ALLIANCE OF FLOOR BROKERS

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Re: File No. S7-02-10

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The Alliance of Floor Brokers represents independent brokers, house brokers, and designated market makers (DMMs, formerly specialists) of the New York Stock Exchange. Our organization has a longstanding history of providing the commission with comments from the unique perspective of the floor community. We are very pleased to have the opportunity to comment on the SEC's recent concept release. This is a critical time for the American regulatory bodies to reevaluate our current market structure for our fast paced and ever-changing financial markets.

The concept of "Agency" has been a consistent theme in our last few letters to the commission. The AFB believes that the agents on the floor of New York are held to the highest standard in the financial industry. No group of participants within the marketplace is regulated more. Often we are the last "touch" to an execution that is of course subject to both SEC and FINRA's standards, but also carefully watched by our diverse group of clients. Floor Brokers are challenged to follow their client's instructions, follow the guidelines of best execution, and maintain profitability within a particularly difficult transaction fee environment. In a past letter to the SEC we stated:

"Regulation NMS had the intention of always shipping an order to the market center with the best price, but the marketplace as a whole has suffered from the loss of block liquidity due to a fracturing marketplace. The presence of a trade through rule does not prevent agents from abusing their responsibility for economic gain. Agents feel they must ship their order to where they can get the best rebate to mitigate their economic impact in representing a principal's order. It is possible that a principal can lose a dime on a transaction, because the agent was looking to recapture a quarter of a penny. This of course does not happen all of the time, but why do we support a system that could allow it to happen?" 1

The Alliance believes that the above citation addresses many of the questions the commission asks within its concept release. Regulation NMS created intense competition for market share away from traditional exchanges. "Payment for order flow" fostered the kind of fragmentation that caused institutional traders to struggle to find blocks of meaningful size. The NYSE has lost much of its block business for the above reasons and much of this order flow has migrated to "Dark Pools". Buy-side Institutions have been forced to find blocks in these venues because of the lack of a central marketplace that aggregates market information. While all customers have the right to have multiple venues to execute their order, the market structure must be fair towards all participants in order to work properly.

1 Letter to the SEC on "Redefining Agency: The Key to Restoring Faith in American Regulation" May 5th 2009

High Frequency trading has been the “hot button” subject of much debate over the last two years. The commission is obviously concerned with the quality of our current market place based on the sheer number of questions that have been raised on this subject alone within the release. The commission begins by questioning the validity of short term vs. long term investing. The Alliance concedes that the risks assumed in both short and long term investing are inherently different. No profit or loss is realized until a position is closed out, whether it has been held for a microsecond or a decade. The AFB questions the motive of a HFT strategy that depends on getting in and out of a position at the same price, just to capture a rebate and make a half a cent on the transaction. This strategy is not adding liquidity into the marketplace as we have known it, and can create a false sense of the depth of the quote. It is very common to see bids and offers disappear as the market moves towards their price. This is not the valued liquidity that institutional interest wants to interact with. There is no doubt that HFT adds volume to the tape, but if you take away the rebate, would they operate in the same manner that they do today? How long a customer holds a position is not the problem, it is economic incentive to “flip” the position at the same price that creates “phantom volume”.

Recently the SEC has considered adding a rule that would require “large traders” to identify themselves to regulators by tagging their order flow. The AFB believes that this would be an important first step to proper post trade transparency for High Frequency Traders. This proposal in combination with the SEC’s recent proposal to ban “Naked Access” will help identify who is making these trades. This will allow the regulators to properly examine the types of order flow that these strategies employ. The AFB doesn’t believe that all HFT strategies are inherently bad, but it is obvious that there are some predatory participants in the marketplace today. These two proposals will allow the SEC to properly police the market.

The AFB questions the ability of HFT to reduce costs for all. There are many large HFT operators that pay online retail brokers a fee for their order flow, not unlike a rebate from an exchange or ATS. Where and how this order flow gets posted should be a question the commission asks. The internalization of this order flow should be examined. Maybe the retail players are being paid a fraction of a penny to post their flow, but he could be losing cents on the execution price itself. If this is repeated several thousand times a day, does HFT truly reduce execution costs? The commission needs to start addressing what the true cost of an execution is. Commissions and exchange fees are easy to quantify, but best execution should be defined through the true cost of a transaction with all parts accounted for. Recently a study from QSG (Quantitative Services Group LLC) suggests they can define the impact cost and have created an algorithmic model to defend their clients against HFT.

“QSG’s ability to isolate the Liquidity Charge®, the cumulative price impact specifically resulting from an order’s individual executions, is essential to this analysis. Understanding the price concessions required to obtain liquidity uncovers important insights into a stock’s liquidity dynamics and the nature of the competition. To succeed, many HFT strategies act as a motivated competitor for liquidity, not a supplier. In addition, such strategies are designed to minimize unnecessary exposure, leading to a rapid unwinding of a position once the exploitable pattern is exhausted.”2

2 “QSG® Study Identifies the Impact of Predatory High Frequency Trading on Institutional Equity Managers” February 17, 2010

There is a great need for creating a new type of dynamic metric that measures true execution cost. How, when, and where orders are executed during the course of its execution life needs to be more closely examined. The SEC mandate of "Best Execution" becomes clouded without these important pieces of the puzzle.

It has been suggested to the commission that HFT has replaced the critical role of the specialist. The Alliance believes that there is an enormous difference in the definition of the two. Every seasoned trader that trades in the current environment knows that their first take (or hit) up two to three cents (or down two to three cents) is usually their best execution. The contra side interest, when made up of HFT types, quickly looks to "dump" their position while the algorithm backs off to wait for another non volatile time to reenter the market place.

For Example:

The consolidated book for XYZ (what is displayed)

		10.27	1200
		10.26	18400
		10.25	32100
26500	10.24		
16700	10.23		
3200	10.22		

Agent A has an order to buy 100,000 XYZ. Agent A's best choice of action is to place an order to attempt to buy stock at .26 cents assuming that the majority of interest at .25 and .26 are HFT related. The HFT interest will immediately look to cover their short positions at higher prices. If Agent A attempts to take the stock offered at .25 only, it is very common that offers will cancel at .26, and the HFT interest that sold at .25 tries to cover at .26

Is this the market that Regulation NMS envisioned?

Consistently being a part of the quote is an important part of market-making. A more critical role that the specialist had (and DMMs have now) was the responsibility to buy a stock when no one else wanted to or sell a stock when no one else wanted to. Charged with making a fair and orderly market, Market Makers dampened volatility, and were an important reason that the NYSE's market held a one time 80% market share. While the Alliance realizes that the landscape has changed for many reasons, this important part of market-making is not lost within the NYSE's new Designated Market Maker model. High Frequency Trading is the first to flee the market in times of stress and volatility. They can simply turn their programs off for the rest of the day. DMMs have an obligation to the marketplace and do not stop trading just because it enters a short period of unprofitability. True market makers need to be rewarded for this difference, and that is why the exchange chooses to pay for their liquidity provided.

There are other types of strategies that are labeled HFT that use sophisticated algorithms that try to ascertain from publically available information the existence of a large buyer or seller that use smaller orders to ping and locate prices in which they can trade in front of traditional interest. These strategies seem to be used in less liquid and more volatile names. These

parasitic traders only take a position when there is order flow to be taken advantage of. Front

running is an illegal practice regardless whether the tools used to accomplish such manipulation
are new or old. It is the suggestion of the Alliance that the SEC creates a division whose sole purpose would be to stay current on the different electronic strategies that prey upon institutional order flow. Any type of parasitic trader that only executes orders to profit from actual order flow should be banned from the marketplace permanently.

"Payment for order flow" has created a large subset of traders that populate our national markets simply to collect a rebate. The Alliance has been encouraged by recent language found in comments made to the SEC in regards to this economic conflict. In a SEC comment letter on Dark Pools, Morgan Stanley stated the following:

"Morgan Stanley has for many years been a strong advocate of appropriate order handling/routing practices, transparency and a level playing field in the equity markets. While we support the Commission's initiative to reexamine and update the regulation of dark liquidity, we question what the Commission hopes to achieve with its dark pool-focused Proposal. Morgan Stanley believes that the real, underlying problem that needs to be addressed is the conduct of market participants. Diverse market participants are engaging in similar economically driven order handling/routing practices without being subjected to the same regulatory obligations merely by virtue of their respective defined roles in the marketplace. This conduct is not limited to specific trading venues, market participant types or systems/technology infrastructures and will continue if a granular approach to regulation is adopted. Market participants will simply shift business models or alter their technology infrastructure to avail themselves of loopholes that could be prevented with a more holistic approach to regulation that focuses on meaningful transparency and a renewed emphasis on up to date order handling/routing practices. "3

The Alliance agrees with Morgan Stanley that the economic conflict needs to be corrected. We propose that an elimination of rebates for proprietary interest that is not a registered market maker with an exchange, and for all agents would be an important first step in reducing fragmentation while keeping our national markets within a competitive landscape. In concert with this proposal there would need to be a reduction in the current ceiling of an exchange fee from 30 mils to a proposed 5 mils. All exchanges should be able to collect a fee for offering a fair environment and platform for the financial community. This may seem like a radical proposal to many, in particular the ATS community. However, until ATSs begin to contribute appropriately to regulation and their HFT participants are regulated like market makers are today, they should not be able to provide a rebate to their client base.

The SEC also asks an important question on the current data feeds that are available to the public. For a very long time the NYSE has chosen to report only lots of a 100 shares or more on the consolidated tape. The national marketplace will be mostly trading in shares beginning in June of this year when the NYSE makes its conversion. The AFB believes that every share that trades is just as important as the larger trades. Retail customers should be able to see their interest reflected on the tape to know that they had a good report within the confines of the market. The Alliance believes that all shares, including lots under100 shares, should report to the tape in the near future.

Innovation is an important key element in the evolution of our National Market Structure.

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3 Letter from Morgan Stanley "Re: Securities Exchange Act Release No.34-60997 (File No. S7-27-09) – Regulation of Non-Public Trading Interest" dated March 4th 2010

The sheer growth in the number of market participants within the last year is a testament to that. It is not the innovation of different types of execution venues that is the problem with our current market structure. The Alliance does not believe that all High Frequency Trading strategies are inherently bad either. The problem lies in the current rule structure that allows an economic conflict of interest to exist. Some will read our proposal and make the assumption that we wish to go backwards to a time when the NYSE controlled 80 percent market share. Not only is that unrealistic for the future, it would be wrong. Choice of an execution venue is an important freedom that investors have a right to. By removing the rebate from non market maker proprietary and agency interest, the SEC would move our market structure forward and would lower investor's true cost of execution.

Respectfully,

Co-Presidents

Patrick D. Armstrong

Daniel W. Tandy