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# NYSE Retail Order Program May Spur Sub-Penny Quotes, Knight Says

*By Nina Mehta - Dec 7, 2011*

Knight Capital Group Inc. (KCG), one of the main market makers on the New York Stock Exchange, said an NYSE plan to offer retail investors better prices than those available to others could disrupt trading by dismantling a ban on quote increments of less than 1 cent.

NYSE proposed a one-year program in October to attract orders from so-called equity wholesalers, firms such as UBS AG (UBSN), Citadel LLC and Citigroup Inc. that execute trades within their own walls. Offering individuals better prices may result in sub- penny quotes on exchanges, requiring technology upgrades and changes to trading rules, said Leonard Amoruso, Knight's general counsel. Such quotes are banned by regulators.

NYSE is trying to capture orders that otherwise would be traded off exchange by financial companies in a process known as internalization. It's seeking to persuade brokers that execute buy and sell requests themselves, often at slightly better prices than are available publicly, to send orders they don't trade to NYSE instead of other securities firms or dark pools.

"If the underlying request is to move to sub-penny quoting, we certainly have a fair amount of concerns," Jersey City, New Jersey-based Amoruso said in a phone interview. The SEC set the minimum price variation for quotes at one cent in 2005 and rules such as the obligations of brokers holding customer orders and the fees that exchanges charge are "keyed off the one-penny increment," he said.

The pilot program, which would allow retail customers to buy shares at least a 10th of a cent lower than the best offer price or sell slightly higher than the best bid, would probably be copied by other exchanges and dark pools, Amoruso said. The NYSE program would save retail brokers at least 50 cents on a 500-share order.

## Market Model

The U.S. Securities and Exchange Commission must approve the program before it can go into effect.

"If the commission were inclined to move in this direction, it is very likely that all market centers, lit and dark, would immediately seek similar relief so as to keep the competitive landscape on a level playing field," Knight's Amoruso told the SEC in a Nov. 28 letter about sub-penny quoting. "To proceed in any other manner would be tantamount to conveying to the NYSE a pricing convention monopoly."

NYSE’s program wouldn’t compel the SEC to lift its ban on sub-penny quotes in all circumstances, said Joseph Mecane, co- head of U.S. listings and cash execution at NYSE Euronext. (NYX)

“We’re not requesting a blanket sub-penny exemption,” he said. NYSE asked the SEC if it could offer the type of price improvement that wholesalers, which include Knight, provide to individual customers, he said. “The question becomes, what type of programs would they be accepting sub-penny quotes for?”

# Individual Share

About 10 percent of U.S. equities volume comes from individual traders, Mecane said in a phone interview. Discount and other brokers that cater to those clients often turn to wholesalers for orders that can be traded at the market’s prevailing price. Charles Schwab Corp. (SCHW) sent 99 percent of its orders to UBS in the second quarter. TD Ameritrade (AMTD) Holding Corp. sent 74 percent of its market orders in NYSE-listed stocks to Citadel and 21 percent to UBS in the third quarter.

Orders from investors are attractive to market makers and asset managers because the senders, unlike professional traders, aren’t expected to know more about short-term price movements than the firm they’re trading with. Soliciting the orders could lure more trading to NYSE, Mecane said.

NYSE Euronext executives have argued that the increase in orders traded away from exchanges erodes the ability of buyers and sellers to interact and yield prices that are deemed reliable. About 30 percent of equities trading takes place over- the-counter, with those transactions based on prices established on exchanges, according to data from Bats Global Markets Inc.

# Liquidity Providers

The program would create two categories of brokers: retail member organizations and retail liquidity providers. Orders from a firm in the first group or a broker acting on its behalf could trade against hidden orders at the exchange intended only for retail clients. The firm would be paid for submitting orders, while approved providers of liquidity who supply quotes for retail transactions would pay a fee when they buy or sell.

The pricing reverses the traditional fee structure on the biggest U.S. exchanges, which normally pay firms adding liquidity and charge as much as 30 cents per 100 shares for those trading against existing orders. Exchanges pocket the difference. The 30-cent cap was set by the SEC.

NYSE’s designated market makers, which include units of Barclays Plc, Getco LLC, Knight and Goldman Sachs Group Inc. (GS), along with the exchange’s so-called supplemental liquidity providers, such as automated firms Virtu Financial LLC and Hudson River Trading LLC, could supply orders for retail brokers through the program. Mutual funds and other investors could furnish orders for individual traders, although their fee would be higher than what NYSE's liquidity providers pay.

# Small Benefit

TD Ameritrade, whose client accounts total $405 billion, said it supported NYSE's program even as it urged an overhaul to give traders more shares instead of marginally better prices. More shares at the best public bid or offer could yield a better average price for retail trades than multiple transactions at different levels, Christopher Nagy, managing director of order strategy at the Omaha, Nebraska-based company, said in a Nov. 30 letter to the SEC.

The program would bring more orders to NYSE without displaying them publicly or making them accessible to everyone. Executives from **Themis Trading** LLC in Chatham, New Jersey, said on the company's blog in October that NYSE's proposal may be a "Trojan horse" intended to force the SEC to reassess the internalization of orders by wholesalers. The adoption of hidden trade requests runs counter to statements by NYSE officials that publicly displayed orders are better for markets, **Themis** said.

The program, which will also apply to stocks traded on NYSE Amex, is meant to fit into the current "ecosystem" that allows prices to be improved for individual investors, Mecane said. The exchange's plan to do this also doesn't try to cut wholesalers out of the execution business, he said.

# Second-Tier Flow

"There's an opportunity for this program to get some of the second-tier retail flow," Mecane said. "There are a lot of relationships and routing already in place. It's designed to be complementary to the business models of the wholesalers."

While NYSE and Amex can't provide the "same level of customization and service that a bilateral negotiation" between a retail broker and wholesaler can offer, the program allows more market makers and liquidity providers to get a shot at orders they wouldn't otherwise see, Mecane said. That competition, based on the ability to differentiate between customers, would benefit individual investors, he said.

Michael Stewart, head of global equities at UBS, told the SEC in a Nov. 30 letter the Zurich-based bank supported NYSE's plan to permit firms to offer prices only to specific client segments such as retail brokers. This currently isn't allowed on exchanges. Dark pools should also be able to segment clients and accept sub-penny orders to level the playing field between exchanges and broker-run venues, he said.

Nasdaq OMX Group Inc. (NDAQ) Chief executive Officer and President Robert Greifeld said at a Goldman Sachs investor conference today that his company supports NYSE's program.

"Anything that will get the SEC to allow more segmented pricing would be a good thing for us," he said. Nasdaq, based in New York, has tried to draw more retail orders to its exchange through pricing and trading requirements, he said.

Kevin Cronin, global head of equity trading at Atlanta- based mutual fund firm Invesco Ltd., said the price improvement NYSE's program would offer isn't significant while the "collateral games" that could result from firms trading ahead of mutual funds and brokers would hurt investors.

"It makes some of us scratch our heads and say, 'Guys, what problem are we trying to solve?'" Cronin said at an Investment Company Institute conference yesterday in New York.

# Reject It

CFA Institute, a trade group that represents investment analysts and managers, said the SEC should reject NYSE's proposal because it harms investors placing limit orders, or requests to buy shares at no more than a specified price or sell at no less than a certain level. The new orders for retail investors would trade before those requests are filled, it said.

"Sub-penny executions, in this case in the order of $0.001 per share, offer little economic benefit to the end investor compared with the cost incurred by market participants posting limit orders who lose an opportunity to trade," CFA wrote in a Nov. 30 letter to the SEC. "This opportunity cost is compounded by the subsequent disincentive to post limit orders."

Hudson River Trading said the SEC should adopt a rule that tests price improvement across multiple exchanges instead of one that applies only on NYSE. Regulators should also examine whether differences in trading rules across exchanges and alternative venues should be more similar, the New York-based automated trading firm said in a Nov. 30 letter.

# Investing Subset

NYSE's request for an exemption from the sub-penny trading prohibition "would allow a subset of the investing public to benefit from those better prices and deny that benefit to other investors," Suhas Daftuar, managing director at Hudson River Trading, wrote. While the program may produce more competition to improve prices for retail investors, doing so "would seem to be materially unfair discrimination against some exchange members," he said.

NYSE's proposal is meant to fit into the current trading structure and doesn't seek to remedy all the concerns and trading rules questioned by respondents, Mecane said.

"There are still a lot of very legitimate market structure debates out there," he said. "It shouldn't warrant holding up our program."

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