November 23, 2009

VIA EMAIL and
BY OVERNIGHT MAIL

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

Re: File Number S7-21-09

Dear Ms. Murphy:

NYSE Euronext, on behalf of New York Stock Exchange LLC (“NYSE”), NYSE Amex LLC (“NYSE Amex”), and NYSE Arca, Inc. (“NYSE Arca”), appreciates the opportunity to comment on the Securities and Exchange Commission’s proposal to ban flash orders and flashing mechanisms. NYSE Euronext supports the Commission’s efforts to address those trading practices that undermine the fairness, transparency, and efficiency of our national market system and to identify regulatory approaches to curtail such practices.

For the reasons set forth in our May 28, 2009 letter1 and discussed below, NYSE Euronext believes that the harm that flash orders and mechanisms cause to the national market system, both for equities and options, outweighs any potential benefits that market participants may derive from the use of such trading practices. In its proposal, the Commission has identified

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those harms and has proposed a regulatory framework that would be applicable to both registered exchanges and, in the equities markets, to alternative trading systems (“ATSs”). NYSE Euronext applauds the Commission’s initiative as a first step in establishing consistent regulatory standards for both registered exchanges and ATSSs.

NYSE Euronext believes, however, that the regulatory solution to banning flash orders and mechanisms identified in the proposal, namely, eliminating Rule 602(a)(i)(A) of Regulation NMS (“Reg. NMS”)2, is unnecessarily broad in that it would ban not only trading practices that harm the market, but also long-standing and appropriate trading practices as well. NYSE Euronext therefore believes that the Commission should adopt a more finely-tuned regulatory approach that would address only those trading practices that undermine the fairness and efficiency of the national market system.

I. Background

Since the implementation of Reg. NMS, competition in the U.S. cash equities markets among registered exchanges and ATSSs has substantially increased. During this same period, the technology supporting trading has advanced dramatically. Quoting and trading now occur in milli- and micro-seconds. These technology changes, together with the minimal standards to register as an ATS, have dramatically lowered the barriers to entry into the U.S. cash equities markets, resulting in an influx of new market centers. Currently there are over 80 registered equities exchanges and ATSSs, with the increase predominantly attributable to new, lightly regulated ATSSs. Technology has also driven order flow and competition in the options marketplace, with seven competing registered options exchanges and up to three more being readied for launch.

To respond to the increased competitive pressure in this high-speed world, both registered exchanges and ATSSs have implemented new trading functionality designed to attract executions to their markets. For the most part, the introduction of new innovative trading functionality is a healthy result of competition, and indeed what Reg. NMS sought to promote. However, some forms of trading functionality may be introduced not primarily to benefit investors and the market as a whole, but because it would attract order flow from order entry firms to the introducing market. This functionality may have serious market structure ramifications.

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As things currently stand, registered equity exchanges and ATSs are subject to different levels of regulatory scrutiny. This had led to a two-tiered market where the more lightly regulated ATSs can implement trading functionality that is not subject to the same level of rigorous review as those proposed by registered exchanges, at times resulting in troubling trading practices, such as the flash order structure in question. This, in turn, has resulted in increased fragmentation across equities exchanges and ATSs. NYSE Euronext therefore believes that the time is ripe to move to a regulatory framework that is applied consistently across all market centers. Addressing flash order trading practices is one element of such a regulatory framework.

NYSE Euronext believes that any proposal must be narrowly tailored to address only those trading practices that undermine the national market system. Therefore, a necessary step to determining the appropriate regulatory response is to define which trading practices cause such harm. If “flashed orders” are defined too broadly, or if the regulatory approach is too broad, then the unintended consequence of the proposal may be to limit or curtail other trading practices that do not harm the market and, in fact, have been demonstrably beneficial to the efficient operation of U.S. securities. This could have significant adverse consequences for the markets and for investors.

II. Electronic Flash Trading Should Be Banned

NYSE Euronext concurs with the Commission’s conclusions as to how electronic flashing mechanisms can harm the market.

As the Commission notes, flash orders are inconsistent with Regulation NMS and the goals of a national market system because they create private, locked markets that are neither transparent nor fair. If, instead of being flashed, such marketable interest were to be quoted via a consolidated quote stream, it would lock the market, in violation of Rule 610(d) of Reg. NMS.3 NYSE Euronext therefore believes that marketable interest routed to a market center should be executed immediately with any available interest in the market center, including displayed liquidity, reserve interest, or interest that offers price improvement from certain market participants, and that any portion of the order that does not execute immediately should either cancel (if the order is an immediate or cancel (“IOC”) order) or route to away markets to trade with protected bids or offers, unless otherwise instructed by the customer.

3 17 CFR 242.610(d).
NYSE Euronext also agrees that flashing mechanisms create a disincentive for the display of limit orders in equity markets. As the Commission notes, flash orders are marketable orders willing to trade at the national best bid or offer (“NBBO”). The participant that receives the flashed order information therefore has the opportunity to take advantage of the information provided by the order being flashed, but is under no obligation to provide liquidity at that price or trade with the flashed order. Rather, the market participant that receives the flashed order is afforded the opportunity to trade at the NBBO with the flashed order, do nothing, or trade ahead of the order that was flashed at a price away from the NBBO. At the very least, the flash recipient gains information about pending market trends that provide an information advantage compared to other market participants that do not have knowledge of such actionable interest.4 The fact that only sophisticated traders can meaningfully respond to the flashed order information is inconsistent with the long-held principles of fairness and transparency that have been cornerstones of the U.S. securities markets for decades.

Additionally, as the Commission noted, because of the artificial delay in executing a flash order, such flashed order may be subject to substantial risk of missing the market during the flash period. If an away market has contra-side interest available at the flash order’s price, under normal trading conditions, such order would route to execute against that interest (unless the order had instructions to cancel if not executed at the market center). Instead, the flash order is held at the market center to attract contra-side interest to that market center. During that holding period, however, the price may move. Indeed, as noted above, the price movement could be driven by a market participant who learns of the flash order and attempts to move the market while the flash order is pending. In such case, the flashed order would miss an execution that it otherwise may have received had it been routed. The flashed order therefore does not receive any additional benefit from being artificially held at a market center. Rather, the primary driver for holding the order is to attract interest to a market center for competitive purposes, rather than to guarantee price improvement or even to find contra-side liquidity for the flashed order.

4 Currently, there are no clear rules on whether a market participant who receives a flash order has any duty not to use the information received in the flash message. To ensure that market participants that receive such flashed order information do not misuse this information, the Commission should, at a minimum, require consistent regulatory controls regarding what actions can and cannot be taken with respect to that information, regardless of where the trade occurs.
Similar considerations are also applicable to the options markets. Flashing mechanisms in the options markets contribute to wider market maker quotes, because providing the national best price loses meaning when an order can be diverted into a flashing period rather than immediately routing to the best quoted price destination(s). The current rules governing the flashing of option orders date back to a time when the inter-market linkage was inefficient and the exchange receiving an order via linkage had up to twenty seconds to report back a fill or cancel of a linked order. In that environment, flash orders were designed to avoid linkage and the inherent delays. Today, with highly efficient electronic systems, even the one-second flash period is much longer than the time required to route an order to an away market center at the NBBO and to receive a response. For example, NYSE Arca and Amex options orders routed to other exchanges that are offering better prices will typically be filled, receive an acknowledgement, and/or be cancelled within a 200-300 millisecond range. Therefore, flash mechanisms in the options markets have the same fundamentally anti-competitive results as occurs in the equities markets.

III. Electronically Flashed Orders Should Be Narrowly Defined

In order to structure an appropriate regulatory approach to flash order mechanisms, it is important to identify which trading practices implicate the harms to the national market system that the Commission has identified in its proposal.

NYSE Euronext believes that the Commission has already outlined the salient attributes of a flash order. As noted in the proposal, the basic features of flash orders are that they are: (i) voluntary (that is, a participant opts in); (ii) marketable; (iii) upon arrival to a market, immediately interact with any available contra-side trading interest at the NBBO; (iv) if not executed against available contra-side interest, the market center artificially delays the execution of the order and instead flashes it to that market’s own participants at NBBO; (v) the market participants that receive the flashed order information have a brief period to respond with their own order at a price that matches the NBBO; (vi) if an order responds, it executes against the flashed order in that market; and (vi) if no order responds to the flash, the flashed order may be canceled or routed away to another market center for possible execution.

NYSE Euronext notes that in the options exchanges, flashing mechanisms are “voluntarily” insofar that customers may choose other order types that are not eligible for routing, such as IOC or Post No Preference (“PNP) orders. In the options markets that have flashing mechanisms, customers that enter marketable orders without an instruction on routing have no choice but to flash prior to routing.
NYSE Euronext notes that these trading mechanisms do not allow for any negotiation with respect to the price or execution of the flashed order.

If these are the basic features of a flash order or mechanism, and it is the Commission’s intent to ban flashing of non-contingent, marketable orders, it follows that any rule proposal to ban such mechanisms should be narrowly construed to focus on these attributes, and that all of the salient features of a flash order should be present for a trading practice to be banned. NYSE Euronext believes that the only type of interest that could meet the above-identified features in today’s markets is electronically flashed interest.

IV. Trading Practices that Do Not Constitute “Flash” Orders

NYSE Euronext believes that the definition of flash orders or mechanisms should be narrowly construed to exclude certain other, long-standing order types or trading practices that do not harm the national market system. In fact, the trading practices described below are distinguishable from flash orders because they do not implicate one or more of the basic attributes of a true flash mechanism and therefore do not cause the harm to the market that flash orders do. Any regulatory response to flashing of orders therefore should be tailored to ensure that legitimate and beneficial practices such as those described below are not included in such a ban.

A. Negotiated Trades

One of the long-standing practices among brokers, both on equities and options trading floors and in “upstairs” locations, is to negotiate, at the customer’s instruction, with other brokers for a trade of a not held order. Most significantly, such not held orders require negotiation in order to consummate a transaction when the order outsizes currently displayed liquidity, is not marketable at the NBBO, or includes contingencies.

This negotiation process is similar among upstairs brokers and floor-based brokers; the main difference being that floor brokers are located on an exchange trading floor and have the option to source liquidity from other market participants located on the trading floor, while upstairs brokers source liquidity from market participants located in an upstairs office. The trading floor thus serves as a venue for brokers representing orders to seek liquidity and price discovery from other market participants in order to meet customer instructions and possibly obtain price improvement. Where there is liquidity on an exchange floor sufficient to fill a marketable order worked by a floor broker, the trade is negotiated verbally and then effected
immediately, subject to Reg. NMS. The same is true for negotiated executions of equity transaction by upstairs brokers.

Floor-based brokers, both equities and options, also generally represent orders and negotiate on behalf of customers in an agency capacity. Therefore, when an exchange floor broker is representing an order in open outcry or an auction market, that broker has a fiduciary responsibility to achieve best execution for that customer. The service a floor broker provides must take many factors into consideration to provide best execution, including but not limited to price, liquidity, timeliness of execution, and market impact. As a fiduciary, the broker makes the determination of what information pertaining to an order should be disclosed in the course of negotiations of “working the order,” consistent with the terms of the order and the customer’s instructions. For example, a floor broker working on the NYSE and NYSE Amex equities trading floor can use Block Talk functionality to disseminate interest in a security. But the information relayed over that service, which is limited to the broker’s identity and the symbol that he or she is willing to trade, does not constitute a firm bid or offer because it does not specify side, size, or price, but rather is an invitation to start negotiations and remains subject to the floor broker’s fiduciary responsibility to that order. NYSE Euronext notes that similar considerations are applicable to upstairs brokers with respect to orders they represent in a negotiated context.

In fact, in the Commission’s recent dark pool proposals, the Commission recognized the unique aspects inherent in executing large orders. The Commission should recognize these unique features when crafting a regulatory approach for flash orders. For such negotiated trades, the original purpose of the exception still exists: capturing them in the quote stream would serve no purpose, because by the time the orders are recorded and displayed, they are gone – executed or cancelled. Electronic flash orders, however, are not only able to be displayed, they are displayed, but only to select recipients.

Another key distinction between broker negotiation and electronic flashing mechanisms is that brokers have discretion not to execute a not held order if the contra-side interest is not bidding

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6 On exchange trading floors, floor brokers may not initiate proprietary orders. Floor brokers representing a principal or proprietary order that has been initiated in the off-Floor premises of the firm are subject both to the yielding requirements of Section 11(a)(1)(G) of the Securities Exchange Act of 1934 and Rule 11a1-1(T) thereunder. NYSE and NYSE Amex Equities Floor brokers are also subject to NYSE and NYSE Amex Equities Rule 92 limitations on trading ahead of an unexecuted customer order.
or not offering a price or size that would satisfy the customer’s instructions and provide the order with its best execution. In contrast, flashed orders are typically smaller orders that are immediately marketable at the NBBO on an away market and not subject to negotiation. Instead of handling the order as required by Reg. NMS, i.e., either quoting or, if such quote would lock the market, routing the order to an away market, a flashed order is artificially delayed and shown to a select group of market participants with the goal of enabling the receiving market to retain the execution of the order on its venue.

The process of negotiation by brokers is thus very different from an electronic flash mechanism in which there is no discretion, no contingencies, no meaningful negotiation, and unclear fiduciary responsibility surrounding the flashed order information. Simply put, a flash order is in essence a marketable firm bid or offer (or actionable indication of interest) that will execute at the NBBO if available contra-side interest responds to the flashed order. Limiting a floor broker’s authority to negotiate an order in a regulated environment prior to an execution will achieve nothing more than moving this negotiation process away from the open transparency of the trading floors and interfere with the orderly audit trail that exists today.

B. Customer-Instructed Order Types

Flash mechanisms are also distinguishable from reserve interest and other non-displayed liquidity. If read too broadly, a ban on flash orders and the concomitant requirement that all marketable interest be publicly quoted could result in a drastic change for all market centers, which each offer market participants the opportunity to enter interest that is not publicly displayed. These customer-instructed order types, however, each have predetermined instructions for when to execute and do not depend on a “flash” of order information before they execute.

For example, reserve interest that is marketable will execute immediately when it arrives at a market center. If reserve interest is not marketable when it arrives at a market, such interest then resides in the market’s systems where it is available to trade with any incoming interest eligible to trade at such a price point and/or to be quoted consistent with the terms of the order.

Similarly, with tracking orders, participants may set parameters under which they are willing to provide additional liquidity at the NBBO price, regardless of who the contra-side is. Tracking orders are automatically activated if such parameters are met, and if activated, guarantee an immediate execution to fill the routable order at the NBBO price. If the tracking order parameters are not triggered, the marketable order immediately routes to the destination
C. Price Improvement Mechanisms

Finally, flash orders and mechanisms are also distinguishable from those trading practices or functionalities that provide price improvement to incoming orders. On both the equities and options markets, certain market participants, mechanisms, and/or order types have the ability to provide price improvement, which may result in retaining an execution at that trading venue. In the equities markets, these price improvement mechanisms do not provide any market participants with an advance look at an order or trading interest. Rather, the functions are automatic, based on pre-determined sources of liquidity that the market participant is willing to provide.\(^7\) Price improvement mechanisms in the equities markets are similar to reserve interest in that the price improving trading interest is triggered and executes against incoming orders, albeit at an improved price to that order.

For the listed options exchanges, flashing mechanisms can also be distinguished from automated price improvement auctions, which essentially seek to replicate how the open outcry market provides price discovery and potential price improvement for the customer. In open outcry, the order is being negotiated in an effort to locate liquidity or price improvement for an order that cannot be filled at the desired price and size based upon the displayed markets. The transaction must either improve on the NBBO, or the floor broker must clear all interest better than the execution price. These same rules apply to electronic price improvement auctions.

An automated price improvement auction guarantees improvement of the NBBO price and also seeks to get additional price improvement for the order. If the price moves during the flash period, the customer is in no way guaranteed to receive the initial, better NBBO price. In contrast, price improvement auctions guarantee an execution at a price equal to or better than the NBBO. Price improvement auctions therefore promote competition over a defined time period, as opposed to flash orders, which provide participants with valuable and

\(^7\) See, e.g., NYSE and NYSE Amex Equities Rule 1000. Reserve interest also can provide price improvement to incoming orders.
exclusive information with no obligation to trade and no assurance a marketable order receives a fill.

NYSE Euronext notes that some commentators have drawn parallels between the NYSE’s former specialist-based market structure and flash order mechanisms. While there are some parallels, there are also significant differences. Specialists were provided with an advance look at orders so that they could provide price improvement or perform other functions with respect to such orders. NYSE specialists had both an affirmative and negative obligation to the market. Moreover, NYSE specialist activity was subject to a regulatory program that included both surveillance of specialist trading and regular examinations for operational, supervisory, and recordkeeping compliance. Specialists were also subject to limitations on trading in away markets, both in securities registered to them and in options markets. Potential abuse by specialists of order information they received in the context of their market making activity was thus subject to regulatory limitations and scrutiny on a consistent basis. In any event, the NYSE eliminated this practice in part because of the same concerns now raised in connection with electronic flash orders. In contrast to the former specialist system, recipients of flashed orders have no obligation to the market or to the orders that are flashed to them. It is also an open question whether it is possible to conduct comprehensive cross-market surveillance in light of the fragmented audit trail in the equities markets.

V. Rule 602(a)(i)(A) Should Not be Eliminated

While NYSE Euronext supports the Commission’s initiative to ban flash trading, we do not believe that eliminating Rule 602(a)(i)(A) is the right approach. Rule 602(a)(i)(A) provides an exception from the requirement that each market disseminate its BBO to the consolidated quotation stream for orders that are either (i) executed immediately after communication or (ii) cancelled or withdrawn if not executed immediately after communication. Flash orders do not fall within either prong of the exception. Therefore, eliminating the exception is unnecessary to accomplish the Commission’s goal of banning flash order mechanisms.

As the Commission notes in its proposing release, the original intent of the Rule 602(a)(i)(A) exception, which incorporates principles dating to 1978, was for oral bids and offers on a trading floor in recognition of the “ephemeral” nature of such quotes if they are either immediately executed or withdrawn or cancelled. Rule 602(a)(i)(A) also permits a market center to accept IOC orders, which, if not immediately executed at a market center, may either be cancelled or, in some circumstances, routed to an away market.
NYSE Euronext believes that flash trading falls outside the exception to the quoting requirement contained in Rule 602(a)(i)(A). Flash orders are not ephemeral in nature as they are firm orders that will execute if there is contra-side marketable trading interest available, nor is it impractical to include them in the consolidated quote. The only purpose of the flash is for the receiving market to avoid routing the order to a protected quote on another market. The time during which these orders are flashed is significant in today’s fast trading environment. To hold an electronic order for even 500 milliseconds can no longer be deemed an immediate execution eligible for an exception from the quote rule. NYSE Euronext therefore believes that Rule 602(a)(i)(A) is inapplicable to flash trading, as defined above.

In contrast, in a manual market, even today, floor broker interest is generally not firm or marketable and is subject to negotiation with other market participants. If and when a floor broker agrees on price and size with another market participant, at that point the trade is reported to exchange systems. At no point prior to consummation of the trade is the interest not ephemeral, nor can it, as a practical matter, be entered into the consolidated quote stream. If Rule 602(a)(i)(A) were to be eliminated, the elimination would, in effect, ban all manual floor-based trading since it would ban oral negotiation unless such negotiations could be electronically captured and widely disseminated. Thus, the proposal as currently structured calls into question the continued viability of the negotiation and execution process on trading floors. It would be virtually impossible to disseminate quotes by floor brokers in a proper time sequence for situations where such quote may be executed, cancelled, or withdrawn before such quote can reach the consolidated quote stream. In addition, public confusion could ensue because by the time floor broker manual interest is represented in the consolidated quote stream, it may already have been executed, cancelled or withdrawn, leading to misinformation in the market about available liquidity. Moreover, if the proposal is enacted as written, it would effectively force all negotiated trading off of regulated exchange trading floors and into the unregulated, and essentially dark, trading rooms of broker-dealers.

Therefore, because in our view, Rule 602(a)(i)(A) does not permit flash trading in the first instance, eliminating the exception would not achieve the stated goal of the proposal. But it would have the consequence of eliminating the ability of brokers on both equities and options trading floors from seeking price discovery or liquidity on behalf of their customers. While trading has moved to a more electronic trading environment, NYSE Euronext believes that trading floors continue to play a vital role in today’s markets, particularly in times of volatility and periods of price discovery. NYSE Euronext has automated many of the trading functionalities on the trading floors it operates, but it also continues to believe that the manual auction process provides floor brokers with the ability to engage in price discovery on behalf
of their customers, similar to how upstairs brokers handle large orders. In fact, by the same rationale, the Commission’s proposal would also need to reach upstairs to similarly require entry of interest into the automated quote stream while negotiating a block transaction.

Eliminating Rule 602(a)(i)(A) would also result in removing the ability to use IOC orders because markets would be required to quote orders that, by their terms, no longer exist. IOC orders have become an invaluable tool in today’s market structure, particularly for compliance with Reg. NMS requirements with respect to intermarket sweep orders (“ISO”). Some market centers, including NYSE, NYSE Amex, and NYSE Arca equities and options exchanges, only accept ISOs that are sent as non-routable IOC orders. Not having IOC order types would defeat the purpose of ISOs, which are intended to be executed at a single market center for purposes of meeting Reg. NMS compliance in connection with trading with protected bids and offers. Although the Commission’s proposal seeks to distinguish IOC orders from flash orders, the fact remains that eliminating Rule 602(a)(i)(A) would have the unintended consequence of eliminating an order type that the Commission does not consider the equivalent of a flash order type.

NYSE Euronext believes that a more tailored regulatory approach would be to retain Rule 602(a)(i)(A) in its current form and instead provide interpretive guidance that flash orders, as defined above, do not fit the stated exception from the quoting requirement in the first instance. This approach will ensure that those long-standing and appropriate trading practices that rely on the exception from the quote rule can continue to function, and ensure that those trading practices that are not eligible for the exception need to be either quoted or executed, including immediately routing to the NBBO price if necessary to avoid creating a locked market in violation of Rule 610(d).

NYSE Euronext further believes that, as the Commission has already proposed, this tailored regulatory approach should be applied consistently across registered equities exchanges, ATSs, and options exchanges.

VI. Conclusion

NYSE Euronext recognizes and supports the Commission’s ongoing leadership in reviewing and addressing trading practices that cause harm to the national market system. The Commission’s analysis of flash trading identifies the key issues concerning the abuses relating to those trading practices. It also proposes a consistent regulatory framework for both registered exchanges and ATSs. All of these laudable and necessary changes can be accomplished so as to ban flash trading, without sweeping into the ban long-standing trading
practices that have been approved by the Commission for decades and are vital to the smooth operation of the capital markets. Eliminating Rule 602(a)(i)(A) would have a negative outcome for our national market system by eliminating longstanding and appropriate trading practices, such as floor broker price discovery on both equities and options trading floors and the use of IOCs. NYSE Euronext therefore respectfully urges that the Commission adopt a narrower regulatory approach that addresses only those trading practices that implicate the concerns and harms associated with true flash orders. NYSE Euronext also believes that the Commission should consider in a comprehensive way the regulatory disparities between exchanges and ATSs and move to a regulatory framework applied equally to trading on exchanges and ATSs. This move would help prevent the development of questionable trading functionally like flash orders in the now, more lightly regulated ATSs.

Very truly yours,

[Signature]

cc: The Hon. Mary Schapiro, Chairman
The Hon. Luis Aguilar, Commissioner
The Hon. Kathleen Casey, Commissioner
The Hon. Troy Paredes, Commissioner
The Hon. Elisse Walter, Commissioner
Mr. Robert W. Cook, Director of Trading and Markets
Mr. James Brigagliano, Deputy Director of Trading and Markets
Mr. Daniel Gallagher, Deputy Director of Trading and Markets