading interest from the general market, where it may have broader impact. Direct Edge's usage of flash technology allows these investors to continue realizing the benefits of non-displayed market participation while broadening access to the related trading interest. Additionally, any subscriber of Direct Edge can be a recipient of flashed orders.

¹⁸ Flash Release at 48636.



If the concern about two-tier quotation access is taken to its logical result, it is unclear how brokers will be able to continue to work customer orders at a defined price without creating a two-tier market. Current regulation does not require all trading interest to be disseminated through the consolidated quotation data stream, nor should it. Today, brokers can decide to route to non-displayed markets or execute orders internally. As such, the two-tier concern raised by the Commission has broader, perhaps unintended, implications for the marketplace.

Nonetheless, should the Commission determine that two-tier quotation access is a concern, then the narrower regulatory options discussed in Section V hereof present a preferable alternative.

c. Discouragement to Trading Interest Display and Harm to Quote Competition

No empirical data corroborates the concern that an investor's attempt to interact with passive liquidity immediately prior to interacting with the displayed market discourages the display of orders. In contrast, a review of available data compiled by Direct Edge suggests that this is not the case.

The peak in flash technology utilization occurred in June 2009, when products using such technology began to be offered by NASDAQ OMX and BATS Exchange, in addition to Direct Edge. While data is unavailable for NASDAQ, BATS reported over 84 million shares of volume executed through the flash-eligible "BOLT" order type on the first day alone,¹⁹ indicating that this period saw a sharp rise in the use of flash technology in the market generally. Concerns about flash discouraging display of limit orders would be validated if an increased usage of flash resulted in a decreased limit order fill rate on non-flash markets, such as NYSE Arca.²⁰ The percentage of shares executed on NYSE Arca, however, continued to be mostly flat or higher in the two months following the introduction of flash technology products on NASDAQ OMX and BATS throughout this period. The data represented in the table below was compiled from publicly available Rule 605 data and, at the very least, underscores the absence of any statistically measurable correlation between the experience of publicly displayed limit orders due to flash technology.

*Table 3:
At the Quote Limit Order Fill Rate on NYSE Arca – April through July, 2009*

	April, 2009	May, 2009	June, 2009	July, 2009
NYSE Listed Equities	5.3%	6.1%	6%	5.2%
NASDAQ Listed Equities	11.4%	11.9%	11.8%	13.2%

¹⁹ Press Release, "BATS Exchange BOLT Volume Reaches 84 Mln On First Day," BATS Exchange, Inc. (June 4, 2009).

²⁰ The NYSE marketplace was excluded for the purposes of this analysis because parity rules distort the application of time/price priority and investor limit order fill rates generally.



Table 4:
Inside the Quote Limit Order Fill Rate on NYSE Arca – April through July, 2009

	April, 2009	May, 2009	June, 2009	July, 2009
NYSE Listed Equities	7.1%	8.3%	8.7%	7.8%
NASDAQ Listed Equities	5.3%	4.9%	5.8%	8.3%

Table 5:
Near the Quote Limit Order Fill Rate on NYSE Arca – April through July, 2009

	April, 2009	May, 2009	June, 2009	July, 2009
NYSE Listed Equities	0.3%	0.3%	0.3%	0.3%
NASDAQ Listed Equities	0.7%	0.8%	0.8%	0.8%

The above data directly does not support the assertion that the experience of publicly displayed limit orders, and thus the incentive to display such orders, is materially impacted by flash technology and the incidence of its usage in the marketplace.

Direct Edge also respectfully disagrees with the notion that flash technology encourages non-displayed liquidity to remain non-displayed.²¹ Much like the two-tier market concern, no empirical data supports such potential discouragement or harm to quote competition and, as with the two-tier market concern, the Release does not suggest that this is *currently* occurring.²² The Release states that incentives to display *could* be undermined *if* flash orders “greatly expanded in trading volume.”²³ Inasmuch as flash orders have not expanded in volume (indeed volume is down sharply), Direct Edge questions whether such concerns should be primary bases for an action as unequivocal as a ban. In the words of Commissioner Paredes:

“One might imagine a set of circumstances under which the activity could deteriorate market quality in some notable respect. However, if those circumstances have not yet actually obtained, is the potential that they might obtain a sufficient basis for regulating? Is it enough to speculate that the concern might materialize or should we require a rigorous assessment of the probability that the concern will materialize and the magnitude of the harm if it does? Perhaps some risks are too speculative to be a cognizable basis for regulatory action.”²⁴

²¹ Flash Release at 48636 (“Rather than displaying their orders or quotations in advance of incoming marketable order flow to attract an execution, [the recipients of flash orders] can wait to receive the flashed order and program their systems to pick and choose when to execute”).

²² *Id.* (“flash orders *potentially* deprive those who publicly display their interest at the best price from receiving a speedy execution” and further “*if* flash orders were offered by all major markets for a security and greatly expanded in trading volume, they *could* significantly undermine the incentives to display limit orders and to quote competitively, and thereby detract from the efficiency of the national market system.”)

²³ *Id.*

²⁴ *Supra* note 4.



We do not believe that the use of the displayed markets' prices by passive liquidity providers makes displayed prices either less valuable or less available to other market participants. Much like a streetlight funded by a locality, the fact that an out-of-town motorist benefits from its light does not make that light either less valuable or available to the local community, which is its primary beneficiary. Analogous to the importance of motorists from other towns to the healthy functioning of an inter-connected economy, passive liquidity providers provide valuable market liquidity as well as execution price data to the marketplace. Changes to this inter-connected environment can have unintended consequences that can damage traders and investors alike. Any regulation which restricts the liquidity that a form of trading activity brings to the marketplace potentially diminishes the liquidity in that marketplace as a whole. Appropriate public policy should not discriminate against one type of market liquidity over another any more than it should discriminate against motorists due to their residency.

d. Undermining of Rule 610(d) of Regulation NMS

The Commission has expressed concern that the flashing orders may “undermine Rule 610(d) of Regulation NMS, which is designed to protect displayed quotations from being locked by equal-priced contra side quotations.”²⁵ Direct Edge does not believe, however, that Rule 610(d) was designed to prohibit locking orders with respect to non-displayed liquidity interactions. Conversely, flash technology promotes the very principles that underlie locked and crossed market restrictions by enabling a market participant to interact with a much greater depth of market liquidity. Specifically, in adopting Regulation NMS, the Commission stated: “the basic principle underlying the NMS is to promote fair competition among markets, but within a system that also promotes interaction between *all* of the buyers and sellers in a particular NMS stock.”²⁶

Regulation NMS does not mandate that a locking order be routed to or executed only on a displayed market center. The price priority rules of Regulation NMS “merely requires the routing of . . . orders that otherwise would be executed at inferior prices.”²⁷ While ensuring that limit orders are executed before other trades occur at inferior prices was deemed essential to “give investors, particularly retail investors, greater confidence” and “promote deep and stable” markets,²⁸ it was never intended to restrict the liberty of a trading center to execute internally or otherwise handle a customer order at the price of an accessible quotation displayed elsewhere. An order that locks the market can execute against passive liquidity at a locking price consistent with the order protection rules of Regulation NMS, reside on an exchange or ATS book on a non-displayed basis, or be price adjusted or cancelled back to the relevant subscriber. Exchanges offer a host of order management products that allow customers to avoid executing with contra-side displayed interest when the entering customer determines that passive and/or non-displayed order management is the most appropriate execution technique for themselves or their customer. The mechanism that flash technology utilizes to source passive liquidity is functionally similar to mechanisms deployed by brokers seeking natural crosses on their books, whether at a locking price or otherwise, before routing the order to displayed markets.

²⁵ Flash Release at 48636.

²⁶ NMS Release at n. 442 and n. 795 (emphasis added).

²⁷ NMS Release at 37530.

²⁸ NMS Release at 37498.



An order that is flashed as part of the routing process to a displayed market does not lock at a price that is posted from within any displayed market's book. Upon arrival at the destination, the flashed order takes the best price that exists on the opposite side of the market and does not create a locked market state. Such order behavior was not of concern to the Commission when the rules on locked markets were adopted. As stated in the adopting release: "a locked market currently may not actually represent two market participants willing to buy and sell at the same price. Often, the locking market participant is not truly willing to trade at the displayed locking price, but instead chooses to lock rather than execute against the already-displayed quotation to receive a liquidity rebate."²⁹ Furthermore, Direct Edge's ELP product offering, unlike the flash technology offerings of its competitors, never offered a rebate to the order originator and, absent such a rebate, the instantaneous nature of the flash technology process virtually assures that users of Direct Edge's ELP program are willing to trade at any displayed locking price.

On a broader level, we note that where a locked market represents bona trading interest, it adds to market depth at the locking price and reduces price volatility. As such, a market that accommodates a zero spread is beneficial for investors.

V. Narrower Regulatory Response

Direct Edge urges the Commission not to take regulatory action that is as unequivocal as a ban. Rather, we urge the Commission to address the perceived concerns that exist with flash trading technology.

In the Commission's rule proposal respecting dark pools, the Commission noted:

"Although flash orders are used to access dark liquidity, the concerns that prompted the Commission's proposal relate . . . to the dissemination of valuable order information to certain market participants rather than in the consolidated quotation data"³⁰

In light of this being a primary concern of the Commission, we believe that a preferable alternative to a ban would be to require the dissemination of flashed order information into the consolidated quote stream. This would align with the Commission's acknowledgement of the role that enhanced consolidated data may play in advancing market structure regulation in the context of its proposed dark pool regulation.³¹ The Commission could implement this requirement solely with respect to flashed orders that will be routed on to other exchanges or more broadly. Should the Commission believe that some action is needed to address perceived inequities, this limited approach would better balance short-term investor confidence and long-term investor execution quality than an outright ban.

Isolating flash trading for concerns that are neither unique nor disproportionate to its use would run contrary to the principles of sound market structure. In this regard, we also recognize the need for improvements to cross market surveillance for the broader market, implemented in a manner that allows flexibility to accommodate innovative products, such as flash technology, that promise to benefit investors.

²⁹ NMS Release at 37547.

³⁰ Dark Pools Release at n. 6 (emphasis added).

³¹ See Dark Pools Release.



VI. Conclusion

Misperceptions respecting flash technology have, to date, stirred a passionate but ill informed debate. As flash technology accounts for a de minimis portion³² of overall trading in the market, many not utilizing the product may be hopeful that a tough regulatory response will help quell public outcry over various other practices across Wall Street. As demonstrated in this letter, however, flash technology is not detrimental to its users or the marketplace and the concerns raised lack empirical basis. We respectfully submit that a prudent, deliberative, data-disciplined approach is fundamental to the sound regulation of our marketplace.

Flash technology empowers provides the customers who utilize it with the choice to interact with a larger marketplace on their own terms while retaining the ultimate certainty of an exchange execution. Rather than conflicting with Regulation NMS, flash technology promotes its underlying principles. As stated in the adopting release for Regulation NMS:

“Greater depth and liquidity will, at a minimum, lower the search costs associated with trying to find liquidity and should lead to improved execution quality . . . [I]ntermarket price protection for accessible, automated orders . . . will help promote efficiency in the markets by more effectively linking markets together and integrating trading centers with different market structures into the NMS . . . [and] will promote investor confidence in the markets by helping to assure, on an order-by-order basis, that customer orders are executed at the best price available and providing protection against limit orders being bypassed by *inferior* priced executions.”³³

While any perceived inequities respecting flash technology should be addressed, creating unnecessary barriers between displayed and non-displayed markets without an adequate justification therefor will only isolate buyers and sellers from each other in a way that will undermine execution quality.

Furthermore, a flash technology ban would send an unequivocal message to the market that the Commission is now designating the winning and losing market technologies and this would change the competitive dynamic respecting innovation. Exchanges or firms with influence would be motivated to attempt to delay or otherwise thwart the innovations of their competitors under the cloak of advocacy for the greater public good, whether or not their proffered concerns are either currently existing or unique to such innovations.

Restricting the flexibility of markets to offer legitimate, innovative technologies that improve execution quality would diminish both choice and market competition. In the words of Commissioner Paredes:

“research, development, and innovation need to be rewarded. Market participants, including investors, brokers, and trading venues, expect that they will be rewarded when they invest in the latest technology and develop their skills to gain a market edge. When the regulatory regime erodes a market participant's opportunity to profit from its legitimate competitive advantage, the incentive to innovate is dampened.”³⁴

³² At its peak in June and July of 2009, flash trading only accounted for 3% of daily executions. See Flash Release at 48635.

³³ NMS Release at 37594 (emphasis added).

³⁴ Supra note 4.



Ultimately, our equities markets will be best served by a regulatory system that harnesses the promise offered by technological innovation for all investors. While innovation may sometimes spur populist fears and demands for tough action, particularly in the wake of the recent challenges our financial markets have faced, we urge the Commission to continue to pursue a prudent, deliberative, data-driven approach to the regulation of our markets.

Direct Edge is ready to be of service as the Commission embarks on this process and thanks the Commission in advance for the consideration of these comments.

Sincerely,

A handwritten signature in blue ink, appearing to read "Eric W. Hess".

Eric W. Hess
General Counsel

cc: Hon. Mary Schapiro, Chairman
Hon. Luis A. Aguilar, Commissioner
Hon. Kathleen L. Casey, Commissioner
Hon. Troy A. Paredes, Commissioner
Hon. Elisse B. Walter, Commissioner
Robert W. Cook, Director of Trading and Markets
James Brigagliano, Deputy Director of Trading and Markets
Dan Gray, Senior Special Counsel for Trading and Markets