May 18, 2010

Similarities between last week's frightening market activities compared to past incidents of extreme dislocation are remarkable, yet for some unknown reason mostly overlooked. Consider 1987, when the industry was experiencing significant transformation that included new trading technologies and complex methodologies, which were accompanied by unprecedented increases in market volatility and trading volumes. With the arrival of that period's academics came new strategies that included the combining of synthetics instruments such as S&P 500 futures and baskets of stocks within traditional portfolios, promising to reduce, if not eliminate investors risks: so called "portfolio insurance," or newly implemented computers with dynamically programmed systems designed to generate simply formatted, execution cost efficient, high-speed orders that stood ready to be deployed. Many portfolio managers, pension fund managers, buy and sell-side traders took great comfort trusting they had found the magic formula that would produce unequaled performance with minimum risk. What happened next? With most of the herd subscribing to this new and innovative methodology, as prices began to deteriorate everyone's "insurance"—employing the same parameters—kicked in and sell orders began to cascade into the market, causing alarming levels of price dislocation. *Does this all sound familiar?*

Now in fairness, it can be argued there are some differences between May 6th market "dislocation" and 1987. During the market's collapse, the depth of decline (in percentages) was larger, the volume of trading much busier, the speed much faster, and the participants predominately professional traders and computer programmers plain vanilla, traditional investors. But then again, fundamentally, perhaps the most critical differences were in the market structure itself: today's marketplace is much different than in 1987. The re-construction or should we say the *deconstruction* of market structure (see The National Market System or NMS, the name of which is a misnomer in and of itself), dramatically altered the market landscape. Instead of crafting a marketplace that would serve as the global blueprint for intelligent redesign while retaining the pieces that served well as it's backbone, some lawmakers and regulators decided to impose changes that have only exacerbated fragmentation, opaqueness, volatility, and in part lead to the unfortunate loss of displayed price discovery, all in the name of efficiency, a supposed leveling of competition and the alleged reduction of investor costs*. (*Along with commissions, price performance (discovery) should also be considered in determining accurate execution cost.)*

I would submit that absent the understandably unhappy retail investor and corporate issuers, some of those who claim to be "shocked" that last week's activities could have happened are either those who helped design this obviously flawed model in the first place, beginning with Reg.NMS (see some legislators, regulators, alleged industry experts, and academics) or those who exploited it. For more than twenty years, many of those responsible for inflicting this completely unworkable market structure have refused to admit they were woefully under-qualified for this critical job. At this juncture it should be remembered—that while not perfect—prior to the redesigning, our markets were the envy of markets around the globe while helping to foster unparalleled growth in the U.S. and throughout the world. If there is any humor to be found within this sad story it must be the "OMG, I didn't know" charade coming from those hiding in the dark pools, internalizing their client's order flows or skulking behind algo-spewing mainframes while reaping the rewards of this ill-conceived and uneven market structure. So that no one feels left out, I would add that **comparisons of high speed traders (HFTs) to specialists** or today's designated market makers (DMMs) is baseless and there are few if any similarities. Yes they provided some liquidity, but they did so when it fit their own strategies and balance sheet. Specialists, by federal securities laws, are required to comply with **"affirmative obligations"** and cannot walk away simply because it will have negative impact on their balance sheet or trading strategies, in my view a very significant difference.

Going forward, discussions of uniform market parameters seem prudent, however they must be implemented carefully. With thirty (??) or so market destinations participating in this market grid I fear that one of the less liquid market centers might exceed preexisting collars and **cause well functioning markets to suspend trading, robbing investors access to real market liquidity** (suggest determination of venue participation include it's traditional market share) . Before making final determinations may I suggest we all refer back to those days of yesteryear: they weren't perfect but there is much that was right to be learned from.

Respectfully,

James K. Rutledge

NYSE floor broker for over 35 years and participant during those 1987 "dislocations".

New York City, New York