

November 30, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. SR-NYSE-2011-55 – Proposing a one year pilot program that would add new Rule 107C to establish a Retail Liquidity Program

Dear Ms. Murphy:

Hudson River Trading LLC (“Hudson River Trading”) appreciates the opportunity to comment on the New York Stock Exchange’s (“NYSE”) proposal to establish a retail liquidity program. Hudson River Trading is a quantitative trading firm that develops automated trading strategies that provide liquidity and facilitate price discovery on exchanges and Alternative Trading Systems (“ATs”). We believe NYSE’s proposal raises significant issues regarding competition among exchanges, ATs and over-the-counter internalizers (“internalizers”). We believe these competitive issues are best addressed through comprehensive rulemaking that aims to create a level playing field in the competition for order flow, rather than with a narrow rule that is targeted to a particular exchange and its policies. Given the current inequity, we understand the NYSE’s desire to reduce the competitive disadvantage it operates under for retail order flow. However, we believe their current proposal to establish a retail liquidity program could set an important precedent with respect to exchanges’ fair access requirements and requires clarification and greater transparency.

Background

Retail investors’ orders are generally considered to be uninformed, in that they are unlikely to cause or have information about short-term price movements. Retail orders are typically executed at the NBBO and are sometimes provided price improvement. Retail brokers are often provided payment in exchange for routing order flow to a particular internalizer or an ATs, a practice known as payment for order flow. The existence of payment for order flow and price improvement are generally driven by internalizers’ ability to discriminate among potential customers, taking the other side of retail orders which, unlike orders from proprietary trading firms or institutional investors, are unlikely to have a short-term adverse impact on the liquidity provider. This ability to discriminate is an advantage that internalizers, and to a lesser extent ATs, have over exchanges, as exchanges are subject to fair access standards that prohibit unfair discrimination among members and cannot customize price improvement or provide execution guarantees.

Furthermore, the ability to even offer price improvement is an advantage that internalizers have over ATs and exchanges. While Rule 612 generally prohibits displaying, ranking or accepting orders in increments of less than one cent¹, the staff of the Division of Market Regulation stated that a market center may provide price improvement relative to the NBBO². In practice, this allows internalizers to provide price improvement whereas exchanges and ATs are generally not able to do so, as they would need to accept a sub-penny order in order to provide price improvement to an incoming order.

Finally, internalizers and ATs have the ability to make accommodations to customers when the customer receives a bad price because the broker “misses the market.” Exchanges generally do not have the ability to adjust prices based on bad fills unless the fill was as a result of a technical failure.

These factors illustrate an unlevel playing field with respect to competition for retail order flow. Greater competition for retail order flow would likely result in better overall prices for retail investors, leading to improved returns.

OTC trading impacts the broader market as well. For instance, as internalizers typically match the best displayed price, they do not necessarily display quotes that contribute to price discovery. Similarly, the retail investors’ orders contribute less to price discovery than if they were routed to a displayed market center for display and execution. In addition, public quote competition would be more intense if more individual investor orders were sent to and executed on the public markets, as the degree of adverse selection on those markets would be reduced.

No rule will eliminate market professionals’ desire to interact with retail order flow. However, the Commission should endeavor to ensure that market professionals compete vigorously on fair and equal terms and ensure that retail investors benefit from that competition. As such, we respectfully recommend that the Commission address the ability for exchanges, ATs and internalizers to compete on equal terms for order flow. Doing so would require addressing all market participants’ ability to discriminate among customers, price improve and provide customer accommodations.

NYSE Proposal

While we understand NYSE’s desire to reduce the competitive disadvantage it operates under in competing for retail order flow, we believe certain aspects of its proposal are flawed. First, the proposal creates a new category of NYSE members called Retail Member Organizations (“RMOs”). The RMO definition is vague and leaves a great deal of room for NYSE to exercise discretion in approving RMOs. Similarly, when an RMO receives and routes a “Retail Order” from another broker, it simply relies on the other

¹ This restriction applies to orders in NMS stocks priced at \$1.00 or more per share.

² See Division of Market Regulation: Responses to Frequently Asked Questions Concerning Rule 612 (Minimum Pricing Increment) of Regulation NMS.

broker's representation. We believe that clear and transparent factors should be considered in determining what firms are qualified as RMOs and what orders can be considered Retail Orders, and that NYSE should make publicly available the list of approved RMOs.

In addition, the filing creates another category of NYSE member called Retail Liquidity Providers ("RLPs"). RLPs are limited to Designated Market Makers ("DMMs") and Supplemental Liquidity Providers ("SLPs") that NYSE approves to act as RLPs in one or more securities. NYSE does not clarify if they will limit the number of RLPs within a security. We believe that NYSE should clarify whether or not RLP status will be open to all firms that can meet the criteria in all stocks or if it will be limited.³ To the extent it will be limited, we believe the criteria for determining which firms will be approved or denied should be clear and transparent. However, it is unclear to us why NYSE would create an advantage for certain firms rather than allowing all firms to compete on a level playing field to provide price improvement to incoming retail orders.

More broadly, it is unclear whether this market structure, in which an exchange discriminates amongst its customers to create a parallel market in which only a subset of its members may participate, is consistent with the prohibitions against unfair discrimination that govern exchanges. As an example, we believe there are many securities for which the minimum tick size of \$0.01 is too large and that the market as a whole would benefit from a smaller minimum increment. This proposal's request for a waiver of the sub-penny trading restrictions would allow a subset of the investing public to benefit from those better prices and deny that benefit to other investors who do not qualify as RMOs or RLPs, which would seem to be materially unfair discrimination against some exchange members.

Moreover, this rule proposal could set a precedent for other exchanges to further discriminate among members. Currently, many exchanges discriminate among members in their pricing, with trading fees frequently based on volume tiers and/or coupled with obligations to provide liquidity. The NYSE also offers a market structure that benefits their designated market makers (DMMs) in the way orders are matched as well as better pricing, granting them preferential priority to trade ahead of some other members' orders, in exchange for meeting trading obligations. However, aside from the NYSE DMM program, no equities exchange currently offers different order type functionality to different members or matches orders differently based on which member sent an order; once an exchange receives an order, the order is handled without regard to the identity of the sender. This unbiased order handling is the foundation upon which competition is promoted among market participants. Consequently, we believe a wider discussion of the kind of discrimination that should be permitted by exchanges and other market centers is warranted prior to any approval of the NYSE rule filing.

³ We note that NYSE's approval of SLPs is similarly discretionary (see NYSE Rule 107B), and the requirement that an RLP must be an SLP or a DMM adds an additional layer of discretion to the proposal.

Conclusion

Hudson River Trading believes the competitive issues raised by this rule proposal are better addressed through comprehensive rulemaking that aims to address the competitive landscape among internalizers, ATSS and exchanges. However, should the Commission decide to move forward with the NYSE proposal, it should require additional clarity and transparency with respect to approval of Retail Member Organizations and Retail Liquidity Providers.

Hudson River Trading appreciates the opportunity to submit these comments and is available to meet and discuss them with the Commission and its staff in order to respond to any questions.

Sincerely,



Suhas Daftuar
Managing Director