SOUTHEASTERN ASSET
MANAGEMENT, INC.®

April 28, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Concept Release on Equity Market Structure (File No: S7-02-10)

Dear Ms. Murphy,

Southeastern Asset Management, Inc. ("SAM") appreciates the Securities and Exchange Commission's ("Commission") examination of equity market structure. We applaud the Commission for adopting a comprehensive approach and requesting input from the investing and trading communities. **Current market structure is flawed because unfair structural advantages permit short-term professional traders to insert themselves between long-term buyers and sellers.** This intermediation conservatively results in $20 billion[1] per year in execution costs and untold billions in opportunity costs for investors. We will discuss these structural advantages, the damage they cause, and potential remedies throughout this letter.

Background

SAM is an employee-owned investment advisor to the Longleaf Partners mutual funds (representing thousands of individual investors) and 200+ separately managed accounts (representing pensioners, foundations, and endowments). SAM advises over $30 billion of assets. In accordance with a good business, good people, good price approach, we seek to achieve superior long-term performance for our investors by acquiring equity securities of financially strong, well-managed companies at market prices significantly below our assessment of business value. We view holding equities as providing capital to and owning pieces of businesses, not as trading pieces of paper. Our low portfolio

[1] Edgar Ortega, Jeff Kearns and Eric Martin, "High-Frequency Traders Say Speed Works for Everyone." *Bloomberg News*, July 28, 2009.
http://www.bloomberg.com/apps/news?pid=20601109&sid=aBBFQ6thBuiY

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turnover indicates that we partner with our investee companies for five to seven years on average, which qualifies us as long-term investors.

Executive Summary

Unintended, yet permitted advantages within market structure have come to dominate and overshadow the true intent of the capital markets – to facilitate the allocation of capital from investors to businesses. The market has become a servant to short-term professional traders, in particular high-frequency traders ("HFT"). As a result, the long-term investor – whether an individual, mutual fund, or hedge fund – incurs unnecessary execution and opportunity costs when allocating capital to businesses. Unfair competition and structurally advantaged short-term professional traders ultimately prevent the markets from reaching their end goal. If obfuscation clouds public debate and sidelines reform, many confidences that bona fide investors have in the capital markets may be irreparably harmed.

The argument for change is predicated upon several fundamental premises:

1. The markets do not exist as an end in and of themselves;
2. The markets exist to facilitate capital allocation, transferring capital from investors to productive businesses that can provide a return on that capital;
3. "Trading efficiency" as defined by HFTs (e.g. increased speed, increased "liquidity," price "improvement") is not straightforward, nor is it an end, and has merit only if it improves the capital allocation process;
4. Practices that implicitly "tax" the allocation of capital or result in investing inefficiencies must be eliminated; and
5. Markets should be fair, open, and accessible to all with the first obligation being to uphold the interests of long-term investors.

Given these assumptions, several areas demand immediate and necessary reform. **Naked sponsored-access, trading center data feeds, and co-location allow users to gain an inappropriate structural time advantage and should be banned and/ or have their incentives removed. Further, removing perverse incentives (e.g. maker/ taker rebates) and requiring full order routing transparency to investors are necessary to increase investor confidence in the overall performance of the capital markets.**

Investors and Traders

Debating financial market structure changes inevitably leads to a call to let free-market capitalism advance unfettered. Free markets work so long as they remain fair (the term "fair" appears 46 times in the Commission's *Concept Release*), open, and accessible to all participants. The *Concept Release* addresses the question of "fair for whom?" when it states that, "where the interests of long-term investors and short-term professional traders diverge, the

Commission repeatedly has emphasized that its duty is to uphold the interests of long-term investors."

The financial markets exist to serve as a conduit to transfer capital from those willing to invest to businesses in need of capital. This efficient transfer enables production to expand and aggregate quality of life metrics to improve. Financial markets provide a public good. Long-term investors serve a critical role by sharing the risks of business ownership in exchange for a return on their investment. In contrast, the short-term professional trader rarely has an opinion regarding the viability of a company, the capability of management, or the long-term value of an enterprise. He is not interested in the efficient allocation of capital within the financial system.

With recently developed technological and structural advantages, a specific breed of short-term professional trader – the high-frequency trader – has consistently inserted himself between investors willing to transact, and become the "casino" to all participants. HFTs are not compensated based on risk housed, but rather they extract a "tax" from capital providers and the businesses they finance as statistics play out in the market. While this "tax" may not be discernable on any given trade, it represents an enormous transfer of wealth from investors to HFTs in aggregate. This is no different from how a casino maintains a house edge in blackjack or roulette.

Given that markets serve to facilitate capital allocation, **long-term investors do not need HFTs for capital allocation, but HFTs require long-term investors for trading.** For example, should the equity markets close for an extended period of time, long-term investors would continue to own profitable, value-accruing businesses. HFTs, on the other hand, would no longer be able to operate. As HFTs have hijacked the equity markets and become the casino (i.e. "the house"), they have become nearly impossible for long-term investors to avoid. Investors must either engage HFTs and pay a "tax" or risk never allocating their capital to worthy enterprises. This forced interaction penalizes long-term investors, undermines the underlying intent of the marketplace, and diminishes the public good arising from the prudent allocation of capital in the economy.

The Commission has aptly characterized HFT firms. Combining firm-specific metrics such as exchange-messages-per-execution and average-rebate-per-share-traded with workflow processes such as the use of sponsored-access and co-location might further define HFTs. Narrowly defining potential "offenders," however, is not necessary. Banning harmful practices and removing permitted advantages will suffice. A detrimental practice is no less harmful if committed by someone other than a HFT. For ease of communication, we will refer to HFTs when discussing some of the inefficient and unfair strategies currently in practice, because HFTs are the main beneficiaries of such strategies.

Market Structure Latency Problems

The following three practices describe some of the ways HFTs gain an unfair advantage and are incongruous with the efficient transfer of capital. Combined, they have created a two-tiered

marketplace based on latency that results in an almost risk-free trading environment for the preferenced group. In all three examples, a trader can join this preferenced group by paying the applicable fee (e.g. sufficient technology investment, program fees). **Paid and unfair latency tiering must end for all investors to have an unobstructed and equal opportunity at best execution.**

Naked Sponsored-Access – By gaining direct access to the exchanges and bypassing individual-trade industry compliance checks, HFTs ensure their position at the front of the execution line. The risks associated with naked sponsored-access far outweigh the supposed benefits of the practice. Given that HFTs can send thousands of orders per second to an exchange, basic compliance assurances must be made as to the veracity and accuracy of those orders. Without such assurances, before any human is aware that a problem exists, a "rogue" or flawed program can easily wreak systemic havoc and create a negative cascading effect as other programs are forced to respond. The Commission has tackled this issue in *Risk Management Controls for Brokers or Dealers with Market Access,* and the Investment Company Institute's March 29, 2010 response reflects our thoughts.

Trading Center Data Feeds – Individual and preferential data feeds offered by exchanges and ECNs do not enhance the fairness of the public markets. With inherent latency in the consolidation of data feeds sent to the general public, individual feeds enable subscribers to virtually predict the future. "Fair pricing" of advantageous data feeds is an oxymoron with regard to public markets. Fairness would dictate that public price information be released to **all** market participants simultaneously. Instead of requiring exchanges and ECNs to measure and add artificial latency to their individual data feeds, the Commission should ban individual data feeds altogether and require public venues to supply additional information (e.g. depth-of-book, odd-lot transactions) to the consolidated data feed.

Co-Location –The use of co-location services further tilts structural latency advantages in the direction of paying users. The head start afforded by co-location allows users to be first in line – all but guaranteed – when a latency-arbitrage opportunity arises. In no way does this add efficiency to the transfer of capital from investors to businesses. Banning exchange-sponsored co-location will not prevent private sector co-location from thriving. The incentive to co-locate must be removed. Batch processing of trades (consider a trading day made up of thousands of one second auctions) by exchanges on a second-by-second basis – in sync with one another – solves the co-location dilemma elegantly. No bona fide investor allocates capital based on intra-second price fluctuations. If batches or auctions occur at one second intervals, **all** market participants will have fair electronic access without significant, if any, additional cost or constraints.

Using these inappropriate advantages, HFTs extract unjustified tolls from the market in several ways. Some simply see information, process it, and trade on it faster than anyone else because of their undeserved structural "time and place" advantage. Some HFTs, enabled by superior technology, will ping (i.e. send multiple small IOC orders on the same side of the market to one venue) or reverse engineer commonly used algorithms to detect large orders to front-run or penny (i.e. enter a $20.01 bid if a larger $20.00 buyer is detected). Other HFTs have created their own venues (e.g. electronic market makers) whereby the HFT receives a free look at order

flow and an option to transact. These venues often provide no-fee executions for the broker that routes the order, compromising best execution obligations by forcing brokers to choose between lowering their own cost versus executing client order flow at the most appropriate venue.

Once the HFT has acquired a position, he has several tricks available to monetize his structural advantage. He may shrink the spread (thereby altering the midpoint if a mid-point peg order was detected) or walk the book higher (lower) before selling to (buying from) the detected order. Another manipulative practice is "spoofing." Imagine a HFT is long 1000 shares of stock ABC. The NBBO is $10.00 x $10.01, and the HFT is offering 1000 shares for sale at $10.01. The HFT may post an outloud bid of $10.00 for an additional 1000 shares on three different exchanges (3000 additional shares in total) in hopes of encouraging another buyer to pay $10.01 and purchase the HFT's 1000 share position. The structural latency tools discussed above enable the HFT to back away from his bids prior to another market participant having the opportunity to execute. The 3000 shares posted on the bidside of the public market are therefore not truly accessible by other market participants. In this case, the HFT does not intend to buy shares, but inappropriately alters the perception of supply/ demand for his benefit. This is tantamount to market manipulation.

There is no social purpose or benefit derived from these strategies. Their purpose is solely to further the goal of the HFT – virtually riskless profitability. **Investing success or failure should not depend on possessing an ever-present "time and place" advantage and receiving information ten milliseconds faster than the competition.** Latency tiering has created an unfair and uneven playing field that must be corrected.

Efficiency

While we support *real* efficiency, "*trading* efficiency" has become a term used to protect and defend the unfair structural advantages employed by HFTs. Their preferred position exclusively benefits them and is not in the best interest of society. Government regulates numerous industries to ensure fairness and increase *real* efficiency and productivity. Trading should be an enabling function, not an end unto itself. If market structure continues to permit "casino operators" to stand between and "tax" long-term investors and the businesses they finance, investors likely will be dissuaded from offering their capital through these tilted "casinos."

Several frequently heard efficiency arguments in support of the HFT participant have either passed the benefit/ detriment frontier of efficiency or introduced inefficiency to the market.

Provide Liquidity – HFTs highlight the perception that they provide a great deal of liquidity to the marketplace. In reference to "spoofing" from above, inaccessible liquidity is not real liquidity. Also, HFT firms swapping 100 shares of the same stock between one another 1000 times a day provides no use to the long-term investor, despite reporting an additional 100,000 shares to the tape. In fact, this "noise" makes it even more difficult for the long-term investor to properly assess market supply/ demand dynamics and determine

the best way to allocate capital. **A liquidity provider's worth should not be determined solely by the quantity, but additionally by the quality of liquidity contributed to the market.**

Given that HFT market share has gone from roughly 0 to 60% or more of volume in just a few years, HFTs have crowded out "natural" liquidity providers and forced them to become liquidity takers. If long-term buyer A and long-term seller B are "natural" counterparties and wish to transact, it is costly and inefficient for each to cross/ pay the spread in order to transact because a HFT has inserted himself into the trade.

Provide Stability – The market makers of the past possessed the distinct quality of engaging negative selection flow. For example, for Nasdaq-listed stocks, market makers responded to incoming client orders, providing stability to dislocated stocks.

HFTs (today's market makers) are decidedly different. HFT firms now provide "liquidity" openly on the exchange (not "upstairs") and have no obligations or even client pressures to keep them "honest." If a stock is in free-fall, nothing forces a HFT firm to provide stabilizing buying interest. **At the least, if HFTs want to continue being the "new market makers", they should be subject to basic obligations, both affirmative (e.g. make reasonable two-sided markets all the time) and negative (e.g. do not cross the spread and cause price changes).**

Price Improvement – HFTs also promote how they tighten spreads and provide price improvement to liquidity takers. At face value, this is true. But to follow the example above, crowding out "natural" liquidity providers, forcing them to become liquidity takers in order to allocate capital, and making them pay a spread (even if it is a reduced spread) is **not** more efficient.

Execution Speed – HFTs have reduced the latency with which all market participants transact. Most investors have benefited from technology that is far superior to that of 2000, yet still inferior to that possessed by HFTs. That said, execution speed has reached a point of negative marginal returns. **Whether execution turnaround is ten milliseconds or one second does not factor into the capital allocation consideration of the majority of market participants, particularly the favored long-term investor.** Execution turnaround of less one second only helps the short-term professional trader use structural advantages to the detriment of the long-term investor.

Maker/ Taker Rebates – The rebate system promulgated by exchanges and ECNs seemed a good idea to deepen liquidity in the capital markets. That said, it has helped drive the explosion of HFTs that engage in the open market-making that crowds out "natural" liquidity providers. Further, since brokers get paid the rebate for posting customer orders, the rebate system has created a perverse incentive not to necessarily act in the best interest of the customer at all times. Liquidity-providing rebates come directly from liquidity-taking fees. Market structure has forced long-term investors to pay a toll to HFTs simply because HFTs are unfairly able to provide liquidity first. The rebate system has succeeded at increasing revenue for the exchanges, ECNs, and HFTs at the expense of long-term

investors. The ability to access liquidity and capture the spread should be enough of an incentive to post outloud.

Transparency and Disclosure

Order handling was once a transparent and easy to understand process. Unfortunately, transparency has been sacrificed in the name of technological advancement and the evolution of market microstructure. Within one second, a customer's order can be routed and re-routed to 70+ venues. Similar to a game of "telephone," the order at the end of the line may look nothing like the order that the customer entered, as it has likely been sliced and transformed (e.g. IOIs, flashes, conditionals, limits), until all order-handling control and auditing ability has been lost.

The enormous complexity introduced by this process has clouded order handling to the point where even educated customers are never completely confident how or why their orders are routed to specific venues in a specific way. While investment firms find great value in brokers' ability to intelligently access multiple venues with low latency, more insight and information must be provided with regard to such an integral aspect of trading.

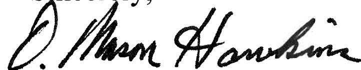
Exchanges and ECNs have also enhanced trading by introducing new dark venues and order types/ tags as customers have asked for ways to refine their interaction with one another. Some of these order types and methods have unexpected consequences that negatively affect other market participants. An investor cannot trade confidently if she does not know how her orders are being handled. **Transparency, openness, and simplicity should be cornerstones of well-functioning and fair capital markets.**

Information that brokers and/ or venues should disclose to increase the confidence of investors includes, but is not limited to:

1. All execution venues accessed by a routing broker or routing venue (including affiliated venues identified as such),
2. Payments, rebates, fees and fee breakpoints (all costs and payment for order flow arrangements) related to execution venues (routing broker or routing venue to venue),
3. Aggregate broker level (not customer-by-customer) detail regarding specific venue (not parent company level) market share based on both shares routed and shares executed,
4. Venue rankings by routing brokers and routing venues, and the inputs that create the routing rankings,
5. Number of orders routed per execution per venue (routing broker or routing venue to venue),
6. Average resting time of orders per venue (by routing broker and routing venue),
7. Full transparency of customer specific order routing and execution available to the specific customer, and
8. Venue latencies for the full cycle from routing broker or routing venue to venue, and back.

SAM is a long-term investor that seeks to maximize returns for the benefit of our clients (e.g. individual investors, pensioners, foundations, and endowments) and to be a supportive partner with the businesses in which we invest. **We do not begrudge short-term professional traders their right to operate in the capital markets as they see fit, so long as the playing field is fair, level, open, and equally accessible to all. To further the underlying purpose of the capital markets and maintain a fairness standard for all who access these markets, the SEC must eliminate practices that give one participant structural advantages that enable time arbitrage and market manipulation.** Failing to properly address these practices ultimately threatens the use of the capital markets as the efficient and preferred means for providing capital to the businesses that form the basis of the U.S. economy. Southeastern thanks the Commission for the opportunity to respond and looks forward to operating in more fair and balanced capital markets.

Sincerely,



O. Mason Hawkins, CFA
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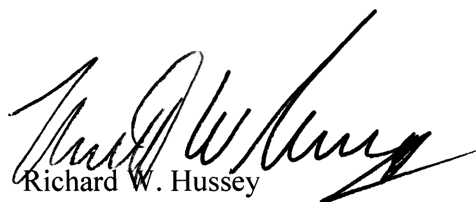

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