

Southeastern's Perspective on Market Structure and High-Frequency Trading April 11, 2014

Since 1975, Southeastern has invested in strong businesses, run by good people, priced at deep discounts to our appraised values. Taking the long-term view to owning these businesses requires that we access the capital markets to build equity positions. Forty years ago, engaging the US equity capital markets was relatively straightforward, requiring us to send an order to either a floor-broker on the NYSE or an OTC/NASDAQ market maker. Today, we use computer algorithms, smart order routers, any or all of 13 exchanges and more than 40 dark pools, broker-dealer internalizers, “upstairs” human traders, and while rare, the same old floor-brokers on the NYSE. As trading has grown more complex, Southeastern has broadened our trading expertise to ensure it remains a core competency.

In the last five years, regulators, lawmakers, and the media have taken an interest in the topic of the capital markets' structure and, in particular, high-frequency traders (HFTs). This debate has been occurring in all global markets, but seems especially acute in the U.S. equity capital markets. Increasing complexity combined with higher visibility has unearthed numerous market participants who have different objectives and use unclear and varying terminology. The public debate has become confusing and unsettling for investors.

While HFTs play a role in improving markets for all participants, certain distortive practices have put investors at a distinct disadvantage. Since capital markets exist to connect companies with investors, the imbalances between HFTs and investors must be addressed to help level the playing field for all who access the capital markets. With or without the necessary adjustments, Southeastern will evolve and continue improving our trading approach to protect the interests of our clients.

The following questions are meant to simplify the discussion about HFTs.

- How did trading become so complicated?
- What are HFTs and how do they operate?
- What does Southeastern believe can resolve much of the imbalance created by HFTs?
- How does Southeastern manage trading to protect and advocate for our clients?

How did trading become so complicated?

Three distinct events largely shaped today's trading landscape. First, in 1999, the SEC enacted Regulation ATS to help coordinate the regulation of registered exchanges with alternative trading systems (i.e. non-exchange trading venues) and promote healthy competition between the two. Second, in 2007, the SEC enacted Regulation NMS to ensure “best execution” by encouraging competition through market structure changes. These two regulations led to an explosion of new trading venues, including exchanges and dark pools. Dark pools are regulated venues that match buy and sell orders. Unlike exchanges, they do not display orders, though they do report trades. Dark pools theoretically allow a large order to be executed while minimizing the order's footprint by removing pre-trade transparency (i.e. being dark). Third, when the NYSE became a for-profit entity in 2006, the era of exchanges as dispassionate third-party utilities connecting buyers and sellers ended.

The creation of more than 50 execution venues caused liquidity fragmentation that necessitated automated tools to manage accessing the markets – algorithms and routers. Brokers, who control access to the capital markets, supply the buy-side (i.e. investment advisors, hedge funds, etc.) with algorithms and routers programmed for two primary tasks. First, the “algo” decides when and how to slice large orders into manageable pieces. Second, the router determines which trading venues receive each piece and how those orders are to be represented at the venue. Carving up an order and sending its

components to many venues at once is meant to protect the client by reducing the order's footprint. While a helpful tool, algos have simultaneously created concern over whose interest is being served with various unanswered questions – how are these venues competing, how are brokers choosing venues worthy of order routes, and how do we know if the algo is achieving best execution? The SEC unintentionally traded the structural inefficiencies of the old market specialist system for new, more complex and opaque loopholes.

What are high-frequency traders and how do they operate?

HFTs have been defined in a plethora of ways, but for our purposes, they have four common characteristics:

1. Use of automated proprietary trading strategies unrelated to investing in companies,
2. Reliance on low-latency technology that provides ever-faster data transmission,
3. Short holding periods of less than one second, and
4. Unwillingness to absorb the overnight risk of holding a stock.

Though completely counter to how we invest, nothing is inherently wrong or illegal with the HFT's approach. The widespread infiltration of HFTs, which many estimate as participating in 50 percent of daily market volume, makes them impossible to avoid and relevant to all investors. Unfortunately, some of the strategies and tactics they employ detract from the ultimate goal of the capital markets – to reduce friction between those with capital to invest and those in need of capital. Technology has enabled the rapidly-repeatable exploitation of structural inefficiencies as HFTs unnecessarily intermediate buyers and sellers, charging an opaque “tax” and hiding behind the veil of regulation.

All market participants have benefited from technological advancement and market venue competition. However, these phenomena have been taken to the extreme and have resulted in some questionable tools that can be used to the detriment of investors and do nothing to advance the true purpose of the capital markets. Some of these tools are:

- **Enhanced Exchange Proprietary Data Feeds:** For a premium cost, subscribers receive enriched trade information at faster delivery speeds than the public data feed.
- **Exchange Co-Location:** For a premium cost, subscribers can physically place their trading computer engine next to an exchange's trade matching engine to reduce latency, thereby receiving information and responding more quickly than others are able.
- **Complex Order Types:** Four basic types of orders (Market, Limit, Price Peg and Immediate-or-Cancel) promote efficiency and place all participants on equal footing. Hundreds of new complex orders often serve the needs of select participants and disadvantage other orders in the marketplace.
- **Maker/Taker Pricing:** Exchanges rebate order providers (i.e. makers) and charge order removers (i.e. takers). Inverse exchanges perversely rebate takers and charge makers.

Longer-term strategies do not require these tools and would benefit very little from their use as investors build positions in companies for longer than one second. However, these tools are powerful when used to exploit the markets' structural inefficiencies and take advantage of investors. HFTs can engage in latency arbitrage by observing trades and bid/offer changes on one exchange, then trading at “stale” prices on other exchanges before bid/offer prices are adjusted across the market. They can front-run by observing a buy order arriving at one exchange, beating that order to other exchanges, and accumulating stock only to sell to the buy order at a higher price. Additionally, when engaging in rebate arbitrage, HFTs can use complex order types to “jump the queue” and be first to trade and receive maker/taker rebates from exchanges, despite other participants having arrived first. By seeing trades and price changes in the market before investors and ensuring they are first to react, HFTs are greatly advantaged at the investors' expense.

Few deny these practices occur, but some argue they represent the minority of activity. Because the negative impact of these practices is difficult to quantify, proponents of HFT argue that the benefits of greater market liquidity and lower explicit transaction costs outweigh any downside of an HFT's information advantage. Southeastern agrees that many HFTs are electronic market makers and provide

significant volume to the market. Less clear, however, is how much true liquidity that volume provides given the following:

- HFTs hold shares for a fraction of a second and rarely, if ever, overnight.
- HFTs may provide only “phantom liquidity” on multiple venues to influence behavior while knowing they will not have to actually trade shares and assume risk.
- Electronic market makers provide liquidity in names that are already highly liquid (e.g. ticker BAC with >100mm shares traded daily) and appear to ignore stocks that would benefit from sincere market making services.

What does Southeastern believe can resolve much of the imbalance created by high-frequency traders?

The debate surrounding the benefits of HFTs does not mean that their basic traits – having proprietary strategies, trading fast and often, holding stocks for short periods of time, and not keeping positions overnight – are inherently bad. In a capitalist society, fair competition among all participants promotes robust markets. Unfortunately, the current system does not allow all market participants to compete on equal ground. This inequality does not warrant an SEC overhaul of the entire capital markets structure, which likely would result in unintended consequences that do more harm than good. Rather, two simple adjustments would protect all investors and promote simplicity and transparency, while allowing free market competition and technological advancement to thrive. Recommendations we believe the SEC should consider, include:

1. Eliminate Maker/Taker: These pricing schemes obfuscate the “best price” and place brokers in a conflict of interest when routing orders on behalf of their customers. Many detrimental practices are driven by the existence of rebates and venues should embrace a transparent fee/fee model. Pricing schedules are frequently adjusted so implementing a ban on maker/taker will not risk the technological stability of the market system.
2. Eliminate Proprietary Data Feeds: All market participants should have the opportunity to receive market data at the same time from the same source via the public feed. We advocate banning all proprietary data feeds whether or not they have enhanced information. Being able to absorb data and react faster than others is an example of capitalism to which we would not object. That said, the same data should be available to all participants at the same time, without having to pay-to-play.

Additionally, we call on all dark pools to adopt similar “investor protection” standards to those created by IEX. IEX is the only dark pool owned exclusively by investors (e.g. investment advisors, hedge funds, family offices, etc.). This ownership structure enables brokers to route customer orders to IEX without a conflict of interest, because they are not IEX owners. As of March 2014, IEX is the only dark pool to have publicly released its “rules of engagement” or Form ATS submission to the SEC. Some characteristics of IEX that we applaud are:

- Equal Access: All brokers and market participants are welcome on equal footing.
- Safe Technology: No co-location or proprietary data feeds are offered.
- Simple Order Types: Only four orders available – Market, Limit, Midpoint Peg and IOC.
- Conflict-Free Pricing: Both makers and takers are charged a low fee thus eliminating maker/taker rebate distortions and further aligning brokers with their clients.

We instruct our brokers to include IEX in their routing schedules when handling Southeastern’s orders and encourage other investors to trade through IEX as well as any other venues that make similar attempts to treat all market participants equally.

How does Southeastern manage its trading to protect and advocate for our clients?

Southeastern has always taken our obligation to achieve best execution seriously. Until the SEC addresses needed changes and dark pools adopt standards that treat all participants equally, Southeastern's holistic approach to trading will help protect our clients. We are simultaneously taking definitive actions to improve trading, broadening our understanding of the marketplace through industry involvement, and working to influence policies to address the capital markets' apparent shortcomings.

Trading operations

It is impossible to avoid trading with HFTs, and dark pools provide benefits in spite of structural concerns. The key to protecting our trades is controlling how our orders engage the marketplace to avoid negative outcomes. Southeastern takes a number of steps to help ensure we trade with trusted partners, retain control of the trading environment, and put ourselves in the most advantageous position possible to achieve best execution.

The most important and unique way that Southeastern approaches best execution is reducing conflicts of interest when placing client orders. Unlike most of the industry, we do not use soft dollars to pay for non-execution services. Therefore, our Trading Department does NOT have a commission budget whereby Southeastern "owes" brokers compensation for services such as research, management access, or conference invitations. This policy allows our traders independence to approve brokers based solely on their ability to provide best execution. Our traders are free to engage brokers as much or as little as warranted.

In addition to being conflict free, our traders require the following four steps be completed before approving a broker for electronic trading.

1. Due-Diligence Questionnaire (DDQ): We send a detailed 100+ question DDQ semi-annually to all current algorithmic trading partners. The DDQ is the first step in analyzing the quality of a potential partner's offering. As of March 2014, our DDQ had been sent to 19 brokers and 10 chose not to proceed because they either would not commit the resources necessary to explain their system or their compliance department would not allow them to respond. Southeastern does not electronically trade with these 10 brokers.
2. Follow-up Interviews: Should the DDQ responses demonstrate an understanding of the broker's system and market structure, we speak with the broker's product specialists (i.e. developers) to understand the system's nuances and discuss how Southeastern should best use that broker's tools to access the capital markets and ensure positive outcomes.
3. Order Handling Instructions: Southeastern gives each partner specific directives regarding how to handle orders. These encompass general guidelines (e.g. trade our orders as though they are your own), actions the broker completely controls (e.g. do not send Indications of Interest or Flash Orders), and instructions the broker must pass along to forward venues (e.g. do not allow re-routing).
4. Customized Algorithmic Strategies and Routing Tactics: We sometimes request customized algorithms and routing schedules to meet our needs.

Further, to ensure that our instructions are being followed, we also require brokers to populate our orders with standardized electronic messages (e.g. FIX tags) that we can use to verify execution information.

Additionally, Southeastern built a customized Transaction Cost Analysis (TCA) system to provide reliable and meaningful quantitative measures of our trading performance. Our TCA system allows us to analyze general characteristics as well as performance and opportunity costs of our global trading. These results inform our approach to trading and guide post-trade discussions with our broker partners.

Industry involvement

To ensure that we stay abreast of the latest trends, Southeastern has ongoing discussions with our broker partners, attends industry conferences and has representation with various industry groups, such as the:

- IEX Trading Advisory Committee

- Buy-side Equity Traders Roundtable (BETR)
- Investment Company Institute (ICI) Equity Markets Advisory Committee
- FIX Protocol Limited Americas Buy-side Working Group

Policy influence

In April 2010, Southeastern wrote a public letter to the SEC in response to its Concept Release on Equity Market Structure. Since 2009, we felt the principal role of the capital markets – as conduits of capital from those willing to invest to businesses in need of capital – was being altered to benefit a narrow slice of financial market participants to the detriment of most investors. Technological advancements had passed the point of diminishing returns and were threatening the stability and overall performance of the capital markets. After the May 6, 2010 “Flash Crash,” we expressed our concern and advocated for our position in Washington, meeting with all five SEC Commissioners, the Department of the Treasury, multiple Senators and Congressmen, and even testifying in front of the CFTC-SEC Advisory Committee on Emerging Regulatory Issues. We have since served as a resource for those seeking input and understanding of how the U.S. capital markets function.