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In recent years the confidence of both retail and institutional investors has been eroded. This is a direct result of the rise of High Frequency Trading ("HFT") and the insufficient regulation in this arena. The diminished confidence of the investing public must be rebuilt for the continued health of our financial markets. Regulating High Frequency Trading firms and their employees will improve investor protection as well as promote stability and transparency in the marketplace.

Rule Change Request:

Anyone placing a server(s) inside the data center of an exchange, broker-dealer, dark pool or other FINRA member firm must register with FINRA as ***both*** a Broker-Dealer and Market Maker and obey FINRA rules and regulations applicable to both classifications. As Market Makers, these firms commonly known as "High Frequency Traders" must:

a. Maintain minimum net capital per FIRNA rules for Market Makers.
b. Financial audit requirements including filing monthly focus reports.
c. Abide by all rules regarding the quotation and execution of stocks.
d. Resolve disputes through FINRA arbitration
e. Mandatory membership in Securities Investors Protection Corporation (SIPC).

Reason for the rule change:

Previously the NASD and NYSE (now collectively known as FINRA) regulated Market Makers and Specialists, respectively, operated in an environment where access to markets was technologically limited. As a result, equity trading took place via the network of Nasdaq broker-dealers and on the floors of the NYSE and regional stock exchanges exclusively.

Today, and for the past several years, trading floors have been replaced by the internet.[1] The majority of US equity trading now occurs on servers collocated within registered exchanges, ECN and ATS.[2]

Despite the technological irrelevance of trading floors market making and Market Makers are thriving outside of regulatory oversight. Numerous unregulated firms refer to themselves as Market Makers, but are not subject to any regulatory oversight from FINRA or the SEC. The trading floor personnel who performed these tasks, who were required to be licensed and trained, have been replaced by computers with no one governing their capabilities.[3]

The extraordinary technological advances in trading, both domestically and globally, as well as the increased size and value of the stock market have made Market Making even more foundational than

[1] https://securitytraders.org/wp-content/uploads/2013/04/HFT0324.pdf page 1
[2] http://www.marketwatch.com/story/this-is-the-last-photo-well-ever-run-of-the-nyse-trading-floor-2014-10-01
[3] https://securitytraders.org/wp-content/uploads/2013/04/HFT0324.pdf page 1

before. Market Making, whether via HFT or otherwise, must be appropriately regulated in order to ensure investor protection and to maintain fair and transparent markets.

How this rule change will protect investors:

1) Obligating these firms to report all order information to the Order Audit Trail System ("OATS") will provide greater transparency into the activities of HFT firms. Currently this information, which is essential to monitoring the equity market, is divided among various exchanges. By adding this regulatory and administrative measure, the information will be centralized and as a result more readily accessible. This increased transparency will enable regulators to more carefully monitor in real time the market activities of these firms.
2) Each firm must comply with rule 15c3-5 increasing protections from erroneous trades.
3) Regulated quoting and execution requirements to provide more transparency to both retail and institutional investors alike. Quotation requirements will help prevent abusive practices such as micro trading, quote stuffing, layering and spoofing.
   E.g.: Cannot back away from prices; must maintain a two sided market in all market conditions, Limit Order Display obligation…

HFT firms should be regulated for the benefit of the investing public, notwithstanding that these firms have no customers.

Many proprietary trading firms use the 15b9-1 exemption to allow them to avoid FINRA membership. However, this exemption is now anachronistic.[4] Prior to the internet, a physical presence on the exchange was essential to execute orders quickly in order to take advantage of price discrepancies.

Prior to enactment of FINRA rule 5320 (the "Manning Rule") and Regulation NMS, proprietary traders as well as Specialists and Market Makers (collectively, "traders") operated in an environment where you could "make" a price without an obligation to be inside the National Best Bid or Offer ("NBBO"). Frequently, these traders had the exclusive ability to take advantage of inverted pricing in equities. Inverted pricing occurs when the bid for a stock is higher than the offer or vice versa. A buyer could make a price below the best bid and sell for a profit immediately. As the volume grew in the 1990s the opportunities for inverted markets increased substantially. Many of these traders were known as "scalpers." Scalpers made quick profits in inverted markets, usually to the dismay of the Market Makers and Specialists providing liquidity.

Exchange seats, whether for proprietary trading firms, day traders, traditional brokerages and Market Makers, increased in cost dramatically. In 1987, a seat on the NYSE sold for a record $1mm. In 1999 a seat sold for $2.65mm.[5] The seats increased in value so dramatically because a presence on the floor was necessary to scalp the market. Additionally, the IPO boom that preceded the internet bubble of 2000 created a uniquely profitable opportunity for scalpers, then called "SOES Bandits."[6] This active period of rising prices created frequent opportunities for short-term traders. Scalping was the most popular strategy for proprietary traders.

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[4] http://www.tradersmagazine.com/news/brokerage/will-the-sec-force-your-broker-under-finra-control-113620-1.html - Davis Polk Page 1
[5] http://econweb.rutgers.edu/ewhite/HighestPriceEverSubmission.pdf
[6] https://www.sec.gov/litigation/litreleases/lr17929.htm

However, the end of this short term trading phenomenon followed shortly thereafter. The adoption of the Manning Rule and Regulation NMS, which outlawed trading outside of the NBBO and required members to report the life cycle of an order through OATS. These rules eviscerated the ability for scalpers to trade profitably and without accountability or transparency.

The fundamental difference between a proprietary trader and a Specialist/Market Maker lived in the absence of these two rules. Market Makers and Specialists have always been obligated to maintain a two-sided quote in a stock. Proprietary traders were never required provide the same societal benefit. As a result these traders were frequently net takers of liquidity. Without the ability to trade inverted markets many proprietary traders left the business and others transitioned into HFT.

Around the early 2000s, HFT was already burgeoning.[7] Computers and dedicated lines replaced the floor and OTC traders because they were faster than human traders and could process market data in fractions of what a human could do.

Computers are able to scalp much more efficiently and with exponentially more scale. The fragmentation of the markets into over thirty exchanges, ECN and ATS, provides further opportunities for HFT to scalp.

Scalping is dependent upon regulated Market Makers and end investor order flow to perpetuate. Scalping is not additionally added liquidity to end investors such as retail investors and money managers.[8] Because they are unregulated and have fewer barriers to entry, HFT has largely replaced regulated Market Making on both exchanges and ATS. HFT benefits from an unfair advantage derived from their minimal regulatory burden.

"The institutional setup of providing dealers with low transaction costs, high transaction speed, and access to order flow information, is clearly valuable. As anecdotal evidence, one needs only to note the premiums paid for seats on the NYSE, the profitability of National Association of Securities Dealers Automatic Quotation (NASDAQ) Dealers, and the expanding role of ECNs. These advantages create an indirect, but real, transfer of wealth from other market participants. If dealers are to have such valuable advantages, then they should be held to the socially beneficial function of providing liquidity, perhaps via narrow bid-ask spreads at reasonable depths at all times. This is, in fact, very similar to the liquidity mandate of NYSE Specialists and NASDAQ Dealers."[9]

Absent regulation regarding the placement of servers inside of a trading venue's data center, investors will be taken advantage of in the exact same fashion as the pre-Manning Rule era. Proprietary traders and HFT firms continue to use their proximity to the exchange's servers and quote feeds to gain a competitive advantage, but provide little added benefit to the investing public, which regulation would mandate.

FINRA-regulated Market Makers engage in similar behavior, but they are bound to a set of regulations that protect investors and increase transparency. To permit HFT firms to persist functioning as unregulated Market Makers will continue to undermine the public's confidence in the market and endanger investors.

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[7] Patterson, Scott Dark Pools: The Rise of the Machine Traders and the Rigging of the U.S. Stock Market, 2013
[8] http://web.mit.edu/finlunch/Fall03/AlbertWang.pdf page 3
[9] MIT page 31