

# TRADING TALK

## Market Structure Analysis & Trading Strategy

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SECURITIES INC.

### **NewsFlash: Tortoise Tries to Become Hare; Forgets to Stretch Before Race, Losing his Flexibility, and that Being Able to Hide in his Shell was a Real Advantage<sup>1</sup>**

In our last piece we focused on some early stats from the Hybrid and overlaid market structure reasons as to why we thought the results were what they were. This time we will focus the market structure lens more squarely at some of the questionable assumptions made in the design of the Hybrid and some of the specific changes we believe are necessary to improve it. While the electronic trading revolution is in full gear, in our opinion, the one thing not racing down Wall Street at the speed of light is the race to sanity. Read on and you'll see why.

#### **The Agent**

Let's start with some good news. In some of our prior pieces we had argued for a rule change that would drop the NYSE's "line of sight" requirement, and expand the definition of a trading crowd to permit more widespread electronic representation by brokers. This became a reality on February 20th. What this means to you is that your floor broker, assuming they have three or more brokers (since the definition breaks up the floor into three zones), will be able to provide the benefits of their "broker file" (such as reserves and discretionary order types) to you floor wide. This change will allow your floor brokers to provide "top of book" protection even to your small orders, eventually even algorithmic orders when the NYSE introduces an API to which agents can write algorithms. "Stock ahead" will now be a problem for your competitors, not for you. While we're sure no longer having stock ahead will be an advantage, our hope is that this will generate new block alternatives down the road. Your brokers are known for their institutional business and anyone seeing them on the bid or offer will realize the potential for greater size behind even a tiny order that is being represented electronically on the book. Hopefully a seller (buyer) of size would show an offer (bid) to your broker providing your desk with an option on how best to fill your order. Although we obviously can't be certain our idea will work, it's been over a decade since anyone on the floor has been able to offer a new service of any sort to their clients and customers are clamoring for more block alternatives so that combination should be appealing.

There is one more thing worth noting about the broker file. Some upstairs trading desks have been pressing for the ability to enter reserve and discretionary orders directly, bypassing floor brokers, as they are accustomed to doing today on ECNs with their DMA order flow. It is not surprising that the NYSE with a Hybrid structure that provides discretion through floor brokers would want to protect the advantages of those floor brokers and one of its key differentiators rather than simply replicate the ECN model, to which it is already exposed through its ownership of Arca. Until floor brokers have an opportunity to explore algorithmic order handling techniques, gain real experience with a fully functional handheld, and re-establish their ability to serve their clients block needs, investors will not be able to assess which system

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<sup>1</sup> Don't worry, the title makes more sense (well, at least a little) when you read the whole piece. The hint is the NYSE is (naturally) the tortoise and ECNs are the hare.

serves them best. This diversity of structure is exactly the edge John Thain is betting on when he states that the customer will be the ultimate judge of the Hybrid market. Interestingly, those screaming loudest to level the playing field are the one's benefiting most from the inequality as they can access these order types easily through their brokers. We would expect the complaints about direct discretionary quote ability to be coming from players that typically do not employ floor representatives such as retail investors (and the firms and advocates representing them), not those with the relative advantage. Perhaps the complaints simply reflect the desire of the buy-side to control and direct their trading, but the relative advantage they currently possess over competitors may be one overlooked casualty of such a change.

Another of our tilts against the windmill centered on the need for an API for the agent that would level the playing field with the specialists who were already given an API for algorithms, and we are happy to report that the ability for your floor broker to run algorithms from his handheld is currently being built. Although useful functionality is still probably several months away, expect your broker to start offering an expanded diverse menu of agency services soon.

New discretionary order types for floor agents are being rolled out that enable floor brokers to automatically trade with incoming orders that better the market while providing much needed price improvement. There are several necessary pieces still missing. The following are some of the fixes for which we are lobbying that we view as essential if the agent is to survive and be a value-add: (i) the ability to have discretion exercised only when the competing order's participation will be greater than a specified percentage (to avoid potentially re-pricing a block because of *de minimis* competition), (ii) the acceleration of the NYSE's plan to hide reserves from the specialist (the current state of affairs is obviously impacting floor brokers' usage levels of reserve functionality), (iii) the modification of the Exchange treatment of IOC orders, which currently allows the specialist to view the unexecuted portion of IOC orders (due to the information leakage to the specialist, no one will ever use them for size and the NYSE can ill afford to discourage this type of flow, which is essential for a Hybrid cross, acting as the other side of the volume discovery coin to the resting orders that brokers and specialists on the floor provide through their respective electronic order files) and (iv) the elimination of the requirement to display 1,000 shares as part of the BBO in order to use discretionary and reserve order types (which in our view signals too much information<sup>2</sup>).

Adoption and implementation of these suggested functionality enhancements would (virtually) instantly create an interactive continuous block crossing mechanism at the NYSE. Jim Ross who joined (and is a welcome addition to) the NYSE by virtue of its acquisition of MatchPoint last year will undoubtedly be able to add some additional creative crossing products to the NYSE mix, but the reality is he would have a great head start if the NYSE made just a few simple tweaks to the Hybrid.

One other positive change that we expect soon for the floor broker community is the NYSE granting brokers the ability to directly access away markets such as other exchanges, ECNs and even crossing networks. Previously, brokers had to rely on specialists to access away markets for them under the ITS rules, which was not ideal because it only included ITS participants and was so slow that it rarely resulted in meaningful access to better away markets. Now, under Reg NMS, the NYSE will route to better away markets automatically, which is far more efficient than the specialist/ITS combination, but it is still a far cry from being in control of one's order, especially since it would not include access to non-displayed markets like crossing networks. With NYSE market share down from 80%+ just a few years back to approximately 55% today, it is absolutely essential that floor brokers have the ability to access the 45% of listed liquidity trading away from the floor if they are to survive and ultimately thrive. While this change will not guarantee their survival, it will give them a shot to compete versus upstairs trading desks.

2 The signalling is largely of two types. First, outside of the most liquid stocks, 1000 shares is not necessarily a small order and if users are accordingly discouraged from posting that amount, the NYSE will end up losing the posted order and the reserve that would have provided the opportunity for a block trade (assuming the IOC residual rule is changed as discussed), especially in light of the new fully hidden order types on the ECNs and block crossing networks. Second, anything posted that's less than 1000 shares alerts other market participants that there is no reserve, which is yet another signal that we're not sure benefits the NYSE or its customers, but rather seems to subject it to gaming behavior.



### The Specialist

There's not as much good news to report on the specialist front at the moment. With perhaps the limited exception of one of the smallest firms, Kellogg Specialists, who has had some early success with algorithmic assisted markets, the specialists are still struggling to define their appropriate role (and make money!) in the Hybrid. Trips down to the SEC to protest capital requirements (which we agree are too onerous) and other rules impeding their profitability have so far borne little fruit, while rumored ultimatums to the NYSE by certain specialist firms that if X, Y and Z don't change, they will walk off the floor, if true, will not bear fruit either as the threat would not be credible with the NYSE able to switch listings to another specialist firm overnight.

Creative, value-added market making that makes better use of automation must be the basis for reestablishing credibility and trust. Trading on equal footing with public orders on the book is not the answer as some specialists continue to argue. That said, specialists should be rewarded when they are really adding to price discovery and providing price improvement, such as when they've established the inside market. In those circumstances, we have no issue with them having parity with the book as repeated observation suggests that the competing market maker algorithms are following the specialist lead in these circumstances and there is no reason the specialist should be shut out then. Similarly, while some of you might remember our insisting that specialist price improvement be meaningful in order to be permitted, we must admit that it looks like that ship has sailed as the whole industry competes for order flow through penny jumping and competing electronic market makers are not constrained like the specialists. So, we give up. Specialists need to be free to price improve by a penny under all circumstances if they are expected to aggressively compete for order flow.

### The Exchange

Having written many previous pieces on pricing issues, we don't want to spend too much time focusing on it here. However, we do want to take a few sentences to give an update on how the NYSE's pricing revamp has affected market share as well as some quick thoughts on routing fees. As we predicted in our prior pieces, the NYSE's elimination of monthly fee caps has helped stem rapid market share losses in listed volume. In fact, Nasdaq, its chief competitor, has gained only one-half percentage point in listed volume in the three months since the NYSE ended the caps on December 1, 2006. This actually includes a loss of nearly a half a point of listed share in February as Nasdaq migrated to a single book and BATS came on line for listed trading, providing an alternative venue for Nasdaq's primary listed customer base for lightening speed, rebate-driven posted orders (not the least of which are BATS' own shareholders). Based on daily figures though, we do expect March figures to pick up fairly significantly for Nasdaq with the single book migration behind them (which had caused an expected dip) and BATS likely experiencing NSX technology limitations for listed order flow and the NYSE not being yet able to route to the ADF in most securities in March despite Reg NMS going live (causing BATS shareholders/users to post mostly on Nasdaq just a while longer). In fact, the recent stabilization may return to the falling off a cliff scenario that had been developing for the NYSE last year, e.g., when Nasdaq gained almost a full percentage point in share in June of '06 followed by a nearly 2 percentage point gain in July. We anticipate further losses in share by the NYSE and believe that substantial changes to the Hybrid are still very much necessary as the brief respite and positive impact from correcting the former irrational pricing structure are over. As we have previously stated, although currently orders are often routed to the low fee (high payout) market, we believe the focus will shift to quality differences as pricing bottoms out, and the Hybrid has work to do.

With respect to fees charged when routing to away markets, kudos to the NYSE for initially agreeing to pick up any ECN fees incurred when routing to better away markets (and simply charging the same 2.75 cents per hundred that would be charged if the stock were executed at the NYSE). This was the most aggressive attempt yet to insure that orders will route to the NYSE first. John Thain's message was clear. No longer will the NYSE stand back and allow other markets to take order flow based on lower fees alone. The NYSE partially reversed itself on this one and now is effectively passing through part of the ECN fees for orders routed off the floor when there are better prices (actually a 25 cents a hundred routing fee, which is still cheaper than all major ECNs and exchanges, even BATS at 26 cents a hundred) while maintaining the full savings for floor brokers when they access away markets, which provides a significant cost advantage (2.75 cents a hundred vs. 25 cents a hundred). Although we supported maintaining the cut-rate pricing for all orders routed away to better markets, especially during the interim period of the Hybrid when the ability of brokers and specialists to interact with incoming auto-ex order flow

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prior to it being shipped to other markets is still very incomplete, we realize the cost might well have been prohibitive as more stocks were rolled out to Phase III of the Hybrid. The new pricing schedule will still allow you to benefit from both NYSE and competing market liquidity through your floor broker.

As agents, nobody has to sell us on the value of listening to your customers. This is a check on how well you're performing and also a great guide to what needs doing. It is a mistake however to automatically assume your customer knows more about your own business than you do. When some customer complaints to the NYSE focused on liquidity replenishment points (LRPs) being hit too often, the NYSE responded by widening them across the board. Greater volatility is the result. Simply widening the LRPs to avoid slow markets misses the point of them in the first place. Actively traded stocks that have relatively few orders on the book because of the risk of significant moves are the types of stocks where big swings can result in a fast market when an LRP is set too far away even though there is plenty of latent interest that would participate if things were slowed down. It is indeed hard to automate individual stock trading personalities and the Exchange should rejoice at that reality. After all, isn't this exactly why the Hybrid might be an advantage to a fully automated market? A slow market is only a detriment when it doesn't serve its function of dampening volatility and that is a stock-by-stock decision that will never work well if too generalized for the sake of the ease of automating.

The Exchange commitment to floor brokers and specialists is based on their being a value added to the price and volume discovery process. This is as it should be, however we remain critical of the lack of coordination of the roll out. Broker discretion is in the early stages, as yet not incorporating the competitive tools mentioned earlier, and the hardware to support these products is just beginning its rollout. The NYSE has yet to give guidance to the specialist community with respect to expectations. It is appropriate that specialists be expected to compete with each other for listings by making better markets, but basic functionality and timetables should have been clearly spelled out by the NYSE already. There should also be expectations about minimum standards for competing with away markets, e.g. meaningful rewards and penalties for matching better away markets, percent of time at the NBBO, etc. This was done on a small scale in creating a pool for specialists to partially replace the commissions they would lose from orders left on the books for five minutes or more, but more needs to be done.

### **Dropping the Ball on the Design of the Hybrid: Misunderstanding Transparency and the Advantage of Flexibility**

#### **Transparency, Volatility and Liquidity**

We have spent most of this piece focusing on particular problems with the Hybrid, the players suffering them, and prescriptions to cure the particular ailments, but when we really sit back and think about it we are dealing mostly with the symptoms and the patients, not the disease itself. So let's make a more complete diagnosis informed by what we view as market structure realities. Broadly speaking, besides flawed thinking in the timing of the implementation of various elements of the Hybrid, we view the NYSE's most serious mistakes in the Hybrid to be the (i) failure to recognize the advantage it possessed in terms of flexibility of timing and (ii) misunderstanding of the benefits and limitations of transparency. Let us take each in turn.

The first naïve assumption the NYSE made about markets in its design of the Hybrid is that mandating order display in the name of greater transparency will lead to greater liquidity. Investors have always and will always display only as much of their intentions as they believe is tactically advantageous and safe. As we have stated on many prior occasions, quotes are not (nor have they ever been) displays of available liquidity, but instead tactics employed to safely attract liquidity. The NYSE seemingly ignored this axiom in building the Hybrid. Whereas the pre-Hybrid trading crowd could interact with incoming liquidity seeking orders simply by responding "take 'em" or "sold", the Hybrid, which necessarily involved conveying interest in some manner in order to be able to interact with auto-ex order flow, also instituted display requirements for brokers to be able to use discretionary order types. The error of mandating display was compounded by the change to NYSE Rule 127 and the modification of the sweep order type, which actually increased the risk of displaying orders as those limit orders became subject to being picked off one-by-one as opposed to being protected in any block trade by participating at a clean-up price. These errors became a comedy of errors in practice with un-displayed liquidity made less safe too by allowing those orders to also be picked off in sweeps and block trades and the ability of the specialist to see the reserves.

The SEC, believing that increased transparency is always a good thing (and a tool to minimize volatility as well as make regulation

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easier), was supportive of (if not pushing the NYSE for) these changes. While we also believe the old maxim that “sunshine is the best disinfectant,” mandating order display butts right up against the natural desire of institutional investors to hide their intentions to reduce market impact. Accordingly, when institutional investors are forced to display in certain venues, they will look for permissible alternatives to go underground and those are available in the form of dark pools and crossing networks that do not require display at all and ECNs/exchanges that offer an option of fully hidden order types. And because of the information leakage and market impact associated with large orders, we don’t believe that increased transparency in the form of limit order display would significantly decrease volatility in any event. It is simply not how volatility works. We can forego the academic definition and complexity required to actually measure volatility and stick to the basics with a layman’s definition: Volatility is “change of opinion” over “available liquidity”. The requirement to post even one hundred shares could significantly reduce available liquidity—driving it to underground alternatives-- and therefore increase volatility, all in the name of (and a misunderstanding of) transparency.

Transparency only enhances liquidity in the crudest of opaque markets. Once a market has established a structure that has achieved credibility (even at the most basic level) further transparency reduces liquidity. This is a key point that the SEC and the NYSE don’t seem to appreciate. Historically, the NYSE because of its manual flexibility (a differentiator that we explore further below) was able to seamlessly shift levels of transparency from opaque to glaring sunshine and therefore maximize available liquidity. In fact, one could certainly argue that the NYSE was the biggest dark pool in history as the latent liquidity on the floor from institutional-sized orders held by floor brokers was certainly not characterized by display (which was mostly limited to retail limit orders and tactical indications of liquidity to attract order flow by the brokers representing the institutions). Naively the NYSE sought to appease (or possibly agreed with) the SEC on transparency and mandated display through the Hybrid structure, seriously hurting liquidity on the floor and creating a greater need for crossing networks and dark pools. One of the main reasons that dark pools and crossing networks haven’t yet really solved the problem though is that they for the most part exist as silos and are not integrated with other liquidity sources as exist on the floor. This fact has bought the Exchange time to correct its error and offer evidence of basic market structure realities to the SEC.

### Flexibility

The NYSE always had a fluid, flexible time frame for discovering price and volume. The speed of a typical transaction was simply put atypical. Each trade was concluded in the minimum amount of time required to achieve acceptable size and efficient pricing. What was missing from the speed continuum was sub-second capability and unfettered auto-ex. Although adding super high-speed functionality certainly made a lot of sense and was a necessary response to the demands of institutional investors (especially certain categories of traders like stat arbs and electronic market makers whose volume has exploded in recent years) and thus crucial to the NYSE’s competitiveness with other market centers, this function was not just added but has virtually replaced all other options. The floor broker previously had the option of fully displaying his client’s order, displaying none of it, and every nuance in between. These choices were constantly modified to conform to changing conditions and opportunities. The assumption that if you weren’t moving at light speed everyone would trade through you was simply not correct. Traders must seek best price and the market center that slows down to improve efficient pricing cannot be ignored. That said, the problem with slowing down today is that the inside market in the largest names is usually made by stat arbs and electronic market makers who require constant high speed access. The NYSE can ill afford to have those markets made everywhere but NY so it is certainly a challenge. However, by focusing on transparency as a cure-all and completely giving up on a flexibility that has been one of its hallmarks, we believe it has missed the mark. The Exchange’s actions in both the conception and implementation of the Hybrid have substantially diminished the opportunity for institutional orders to safely attract and interact with contra-parties, creating an increased need for dark pools and crossing networks.

### Conclusion

We continue to believe that the NYSE can provide enormous value due to its unique position in the industry and its incorporation of on-site agents and specialists. The mandate of the Hybrid was to provide automated execution services while preserving the benefits of the specialist system and agency floor brokers. For the most part it is failing to date on the latter charge. Specialists, reduced in number significantly, are less and less able to provide vital trading information and, without a flexible time frame, act as catalysts for large transactions. Floor brokers are still unable to interact efficiently with incoming orders and bring their liquidity to bear appropriately,



although there are some positive upcoming changes. The real problem with dark pools—which we use extensively and believe add a lot of value<sup>3</sup>-- is not that they are dark, but that they are fragmenting the market. Fragmentation was not an issue facing the NYSE. But by getting it wrong, it soon may be. The toughest part of taking on a structure change the magnitude of the Hybrid is keeping your ego out of it and quickly correcting mistakes along the way. It remains a serious concern of ours that the final determinant of the shape of our markets be made not by investors choosing among all markets operating within their differing structures at peak efficiency, but being forced to judge the Hybrid with its worst foot forward and shaped too much by regulator/SRO misconception of market realities.

<sup>3</sup> We have written extensively on the benefits of dark pools and crossing networks previously. See, for instance, [A Diamond in the Rough: The Potential for a Crossing Network to Emerge from the Hybrid](#). In addition, we recently gave some extensive comments on dark pools for an upcoming issue of The Trade magazine. In the interest of not accidentally “scooping” them, we are not including the comments here, but if they are of interest email us and we will send on.

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