

**Marcia E. Asquith**  
Senior Vice President and  
Corporate Secretary

April 23, 2010

Via Email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

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

**Re: Comment Letter on Securities Exchange Act Release No. 61358 –  
Concept Release on Equity Market Structure (File No. S7-02-10)**

Dear Ms. Murphy:

FINRA staff<sup>1</sup> appreciates this opportunity to comment on the Securities and Exchange Commission's ("Commission") concept release on equity market structure, as published in the *Federal Register* on January 21, 2010 (the "Concept Release").<sup>2</sup> The Concept Release is part of the Commission's broad review of equity market structure and requests comment on a wide range of market structure issues, including high frequency trading, market data linkages, and undisplayed liquidity. FINRA offers its views below on enhancements that can be made to the existing regulatory structure to improve the surveillance of the equity markets.

Throughout the Concept Release, the Commission emphasizes that it is seeking to balance the benefits of market innovation with the potential adverse consequences of innovation. FINRA agrees with this approach by the Commission and believes it is critically important to also have a regulatory structure in place that appropriately reflects and responds to the realities of today's market structure, which is increasingly characterized by aggressive competition; fragmented markets; complex trading strategies;

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<sup>1</sup> The comments provided in this letter are solely those of FINRA staff; they have not been reviewed or endorsed by the FINRA Board of Governors. For ease of reference, this letter may use "we," "FINRA," and "FINRA staff" interchangeably, but these terms all refer only to FINRA staff.

<sup>2</sup> See Securities Exchange Act Release No. 61358 (Jan. 14, 2010), 75 FR 3594 (Jan. 21, 2010) (File No. S7-02-10).

high volumes of quotations, orders, and trades; direct access to trading centers by customers and non-members; fragmentation of orders; greater opportunities for undisplayed liquidity; and almost instantaneous quotation updates and executions. To this end, as the Commission resolves the discrete equity market structure issues raised in the Concept Release, FINRA believes that the Commission must make sure that there is a regulatory structure in place that:

- provides a holistic approach to regulation where regulators can monitor and detect problematic activity across markets and products (i.e., cash, equity, debt, and derivatives), not just within each market and market segment;
- guarantees that there is sufficient granularity and aggregation of audit trail data across markets and financial products so that regulators can with confidence identify activity such as direct market access, high frequency trading, and algorithmic trading, among other things, so that surveillance systems can be better designed to detect market manipulation and other abusive trading strategies; and
- ensures that audit trail data is transparent so that market participants' trading activity is discernable to regulators and they are not able to mask their identity through the use of multiple market participant identifiers ("MPIDs") or the MPID of another broker-dealer.

Effective regulation of trading activity on the equity securities markets—and surveillance of that activity—is one of the most fundamental obligations of securities regulators. An effective audit trail is essential to ensuring that regulators are able to meet this obligation. In Section IV.B.1 of the Concept Release, the Commission identifies types of proprietary trading strategies that may present serious problems in today's market structure. FINRA agrees with the Commission that certain of these strategies, particularly momentum ignition strategies, may under particular circumstances violate existing laws and/or rules, such as front running rules and anti-manipulation provisions. Accordingly, FINRA believes that broker-dealers must be especially diligent when developing and executing proprietary trading strategies, or enabling their customers to employ such strategies, to ensure that the trading conducted using these strategies is consistent with the Exchange Act and FINRA rules. This would include, for example, upfront reviews of the strategies before they are implemented, as well as developing ongoing controls to assess and review that the trading strategies continue to meet applicable regulatory requirements. Essentially, firms implementing trading strategies for themselves or their customers stand as the initial check to ensure that these trading strategies comport with applicable laws and rules.

Moreover, as the Commission notes throughout the Concept Release, in addition to new strategies being employed in the equity markets, trading has become increasingly more fragmented across automated trading centers and exchanges. Equity trading activity is now dispersed across not only multiple exchanges, but also dozens of alternative trading systems and hundreds of broker-dealers trading in the over-the-counter market.

By spreading trading activity across different market centers, firms could potentially attempt to disguise abusive trading activity by exploiting the existing gaps in audit trail data. Although regulatory authorities currently examine for, investigate, and prosecute abusive trading activity when it violates existing regulatory obligations, they are hampered by the lack of a comprehensive, sufficiently granular and robust consolidated audit trail across the equity markets. The most effective way to surveil for these trading practices across the wide range of market centers is to consolidate audit trail data in a single place so that violative trading practices can be more readily identified.

Each exchange and association market is required to have in place rules that, among other things, seek to prevent fraudulent and manipulative acts and practices and protect investors and the public interest.<sup>3</sup> Although each market is responsible for regulating and surveilling the trading conducted on its market, as markets become increasingly fragmented and securities trade on multiple venues, regulation across markets is a vital component of ensuring overall market integrity and maintaining investor confidence. This is particularly so when trading abuses such as insider trading, market manipulation, marking the close, and trading ahead of customer orders can be conducted across multiple markets. FINRA believes that a consolidated audit trail across markets, and across investment products, is essential to ensure comprehensive surveillance of the equity markets and related markets so that abusive trading activity can be detected in a more timely, efficient, and comprehensive manner.

Today, regulation of the equity markets is split among FINRA and seven other self-regulatory organizations (“SROs”), and no single regulator has a full picture of all trading activity in the U.S. equity markets, either on a product-specific, firm-specific, or under certain circumstances, even an order-specific basis. This fragmentation of market regulation provides opportunities for market participants to engage in regulatory arbitrage, encourages the dispersion of manipulative trading activity across multiple markets, and can lead to inconsistent and inefficient regulatory approaches. If regulatory authorities are to effectively surveil for illicit trading activity, there must be an ability to obtain a complete view of trading activity across equity markets. Not only do inefficiencies result from multiple regulatory authorities reviewing incomplete order and trading data for the same misconduct, potential violative trading can be spread across markets, making it less likely that it will be detected by any one regulator.

For example, since the adoption of Regulation NMS in 2005, there has been a significant increase in market linkages, the result of which is that trading activity on one market can have a profound effect on other markets. This, in turn, has led to a much greater possibility of cross-exchange market manipulation where, for example, trading on one market is used to artificially affect a security’s price and trading on another market is used to take advantage of that price change. A similar problem exists when surveilling for compliance with rules that prohibit firms from trading ahead of a customer order, such

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<sup>3</sup> See Securities Exchange Act §§ 6(b)(5) and 15A(b)(6).

as limit order protection rules and front running rules. In these cases, the proprietary trading may be executed on one market while the customer trade is executed on another. These problems are exacerbated by the fact that some firms trade using multiple MPIDs or trade pursuant to market access arrangements whereby the firm's trading is identified with an MPID assigned to a different firm.

Although FINRA is able to reconstruct a significant part of equity market activity through its responsibilities for regulating the over-the-counter market and its regulatory services agreements with other SROs, the existing audit trails have a number of limitations. For example, two separate, unlinked order audit trails currently exist in the equity markets: FINRA's Order Audit Trail System ("OATS") for Nasdaq-listed securities and over-the-counter equity securities and NYSE's Order Tracking System ("OTS") for NYSE-listed securities. In addition, while trades by high frequency traders are captured in the audit trail, the absence of a flag for these types of trades requires regulators to take additional, often time-consuming steps, to identify the ultimate parties behind the trade.<sup>4</sup> There is also no consistent convention among SROs in identifying market participants, as the same market participant may be known under a different identifier on different markets.

As noted above, to enhance the audit trail, FINRA believes there should be consistent and uniform gathering of order, trade and quote information across all equity and options markets and that the audit trail must be sufficiently granular to enable regulators to readily identify trading activity by market participants across markets (for example, by requiring unique MPIDs for walled-off areas within broker-dealers, ATSS, each entity with direct market access, and large traders and by ensuring that these MPIDs are used uniformly across market centers).

As the Concept Release notes, in recent years, the trading activities of proprietary trading firms has increased significantly, due in large measure to changes in technology, market access arrangements, and overall equity market structure. Proprietary trading is now a substantial component of the current equity market structure and affects numerous aspects of the market's performance. Proprietary trading activity is conducted by numerous different types of market participants, including registered broker-dealers, trading desks of registered multi-service broker-dealers, and proprietary trading firms that are not registered as broker-dealers.

Although a significant portion of proprietary trading activity is conducted by firms that are registered as broker-dealers, not all such firms are members of FINRA. Thus, while these firms are subject to SEC requirements regarding broker-dealers and any applicable exchange rules, they are not subject to FINRA rules, including order audit trail and trade reporting obligations. Consequently, there is not uniform regulation among

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<sup>4</sup> FINRA notes in this regard that the Commission's recent proposal concerning large trader reporting would, if adopted, enhance the regulatory transparency of trading by many such firms. *See* Securities Exchange Act Release No. 61908 (April 14, 2010).

registered broker-dealers, nor is there consistent and comprehensive audit trail information about such firms' proprietary trading activity. This disparity in membership requirements among registered broker-dealers also contributes to regulators' inability to create a consolidated audit trail.

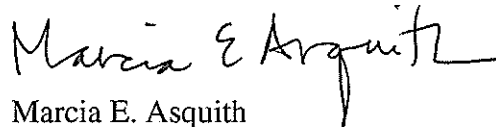
Quite simply, technological advances in trading systems, coupled with market fragmentation, have led to a situation where comprehensive intermarket surveillance is essential to ensuring the overall integrity of the equity markets. Moreover, the major hurdles of just a few years ago to consolidated market surveillance have been significantly reduced due to the progression of market structure and the convergence of many aspects of exchanges' business models. With the changes to market structure resulting from Regulation NMS and virtually all aspects of trading becoming electronic, the previous distinctions between market types are quickly fading away, minimizing many of the prior obstacles to consolidated audit trail data and oversight.

As the Commission moves forward with its review of equity market structure, FINRA strongly recommends that the Commission continue to consider the benefits of moving toward a consolidated audit trail that comprehensively captures order and trade information across the U.S. equity markets.

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Please contact Stephanie Dumont, Senior Vice President and Director of Capital Markets Policy, at (202) 728-8176, or Brant Brown, Associate General Counsel, at (202) 782-6927, if you would like to discuss FINRA's comments or have any further questions.

Sincerely,

  
Marcia E. Asquith  
Senior Vice President and  
Corporate Secretary