3/11/2011

US Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Summary Report, Joint CFTC-SEC Advisory Committee

Dear Staff and Commissioners:

We read with interest the Panel's Flash Crash findings and market-structure recommendations.

We are commenting on the flaws of incentivized trading and its obfuscating effect on public companies' capacity to understand their trading activity and link market valuations to intrinsic business value. Nowhere are the interests of public companies or capital formation considered in the Panel's conclusions.

We track trading patterns for public companies, using sophisticated database and software tools to separate speculative and rational behaviors. Our median client has a market cap of $4 billion, but our client base spans the largest publicly traded companies and the industry spectrum on US listing exchanges.

The Panel's recommendations increase dependence on "artificial liquidity," by which we mean buying and selling that would not occur without incentives. The Panel found that "there remain legitimate concerns over the absence of present incentives for market participants to provide liquidity in the present market structure." Yet the major exchanges file hundreds of rules each year, all of which must be granted or denied by the SEC, and most of which relate to fees and rebates for adding and removing liquidity.

In calling for more incentivized liquidity, perhaps with access fees and rebates changing in real-time during "peak load" periods, the Panel mistakenly concludes that markets have a liquidity problem. Natural buyers and sellers who make decisions based on the intrinsic worth of the securities, their availability, and the risk associated with buying or selling them, need no short-term incentives. But trading built on intermarket arbitrage comprised of make/take spreads and minute price moves will develop valuation uncertainty – which is what happened May 6, 2010. Incentivizing more liquidity will worsen the distortion.

Imagine if the market for coffee beans relied on incentivized bids or the furnishing of some coffee-bean derivative whenever supply and demand was imbalanced. How would any broker, let alone the consumers of coffee, know if they were paying correct prices? Or how about a sudden run on golf clubs, where the proposed solution was to incentivize golf-club traders to furnish supplies of golf clubs to meet market demand? It's the sort of construct that could produce disruptive golf-club trading practices, dark pools for golf clubs, internalized golf-club orders, and even golf-club naked access in which fast golf-club traders might simply rent access to the golf-club market in order to churn the same clubs over and over for profit.

Rules have replaced brokers with shill bidders. The Panel recognized that Regulation NMS "effectively eliminated much of the profitability of the registered market function," and yet acknowledged two

paragraphs on the widespread reports that "high frequency market making is a significantly profitable activity." From the Buttonwood Tree to 1997, our capital markets worked on minimum commissions and preferences for brokers in matching up buyers and sellers. Now instead, markets rely on incentivized intermediaries that commit to nothing and profit from the absence of things.

History shows that price distortions arise in over-intermediated markets. Now add price controls. Every make/take fee is approved by the SEC. Trades must meet at the NBBO. New proposals would set limit-up/limit-down price movement and circuit breakers for nearly all securities. Efforts to control and manage pricing behavior historically breed black markets. No surprise, the bulk of equity-securities volume has moved into the dark, where prices are less distorted.

In that vein, our data show that not one-third but roughly 70% of trading volume for securities listed on the NYSE and the NASDAQ are trading off the exchanges. Public companies are relying on data for only 30% of trades – since regulations prohibit them from accessing data on the other two-thirds of trades – to understand their trading activity. The blame rests with market rules and incentivized trading.

Whenever rules are considered, Section 23(a)(2) of the Exchange Act requires regulators to evaluate the anti-competitive effect. Further, Section 3(f) of the Exchange Act, and Section 2(c) of the Investment Company Act mandate that rulemaking not only be driven by public interest and the protection of investors, but by whether the action will promote efficiency, competition and **capital formation**.

Equity markets exist so growing enterprises can meet risk-taking investors. In order for markets to effectively facilitate capital-formation, traded shares must bear some resemblance to business value. In markets predicated on the artificially incentivized production and consumption of liquidity, in time the connection between the underlying business and its derivative security, its traded shares, disappears.

In deference to the wisdom of the Busttonwood Agreement's two sentences, two suggestions for bringing natural liquidity back: Remove price controls. No NBBO, no mandated penny spreads. People drive across town to save ten cents on a gallon of gas. Under current rules, in trading markets that's not possible. Second, get rid of rebates. Rebates should be the domain of brokers, not exchanges. Costs should be the same for buying or selling; otherwise, the behavior behind it will not be real.

Finally, the Panel observed: "Price discovery depends upon the interaction of all types of market participants." Really? By what proof? Price discovery depends on willing buyers and sellers. Until regulators cease trying to manage outcomes and instead content themselves with refereeing a fair contest, price discovery will remain uncertain and another Flash Crash likely. And public companies will know ever less about their trading activity and the real price of their shares.

Yours sincerely,

Timothy Quast
Managing Director