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August 21, 2009

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Comprehensive Review of Market Structure Issues

Dear Chairman Schapiro:

I am writing to you concerning the present SEC review of questionable market structure issues that have developed in recent years, such as so-called "flash orders" (selectively displayed orders) and dark liquidity pools. I request that the SEC undertake a comprehensive, independent "zero-based regulatory review" of a broad range of market structure issues, analyzing the current market structure from the ground up before piecemeal changes built on the current structure increase the potential for execution unfairness. I am concerned that questionable practices threaten to further erode investor confidence in our financial markets and that our understanding and regulatory capacity have not kept pace with those changes.

Actions by the SEC over recent decades have, perhaps unintentionally, encouraged the development of markets which seem to favor the most technologically sophisticated traders. The current market structure appears to be the consequence of regulatory structures designed to increase efficiency and thereby provide the greatest benefits to the highest volume traders. The implications of the current system for buy-and-hold investors have not been the subject of a thorough analysis. I believe the SEC's rules have effectively placed "increased liquidity" as a value above fair execution of trades for all investors.

Markets have become so fragmented – and the rise of high-frequency trading that can execute trades in milliseconds has been so rapid – that the SEC should review and quantify the costs and benefits of these market structure developments to all investors. Regulation NMS (or Reg NMS – or Regulation National Market System) appears to have had many unintended consequences, driving order flow into dark pools when it was intended to strengthen public order display. Regulation ATS (or Reg ATS – or Regulation Alternative Trading Systems) has permitted execution venues to flourish, and competition generally has been beneficial. More than 50 execution platforms now exist. This has led to increased competition for market share, however, that now includes questionable practices such as liquidity rebates, flash order offerings, co-location of

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servers and other inducement arrangements with broker-dealers and other market participants.

Moreover, market structure developments have taken place so quickly, that the SEC rule-making process is applying principles and precedents based on floor-based trading to electronic environments. For example, in May 2009, the SEC staff permitted two exchanges to introduce flash-order offerings, even though both admitted that the practice was of dubious value and that they simply were being driven to adopt it by the loss of market share to competitors. Instead of simply applying precedent from an obsolete business practice to a particular electronic order type or technological development, we need a comprehensive evaluation of each proposal's direct and indirect costs to the average investor.

In short, the SEC and the public it serves needs to step back and gain a clearer picture of what has happened. We need a thorough review of market structure issues so that our laws and regulations can keep pace with market developments. In particular, the SEC must look quickly into the following:

(1) Are **conflicts of interest** leading to failures to protect retail investor orders from execution strategies that take advantage of such investors because of the latent disparities within the market? Such disparities lead to opportunities to take advantage of market structure. Permitting a high-frequency trader to see information in "tomorrow's newspaper" does not benefit retail investors who are still reading today's newspaper (and who have been told repeatedly that a buy-and-hold strategy is best);

(2) Are the over 50 execution venues being **monitored and audited for best execution versus national best bid and offer**? The SEC needs to improve the reporting of execution quality for all trading venues in Rule 605. The SEC should also make brokerage firms produce better and usable execution quality statistics in Rule 606.

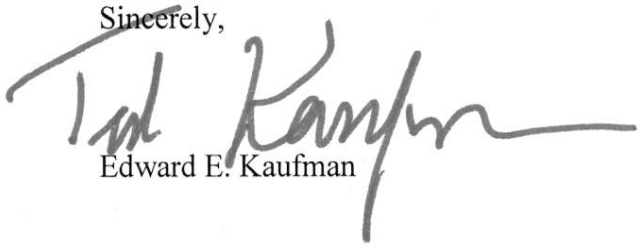
(3) Are the national best bid and offer (NBBO) **truly reflecting the quotes consolidated from the various venues at current execution speeds**? Otherwise, NBBO is questionable as a benchmark measure of execution fairness.

Market fragmentation and high-speed electronic trading have produced benefits, including increased liquidity, narrowed spreads, and lowered commissions for most investors. Yet the increase in liquidity and decrease in spreads has been centered around the most active stocks – liquidity is still light and spreads are still wide on many lower volume stocks (reminding us that providers of liquidity follow the profits in that activity; they do not provide liquidity across all stocks as a service to the market or as a public good).

Liquidity, speed and the role of arbitrage functions cannot be the end of the discussion. Indeed, this conversation is only now beginning to take place, as recent questionable market practices, which few previously understood, are only now coming to light.

For the markets to have credibility and investors to have confidence, the SEC must act urgently to restore a level playing field for investors. "Fair markets" is admittedly an elusive and evolving concept but one that needs to be clearly defined by the regulators. In the attached paper, I have elaborated on the topics and questions raised by current market structure developments. I encourage you to direct SEC staff to undertake a comprehensive study of these and other issues. This study should include independent outside experts from across the United States, including representatives of the retail investor community and small business.

Sincerely,



Edward E. Kaufman

cc: The Honorable Luis A. Aguilar, Securities and Exchange Commission
The Honorable Kathleen L. Casey, Securities and Exchange Commission
The Honorable Troy A. Paredes, Securities and Exchange Commission
The Honorable Elisse B. Walter, Securities and Exchange Commission

MARKET STRUCTURE ISSUES

Selectively Displayed Orders (So-Called "Flash Orders")

- DirectEdge is gaining market share through a flash order offering that allows it to invert its fee schedule.

- Nasdaq's and BATS's decisions first to offer and then to eliminate flash order offerings – without waiting on the SEC to ban flash orders – are commendable, though a telling illustration of the regulatory problems.

- Privileged information for select market participants creates information asymmetry. Whether it is advanced knowledge of research or block orders, the result for smaller investors is unfairness.

- The SEC should move to ban selectively displayed orders and indications of interest that are the functional equivalent of orders.

High-Frequency Trading (HFT)

- High Frequency Trading is estimated by the Tabb Group to represent 61% of share volume.

- The markets are so fragmented and speeds vary so much that potential for abuse needs to be subjected to a searching examination.

- Issues:

    - Regulators need deeper understanding of how these proprietary HFT algorithms use speed and cancelable orders to gain a more granular view of order flow.

    - Opportunities for abuse that exploit the market structure should be subjected to a searching examination and review and possibly prohibited. For example, in the late 1990s, the SEC regulated "SOES bandits," groups that were making easy profits from exploiting lags of a few seconds between exchanges in the US. In 2003, we learned that sophisticated investors were actively trading international mutual funds to take advantage of a time zone differential.

    - Can HFT's trace investor order flow and gain asymmetric information advantages without committing any capital and then use this information to execute ahead of orders in a risk-free manner?

- If it has not already done so, the SEC should investigate the claims made by two ex-employees from Renaissance Technologies, who according to press accounts said they were instructed to create trading strategies "to defraud investors trading through the Portfolio System for Institutional Trading, or POSIT."

- When trades are executed in milliseconds, why do we permit a 90-second delay in reporting trades to the tape (and how does this affect the average investor's ability to evaluate the quality of execution or the broker to monitor it in various execution venues)?

- How much of this high speed trading is done indirectly for investors through pension and mutual funds or ETFs? Or is it done mostly by hedge funds for their partners? Which mutual funds if any specialize in this trading?

- Do our high frequency markets need high frequency safeguards against major machine malfunctions?

Co-location of Servers at the Exchanges and other Execution Venues

- The SEC needs to ensure "fair access" by pro-actively determining a "method of allocation" of co-located capacity.

- The commission must also insure that such closeness is consistent with its plans for protection against terrorist attacks in the various business continuity directives.

- Fees for co-locating servers should be approved by the SEC.

- Agreements should offer the same terms and conditions and be transparent to regulators.

- Retail investors should have adequate choice of co-located execution by wholesalers.

Direct Market or Sponsored Access

- How much trading volume is now occurring directly (circumventing broker-dealers) between liquidity providers and execution venues?

- How does the SEC ensure adequate surveillance of these trade volumes?

Dark Pools

- There are now over 50 execution venues, many of which are dark pools. Dark pools go against the spirit of Reg NMS Rule 610, which requires fair and non-discriminatory access to quotations.
    - The growing volume of trades executed in dark pool is undermining public price discovery.
    - Order Audit Trail System (OATS) reporting should be expanded to NYSE-listed stocks and to all market centers so that regulators can better track what is happening with order execution.
    - Better understanding of the dark pools is necessary to determine the impact of dark pools on retail investors.
    - Do certain dark pools send out indications of interest to gain illumination of order flow granularity and in effect enable trades ahead of the orders?
    - Indeed we need audits of execution in dark pools and other execution venues to ensure prices at national-best-bid-or-offer.
    - Registrations of dark pools at the SEC should be transparent to the public.
    - What self-policing systems do dark pools employ concerning anti-gaming logic and rules and do these raise conflict of interest questions?

Liquidity Rebates

- The use of liquidity rebates (payment for order flow) to attract market share should be reconsidered. The London Stock Exchange has decided to end liquidity rebates by replacing them with a flat fee beginning September 1. Unfortunately, in an effort to take LSE market share, BATS will offer inverted pricing and a free liquidity removal incentive for UK stocks beginning on the 1st of September.
- If risk-free trading strategies exist that are driven solely by the ability to recoup a rebate, then what is the utility to the markets of such liquidity?

Retail Order Flow

- What are the financial inducements for directing retail order flow and are we confident they don't create conflicts of interest? For example, wholesalers get paid by the institution or HFT trader for execution against retail order flow. Does

that create a conflict of interest? Are the retail order flows being led to an HFT execution advantage, even if it's only a penny here and there?

- Disclosure of order flow payments under Rule 607 should require disclosure of the percentage of the payment that reverts to the customer.

- How many best execution cases have been brought in the last 10 years by either the SEC or FINRA?