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VIA E-MAIL AND FEDERAL EXPRESS

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

Re: File Nos. SR-NYSE-2011-55 and
SR-NYSEAmex-2011-84 – Response to Comment Letters ("Response")

Dear Ms. Murphy:

NYSE Euronext on behalf of New York Stock Exchange LLC ("NYSE") and NYSE Amex LLC ("NYSE Amex," collectively with NYSE, the "Exchanges") submit this letter in response to comment letters received by the Securities and Exchange Commission (the "SEC" or the "Commission") in connection with the above-referenced filings, which propose to establish a Retail Liquidity Program (the "Program" or "Proposal") on a pilot basis to attract additional retail order flow to the Exchanges.

I. Summary of the Retail Liquidity Program

As discussed more fully in the above-referenced filings, the Exchanges have proposed the Program to attract additional retail order flow to the Exchanges for NYSE and NYSE Amex-traded securities while also providing the potential for price improvement to such order flow. The Program would create two new classes of market participants: Retail Member Organizations ("RMO") and Retail Liquidity Providers ("RLP"). An RMO is a member organization approved by the Exchanges to submit Retail Orders. An RLP is a member organization approved by the Exchanges that agrees to provide liquidity to interact with orders submitted by RMOs with at least a minimum amount of price improvement, currently specified at $.001 per share. The Exchanges will disseminate a Retail Liquidity Identifier ("RLI") when interest priced $.001 better than the protected best bid (PBB) or protected best offer (PBO) is available. RLIs will not contain prices.

As proposed, the Program would be a pilot, extending twelve months from the date of implementation. The pilot would allow the Exchanges and the Commission an opportunity to assess its operation and impact. The Exchanges simultaneously have submitted a request for exemptive relief pursuant to Regulation NMS Rule 612 that would permit them to accept and rank the undisplayed Retail Price Improvement Orders ("RPI").

II. Summary of Comments and the Exchanges' Response

At the time of the filing of this Response, the Commission has received 28 comment letters relating to the Program. Some of these comments address the mechanics and implementation of the Program, while others focus on longstanding market structure issues. This Response first will review the competitive and regulatory context in which the Program would operate, and then address market structure-related comments and other comments, respectively, on an issue-by-issue basis.

A. The Competitive and Regulatory Context

The Exchanges appreciate the thoughtful comments analyzing the Program in light of the structure of our equity markets and identifying other implications. Before addressing the specific issues raised in the comment letters, it is worth underscoring that our equity markets, and the Exchanges in particular, have undergone more than a decade of continual structural changes driven by increased competition and evolving technology facilitated by regulation. This transformative period has presented the Commission with a virtual thicket of structural challenges that remain humbling in their complexity and significance. A number of commenters have suggested that the Proposal significantly implicates the Commission's approach to five interrelated structural issues: sub-penny increments; the development of private or two-tiered markets; fair access and access fees; order protection and order handling; and best execution in light of the evolution of execution venues. With the exception of sub-penny increments, which the Exchanges addressed in their application for exemptive relief, these issues date to the mid-1990s[1] and have since undergone extensive and sustained consideration by the Commission and staff. Each was addressed in the Commission's comprehensive effort to modernize and strengthen the national market system in Regulation NMS in 2005.[2] Equity market structure remains the subject of a current, comprehensive Commission review.[3]

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1 *See* Exchange Act Release No. 34-38180 (Jan. 16, 1997); Exchange Act Release No. 34-37619A (Sept. 6, 1996), 61 Fed. Reg. 48290 (Sept. 12, 1996) ("Order Execution Obligations"); Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844 (Dec. 22, 1998) ("Reg. ATS Adopting Release"). For discussions relating to access fees and fair access, see Reg. ATS Adopting Release at 70870-75. For discussions relating to order protection and order handling, see generally Order Execution Obligations Adopting Release and Reg. ATS Adopting Release at 70903-04. For discussions relating to private markets/two-tiered markets, see Reg. ATS Adopting Release at 70866-69, 70903 and Order Execution Obligations Adopting Release at 48308, 48312, 48326. For discussions relating to best execution as related to evolving execution venues, see Reg. ATS Adopting Release at 70869-71, 70885, 70902 and Order Execution Obligations Adopting Release at 48292-93, 48297-98, 48308-09.

2 Exchange Act Release No. 34-51808, 70 Fed. Reg. 37496, 37497 (Jun. 29, 2005) ("Reg. NMS Adopting Release").

3 Exchange Act Release No. 34-61358 (Jan. 13, 2010), 75 Fed. Reg. 3594, 3596 (Jan. 21, 2010) ("Concept Release on Equity Market Structure") ("[T]he Commission is conducting a comprehensive review of equity market structure.").

The Exchanges fully recognize that many market structure challenges, by their very nature, do not lend themselves to definitive, final resolution, particularly where change continues to sweep our markets. Indeed, we agree with the commenter who states that the great success of our equities markets stems from "ongoing innovation, prudent regulation and an unrelenting competitive dynamic."[4] We remain committed to engaging with the Commission, our members, and other market participants with respect to the core structural challenges of today and tomorrow, and to revisiting compromises of yesterday where appropriate.

We regard the Program as an important but structurally modest effort by the Exchanges to attract retail order flow. As proposed, the participants, structure, and economics of the Program would parallel practices that have operated in more or less their current form for well over a decade. In particular, OTC market makers negotiate directly with retail order flow providers to pay an agreed upon per share fee in exchange for retail order flow.[5] They do not, in other words, attract retail flow by displaying their quotes. Retail flow providers similarly do not route their customers' orders based on the quotes displayed by internalization venues but rather based on negotiated routing arrangements. As the Commission has stated, internalized executions "primarily reflect liquidity that is not included in the consolidated quotation data" and should therefore be "classified as undisplayed liquidity."[6] The Commission recently estimated that more than 200 broker-dealers internalize approximately 17.5 percent of the volume in NMS stocks.[7]

Under the Program, the Exchanges expect to charge liquidity providers a fee to interact with Retail Orders, and to provide credits or free executions to RMOs for orders routed to liquidity providers in the Programs. The fees and credits for liquidity providers and RMOs will be determined based on experience with the Program in the first several months.[8] Initially, non RLPs will be charged a fee of $.0003 and RLPs will not be charged a fee for execution of their RPIs. RMOs will be provided a rebate of $.0005 for executions of their Retail Orders. These fees and credits, along with the RMO certification process, would seek to replicate the segmentation and economics of order flow arrangements currently in place between OTC internalization venues and retail flow providers. Liquidity providers would not enter quotes under the Program. RPIs would not be visible to RMOs or any other market participant. Thus, the Program would parallel established and longstanding practices and would break no

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4 Letter from Leonard J. Amoruso, Knight Capital Group, Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Nov. 28, 2011) ("Knight").

5 According to the Commission, the payment generally amounts to 0.1 cent per share or less. *See* Concept Release on Equity Market Structure at 3600.

6 *Id.* at n. 83.

7 *Id.*

8 Although several commonly used pricing structures are available for the Program, the Exchanges are still considering eventual pricing for the Program and will file the ultimate pricing plan with the Commission. Currently the Exchanges are evaluating a charge for RLPs to post of $.0007 per share; for non RLPs, a charge of $.0010 per share ($.0008 upon achieving a volume tier), and a rebate for RMOs of $.0003.

new market structure ground. Instead, it would offer an incentivized path by which established internalization arrangements could migrate into the Exchanges' environment through competitive forces.

It bears emphasis that before the Exchanges can innovate and compete as contemplated by the National Market System, we typically must file proposed rules and expose them to public comment as we have done here. The Commission has noted more than once the asymmetry of the competition exchanges face:

> National securities exchanges registered under 6(a) of the Exchange Act face increased competitive pressures from entities that trade the same or similar financial instruments, such as foreign exchanges, future exchanges, electronic communications networks ("''ECNs"), and alternative trading systems ("ATSs"). These competitors, however, can change their trading rules or trade new products with greater ease and without the required Commission review.[9]

The Exchanges do not point this out to object in any way to their obligations to submit an initiative such as the Program to the comment process and the Commission's review and approval. We embrace our roles as SROs and, as indicated above, our proposals typically benefit substantially from the comment process. Moreover, the Exchanges are especially well-positioned to appreciate the importance of proceeding carefully and deliberately with new initiatives. We recognize the appeal of requests from industry associations that the Commission defer or delay regulatory approval or action.[10]

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[9] Exchange Act Release No. 34-58092 (November 5, 2008) (footnotes omitted). *See also* Exchange Act Release No. 43860 (Jan. 19, 2001), 66 Fed. Reg. 8912, 8913-14 (Feb. 5, 2001) ("Rule 19b-6 Proposing Release").

[10] Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Dec. 7, 2011) ("SIFMA") ("While the proposed Program would be implemented as a pilot program . . . , SIFMA believes that the Program and related request . . . raise significant market structure implications that require additional time to be considered before implementing."); *see also* Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (June 23, 2011) (commenting on short sale reporting study required by Dodd-Frank Act) ("We strongly urge the Commission to consider the policy goals further, and engage in a thorough cost-benefit analysis, prior to adopting rules governing additional disclosure of short sales and short positions."); Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Jun. 22, 2011)) (commenting on plan to address extraordinary market volatility) ("SIFMA believes that it is important that guidance on these and other interpretive issues related to [the Plan to Address Extraordinary Market Volatility] is provided to firms by SROs and the Commission prior to implementation . . . ."); Letter from Ann Vlcek, Managing Director, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Feb. 1, 2011) (commenting on issues raised by dark liquidity) ("We believe that it is critical that regulators, academics, market participants and other interest parties continue to perform empirical analyses . . . before making market structure changes . . . ."); Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (April 16, 2010) (commenting on risk management controls for brokers or dealers with market access) ("SIFMA, however, believes the rule should not be adopted until significant complex

We respectfully note, however, the incongruity of delaying a proposed exchange pilot that would compete within the existing regulatory framework to synchronize its consideration with a longstanding, continuing market structure debate. The disconnect appears even more stark against the backdrop of a structural framework that is driven primarily by competing, connected markets rather than by regulation—a system designed specifically to foster not only competition among exchange markets, but competition between exchange and non-exchange markets.[11] We will defer to the Commission's view of the appropriate comment period. We would ask, though, that the Commission examine critically calls to defer consideration of the Program.

As the Commission made clear in a proposal to streamline the SRO rule filing process in 2001, there is more at stake than any single pilot program or the particular commercial advantage of any one exchange:

> Enhancing the SROs' ability to implement and to respond quickly to changes in the marketplace should encourage innovation and better services to investors, such as further automating the execution of trades. Investors should also benefit from a competitive environment in which SROs may easily adapt their trading rules to respond to market opportunities.[12]

Two other procedural features of the Proposal make it an unlikely vehicle for rushed structural change. First, the Proposal requires exemptive relief from the Commission. Second, the Program, if approved, would operate as a one-year pilot, providing an opportunity for the Commission to review the impact of the Program and study its effects and to obtain empirical data to assess whether the Program should be modified. The Commission therefore remains particularly well-situated to intervene (either by withdrawing the exemptive relief or refusing to extend or make permanent the pilot) in the event of negative, unintended structural consequences.

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issues are addressed."); Letter from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (February 18, 2010) (commenting on regulation of non-public trading interest) ("Given the significance of each initiative to equity market structure, SIFMA asks that the Commission consider whether it would be beneficial to wait until it has received comments on the Concept Release . . . before acting on any single initiative").

11 *See* Concept Release on Equity Market Structure at Section II (discussing Exchange Act Requirements for a National Market System).

12 Rule 19b-6 Proposing Release at 8912.

B. Comments Related to Market Structure

1. The Sub-penny Implications of the Program Would Be Minimal Because RPIs Would Be Undisplayed and RLIs Would Be Unpriced.

One commenter expressed concerns with the Program's proposed use of sub-penny increments stating that a "non trivial tick size protects limit orders" and that allowing "dark orders to step in front of the orders that are publicly displayed for a mere $.001 per share effectively eliminates the incentive to display public liquidity in a limit order book."[13] We appreciate the seriousness of this concern. It is important to recognize, though, that our current market structure does not protect a publicly displayed limit order against an internalizing order trading *at the same price*, not to mention an order priced at a sub-penny increment better. There are valid reasons to question this aspect of our market structure, and it has been examined by the Commission closely for more than a decade.[14] The Proposal seeks to operate within this current reality and to stimulate price competition within it through the Program's multiple liquidity providers, priority rules and minimum price improvement.

Another commenter takes the position that ranking sub-penny orders, regardless of whether the orders are displayed, implicates the Commission's concern regarding stepping ahead of displayed limit orders by an insignificant amount.[15] The language of the Commission's guidance makes clear that the execution priority of visible trading interest was the focus of the Commission's concern with sub-pennies. Specifically, the Commission consistently articulated its concern about sub-penny trading in terms of a market professional "stepping ahead" and gaining execution priority[16] over customer limit orders or customers losing execution priority to a later arriving quotation or order.[17] The references assume that both the disadvantaged limit order and the order stepping ahead are displayed. Indeed, it is essential to "stepping ahead" that the one stepping can *see* what he or she is *stepping ahead of*. Similarly, the references assume that the order or quote stepping ahead is displayed because, if it was not displayed, it would be unable to gain execution priority. Because RPIs are undisplayed (and because RLIs are unpriced), there is no possibility of RPIs gaining execution priority against a

13 Letter from James Angel, Associate Professor of Finance, Georgetown University, dated November 28, 2011, at 2.

14 *See, e.g.*, Exchange Act Release No. 34-42450 (Feb. 3, 2000), 65 Fed. Reg. 10577 (Feb. 28, 2000) ("Fragmentation Concept Release"); Concept Release on Equity Market Structure.

15 Letter from Eric J. Swanson, Secretary, BATS Global Markets, Inc. dated December 6, 2011, at 5 ("BATS").

16 Exchange Act Release No. 34-49325 (Feb. 26, 2004), 69 Fed. Reg. 11126, 11166 ("Reg. NMS Proposing Release") (defining "stepping ahead" or "pennying" as "attempting to gain execution priority by improving the best bid by a penny").

17 Reg. NMS Adopting Release at 37588 (referring to the prohibition of sub-penny trading as "deterring the practice of stepping ahead of exposed trading interest by an economically insignificant amount" and execution costs increasing if "quotations or orders can lose execution priority because of economically insignificant price improvement from a later arriving quotation or order").

displayed public limit order that they do not already have under the current market structure. The concerns animating Rule 612 are therefore not implicated. As noted above, the fact that a displayed limit order has no execution priority with respect to an internalizing OTC market maker trading at the same price is simply a reality of our current market structure rather than a cause for concern with respect to the Program.

On a related point, at least one commenter expressed concern about a potential increase in sub-penny trading if the Program were approved.[18] While the Exchange remains hopeful that measures like the Program may improve the confidence level of the retail investor, they do not expect the Program to fundamentally increase the size of the retail segment. Rather, if successful, the Program would more likely result in a reallocation of the existing retail share. Sub-penny executions occur regularly as a result of existing internalization arrangements and we see no reason to expect a spike in current levels. Moreover, if the level of sub-penny executions increased as a result of a higher level of price competition and price improvement experienced by retail orders, the result would be desirable, especially where operational, capacity, and quote flickering implications are non-existent.[19]

Another commenter suggests that under the Proposal "the Rule 612 tick size would be reduced to $.001" and that other exchanges would copy the Proposal.[20] The comment ignores the undisplayed nature of sub-penny increments in the Program. Indeed, the reference to "tick size" to describe the sub-penny increments under the Program confuses the issue as the term is typically used in relation to a visible quote stream. We leave for the Commission the question of how to approach future filings by other exchanges, if any. We would underscore, though, that the sub-penny relief requested here is narrowly tailored for this Program only and would not permit the display of sub-penny quotes. Accordingly, it presents none of the operational challenges that sub-penny increments in the public quote stream do.

One commenter stated that, while a lower minimum price improvement value threshold is a positive for retail clients and the market, they believed the Program should be amended so that the minimum threshold would be a tenth of the current regulated minimum increment.[21] The desired outcome of the commenter is to avoid locking and/or crossing the market for stocks below $1.00. The one-year pilot program will only be conducted in stocks valued over $1, where a $.001 price improvement will apply.

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18 Letter from Christopher Nagy, Managing Director, TD Ameritrade, dated November 30, 2011, at 2 ("TD Ameritrade").

19 *See* NMS Adopting Release at 37556 ("The Commission believes at this time that trading in sub-penny increments does not raise the same concerns as sub-penny quoting. Sub-penny executions do not cause quote flickering and do not decrease depth at the inside quotation. Nor do they require the same systems capacity as would sub-penny quoting. In addition, sub-penny executions due to price improvement are generally beneficial to retail investors.").

20 SIFMA at 2.

21 Letter from Mike Stewart, Head of Global Equities, UBS, dated November 30, 2011 at 3 ("UBS").

Finally, a commenter raised the issue of retail investors seeing sub-penny prints as disadvantaging their order.[22] The Exchanges understand the optical issues that exist regarding sub-penny trading and their impact on retail investor confidence; however, we note that today retail investors see sub-penny prints through the Trade Reporting Facilities for internalized orders. The Exchanges support a broader continued review by the Commission regarding sub-penny printing, but believes the review should be part of the equity market structure review rather than a precondition of approving the Program.

2. The Program Bears No Resemblance to a Private or Two-Tiered Market.

At least two commenters raised concerns that the Program creates a limited-access dark pool outside the reach of Regulation ATS, possibly creating a two-tiered market.[23] The Exchanges find the characterization puzzling in that references to hidden, private, or two-tiered markets are typically directed at venues where sophisticated traders can see and access better prices than those available to the general public. The Program would produce just the opposite—an exchange venue designed specifically to produce better prices for retail orders. Moreover, two-tiered markets typically feature private quote streams or pricing messages not visible to the public. Under the Program, again, the RLI would not contain prices and the indicator would be available to anyone who would like to receive it.

One commenter stated while an alternative trading system ("ATS") must revert to exchange rules when its market share reaches a certain threshold, the Program is not subject to this requirement.[24] In fact, the Program will be created by and subject to the rules of the Exchanges and remain subject to the Exchanges' regulatory program.

Another commenter takes the position that the Program "contemplates both selective viewing of data through a proprietary data feed and selective access to that quote."[25] That same commenter states that it "believes that the NYSE is in fact disseminating over [the Exchanges'] "private communication" lines what is *essentially a quote* to indicate that [the Exchanges] have resting liquidity priced at a sub-penny better than the current best bid or offer."[26] The commenter's position makes no reference to the definitions contained in NMS Rule 600, or any other Commission guidance. Under Regulation NMS Rule 600(b)(62), a "quotation" is defined as a "bid or an offer." Rule 600(b)(8) states that a "bid or offer" means the price "communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of an NMS security, as either principal or agent,

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22 TD Ameritrade at 2; Letter from Al Patten, retail investor, dated December 29, 2011.

23 SIFMA at 3; Knight at 5.

24 Knight at 5.

25 SIFMA at 3.

26 *Id.* at 2 (emphasis supplied).

but shall not include indications of interest." The Retail Liquidity Identifier ("RLI") does not contain a price and therefore is not a "bid or offer" and consequently not a quotation as defined by Rule 600(b)(62). Additionally, an RPI would not fall within the definition of a quotation since the order is not "communicated" to any broker or dealer, or any customer; the RPI is simply a flag reflecting non-displayed interest that is available in the exchange systems to interact with incoming Retail Orders.

Similarly, the subtext suggested by the commenter's reference to selective viewing and private communication finds no support in the language or logic of the NMS Rule governing the consolidation, distribution and display of data. In short, the Commission adopted NMS Rules 602 and 603 after one of the most exhaustive analyses since the establishment of the National Market System.[27] Rule 603 established a framework whereby SROs must provide their "core data," including top of book quotes, and trades to a Network processor for consolidation, but left markets "considerable leeway in determining whether, or on what terms, they provide additional, non-core data to a Network processor."[28] RLIs are not "quotations" and therefore are "non-core" data. Accordingly, the Exchanges' proposal to distribute RLIs through a proprietary feed of non-core data is wholly consonant with the thoroughly considered market data framework established by Regulation NMS. Moreover, the suggestion of exclusivity is belied by the fact that the NYSE Alerts feed, through which the RLIs will be distributed initially, is available to any market participant for $500 per month. In any event, the Exchanges understand from preliminary conversations about the Program with members that the industry would prefer to see the RLIs integrated into the public market data stream. The Exchanges have committed development resources and are working with the Securities Industry Processor to make this broader distribution of RLIs available.

To the extent that the commenter is concerned with the competitive fairness of the Exchanges distributing an unpriced flag advertising firm liquidity resident in the Exchanges' systems (notwithstanding that RLIs as illustrated above are beyond the plain language of the NMS definition of "quotation"), it is worth stressing that industry participants will retain discretion on their utilization of the Program regardless of whether the RLIs are disseminated publicly. Specifically, RLI data will be available to venues for evaluating price and size improvement opportunities for retail order flow providers whether or not they choose to participate in the Program. These venues will be able to leverage execution quality statistics to maintain or expand existing relationships or seek to capture whatever retail order flow the Program attracts. In any event, there is nothing unfair about the Exchanges advertising their liquidity as the RLI would do, particularly since this non-core data originates from the open ability for participation in the Program, reduces potential message traffic from "pinging," and has the potential to stimulate additional price competition that would benefit retail investors.

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[27] Exchange Act Release No. 34-42208 (Dec. 9, 1999); Report of the Advisory Committee on Market Information, SECURITIES AND EXCHANGE COMMISSION (Sept. 14, 2001) (stating the Advisory Committee held four full-day and two half-day meetings, generating transcripts totaling more than 1,000 pages).

[28] Reg. NMS Adopting Release at 37569.

One commenter voiced concerns over "the [E]xchanges' practice of charging their member firms a myriad of fees, including various types of access fees, market data fees and regulatory fees," and is worried that the Program would be "yet another reason to increase the regulatory charge."[29] While the Exchanges understand the industry's focus on cost-cutting, they would note the obvious and considerable infrastructure required to deliver fair, fast and reliable executions, rich, low latency market data, and robust regulation. Never before have exchange fees been more transparent to members, and never before has the competition among registered U.S. exchanges to provide cost-efficient execution functionality, data, and regulation been more intense. This of course is not to mention the competition that exchanges face from non-exchange and non-U.S. regulated competitors and the pressure on exchange fees that those asymmetrical competitors create. There is in short no basis for believing that the Exchanges are able to, or inclined to, add unwarranted fees or to "increase the regulatory charge," as the commenter suggests. We also do not understand the logical conclusion of the point being made. Clearly any Exchange innovation, which the commenter supports, will come with associated levels of oversight. Therefore, unless the commenter is not in favor of innovation by Exchanges, we fail to recognize any recommended action on this point.

Another commenter stated that the Program would raise "many of the concerns raised in the past regarding flash orders," arguing the Exchanges are disseminating information to a private network about its best priced orders that is unavailable to anyone outside of the network.[30] Equating the Program with flash orders is a mischaracterization. Flash orders involved the communication of orders priced at the national best bid or offer, sometimes in a selective manner.[31] Under the Program, only a liquidity flag (an RLI) would be communicated, not an order or a price. Additionally, the communication would occur over a commonly used feed available to any market participant, and as previously stated, the Exchanges are working to make RLIs available through the public market data stream.

3. Consideration of the Program Does Not Require Reexamining the Vexatious Issue of Access Fees.

One commenter suggested that consideration of the Program required the Commission to revisit the question of access fees addressed in Regulation NMS.[32] NMS Rule 610 ("the Access Rule") grew out of what was arguably the most complicated and hotly debated market

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29 SIFMA at 3.

30 BATS at 3.

31 Exchange Act Release No. 34-60684 (Sept. 18, 2009) ("Elimination of Flash Order Exception from Rule 602 of Regulation NMS") ("When a marketable flash order arrives . . . the market will flash the order to its market participants at the national best offer for flash order to buy and the national best bid for flash order to sell. The markets disseminated the order information as part of their data feeds. Some distribute the data only to members, and some provide the data to anyone who wants to receive it.") (footnotes omitted).

32 Knight at 3-4.

structure issue of the previous decade.[33] Importantly, the debate about access fees related to visible prices—the Access Rule sets forth a standard "governing *quotations* in NMS stocks."[34] Driving the complexity and difficulty of the issue was its inextricable link to the centerpiece of Regulation NMS, the Order Protection Rule. Commenters had stressed that "protecting the *best displayed prices* against trade-throughs would be futile if broker-dealers and trading centers were unable to access those prices fairly and efficiently."[35] It is worth recalling that the resolution provided by the Access Rule was much needed. The Commission noted:

> Although consensus could not be achieved on any particular approach, commenters expressed a strong desire for resolution of a difficult issue that had caused discord within the securities industry for many years.[36]

The Program does not require reopening the debate leading up to the Access Rule. As stressed throughout, the Program would not involve the display of quotations or orders in any increment, and therefore, the Access Rule simply has no bearing on RPIs entered under the Program. Similarly, RLIs, as discussed above, are unpriced liquidity flags and therefore are not quotes; no question of the fairness of accessing them arises. Obligations that may arise under Reg NMS to route to a protected best bid or offer therefore would not require a broker with a retail order to interact with an RPI. Any access or other fees associated with the Program therefore could be avoided.

More fundamentally, the Exchanges emphasize that the Program in no way represents an effort to cordon off liquidity from competitors akin to those that gave rise to the Access Rule. Quite the opposite. We look forward to broad participation across our extensive membership. RMO and RLP participation is critical to developing a critical mass of liquidity within the Program. Given the range of applicants we expect to seek RLP and RMO status, the prices available under the Program will be, as a practical matter, accessible to retail investors. The Program, in other words, would offer retail investors a competitive way to move from the current relatively closed and bilateral form of retail flow segmentation to a more open and competitive form.

The Exchanges' commercial interest in the Program therefore aligns entirely with those of retail investors—the growth of transactions and liquidity in the Program has the potential to produce a higher degree of order interaction and more vigorous price competition than exists in current internalization arrangements, in a robust regulatory environment.

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33 The Commission stated in adopting the Access Rule that "[p]erhaps more than any other single issue, the proposed limitation on access fees splintered the commenters." *Id.* at 37502.

34 Reg. NMS Adopting Release at 37502 (emphasis added).

35 *Id.*

36 *Id.* at 37503.

4. Order Protection and Order Handling.

One commenter raised concerns about Manning protection issues under FINRA Rule 5320, stating that either market makers would be limited in their participation in the Program or amendments to FINRA Rule 5320 would be needed.[37] A liquidity provider in the Program would be required, by virtue of its interaction with marketable Retail Orders, to satisfy its customer limit orders in the same way that an OTC market maker is currently obligated to satisfy its customer limit orders. It is not clear to the Exchanges why the Program would necessitate FINRA guidance distinct from that applicable to existing internalization arrangements.

We would expect liquidity providers in the Program to utilize the Rule 5320 exceptions available to them just as OTC market makers do today. Specifically, Rule 5320 provides mechanisms by which a firm's market-making desk can trade at prices that would satisfy customer orders.[38] Under the "No-Knowledge" exception, as long as a firm implements and uses an effective system of internal controls that operate to prevent one trading unit from obtaining knowledge of customer orders held by a separate trading unit, those other trading units trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit.[39] Again, if the commenters are suggesting that executions should not be allowed to occur at a price displayed in the public market, we would encourage the continuation of that broader market-structure debate away from this Program.

5. The Program Would Present No Special Best Execution Challenges.

Several commenters expressed concerns that the Program raises best execution questions that require responses before moving forward.[40] The Exchanges understand the myriad of challenges that brokers face as they consider execution venues in today's dynamic environment. We acknowledge that as the Program gains traction, brokers likely will begin to consider its execution quality statistics in their routing decisions. There would be little new in this in that brokers necessarily have become accustomed to the continuing appearance of new exchanges, ATSs and OTC market makers.

The regulatory guidance with respect to best execution anticipates the continued evolution of execution venues.:

> [B]est execution is a facts and circumstances determination. A broker-dealer must consider several factors affecting the quality of execution, including, for

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37 Knight at 4.

38 *See* FINRA Rules 5320.01, 5320.02.

39 FINRA Notice to Members 11-24, at 2.

40 Knight at 3.

> example, the opportunity for price improvement, the likelihood of execution . . . , the speed of execution and the trading characteristics of the security, together with other non-price factors such as reliability and service."[41]

Applicable best execution guidance, in other words, contains no formulaic mandate as to whether or how brokers should direct orders to the Program.[42] The Exchanges note that, as discussed above, internalized order flow arrangements already operate in a structure similar to that proposed in the Program. Accordingly, to the extent there may be best execution obligations at issue, they are no different than the best execution obligations faced by brokers in the current market structure.

One commenter suggested that the Exchanges make a dual-priced order available to all participants, allowing market participants to submit an order that will interact with non-retail order flow at the desired whole penny increment, while simultaneously submitting a price-improving order to interact with incoming retail order flow.[43] The Exchanges believe that the dual-priced order is a good suggestion and will consider building it into the Program.

C. Other Concerns

1. Comment Period.

Commenters raised concerns over the 30-day time comment period and urged that the Commission extend the comment period. Another commenter stated that the Program and request for exemption "raise significant market structure implications that require additional time to be considered before implementation."[44] As discussed at the outset, while deferring to the Commission, the Exchanges do not believe that a further extension of the comment period is necessary based on the analyses already completed in the adoption of Regulation NMS, the extent of comments received in the current period and the previous point made regarding the separation between this Program and the broader market structure debate.

2. Retail Certification and RMO Definition.

Commenters also expressed concern about the feasibility and reliability of the certification process whereby RMOs would attest that orders they submit qualify as "Retail Orders" under

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41 NASD Notice to Members 01-22 (citing Exchange Release No. 34-37619A, 61 FR 48290 (Sept. 12, 1996) ("SEC Order Handing Release")).

42 Regulatory guidance also has stated that "the scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade at more advantageous prices," and that as technological developments and changes to market structure occur, brokers "must analyze and modify their order execution procedures to consider price opportunities that become 'reasonably available.'" *See* Order Execution Obligations Adopting Release at 48322-23; NASD Notice to Members 01-22.

43 UBS at 3.

44 SIFMA at 1-2.

the proposed Rules. One comment letter stated that the factors that determined which firms and orders qualified should be more clear and transparent, rather than subjective.[45] Another comment letter stated that the administrative requirements of the proposed rules were too burdensome and still might not be effective in precluding professional traders from securing access to price improvement opportunities under the Program.[46] One commenter suggested that the Exchanges publish a list of approved RMOs.[47]

The Exchanges appreciate the thoughtful comments relating to the certification process, and during the pilot period, the Exchanges will continue to assess all of aspects of that process. The Exchanges believe, however, that the Program's authentication and certification procedures relating to retail order flow, together with the requirement that RMOs have written policies and procedures to assure that they only submit qualifying retail orders, will result in a reliable identification and segmentation of retail order flow. In fact, the proposed process is more robust than the subjective process that currently exists in the wholesale market. Further, the trading activity conducted through the Program will be subject to regulatory review by the Financial Industry Regulatory Authority (FINRA) on behalf of the Exchanges pursuant to its regulatory services agreement with the Exchanges.

The approval process and RMO definition are structured to reflect the complex nature of the industry. The Program provides multiple layers of protection to assure fairness in the approval process. In addition to the approval process, a member organization may request that the Retail Liquidity Program Panel review a decision to disapprove or disqualify it from RMO status. In addition, the Exchanges will perform quantitative checks designed to identify order flow that does not meet the characteristics of retail orders, and may, at its discretion, disqualify an RMO submitting such order flow.

The Exchanges agree with the commenter's suggestion about providing a list of approved RMOs, and as such, will post the list on the Exchanges' websites.

3. Retail Liquidity Identifier.

One commenter expressed concerns that the RLI could be "used in a deleterious manner as it will be available to anyone who subscribes to the proprietary exchange data feeds" and expressed its strong belief that there is no benefit to disseminating the RLI.[48] In particular, the commenter expressed a concern that high frequency traders would use the data to the disadvantage of retail investors. The Exchanges' staffs at the business level are committed to monitoring activity in connection with the Program to identify and address any adverse unintended consequences as the Program goes forward, but since the indicator provides

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45 Letter from Suhas Daftuar, Managing Director, Hudson River Trading, dated November 30, 2011, at 2-3 ("Hudson River").

46 Knight at 5.

47 Hudson River at 3.

48 TD Ameritrade at 3; *see also* Patten letter.

limited detail, and only contains information regarding liquidity provision, and not the retail customer, the opportunity for adverse behavior is limited.

4. RLP Approval Process/Discrimination Issues.

At least one commenter raised concern about whether the Exchanges will limit the number of RLPs within a security.[49] In a related point, the same commenter indicated concern over discrimination by the Exchanges among its members, and wondered whether the Program was consistent with the prohibitions against unfair discrimination that governs exchanges.

In response to the first point, the Exchange does not plan to limit the number of qualified RLPs within a security. As to the possibility of discrimination, the Exchanges do not believe the Program unreasonably discriminates against any class. The Program is meant to provide better price improvement opportunities for retail investors by incorporating an enhanced form of a price improvement mechanism that is already available off the Exchanges into the Exchanges' environment.

In support of the potentiality for discrimination, the commenter stated that the Program's request for a waiver of the sub-penny trading restrictions would allow a subset of the investing public to benefit from better prices for those securities where the minimum tick size of $0.01 is too large. The discussion regarding tick increments is a topic that has been put before the Commission through the concept release process. While we encourage the Commission to continue the review of this topic, we do not believe that this is an issue that should prevent approval of the Program.

III. Conclusion

The Exchanges have proposed to adopt the Program in an effort to attract retail orders to an exchange environment with increased price competition and price improvement. The pilot Program would offer an enhanced but structurally similar complement to existing OTC internalization arrangements. Because the Program would operate as a pilot, the Commission would be positioned to review its operation and impact during its initial implementation and modify the rule as may be warranted. As part of that review, the Exchanges will produce data throughout the pilot, which will include statistics about participation, the frequency and level of price improvement provided by the Program, and any effects on the broader market structure. At the end of the pilot, the Exchanges will determine the appropriateness of extending the pilot or seeking to make the Program permanent. Because the Program is an important component of the Exchanges' effort to innovate and compete with exchange and

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[49] Hudson River at 3.

non-exchange markets for retail orders, because it offers the potential to improve the prices received by retail orders and because it would present no meaningful operational, capacity, regulatory or other concerns, the Exchanges respectfully request that the Commission approve the Proposal.

Very truly yours,

Janet McGinness