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Morgan Stanley

March 4, 2010

Via E-Mail: rule-comments@sec.gov

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

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

Dear Ms. Murphy:

Morgan Stanley & Co. Incorporated ("Morgan Stanley") appreciates the opportunity to comment on the above-referenced Securities and Exchange Commission ("SEC" or "Commission") proposal on the regulation of non-public trading interest (the "Proposal").[1] The Proposal, if adopted, would impose additional regulations on alternative trading systems ("ATSs"), including dark pools, as well as certain other market participants with a quoting obligation. Specifically, the Proposal would (1) effectively re-characterize actionable indications of interest ("IOIs") as quotations, (2) reduce the Regulation ATS display obligation volume threshold from 5% to 0.25%, and (3) require real-time post-trade disclosure of the identity of the ATS in which a trade occurs.

Morgan Stanley has for many years been a strong advocate of appropriate order handling/routing practices, transparency and a level playing field in the equity markets. While we support the Commission's initiative to reexamine and update the regulation of dark liquidity, we question what the Commission hopes to achieve with its dark pool-focused Proposal. Morgan Stanley believes that the real, underlying problem that needs to be addressed is the conduct of market participants. Diverse market participants are engaging in similar economically driven order handling/routing practices without being subjected to the same regulatory obligations merely by virtue of their respective defined roles in the marketplace. This conduct is not limited to specific trading venues, market participant types or systems/technology infrastructures and will continue if a granular approach to regulation is adopted. Market participants will simply shift business models or alter their technology infrastructure to avail themselves of loopholes that could be prevented with a more holistic approach to regulation that focuses on meaningful transparency and a renewed emphasis on up to date order handling/routing practices.

[1] Securities Exchange Act Release No. 34-60997 (Nov. 13, 2009), 74 FR 61208 (Nov. 23, 2009).

For the reasons discussed more fully below, we believe that the Proposal will not meet all of the Commission's stated purposes. While we support the reclassification of actionable IOIs as quotations being implemented immediately, the limitation of the new quoting obligation to current quoting market participants will permit non-quoting participants to continue to privately use actionable IOIs, thereby circumventing the intent of the regulation. We also question the effectiveness of lowering the Regulation ATS display volume threshold to 0.25% and the accompanying rationale that only dark pools that privately quote will be impacted. Given that the easiest way to avoid regulation is to simply move such quoting activity to an order handling system outside of the ATS's infrastructure, the benefits of the reduction are likely to be fleeting. Finally, we believe that real-time disclosure of the ATS identity in which a trade occurs will not benefit public investors and may hurt customers of dark pools. We believe that the unintended consequences created by such a piecemeal approach to regulation could further harm investors and the overall quality of our markets.

Underlying Cause – Aggressive Order Handling/Routing Practices Driven by Economics

The Proposal is one of many pending and expected SEC initiatives to respond to the evolution of market structure and trading practices since the implementation of Regulation NMS. Among other proposals, the Commission is considering (1) a ban on flash orders; (2) pre-trade risk management controls for market access; (3) a reporting requirement for high frequency traders; and (4) a comprehensive review of equities market structure.[2]

We believe that many of these issues, including the Proposal, are symptoms of the larger underlying cause – aggressive order handling/routing practices that have emerged in recent years. These practices, including the aggressive use of actionable IOIs and blind pinging, are driven by economic incentives to engage in such practices across many different venues and market participants, not just by dark pools. The economic incentives that exist in the market to reduce execution costs inevitably lead to a race for cheaper execution alternatives. The acceptance of the "free look for a free execution" mantra has lead to many market participants, including broker-dealers and exchanges, routing their orders to various alternative liquidity providers in lieu of the traditional lit marketplace.[3] Competition and advances in technology have not only permitted, but have encouraged participants to look for the most cost effective

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[2] *See* Securities Exchange Act Release Nos. 34-60684 (Sep. 18, 2009), 74 FR (Sept. 23, 2009) ("Flash Order Ban Proposal"); 34-61379 (Jan. 19, 2010), 75 FR 4007 (Jan. 26, 2010) ("Market Access Proposal"); and 34-61358 (Jan. 14, 2010), 75 FR 3594 (Jan. 21, 2010) ("Equity Market Structure Concept Release"). In addition, the Commission staff has indicated that it plans to issue a release that would impose reporting requirements on high frequency traders.

[3] We estimate that the annual economic benefit for broker-dealers aggressively routing in this manner could amount to $63 million (based on a 100 million shares average daily trading volume). Similarly, exchanges that would have otherwise incurred a net loss of approximately $10 million from having to route to other exchanges could turn that loss in an annual economic benefit of approximately $76 million dollars (based on a 100 million shares average daily trading volume) through fiscal routing to alternative liquidity sources. We encourage the Commission to carefully examine the current level of access and market data fees, which we believe are driving the current order handling/routing behavior. We note that the Commission has raised the fee issue in its Equity Market Structure Concept Release and we plan to provide more detailed comments in response to that release.

execution, many times in conflict with the underlying customer whose order information is being "leaked" to sophisticated market participants and who is not the ultimate recipient of the resulting economic benefit.

By way of example, the traditional role of a broker-dealer and the traditional role of an exchange have, in some cases, blurred to the point that their activities now overlap. Historically, the role of the broker-dealer has been to deliver best execution for its customers in line with the customers' instructions. This includes finding natural, contra-side liquidity to fully or partially execute its customers' orders. The role of an exchange historically has been to match orders against its order book or to route the orders to other exchanges displaying the contra-side order at the best price. Over the last few years, many continuous match broker-dealer dark pools have been designed to compete with exchanges and actually market themselves as execution venues. They typically cross orders in real time at the national best bid and offer in smaller size, and build up their overall volumes by soliciting orders into their respective dark pools. Exchanges have also ventured out of their traditional role by looking for economic ways to compete with broker-dealers and other exchanges for volume. They began operating programs utilizing IOIs and/or blind pinging. As a result, exchanges have come to replicate aspects of the traditional activity of a broker-dealer by soliciting the other side of orders to their exchange books to minimize routing costs and increase their market share. It is important to look at the reason why this overlap in roles is occurring – economics.

Exchanges have become for-profit and must consider their commercial interests. Broker-dealers are faced with balancing best execution obligations to their customers with economically motivated routing to liquidity providers in a manner that could save them millions of dollars annually in transaction related costs. In addition, the Commission itself has acknowledged that high frequency traders today have replaced the traditional roles of specialists and market makers as liquidity providers, but without the same affirmative and negative obligations.[4] The common thread driving these evolving and conflicting roles is economics, whereby market participants are engaging in selective cost saving activities traditionally associated with other market participants' roles without necessarily being subject to the same regulatory obligations. These market participant roles need to be more clearly delineated by the Commission, as each role serves a different and vital purpose in the marketplace.

We believe that understanding the roles and motivations of the various market participants serves to highlight the aggressive order handling/routing practices that have emerged and caused the recent public and regulatory scrutiny. In our view, the regulatory framework needs to address this economically-driven conduct in order to resolve much of the discord in the marketplace and to ensure that all market participants, including broker-dealers and exchanges, are adequately performing their functions and meeting their responsibilities.[5] While it is necessary for the SEC to fully understand the overall marketplace's evolution, we do not advocate that it wait to act on

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[4] *See* Equity Market Structure Concept Release, *supra* note 2 at 3607-08.

[5] While it may be more appropriately discussed in the context of the Equity Market Structure Concept Release, new order routing and handling disclosure metrics are needed to capture potential conflicts and to provide both buy and sell-side firms with sufficient information on which to base their order routing decisions.

any of its initiatives in the interim – allowing aggressive practices to persist longer than they already have would continue to harm customers. On the other hand, it also makes for bad public policy to apply regulations to select trading venues, market participants and/or systems while permitting others to engage in harmful practices in the interim (for example, the limited focus of the Proposal on dark pools and quoting participants). The Commission should seek to strike a delicate balance between acting quickly to address inequities and ensuring new regulation applies equally to all relevant market participants and business models.

Response to Specific Proposal Requirements

Notwithstanding our concerns regarding piecemeal regulation and the need to regulate conduct, if the SEC intends to proceed in regulating dark pools and actionable IOIs as contemplated by the Proposal, below are our specific comments on the various aspects of the Proposal. Our comments also highlight the dangers of not taking a broader approach to regulation, and illustrate some of the loopholes and unintended consequences that may be created by the Proposal.

The Proposal Fails to Adequately Address the Use of Actionable IOIs

The discussion in the Proposal regarding actionable IOIs focuses exclusively on ATSs, including dark pools, that transmit the IOIs.[6] This view that actionable IOIs are used by dark pools to solicit orders into such dark pools seriously limits the efficacy of the regulation proposed by the SEC. As noted earlier, not all IOIs are transmitted to third parties by the dark pool. Broker-dealers that operate dark pools currently utilize (or may in the future if overly narrow regulation permits them to) other systems or technology, including smart order routers, algorithms or any part of their order handling system/technology to transmit IOIs to select market participants who, in turn, route orders to interact with orders in those broker-dealers' dark pools. Certain broker-dealers may then reflect any resulting trades as executed in their own respective dark pools. As a similar practice, a broker-dealer may receive inbound IOIs into its smart order router from third parties and then "lift" contra-side matching orders from its dark pool and route them to the third party IOI provider for execution. Again, any resulting trades are reflected by certain broker-dealers as executed in their own dark pool regardless of the fact that the broker-dealers did not actually execute the orders within their own infrastructure. The SEC's Proposal would not cover these types of arrangements and such a gap in regulation could lead others who transmit IOIs from their dark pools to establish similar infrastructure changes to avoid regulation. Regulation should focus on the underlying conduct at issue, not the particular system or technology used.

Actionable IOI Quoting Obligations Do Not Apply to All Market Participants

The Proposal's recharacterization of actionable IOIs as quotations falls short in that it is limited to market participants with quoting obligations (*i.e.*, exchanges, OTC market makers and ATSs (including dark pools)). This effectively creates an unlevel playing field because it does not

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6 *See* Proposal, *supra* note 1 at 61222, 61224 (The Commission notes that of the 73 ATSs that are subject to Regulation ATS, 30 are dark pools, and that of number that 11 are "dark pool ATSs that use actionable IOIs.").

apply to market participants who do not have a quoting obligation. It does not cover all broker-dealers or any non-broker-dealer entities transmitting actionable IOIs. Again, the focus should not be on the type of market participant, but on the underlying conduct.

Actionable IOIs are the Equivalent of Quotations – Similar to Flash Orders

The Proposal seeks to amend the definition of "bid or offer" (*i.e.*, a quotation) to expressly apply to actionable IOIs that are privately transmitted by various market participants, including dark pools. Morgan Stanley supports the proposed treatment of actionable IOIs as quotations. We believe that actionable IOIs are essentially no different than flash orders, as both transmit full quotation information (explicitly or implicitly) to solicit orders in return from select third parties. Morgan Stanley publicly voiced its opposition to the NASDAQ and BATS flash programs in the summer of 2009 in a formal comment letter to the SEC[7], in advance of the SEC's subsequent proposal to ban flash orders.[8] For the reasons stated in our Flash Comment Letter, we commend the SEC's approach to ban flash orders, as well as to treat actionable IOIs as quotations. As a policy matter, however, we are concerned that certain market centers are permitted to continue utilizing a practice in the midst of public and regulatory concern while the proposed ban is being contemplated. This does not contribute to a level playing field, especially for those market centers that have voluntarily ceased to operate their flash programs or for customers who may have their orders "flashed" without their knowledge or consent.

Actionable IOI is defined broadly as implicitly or explicitly conveying all four components of a quotation (*i.e.*, symbol, side, quantity and price), combined with a facts and circumstances analytical component. We believe that this broad, subjective definition of an actionable IOI is a good approach that should prevent market participants from skirting a more precise, granular definition. However, the potential for abuse with such a broad definition is that it leaves significant room for interpretation. Therefore, the Commission's approach will only be effective to the extent that the definition is uniformly applied and enforced.

Actionable IOIs representing a market value of $200,000 or more ("Block IOIs") would be excluded from the definition of a quotation. The Proposal provides that the exception for Block IOIs requires a "reasonableness" test for any contra-party recipient of such Block IOI. If the intention is to keep the requirement vague to provide the SEC with the most flexibility when analyzing the activity, the SEC should note that without appropriate review of compliance with this requirement, there is a potential for abuse. For example, a dark pool operator could send Block IOIs to a third party who may routinely respond back with a block order, but nothing prevents the dark pool from then partially filling every order (*i.e.*, sending Block IOIs to avail

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7 *See* letter from William P. Neuberger, Managing Director and Global Co-Head of Morgan Stanley Electronic Trading, and Andrew F. Silverman, Managing Director and Global Co-Head of Morgan Stanley Electronic Trading, to Elizabeth M. Murphy, Secretary, SEC, dated June 17, 2009, in response to Securities Exchange Act Release Nos. 34-59875 (File No. SR-NASDAQ-2009-043) and 34-60040 (File No. SR-BATS-2009-014) ("Flash Comment Letter").

8 *See* Flash Order Ban Proposal, *supra* note 2. Our comments on the Flash Order Ban Proposal were previously reflected in our Flash Comment Letter on the NASDAQ and BATS flash program filings.

itself of the exception with no intention to ever trade in that size each time). Again, this is yet another potential unintended consequence of the Proposal.

Furthermore, while we believe that it is the right result to subject actionable IOIs (and flash orders) to quoting requirements, it should not be presumed that this regulation will result in more quoting activity in the lit marketplace. Instead, if the SEC's proposed approach is adopted, we expect providers of IOI feeds and flash order programs to change their business models to use another mechanism such as "blind pinging" to maintain the viability of their business model. As discussed earlier, the economic incentives (*i.e.*, the opportunity for a free execution) to blindly ping a liquidity provider remain even without the benefit of actionable IOI or flash order information and despite the expected drop in fill rates as a result of no IOI information being conveyed. The Commission should understand the potential implications of any proposed regulation and the business changes that may occur as a result that would diminish the intended effectiveness of the regulation.

Reduction of the Regulation ATS Display Threshold – What is this Meant to Accomplish?

The Proposal seeks to lower the Regulation ATS display obligation volume threshold from 5% to 0.25% in order to address the concern regarding the transmission of private quotes to select market participants.[9] It would apply to those ATSs, including dark pools, that transmit actionable IOIs or quotations, but would not apply to those dark pools that do not transmit such information. The intended consequence is that the change to the display requirement should not have a direct impact on dark pools that are truly dark. The unintended consequence of the proposed change, as discussed earlier, is that it is limited to the scenario in which the dark pool itself is transmitting the information. It would not necessarily apply to a broker-dealer transmitting IOIs or quotations to third parties through another of its systems and crossing orders sent in response in its own dark pool. While Regulation ATS covers activity of the ATS itself, it would not extend to activity that occurs outside of the ATS's infrastructure. Transmitting order information in this manner outside of the ATS allows certain dark pool operators to circumvent this display threshold requirement altogether, regardless of whether the volume threshold is 5%, 0.25%, or any other number.

The Commission's stated rationale for the 0.25% threshold is to ensure new start up ATSs are not faced with a barrier to entry, enabling such ATSs to build sufficient liquidity to become viable. While we support the SEC's intent to promote innovation, we do not think that the minimal threshold will have the expected result. While a new ATS may use actionable IOIs or quotations to solicit liquidity up to the 0.25% threshold in a given security, the assumption that the liquidity will remain once the ATS reaches the threshold is questionable. The likely outcome

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[9] We understand that the Commission decided not to address the fair access threshold of Regulation ATS in the current Proposal, and instead questioned whether that threshold should be lowered in its Equity Market Structure Concept Release. *See supra* note 2 at 3614. While we intend to comment on the issue, we note that there are current issues with the fair access threshold highlighted by certain dark pools that currently exceed the 5% fair access threshold in the absence of required disclosure or guidance on how to provide access to an otherwise truly dark pool with no quoting/display obligation.

is that either the ATS will start to publicly display quotations or the ATS will cease crossing in any securities in which it may meet or exceed the volume threshold. We believe that dark pools are not likely to publicly display quotations, as this defeats the purpose of their "dark" model. Therefore, if the ATS ceases crossing to avoid the threshold, we believe the likelihood that it will retain the liquidity that it acquired while using IOIs and quotations is minimal to none once that order information is no longer conveyed. There is no guarantee that certain securities will continue trading on that ATS and market participants may not be willing to route orders to it without the benefit of the additional information. While we support innovation, we question whether the proposed reduction to 0.25% of the display requirement will achieve the SEC's intended goal. It is important to note that many new broker-dealer, standalone and consortia ATSs in the past have been able to build meaningful liquidity without leaking order information.

The reduced display threshold in the Proposal contains an exception for orders of $200,000 or more in market value ("Block Orders"). This exception would benefit those ATSs that match orders in large size and provide incentives for others to build similar functionality. The use of the 0.25% carve out for private quotes from display combined with the carve out for Block Orders may give block dark pools an unfair advantage over other dark pools by allowing them to rely on the exception for the bulk of their crosses and permitting them to rely on the 0.25% threshold for any of their orders or IOIs that fall short of $200,000 in market value. We do not believe that the SEC intended this use of the exception by block dark pools so that they can continue using actionable IOIs of any value and avoid the display requirement.

Finally, we support the proposed change to apply the display obligation to situations in which private quotations are being communicated to non-ATS subscriber parties, which is common practice today. We would further support clarification that non-ATS subscriber parties include any third parties that can misuse the private quote information (*e.g.*, by frontrunning the order or backing away from their quotes, if they have any reflected), and not messaging between a broker-dealer's own internal systems that do not pose the same conduct concerns.[10] The proposed Regulation ATS amendment further permits display of orders to "ATS employees" – without any limitation as to the type of employees and their respective functions. In practice, the term could be read broadly enough to include traders and sales traders, yet another way that an ATS operator may be able to game the display requirement.

[10] Certain broker-dealer dark pools permit limited messaging between their systems to appropriately route and execute orders, including messaging to determine the availability of a contra-side order in the broker-dealer's dark pool by its smart order router when making routing decisions. This prevents latency associated with the smart order router either routing all orders through the broker-dealer's dark pool or blindly pinging the dark pool before routing orders to the marketplace for execution. Absent such messaging, the added latency could prevent orders from receiving executions because the market has by then moved away while the broker-dealer attempted to find liquidity in its own dark pool. The underlying conduct is based solely on routing efficiency and best execution by the broker-dealer and does not raise the same concerns as a third party receiving order information to further its own trading strategies.

Real-Time Post-Trade Disclosure of ATS Trades Will Harm Customers and Provide Little or No Public Benefit

The Proposal would require real-time disclosure to the consolidated tape of the identity of the ATS in which the execution occurred, and would require each ATS to use a unique identifier for this purpose. Morgan Stanley has consistently advocated for increased transparency to the order placer, especially in the dark pool space. However, we believe that real-time public disclosure of dark pool trades to the world is not in the best interest of market participants and will have the opposite effect of what the SEC hopes to achieve. Instead of providing additional transparency to public investors, it will provide a new source of real-time information to those market participants that have the ability to systematically read the consolidated tape. Knowing which dark pool has printed a trade in real time would be useful information for the trading models of such participants. The ultimate harm would be to the dark pool customers. Even sequential, small prints to the tape indentifying the individual dark pool source may signal that there is a large order resting in that dark pool. In effect, the proposed requirement encourages predatory activities and would discourage customers from using dark pools to find natural liquidity. We do not believe that this is in the best interest of investors or the equity marketplace.

Morgan Stanley strongly supports uniform, mandated reporting of ATS/dark pool volume whereby both tape reported and publicly advertised volume should be identical. We would support an end of day reporting requirement identifying the dark pool and representing its volume in the aggregate. If this is deemed insufficient, we would further support end of day reporting by individual security, however, we caution that such a requirement must take into account a carve out for thinly traded securities, which could signal an order that would be worked over multiple days. If the Commission concludes that some form of end of day reporting is not enough to provide the necessary transparency for investors, we would then support a real-time disclosure reporting requirement (for example, a ".D" or ".DP" identifier) indicating that the trade was executed in a dark pool without identifying the dark pool by name. This form of real-time disclosure would convey less information that could otherwise result in predatory activity within and outside of the specific dark pool.[11] Reiterating our concern that real-time disclosure does not provide any real value to the public investor, we believe that any of these alternative options would strike a more appropriate balance between providing transparency to public investors and protecting the anonymity of orders for those customers who use dark pools.

In addition, executions of $200,000 or more in market value ("Block Prints") would be excluded from dissemination to the consolidated tape. Such a requirement would go against the SEC's intent to provide more transparency to investors regarding dark pool trades. We believe that there is as great a need to protect smaller, sequential prints to the tape in real-time as such trades may signal a large order residing in a particular dark pool. We note that such an exception would not be necessary if the Commission adopts a more practical and appropriate end of day reporting standard in lieu of the more harmful proposed real-time disclosure.

[11] We do not support a separate MPID identifier requirement for each ATS. This requirement would pose unnecessary technological and implementation burdens on broker-dealers who must acquire and use the additional MPIDs without providing meaningful transparency.

Conclusion

Morgan Stanley commends the Commission on its initiative to review the equity markets space. We understand and appreciate the difficulties that the Commission faces in attempting to address the current flaws in an otherwise healthy and thriving U.S. equities market structure. We are concerned, however, with the piecemeal approach that the Commission has undertaken to discretely regulate individual trading venues, market participants and systems infrastructures, instead of regulating the underlying conduct of various market participants. As reflected in our comments on the Proposal, business models can easily be changed to circumvent regulation by slightly shifting current trading practices to other technical infrastructures or adopting a different market participant role. We therefore urge the Commission to focus its attention on the underlying aggressive order handling/routing practices, and not on the myriad symptoms of such behaviors.

Morgan Stanley has voiced its objections to aggressive order handling/routing practices in the equities markets in recent years. We have also highlighted the need for increased transparency and disclosure. We continue to believe that these practices mandate Commission review and action to protect investors and the integrity of the national market system as a whole. We welcome the opportunity to discuss these issues further with the Commission.

Very truly yours,

William P. Neuberger

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