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COMMITTEES:
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RULES
FINANCE

United States Senate

WASHINGTON, DC 20510

October 20, 2009

Mary Schapiro
Chairman
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Schapiro,

I write out of concern that the proliferation of Alternative Trading Systems (ATSs) and the disparate regulatory treatment between these ATSs and registered exchanges is creating a two-tiered system that undermines the transparency of our national market system and exposes our capital markets to significant additional risks. I understand the Commission is holding an open meeting this week at which it will address some of the issues discussed below, and is conducting an ongoing review of broader market structure issues. I am glad to see the Commission is taking a proactive approach in addressing these issues, and Wednesday's open meeting is another good step in the right direction.

As the Commission considers the treatment of ATSs, at this week's open meeting and beyond, I respectfully ask that you consider the proposals outlined below to ensure that ATSs, while continuing to provide beneficial competition to registered exchanges that directly and indirectly benefits retail investors, do not undermine the fairness, transparency and integrity in our markets that the Commission has worked for so many decades to foster.

As you know, the Securities Exchange Act of 1934 (the Exchange Act) requires that exchanges bear the burden of self regulation, including market surveillance, capacity and systems compliance, and ensuring that exchange members comply with applicable securities laws and other rules, regulations and listing standards. Registered exchanges also must submit rule changes to the SEC for pre-approval, and are required to publicly quote and participate in price discovery.

In 1998, the SEC promulgated Regulation ATS with the goal of introducing competition to the New York Stock Exchange and Nasdaq, which dominated trading in the equities markets at the time. Regulation ATS promoted competition by making it easy to set up an alternative trading system – broker-dealers are simply required to file a notice with the SEC at least 20 days prior to beginning operations, the notice contains only a general description of the ATS's proposed operation methods, and is not subject to prior approval by the SEC. Once they are operational, ATSs are not responsible for conducting market surveillance (FINRA conducts market surveillance for all broker-dealers operating ATSs) or for monitoring their users' compliance with securities and other laws – they are only required to maintain an order audit trail in case FINRA or the Commission examines them.

Regulation ATS has had the desired effect: the number of ATSs has proliferated, and ATS market share has dramatically increased. Approximately 35% of trading volume now takes place off-exchange, up from only 9 percent in 2001. This competition has resulted in significant benefits, direct and indirect, to retail investors – liquidity is greater than ever, bid-ask spreads are lower than ever, and transaction costs have been reduced significantly.

But all of these benefits have come at a cost, as our capital markets have become increasingly fragmented, market surveillance has not kept pace and I am concerned that a large and growing portion of market activity takes place in dark or semi-dark spaces. These developments risk undermining the transparency that is so critical to maintaining fair and efficient markets, and have made it increasingly difficult – especially in light of technological developments that facilitate large volumes of trading at very high speeds – to conduct adequate market surveillance across all markets. Together, these developments risk undermining the fairness, transparency and integrity that have become hallmarks of the US capital markets.

That is why I am urging the Commission to consider the following proposals:

1. Establish Consolidated Market Surveillance

In 1975, Congress vested in the Commission the authority to create the National Market System, which provided a framework for connecting the growing number of trading venues. However, with the fragmentation of trading volume between different markets also came the fragmentation of market surveillance. Currently, each exchange has a separate arrangement for monitoring trading on its respective market, while FINRA conducts market surveillance of broker-dealers operating ATSs. I am concerned that this fragmented system of market surveillance makes it nearly impossible to monitor market manipulation, trading ahead of customer orders and other abuses at the same time that the fragmentation of our markets and technological advances make such abuses easier to carry out. For example, a trader can manipulate share prices through complex trading strategies at different exchanges and ATSs but escape unnoticed because no individual exchange is responsible for monitoring beyond its respective trading platform. I respectfully request that the Commission consider requiring that market surveillance be consolidated across all trading venues and that data from all exchanges and ATSs be submitted on a real-time basis to a consolidated audit trail. The costs of providing this consolidated surveillance would be covered by fees assessed by the consolidated regulatory authority on all trading venues on the basis of their respective proportion of total trading volume.

2. Require Broker-Dealers to Obtain Commission Approval Prior to Operating ATSs or Amending Their Operations

I believe the establishment of a trading venue is no light matter and that an ATS should demonstrate that it has adequate policies and procedures in place to ensure compliance with applicable laws and regulations by itself and its users, and to monitor system capacity, security, and contingency planning procedures as described below. Currently, in order to operate an ATS, a broker-dealer is only required to file a notice 20 days prior to commencing operation. Crucially, this notice procedure does not require Commission approval. I respectfully request that the Commission consider replacing this notice procedure with a robust approval process in order to determine whether the ATS would (i) ensure fair access and market transparency in accordance with existing law, (ii) comply with applicable market surveillance obligations and (iii) promote market stability and protect against systemic risks as well as risks posed to potential users of the ATS. I also respectfully request that the Commission require ATSs to obtain prior approval from the Commission for material changes to their operations.

3. Require ATSs to Have Procedures for Reviewing System Capacity, Security, and Contingency Planning

Regulation ATS only requires an ATS to adopt policies and procedures for reviewing system capacity, security, and contingency planning procedures if 20 percent or more of the average daily volume of any NMS stock has taken place on that ATS for at least four of the preceding six months. I respectfully request that the Commission consider eliminating this 20 percent threshold and require *all* ATSs to adopt such policies and procedures, provide a reasonably detailed description of such policies and procedures on Form ATS, and obtain the approval of the Commission prior to materially amending such policies and procedures.

4. Daily and Standardized Reporting

Presently, ATSs are required to report trades to the Consolidated Tape on a 90-second delay. They also report aggregate trade volume to the Commission on a quarterly basis. This trade volume data is not standardized – for example, some ATSs "double-count" by counting a matched order as two trades, while others treat a matched order as only one trade. I am very concerned that nobody seems to know the precise amount of trading volume that occurs in the non-displayed markets, and that this information is not available more frequently than quarterly.

I understand you intend to address post-trade reporting at your open meeting this week, and I respectfully request that the Commission consider requiring real-time reporting of trade information to the Consolidated Tape. I also respectfully request that the Commission consider requiring each ATS to report to the Commission, at the end of each trading day, aggregate trade volume by ticker symbol. This information should be reported in a standardized format that avoids double-counting of matched trades. Finally, I would urge the Commission to consider requiring public disclosure of aggregate daily trade volume for each individual ATS. I strongly believe that accurate and transparent reporting by ATSs will help reduce risks to market integrity and stability and greatly contribute to rebuilding public confidence in our markets.

5. Lower Percentage Threshold for Order Display and Review Fair Access Threshold

I am increasingly concerned that, as more trading volume moves onto non-displayed markets, including so-called "dark pools" and internalized broker-dealer networks, a two-tier market is beginning to develop in which a large segment of the market does not participate in price discovery. Thus, even though dark pools are generally required to execute trades at the best "market" price as determined in the lit markets – i.e., the national best bid and offer – the very process by which that market price is determined may be impacted.

Currently, ATSs are only required to disseminate their quotes for any given NMS stock to the Consolidated Quotation System if five percent or more of the aggregate daily share volume of that stock has been traded on the ATS for at least four of the preceding six months. Individually, most ATSs do not trade in volumes even approaching this threshold, but in the aggregate they account for a significant and growing portion of trading volume, most of which does not contribute to the price discovery process. Accordingly, I respectfully request, at the open meeting scheduled for Wednesday, October 21, 2009, that the Commission consider lowering the public quoting threshold from five percent to one percent. However, I recognize the important role that certain ATSs fulfill by executing large block orders on behalf of institutional investors in a non-display environment, and I would urge the Commission to consider an exception to the one-percent threshold as may be necessary to facilitate such block execution services.

In addition, I respectfully request that the Commission review the current threshold for fair access requirements under Regulation ATS, in order to determine whether those thresholds are meaningful in light of current trading volumes on ATSs.

6. Treat Actionable Indications of Interest as Firm Quotes Under Regulation NMS

I understand that the Commission intends to address so-called "actionable indications of interest" at this week's open meeting. As you know, I feel that so-called flash orders undermine the fairness and transparency that are hallmarks of our markets, and I strongly support the rule proposed by the Commission at its open meeting last month that would effectively eliminate flash orders. However, I believe that certain "actionable" indications of interest (IOIs) operate similarly to flash orders. These IOIs bear virtually all the indicia of a firm quote, but are not required to be treated as such under Regulation NMS. As a result, very detailed information about potential order flow is exchanged among a small group of market participants, presenting even greater opportunities for abuse as flash orders. This anomaly should be eliminated. While many indications of interest are perfectly legitimate, and contribute to the efficient functioning of the non-lit parts of our markets, I believe that IOIs that walk and talk like firm quotes should be treated as such under Regulation NMS.

Accordingly, I respectfully request that the Commission consider, at this week's open meeting, classifying such actionable indications of interest as firm quotes that must be disseminated to the Consolidated Quotation System (assuming the applicable volume thresholds are met). Combined with the reduction of the volume thresholds for order display described above, this proposal will result in bringing significant additional trading volume into the lit markets where it will participate in price discovery, thereby bolstering the efficiency and transparency of the markets.

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I applaud the hard work you and your staff have done on these and related issues and greatly appreciate your consideration of the proposals outlined above. I look forward to working with you to address the critical issues arising in our ever-evolving financial markets.

Sincerely,

Charles Schumer

Charles Schumer
United States Senator