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6 January 2010

Robert W. Cook
Director, Division of Trading and Markets
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Subpenny Trading on Regulated Markets

Dear Mr. Cook:

CFA Institute[1] would like to take this opportunity to draw the attention of the Securities and Exchange Commission (the "Commission") to certain trading activities that our members believe is both a potential market abuse and an issue that may create long-term problems for U.S. capital markets. Specifically, the issue is sub-penny trading on regulated exchanges.

To support our letter and provide evidence of how this trading occurs, we have attached a presentation for your review that was created by a CFA Institute member and CFA charterholder. This presentation shows sub-penny trades and how they undercut the National Best Bid or Offer ("NBBO"). We also have discussed these trading activities with members of our Capital Markets Policy Council and with other external organizations to verify these concerns. In all cases, the individuals confirmed that they, too, have seen or experienced these trades and believe it is an issue that the Commission needs to address very soon.

In the rest of this letter we will describe our concerns. In summary, we believe sub-penny trading creates four important problems for market fairness, efficiency, and trust. These problems are:

- There are different rules and regulations applicable to different market participants and trading venues.
- Limit orders are being undermined because of sub-penny trades.
- As investors recognize what is happening, they are refraining from submitting limit orders with consequent negative effects on price discovery.
- If the disparity in rules is not appropriately addressed, this type of trading will cause liquidity providers to leave the market. This could have serious negative effects for market order and efficiency during a future market sell-off.

[1] CFA Institute is a global, not-for-profit professional association of 97,152 investment analysts, advisers, portfolio managers, and other investment professionals in 136 countries, of whom 85,841 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

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Uneven Rules and Regulations

Rule 612 of Regulation NMS specifically prohibits any "exchange, national securities association, alternative trading system, vendor, or broker or dealer" from displaying ranking, or accepting "a bid or offer, an order, or an indication of interest in any NMS stock priced in an increment smaller than $.01" for shares priced above $1 per share. (The increment declines to $.0001 for shares priced less than $1 per share.) In paragraph "c" of the rule, however, the Commission reserves the right to exempt any class of persons, securities, quotations, or orders "if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."

In the adopting release for Regulation NMS, the Commission noted that it did not believe that sub-penny trading raised the same concerns as sub-penny *quoting*. As a consequence, the Commission expressly stated its willingness to grant an exemption to broker-dealers, saying:

> *"... a broker-dealer could, consistent with the proposed rule, provide price improvement to a customer order that resulted in a sub-penny execution as long as the broker-dealer did not accept an order priced above $1.00 per share in a sub-penny increment."*

Our reading of this rule is that it was adopted principally to prevent market participants from obtaining execution priority for a nominally better price. The fear was that such incremental price improvements would impair market liquidity and depth. Any exemptions were given to ensure orderly markets and to permit dealers to provide liquidity.

While we support the intention of the rule, we believe it has created a two-tiered market for both market participants and for trading venues. First, while the rule prevents bids, offers, orders, or indications of interest priced at increments of less than one penny, it does not prohibit actual sub-penny trades. Consequently, those who can trade without submitting a bid, offer, order, or indication of interest—i.e. certain broker-dealers, and others transacting through less-regulated venues—have an advantage that permits them to pre-empt the NBBO.

Second, the Rule applies to exchanges, national securities associations, alternative trading systems, vendors, or brokers or dealers. In practice, the rule appears to exempt so-called "dark pool" crossing networks from such sub-penny prohibitions. Our members have found that this exemption permits certain market participants to use computer algorithms to preempt the NBBO with sub-penny trades.

As a matter of principle and fairness, and out of concern for investor trust in the integrity of financial markets, CFA Institute believes that all market participants and venues should have to abide by the same rules, particularly with respect to sub-penny trading. As shown in the attached presentation, the differentiated rules have created a de facto two-tiered market that is benefiting a few firms at the expense of the greater market.

Preempting Limit Order Execution

In general, the parties most susceptible to sub-penny trading are those investors who submit passive limit orders. Even when such limit orders represent the NBBO, however, these orders are getting by-passed on a regular basis by other market participants who are able to improve the price by a mere $.0001. The member who prepared the attached presentation says that this happens thousands

of times per day to his firm's limit orders. In response, we've been told the firm's senior management has told the firm's traders not to submit passive limit orders. Such responses, while rational, could create long-lasting problems for the markets in the United States.

Potential to Impair Price Discovery

In its 2004 Regulation NMS proposal, the Commission cited the strong support of large institutional investors for enhanced protection of limit orders. These institutions, the Commission reported:

> *"…emphasized that limit orders are the building blocks of public price discovery and efficient markets. They stated that a uniform rule for all NMS stocks, by enhancing protection of displayed prices, would encourage greater use of limit orders and contribute to increased market liquidity and depth. The Commission preliminarily agrees that strengthened protection of displayed limit orders would help reward market participants for displaying their trading interest and thereby promote fairer and more vigorous competition among orders seeking to supply liquidity."*

Given the important benefits for price formation provided by limit orders, we believe it should concern the Commission that many such orders are being preempted by sub-penny trades. If investors are discouraged from submitting limit orders due to the expectation that such orders will be jumped by a sub-penny trade, the price-discovery mechanisms of U.S. securities markets could suffer. In particular, we are concerned that price volatility could increase, with negative consequences for both investor returns and issuer costs of capital.

Potential to Loss of Liquidity Providers

Equally disconcerting is the potential that sub-penny trades are discouraging liquidity providers. While entities benefiting from such trading may argue that volume from high-frequency trading ("HFT") will replace volume from departing liquidity providers, CFA Institute is not reassured.

In particular, HFT firms are in the business of trading for their own purposes. They are not there to provide a service to the market. Liquidity providers, such as traditional market makers, on the other hand, supply a much-needed service, in particular during circumstances such as those seen in late 2008 when markets were highly volatile and, at times, in a near freefall. If those liquidity providers ultimately leave the market because of the disparity in trading rules, it could have very serious consequences for market order in future sell-offs. At such times, HFT firms can remove their liquidity by quickly changing their algorithms' parameters, and rather than supporting the market with liquidity could join others by selling into the market. Such a circumstance would leave no one to provide a cushion for freefalling share prices. The effects could be devastating for millions of small and institutional investors, alike.

Recommended Response

As a consequence of the concerns raised in this letter and in the accompanying presentation, CFA Institute urges the Commission to take steps to remedy these problems. First, we suggest that the Commission remove any exemption permitted under section (c) of Rule 612, including those

applicable to broker/dealers. We believe this will create a more even market structure that will not favor one market participant over another. The similar trading rules will remove many of the factors that are currently discouraging liquidity providers to submit limit orders to the market.

Second, we recommend that the Commission reopen Rule 612 to discussion from market participants. In particular, we request that the Commission consider how best to ensure all market participants and trading facilities, including "dark" crossing networks, adhere to the same rules. Among the questions that we believe need consideration include:

- Will eliminating all exemptions under section (c) of Rule 612 prevent sub-pennying?
- Would prohibiting actual trades at increments of less than $.01 solve this problem?
- If not, what is the best way to prevent traders from stepping in front of standing limit orders by $.0001? Would requiring minimum price improvement at the mid-point between the bid and ask solve the problem?

Conclusion

CFA Institute appreciates the willingness of the Commission to listen to these concerns and to consider ways to remedy the potential market abuses that are occurring. As noted above, CFA Institute requests that the Commission change aspects of Rule 612 of Regulation NMS and to seek the input of other market participants both to verify the extent of the issues raised in this letter and to receive additional perspectives on possible remedies for these issues.

Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or James Allen at james.allen@cfainstitute.org or 434.951.5558.

Sincerely,

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