

Morgan Stanley

June 17, 2009

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 and Exchange Commission Release No. 34-59875 (File No. SR-NASDAQ-2009-043) and Securities and Exchange Commission Release No. 34-60040 (File No. SR-BATS-2009-014)

Dear Ms. Murphy:

Morgan Stanley & Co. Incorporated (“Morgan Stanley”) appreciates the opportunity to comment on the above-referenced NASDAQ Stock Market LLC (“NASDAQ”) and BATS Exchange (“BATS”) proposed rule changes. The filings permit the display of marketable orders to their own members via their respective proprietary direct market data feeds prior to such orders being routed to away markets and/or otherwise cancelled (together, the “Proposals”).

NASDAQ and BATS have designated their filings as “non-controversial” pursuant to Rule 19b-4(f)(6) under the Securities Exchange Act of 1934 (the “Exchange Act”), which requires that a proposed rule “not significantly affect the protection of investors or the public interest” and “not impose any significant burden on competition”.¹ For the reasons discussed more fully below, we do not believe that this standard has been met and therefore respectfully request that the Securities and Exchange Commission (“SEC” or “Commission”) abrogate the Proposals pursuant to its authority under Section 19(b) of the Exchange Act.² Furthermore, Morgan Stanley believes that the Proposals raise novel issues regarding exchange order handling practices in the equities marketplace, which require more thorough consideration by the Commission, subject to the benefit of meaningful input through public notice and comment.

¹ 17 CFR 240.19b-4(f)(6).

² 15 U.S.C. 78s(b)(3)(C).

Brief Summary of the Proposals

The Proposals implement similar new order routing and execution functionalities for the respective markets. These functionalities enable select market participants to receive a first look at quotations “flashed” by the exchange (reflecting orders entered by other market participants) before they are either cancelled or routed to away markets for execution (“flash quotations”). Certain routable orders are defaulted to flash quotation status unless an order placer specifically opts out. The filings permit the routine entry of flash quotations which will knowingly lock the market.³ Although they are “actionable order messages” being widely disseminated through an electronic data feed, flash quotations are not considered protected quotations for Regulation NMS purposes – even when they represent the best bid/offer of an exchange. The commingling of protected and better-priced non-protected quotations in a private market data feed presents a number of challenges for firms that rely on the direct market data feed for best execution and Regulation NMS compliance purposes.

The Proposals are Not “Non-Controversial”

Morgan Stanley respectfully disagrees with the designation of such Proposals as “non-controversial” and, hence, immediately effective. Section 19(b) of the Exchange Act generally requires that (1) self-regulatory organizations (“SROs”) file proposed rule changes with the Commission, (2) the Commission publishes notice of the filings to give interested parties the opportunity to provide comments, and (3) the Commission approves the proposed rule changes if it believes that doing so is consistent with the Exchange Act and the rules and regulations thereunder.⁴ Rule 19b-4(f)(6) under the Exchange Act, however, permits filings to become effective immediately without the typical notice, comment and approval process, if the filings are deemed “non-controversial”.⁵ When expanding the category of filings that could be designated as immediately effective under Rule 19b-4 to include non-controversial filings, the Commission did not intend to preclude meaningful public comments when necessary. In fact, in the Non-Controversial Filings Adopting Release, the Commission stated that the expansion of the rule was meant to, “expedite those SRO filings that are inherently simple and concise, and that would otherwise require little in the way of extended review or analysis by the Commission” and that are “generally less likely to engender adverse comments.”⁶

The Proposals clearly do not meet the standard of “non-controversial” in that they have already generated controversy from a diverse group of market participants.⁷ Not only have the Proposals

³ See NASDAQ OMX Equity Trader Alert #2009-35, May 28, 2009, which states in part that both NASDAQ Only and Routable Flash Orders will be displayed/disseminated, “at the most aggressive price possible that would not result in a trade through.” (emphasis added); BATS BOLT bulletin, June 2009, available on www.batstrading.com, which states in part that “BOLT displays the marketable order at the opposite side of the NBBO.” (emphasis added).

⁴ 15 U.S.C. 78s(b).

⁵ 17 CFR 240.19b-4(f)(6). See Securities Exchange Act Release No. 35123 (December 20, 1994), 59 FR 66692 (December 28, 1994) (“Non-Controversial Filings Adopting Release”).

⁶ See Non-Controversial Filings Adopting Release, *supra* note 5.

⁷ To date, we are aware of at least four comment letters filed on one or both of the Proposals, press articles detailing the controversy and numerous individual and joint industry calls made to the SEC and the exchanges. See letters from Janet M. Kissane, Senior Vice President, Legal & Corporate Secretary, Office of the General Counsel, NYSE

generated negative responses from various market participants, but the Commission itself has recently indicated that the appropriateness of the underlying practices permitted by the Proposals is something that the Commission may reconsider in the context of today's electronic market environment.⁸ For these reasons alone, the Commission should abrogate the Proposals and seek meaningful public comment.

In their respective Proposals, NASDAQ and BATS indicated that the basis for designating their filings as "non-controversial", and therefore immediately effective, was prior Commission approval of similar Chicago Board Options Exchange ("CBOE") proposals⁹ – the rationale being that the CBOE filings were already subject to notice and comment and consideration by the Commission. The Commission acquiesced to the Proposals' status as non-controversial in its published notices of the Proposals. This reliance and logic, however, is fundamentally flawed. It is important to note that the approval of the original CBOE filing occurred prior to the full implementation of Regulation NMS.¹⁰ The original CBOE filing was vetted in the context of the options markets with respect to options market makers. The latter CBOE filing on behalf of the CBOE Stock Exchange ("CBSX") transferred the concept of flash functionality from the options context to the equities markets for a larger group of select participants searching for more efficient means of executing stock hedges for options trades. The original 3-second flash exposure period approved for both filings is evidence of the options-oriented nature of the considerations given to these filings.¹¹ When the approvals were granted, CBSX engaged in very little independent equities business and the majority of market participants did not utilize CBSX's proprietary direct market data feed. This stands in marked contrast to the large number of market participants who currently utilize the NASDAQ and BATS proprietary direct market data feeds.

Rubber stamping an SRO filing as "non-controversial" based on something originally approved years ago under a fundamentally different regulatory regime and that was subsequently expanded without appropriate consideration of the impact such expansion would have on the entire equities

Euronext, dated May 28, 2009 (the "NYSE letter"); William O'Brien, Chief Executive Officer, Direct Edge ECN LLC, dated June 3, 2009; John A. McCarthy, General Counsel, Global Electronic Trading Company, dated June 4, 2009; and Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated June 4, 2009. *See also* Peter Chapman, *SEC to Reconsider Legality of 'Flash' Orders*, *Traders Magazine*, May 29, 2009 ("Legality of Flash Orders Article").

⁸ Speech by James A. Brigagliano, Co-Acting Director, Division of Trading and Markets, SEC, Speech by SEC Staff: Keynote Address to 2009 SIFMA Market Structure Conference, May 20, 2009, available at www.sec.gov/news/speech/2009/spch052009jab.htm, and Remarks by David Shillman, Associate Director, Division of Trading and Markets, SEC, delivered at the SIFMA Market Structure Conference, May 20, 2009 (together, "SEC Speeches"). *See also* Legality of Flash Orders Article, *supra* note 7.

⁹ Securities Exchange Act Release No. 54422 (September 11, 2006), 71 FR 54537 (September 15, 2006) (SR-CBOE-2004-21); Securities Exchange Act Release No. 34-59359 (February 4, 2009), 74-FR 6927 (February 11, 2009) (SR-CBOE-2008-123).

¹⁰ *Id.*

¹¹ For example, the Boston Options Exchange's PIP and International Security Exchange's PIM price improvement mechanisms route orders into an electronic auction process for potential price improvement opportunities. These mechanisms initially operated at a three second interval, but have recently lowered the order exposure time period to one second. Notably, participation in these mechanisms is tightly controlled and subject to exchange regulation with respect to participation and behavior.

marketplace is not in and of itself sufficient grounds for filing these Proposals as non-controversial and immediately effective under 19b-4(f)(6) of the Exchange Act.

The Proposals are at Odds with the Principles of Regulation NMS

We believe that exchange flash functionality directly conflicts with certain key principles of Regulation NMS. These conflicts warrant review and discussion. In the Commission's own words regarding the adoption of Regulation NMS, "**all investors** will be able to ascertain the best prices for NMS stocks, obtain fair and non-discriminatory access to the markets displaying such prices, and have assurance that their orders will be executed at the best prices that are immediately and automatically accessible."¹² The use of exchanges' private market data feeds to disseminate better priced flash quotations to a select group of market participants directly undermines this principle.

We believe that the Proposals will provide a material disincentive to publicly display limit orders on exchanges, thereby impairing price discovery. In the Reg NMS Adopting Release, the Commission specifically stated that, "[d]isplayed limit orders are the primary source of public price discovery. They typically set quoted spreads, supply liquidity, and in general establish the public 'market' for a stock."¹³ The Commission went on to compare the benefits of providing liquidity versus removing liquidity in the context of the order protection rule, stating that, "promoting the display of limit orders, which directly provide liquidity to the market, rather than promoting short-term trading strategies that require millisecond response times for orders that take displayed liquidity, is the most appropriate approach to protect investors and enhance market efficiency."¹⁴ Permitting a select group of liquidity takers to systematically step up and trade at the same price established by displayed limit orders impedes efficient price discovery and creates an artificial NBBO that does not accurately reflect the interest or the prices at which buyers and sellers are actually willing to trade.¹⁵

Permitting exchange flash quotation functionality to lock the market provides a disincentive to all liquidity providers that post limit orders outside of the flash process. Although their quotations may be protected in the public quote stream, exchanges' flash quotations effectively trade through by systematically locking the protected quotation and trading at the same price. While matching displayed prices is not a new or novel concept, institutionalizing it in a private quote stream under the aegis of an equities exchange is. Allowing exchanges to lock the market with "actionable order messages" and trade in place of displayed limit orders that created the best price, undercuts what the Commission stated was the basic underlying principle of the national market system:

¹² Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005), at 406 ("Reg NMS Adopting Release") (emphasis added).

¹³ *Id.* at 118.

¹⁴ *Id.* at 411.

¹⁵ "Impaired price discovery could cause market prices to deviate from fundamental values, reduce market depth and liquidity, and create excessive short-term volatility that is harmful to long-term investors and listed companies. More broadly, when market prices do not reflect fundamental values, resources will be misallocated within the economy and economic efficiency – as well as market efficiency – will be impaired." *Id.* at 15.

“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. **Allowing market participants simply to ignore accessible quotations in other markets and routinely display locking and crossing quotations is inconsistent with this principle.** The restrictions on locking or crossing quotations, in conjunction with the Order Protection Rule, should encourage trading against displayed quotations and enhance the depth and liquidity of the markets.”¹⁶

In short, the Proposals have simply not been adequately vetted in light of the implementation of Regulation NMS by the Commission or the general public.

The Proposals Directly Contradict the Spirit and Letter of the Quote Rule

Rule 602 of Regulation NMS (the “Quote Rule”) plays a pivotal role in the price discovery mechanism of the national market system. The Quote Rule requires in relevant part that “[e]ach national securities exchange shall at all times such exchange is open for trading, collect, process, and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed or admitted to unlisted trading privileges which is communicated on any national securities exchange by any responsible broker or dealer”. This requirement contains a limited exception for “[a]ny bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication”. The Commission has relied on this exception for its tacit approval of flash quotation functionality.¹⁷ We disagree with this conclusion and believe that the implementation of the Proposals’ flash quotation functionality is directly at odds with the Quote Rule and is not covered by this exception.

In the Reg NMS Adopting Release, the Commission expressly rejected the adoption of a standard for defining automated trading centers that relied on a mechanical response time standard. Based in part on public comment, the Commission concluded that any such standard would become outmoded as technology evolved and would serve as an artificial brake on performance.¹⁸ In the context of this discussion, the Commission defined what constituted an automated quotation, and by extension what the definition of “immediate” was. Specifically, the Commission stated: “immediate – i.e., a trading center’s systems should provide **the fastest response possible without any programmed delay**”.¹⁹ The Proposals directly contradict this

¹⁶ *Id.* at 339 (emphasis added).

¹⁷ See SEC Speeches, and Legality of Flash Orders Article, *supra* note 7.

¹⁸ See Reg NMS Adopting Release, *supra* note 12, at 87-89.

¹⁹ *Id.* at 89 (emphasis added). The Commission also stated that: “The term ‘**immediate**’ precludes any coding of automated systems or other type of intentional device that would delay the action taken with respect to a quotation.” (emphasis added). *Id.* at 145. See also the definition of “immediate”, which states in part “1. occurring or accomplished without delay; instant. 2. of or pertaining to the present time or moment. 3. following without a lapse of time. 4. having no object or space intervening; nearest or next. 5. without intervening medium or agent; direct. 6. having a direct bearing.” The Random House College Dictionary 664 (1988).

definition of immediate by introducing a programmed flash quotation exposure period of anywhere from 20 – 500 milliseconds before such marketable order can either be routed away for execution or cancelled. The flash quotation functionality institutionalizes latency for marketable orders that would otherwise have to be executed or cancelled immediately in order to qualify for the exception to the Quote Rule. Automated trading centers systematically holding up marketable orders (via a programmed delay) that are not matched on their books from either being cancelled or potentially executed at an away market in order to give their own participants a first look effectively prevents the automated trading center from relying on the exception to the Quote Rule that requires immediate action. We fail to understand why the Commission's clear statement on the definition of "immediate" in the Reg NMS Adopting Release should not govern the application of the Quote Rule to flash quotation functionality.

Inaction Sanctions the Creation of a Tiered Marketplace

The flash quotation functionality effectively creates a tiered marketplace that favors select market participants at the expense of individual order placers. Even among market participants that receive the exchange's direct market data feed, certain market participants will have an inherent advantage accessing and responding to flash quotations. In effect, the Proposals create an unlevel playing field among multiple categories of market participants and investors.

The Competitive Issues Raised by For-Profit Exchanges Need to be Carefully Examined

Exchanges enjoy unique benefits by virtue of their exchange status in today's national market system. Exchanges participate directly in the revenue from a sizable market data fee pool. In addition, their quotations enjoy protected status under Regulation NMS, forcing market participants to interact with their protected quotations. Based on the privileges that exchange status confers, it is only reasonable to expect exchanges to act in a manner that does not adversely impact the national market system relative to other market participants. The "copycat" nature of the exchange rule filings demonstrate what the future holds if the SEC fails to address the practice of exchange flash order functionality. We believe that competitive forces will likely drive all exchanges to implement their own form of flash order routing and execution functionality.²⁰ Rather than let the force of inertia determine a significant market structure question in an extremely compressed time frame on behalf of self-interested exchanges aggressively battling for market share, the Commission should take immediate action to enable a thorough review of the practical implications of the proposed rules and their impact on the national market system and all market participants.

Information Leakage and Market Integrity Issues

The Proposals fail to address information leakage in the context of flash quotation functionality. Neither of the filings provides any guidance as to what flash quotation recipients are permitted to do (or not do) upon receipt of the flash information within whatever time parameter is established. Before permitting exchange flash quotation functionality, exchanges should be

²⁰ See NYSE Letter, *supra* note, at 6.

required to mandate reasonable policies and procedures governing the behavior of flash quotation recipients and incorporating existing exchange guidance on front running, backing away and best execution obligations. Any reliance on the flash quotation only being displayed for a brief period of time ignores the realities of today's technology driven markets. Even twenty milliseconds is more than enough time for an order to be systematically disadvantaged via an automated mechanism. Such required policies should also address an appropriate disclosure regime on the part of exchange members so that order placers fully understand the risks they are running by having their full order information flashed to a select group of market participants.

Serious Implementation Issues were Ignored by the SROs and the Commission

The Proposals have created several vital implementation issues for market participants in a manner that has significantly affected the protection of investors and the public interest, and has imposed a significant burden on competition. We believe that establishing exchange flash quotation functionality on a widespread basis represents a material change to accepted market structure and the existing regulatory framework. Implementing such a material change on an immediately effective basis is dangerous, as it does not enable market participants adequate time to analyze, program and test their routing and execution systems and may have significant unintended consequences on quotation and message traffic and a downstream impact on customers. The Commission published notice of three more NASDAQ proposals relating to flash functionality filed for immediate effectiveness in the two business days prior to, and one business day after, the NASDAQ flash quotation functionality implementation date. The timing of such publication did not provide sufficient notice to market participants that were directly impacted by the changes. This is simply not the correct way to introduce material changes to a dynamic and complex marketplace.

The Commission, NASDAQ and BATS failed to examine and appreciate the potential impact that the Proposals would have on market participants who utilize the exchanges' proprietary direct market data feeds to fulfill their Regulation NMS and best execution obligations. We note that the exchanges initially neglected to consider differentiating between protected quotations and flash quotations that were not subject to dissemination on the consolidated public feed. We further note that the exchanges did not provide technical specifications to differentiate between the quotations (and in the case of NASDAQ, a new market data feed) until a few days before their initial June 1 go-live date for their respective flash quotation functionality. Upon hearing concerns from a number of market participants, the exchanges conceded to providing firms with an additional four days to make any necessary implementation changes, but would not provide more time despite the potential implications of not doing so. The Commission and the exchanges would have benefited from feedback from market participants (and their customers) who were most impacted by the Proposals and who would have raised these issues sooner if provided the opportunity for notice and comment.

A Flash Quotation Example: Who Really Wins and Who Really Loses?

We believe that the following example highlights some of the significant issues and concerns associated with the Proposals.

Assume the current NBBO in IBM is 101.01 – 101.02. Client A submits a 300 share market order to buy IBM. Client A enters her order through her broker, Broker & Co. (“Broker”). Wanting to reduce its own exchange execution costs, Broker routes Client A’s marketable order to NASDAQ using the SCAN strategy. Upon receipt of the order, NASDAQ immediately executes 100 shares of Client A’s order against a contra sell order on its own book at 101.02. NASDAQ then flashes the remainder of Client A’s order at 101.02 for up to half a second to a select group of market participants over its proprietary ITCH feed, thereby locking the market. One of the market participants who pays for the ITCH feed is Alpha LP (“Alpha”). Alpha is a proprietary trading firm that has co-located its server directly at the NASDAQ technology site to maximize its speed to market.

If none of the market participants using the ITCH feed respond to the flash and Client A’s order is held up for the maximum permissible flash period while it was exposed, she may get a worse execution or no execution at all if her order is then routed to an away market center for execution and the NBBO changes in the interim. In addition, all other market participants who saw Client A’s order flashed over the ITCH feed and decided not to respond could then trade based on Client A’s order information or reprice their existing quotations. For purposes of this example, however, assume that within three milliseconds of receipt of the flash quotation, Alpha sends an order to NASDAQ in response to the flash. Client A may get an execution at 101.02 – but at what cost? If her order had been immediately routed to an away exchange for execution, Client A might have received price improvement. Also, consider Client Z who was displaying a sell limit order for 500 shares at 101.02 on NYSE Arca, Inc. when Client A entered her order. Before flash functionality was implemented, the Client A and Client Z orders would likely have traded in the public marketplace. Client Z’s order is theoretically a “protected” quotation for Regulation NMS purposes and contributes to price discovery, however, he does not receive an execution because NASDAQ was permitted to lock the market with a private flash quotation that only its members could access. Client Z effectively gets traded though by Alpha – although some may refer to this as “traded at”, or “flashed through”. Regardless of the characterization, Client Z’s protected order was ignored in the public quote stream in favor of a select market participant.

Conclusion – Why the Rush to a Questionable Policy?

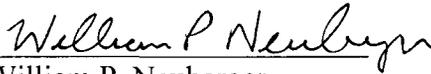
No one has made a persuasive case as to why the Proposals need to be implemented urgently. The deployment of innovative order routing and execution functionalities may have a positive impact on the overall efficiency and functioning of the national market system. However, flash order functionalities need to be examined thoughtfully and carefully before being rushed into production on a wide scale. The Proposals present the Commission with an ideal opportunity to examine the evolving nature of the equities markets and establish acceptable order routing and handling practices in the current for-profit exchange environment. The regulatory permissibility

Ms. Elizabeth M. Murphy
U.S. Securities and Exchange Commission
June 17, 2009
Page 9 of 9

of flash orders should not be shoe-horned into flawed justifications in order to serve a perceived competitive imperative on the part of the exchanges. Abrogation and refiling for notice and public comment will enable the Commission to fully evaluate the potential benefits and drawbacks of exchange flash order functionality and to deliberately consider the real impact of these filings on market participants and the national market system.

Morgan Stanley has publicly voiced its objections to certain evolving order handling and routing practices in the equities markets in recent years. We have also highlighted the need for increased transparency and disclosure. The bleeding over of certain practices from the broker-dealer space into the exchange space mandates immediate 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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Andrew F. Silverman
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