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February 24, 2010

Ms. Elizabeth M. Murphy  
Secretary  
Office of the Corporate Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.W.  
Washington, D.C. 20549-1090

Re: **Securities Exchange Act Release No. 34-60997**  
**File No. S7-27-09, Regulation of Non-Public Trading Interest**

Dear Ms. Murphy:

Knight Capital Group, Inc.<sup>1</sup> (“Knight”) welcomes the opportunity to comment on the U.S. Securities and Exchange Commission’s (the “Commission”) proposal relating to the Regulation of Non-Public Trading Interest. Knight fully supports the Commission’s initiative to review market structure evolution that ultimately shapes the U.S. equity market. Knight believes that the U.S. equity market is the best functioning and fairest market globally. This has been achieved through fact-based decisions, prudent rulemaking, structural transparency and timely and efficient disclosure, all of which are products of a competitive and fair market structure that allows choice and fosters innovation.

## INTRODUCTION:

Regulatory fine tuning is necessary in a market as dynamic as U.S. equities. Knight, therefore, fully supports the Commission’s Concept Release on Equity Market Structure<sup>2</sup> (the “Concept Release”) and believes that with the many market structure changes that

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<sup>1</sup> Knight Capital Group, Inc. is the parent company of Knight Equity Markets, L.P., Knight Capital Markets LLC, Knight Direct LLC, Knight BondPoint, Inc., and Knight Libertas LLC all of whom are registered with the SEC and various self-regulatory organizations. Knight Capital Europe Limited and Hotspot Fxi Europe Limited are authorized and regulated by the Financial Services Authority. Knight Capital Asia Limited (f/k/a Knight Equity Markets Hong Kong Limited) is authorized and regulated by the Securities and Futures Commission. Knight, through its affiliates, is a major liquidity center for the U.S. securities markets. We trade nearly all equity securities. On active days, Knight can execute in excess of five million trades, with volume exceeding ten billion shares. Knight’s clients include more than 3,000 broker-dealers and institutional clients. Currently, Knight employs more than 1,100 people worldwide. For more information, please visit: [www.knight.com](http://www.knight.com).

<sup>2</sup> File No. 34-61358; File No. S7-02-10, January 14, 2010.

have taken place in recent years, a holistic review of the U.S. equity market structure is timely, relevant and needed. Furthermore, Knight believes that Regulation of Non-Public Trading Interest, Elimination of Flash Order Exception From Rule 602 of Regulation NMS, and Amendments to Regulation SHO<sup>3</sup> should all be considered as part of the Concept Release. We strongly urge the Commission not to take action on any small part of the market ecosystem until overall consideration of the current market structure is accomplished, which would include feedback from market participants such as broker/dealers, institutions, exchanges, ECNs, ATs and off-exchange liquidity providers, regulators, academics, investors and industry experts. As Commissioner Casey stated on January 13, 2010 in Washington, D.C. at the SEC Open Meeting: “We should strive to avoid playing a game of Whac-a-Mole in this area, where we solve one problem and inadvertently create a new one.” Additionally, Knight would like to suggest that any proposed change be subject to rigorous analysis, study and piloting before considering approval of any outstanding market structure sensitive proposals.

Knight has advocated repeatedly that choice, innovation and competition, rather than mandated and prescribed paths to trading, benefit market participants and all investors. Knight does not believe that market structure debates that are fundamentally competitive in nature can be addressed by regulation. Knight further believes that the U.S. equity market structure should encompass a variety of execution choices for the many different types of investors that execute trades on a daily basis. Commissioner Casey expressed a similar sentiment at the same meeting on January 13, 2010: “We are concerned that many of the issues being raised are less of a market structure regulatory nature than a fundamentally competitive issue. As my colleagues on the Commission know all too well, those requesting such a result should be greeted with some skepticism, because in Washington, calls for a level playing field roughly translates to ‘I’m losing market share, and need a regulatory advantage.’”

As a subtext to many of the discussions around U.S. equity market structure, there is a sense among many that the goals of traders and investors are not aligned. Knight disagrees with this assessment and believes whether an investor or trader’s time horizon is measured in seconds, days, weeks, months, years or decades, each market participant desires the best execution possible. Further, it has become apparent as a result of many discussions that there seems to be a sense that the market has become less fair over time and that technology and innovation have put certain classes of investors at a disadvantage. We disagree and believe that by all measures there has never been a better time to be an investor (institutional or retail) in U.S. equities.<sup>4</sup>

With regard to the proposal at hand, Knight believes that the proposed changes, in sum, will limit the choice and flexibility of trading decision makers of all types, will inhibit

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<sup>3</sup> File No. 34-60997; File No. S7-27-09, November 13, 2009. File No. 34-60684; File No. S7-21-09, September 18, 2009. File No. 34-60509; File No. S7-08-09, August 17, 2009. File No. 34-59748; File No. S7-08-09, June 19, 2009.

<sup>4</sup> “The Economics of Trading in the 21<sup>st</sup> Century” Angel, James; Harris, Lawrence; Spatt, Chester February 23, 2010.

trading and will directly impact the implicit cost of trading to institutional retail investors alike.

### **OFF-EXCHANGE LIQUIDITY:**

Non-visible, or “dark”, liquidity has been a hallmark of the U.S. equity market since inception and has maintained a relatively constant percentage of trades over time<sup>5</sup>. Historically, the largest dark pool resided on the NYSE trading floor. The transformation from human based trading practices to electronic replications of those practices seems to be driving many of the market structure discussions. The Regulation of Non-Public Trading Interest proposal looks at practices that have been part of the U.S. equity market structure since the earliest days of trading. This is not to argue, however, that because it has always been an important part of the market structure it is good. On the contrary, this liquidity created a two-tier market, providing a small group of club members with access to large blocks of stock at better prices than available on the public exchanges.

The market has been significantly flattened since those days by the extremely networked lattice structure of venues. In fact, this is the fairest market structure that has ever existed<sup>6</sup>. To move away from the networked venue system of today with its lit and dark venues that offer more execution flexibility would be a step backwards. From the point of view of smaller market participants, such as retail investors, the market has never been so inclusive and efficient. For the first time, small investors have access to dark liquidity and the corresponding better execution benefits of price improvement and improved spreads.

Knight believes that all market participants are benefiting from the current market structure. The entire spectrum of market participants has the option to participate on an even playing field: from small investors to large, there exist numerous options to rent, buy or build the connectivity to this array of trading tools.

Knight will first share our comments on Part I (Actionable Indications of Interest (“IOIs”)) followed by Part II (ATS Pre- and Post-Trade).

### **ACTIONABLE IOIs:**

The Commission is proposing to amend the definitions of “bid” or “offer” in Rule

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<sup>5</sup> Based on Rosenblatt Market Structure Analysis & Trading Strategy, January 2010 and past data from exchanges, the percentage for off-exchange transactions typically are in the 15-20% range of overall U.S. equity volume. According to the Market Structure Overview prepared by Goldman Sachs in September 2009: Trade Reporting Facility (TRF) volumes have hovered in the 20% range for the last few decades, and; In 1993 NYSE estimated that dark liquidity (excluding activities on the floor) accounted for 20% of equity volume.

<sup>6</sup> “The Economics of Trading in the 21<sup>st</sup> Century” Angel, James; Harris, Lawrence; Spatt, Chester February 23, 2010. See pages 7-26 for data market structure data metrics.

600(b)(8) of Regulation NMS of the Exchange Act so that they apply explicitly to actionable IOIs. The proposal would also impact the scope of bids and offers subject to the display requirements of OTC market makers under Rule 602 of Regulation NMS and Rule 301(b)(3) of Regulation ATS. As a result of this proposal, actionable IOIs sent by ATSS and other trading venues would be deemed “bids” and “offers” and potentially subject to the public display requirements of the Quote Rule.

Knight believes that subjecting all variations of actionable IOIs to the Quote Rule would be an incorrect approach. From our vantage point, it is crucial to draw distinctions between types of IOIs. For instance, IOIs associated with a firm order need to be considered as more quote-like than an IOI that is exploring the possibility of a trade or probing the marketplace for the natural contra-side of a trade. Knight believes that the Commission is able to properly distinguish the level of actionability of an IOI based upon the information contained in the IOI such as symbol, buy/sell, price and size. However, the level of content required for an IOI to be considered actionable needs to be further clarified.

Much of the proposed rule assumes that actionable IOI liquidity, if diminished, would translate linearly into visible liquidity benefits such as increased quoting or improved spreads. For instance, the Commission states in the proposed rule that “Actionable IOIs with prices better than the NBBO would effectively narrow the quoted spread for an NMS stock if included in the consolidated quotations.” Knight believes this is speculative, most likely inaccurate and fails to account for the many types of market participants and their incentives. For instance, a large institutional investor might be using IOIs to express interest for a large order at prices that improve the NBBO, but would not quote for fear of disclosing the firm’s intention<sup>7</sup>. We do not believe that the liquidity that exists in the market in the form of actionable IOIs, if they were regarded as quotes, would become another type of liquidity. Moreover, since many of the market participants that utilize IOIs as part of their strategy have been significant sources of liquidity, the removal of this liquidity without the translation into quoting could increase the volatility of many stocks.

The proposed rule further states that IOIs for NMS stocks having a market value greater than \$200,000 will be exempt from the proposed changes. This will effectively move the market backward into an earlier age when dark liquidity was truly tiered. Virtually no retail order will meet the size requirement discussed, thus preventing retail and small institutions from participating in the benefits of dark liquidity. The current landscape of dark liquidity has venues with average share size per trade ranging from 200 shares to over 40,000 shares<sup>8</sup>. Many of the venues with smaller average sizes contain retail order flow that has been routed to them for best execution and price improvement purposes.

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<sup>7</sup> Without additional study on the impact of this change, we believe that the unintended consequence of this action would be increased volatility and bid/offer spread widening as a certain class of liquidity providers exit the market.

<sup>8</sup> See Rosenblatt’s Monthly Dark Liquidity Tracker.

Additionally, one of the results of the proposed rule changes would be to remove any gradients, or shades, of dark liquidity. The proposed ruling has no impact on venues that are completely dark, and one of the direct results of this amendment could be to increase the “black liquidity” at the expense of other shades of gray.

Knight strongly believes that changes to actionable IOIs provides the greatest risk of negative unintended consequences and believes this should be part of the Concept Release discussion to ensure all ideas are properly understood, vetted and tested. Knight is firm in its belief that this change would limit choice and innovation in the U.S. equity market. It would remove an important tool that brokers have to maximize client execution efficiency for a wide cross section of clients, from retail to large institutions. In many cases, forcing IOIs to be part of the quote will lower liquidity provision and disadvantage clients as they will get inferior execution as spreads widen and volatility increases. The impact on spreads, volatility and information leakage are three areas of concerns that we would ask the Commission to explore as it considers taking action on this proposal.

#### **ATS DISPLAY & ATTRIBUTION:**

##### **DISPLAY OBLIGATIONS:**

The Commission is proposing to lower the volume threshold from 5% to 0.25% to help assure that the public, through the consolidated quotation data, has access to valuable order information (including actionable IOIs) about the best prices and sizes for NMS stocks that trade on an ATS.

Knight believes that the threshold that would most positively impact the market structure of U.S. equities should be explored, and we would suggest it be based on an analysis of the impact on the market. This would result in the optimum percentage of a stock’s average daily volume (“ADV”) being traded before a venue sends quotes to the consolidated tape. Knight asserts that further analysis is required to determine the proper percentage of the ADV that would change the threshold levels. The actual percentage should be a function of the type of equity, the type of venue and the general level of volatility, amongst other parameters. The assessment should also take into account operational issues that the change in threshold levels could create in the market.

At this time, Knight does not know the optimal threshold levels, nor does it believe that a conclusion can be reached without additional study of this point. Knight does believe, however, that selecting an arbitrary threshold does not help the overall U.S. equity market structure.

## POST TRADE ATTRIBUTION:

The proposal envisions the Commission creating a joint industry plan for publicly disseminating consolidated trade data that requires real-time disclosure of the identity of an ATS on trade reports. The proposed amendments would require disclosure of the identity of individual ATSs on FINRA trade reports in the same way exchange trades are currently identified on trade reports. At present, firms sponsoring ATSs report trades to FINRA with a Market Participant Symbol ("MPID") attached, but the MPID is not disseminated publicly on trade reports. Under the proposed rule, broker-dealers that have ATSs and are using a MPID for their firm when reporting ATS trades would need to apply for and be assigned a separate MPID for their ATS.

Knight believes that post trade attribution beyond the current reporting to the consolidated tape by ATSs is unnecessary and potentially damaging to various liquidity providing business models. As described earlier, dark pools have always served a purpose. Historically, investors utilized human dark pools despite the risks of information leakage, given that the rewards of completing a block trade outweighed the cost of showing one's hand. In the current market landscape, there are a variety of dark pools, each offering their clients particular functionality<sup>9</sup>.

Knight is of the opinion that investors who rely on dark liquidity to minimize implicit and explicit trading costs will be harmed by real-time attribution. Knight can see no merit for real-time attribution. It would potentially provide information to certain types of traders that could game the data and hence be a detriment to long-term investors or draw liquidity from the marketplace. Moreover, it will be difficult to establish a time frame for reporting that does not provide some risk of information leakage. The time frame for attribution should, most likely, be dependent on the ADV of a stock. While an end of day ("EOD") report mitigates the operational complexity and potential for gaming, it leaves investors that trade in illiquid, low ADV stocks at risk. For example, if a mutual fund has a 1 million share position in an equity with an ADV of 10,000 shares, the information leakage from EOD, weekly and possibly monthly attribution would put the investors at a disadvantage due to the amount of time that would be required to complete the order.

Knight believes the necessary information is already being reported to FINRA, and additional attribution will place the chief beneficiaries of dark liquidity at the greatest risk. Lastly, real-time attribution serves no additional informational purpose for a very broad segment of market participants.

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<sup>9</sup> Broadly speaking, the universe of dark liquidity can be divided into four types: consortia, broker, exchange hidden and independent.

## CONCLUSION:

In conclusion, Knight believes that an intelligent regulatory regime combined with innovation has yielded a fair U.S. equity market structure. The ongoing, incremental regulatory changes are crucial to subtly adjusting a fast-paced and innovative equity market. We appreciate the consideration of the many small parts of the market within the context of the whole. We summarize our main points as follows:

- All the recent proposed rule changes, including short sales I and II, flash trading, non-public trading interest and IOIs should be considered as part of the more holistic Concept Release which is already under consideration.
- Very careful consideration must be given to changes to actionable IOIs. The unforeseen consequences include potentially damaging market liquidity, increasing spreads, increasing transaction costs to investors and increasing volatility.
- Before any action is implemented with regard to the level of attribution from ATSS, careful consideration must be given to the potential implications for the major users of non-visible liquidity.

Thank you for providing us with the opportunity to comment on these rule proposals. We would welcome the opportunity to discuss our comments with the Commission.

Respectively submitted,



Leonard J. Amoruso

cc SEC Chairman Mary L. Schapiro  
SEC Commissioner Kathleen L. Casey  
SEC Commissioner Elisse B. Walter  
SEC Commissioner Luis A. Aguilar  
SEC Commissioner Troy A. Paredes  
Robert W. Cook, Director, SEC Division of Trading and Markets