CFA INSTITUTE

Setting the global standard for investment professionals

30 November 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-NYSE-2011-55 and SR-NYSEAMEX-2011-84

Proposal to Establish a Retail Liquidity Program to Attract Additional Retail Order Flow to the Exchange

Dear Ms. Murphy,

CFA Institute is pleased to respond to the Securities and Exchange Commission's (SEC's) solicitation of comments on the NYSE's *Proposal to Establish a Retail Liquidity Program to Attract Additional Retail Order Flow to the Exchange* for NYSE-listed Securities and NYSE Amex Equities Traded Securities.

CFA Institute[1] represents the interests of investors and investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, and on the efficiency and integrity of global financial markets. CFA Institute promotes fair, open, and transparent capital markets, and advocates for investors' protection.

General Comments

Over the past decade, technological advancements, combined with regulatory changes, have significantly altered the structure and functioning of equity markets. The U.S. equity market today represents a vast, decentralized electronic network, critically dependent on technology to generate and match order flow at ever greater speed. Whilst certain trading costs have fallen, the fragmentation of liquidity across this network, combined with the speed and automation with which transactions are executed, has raised various issues for market participants. Investors and regulators have expressed concerns over the depth of liquidity, the efficiency of public price discovery, and over the transparency, fairness, and resiliency of equity markets.

[1] With headquarters in Charlottesville, Virginia, and offices in New York, Hong Kong, London and Brussels, CFA Institute is a global, not-for-profit professional association of more than 111,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 135 countries. Of these, more than 101,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

560 Ray C. Hunt Drive
Charlottesville, VA
22903-2981 USA

434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

CFA Institute believes that the efficient functioning and integrity of the equity secondary markets is of utmost importance to serve the diverse needs of all types of investors. To that end, rules and policies should support greater transparency and greater consistency in the regulatory framework, so that all functionally similar trading venues and trading activities are subject to similar rules.

Summary of the Proposal

The NYSE's proposal is to establish a non-displayed retail liquidity pool. Under the proposal, "Retail Member Organizations" (RMOs) could submit retail orders to the Exchange in either an agency capacity (specifically, where no change is made to the terms of the order and the order does not originate from a trading algorithm or any computerized methodology), or a principal capacity (specifically, a proprietary order resulting from liquidating a position acquired from the prior internalization of a retail order). The retail orders submitted by RMOs would be sent for execution against Retail Price Improvement orders (RPIs) entered by Retail Liquidity Providers (RLPs). RPIs would represent non-displayed trading interest that is better than the best bid or offer by at least $0.001.

RLPs would either be Designated Market Makers or Supplemental Liquidity Providers. To be granted RLP status, they would be required to supply RPIs that are better than the best bid or offer for the designated security at least 5% of the trading day. The 5% requirements would be calculated by determining the average percentage of time the RLP maintains an RPI during the regular trading day. In return, RLPs would be eligible for execution fees that are lower than non-RLP rates. Similarly, RMOs would receive a credit for executions of their orders against the RPIs submitted by RLPs. In other words, RMOs would effectively receive a payment for order flow for directing retail orders to the exchange's retail liquidity program.

Discussion

The substance of the Exchange's retail liquidity program is to create a trading functionality that represents a similar business practice to retail internalization conducted by broker/dealers. This proposal likely reflects the NYSE's desire to halt its competitive disadvantage that has resulted in a significant loss of market share to non-displayed trading centers, specifically broker/dealer internalizers. It would achieve this by undertaking a similar business practice itself. One might construe this effort as an indication of the Exchange's frustration with the practice of internalization, which continues to benefit from a different set of rules from that which applies to exchanges. We sympathize with this view. However, if the SEC were to approve these proposals, it would likely exacerbate the loss of displayed liquidity, undermine the integrity of public price discovery, and compound the market structure issues that the SEC is seeking to address.

Non-displayed internalization pools remove the incentive for market participants to display orders because they allow privileged participants to effectively free-ride off the price discovery function fulfilled by displayed limit orders. Investors who submit passive limit orders frequently find that those orders aren't executed due to the ability of off-exchange market participants to step in front of those orders by internalizing desirable retail order flow. This interception of marketable retail order flow provides customers with, at best, nominal price improvements. Orders not internalized are sent to the exchange for execution in large part because these orders are not profitable for the internalizer; in other words, they are executed against displayed limit orders typically on the wrong side of the market.

This practice has a corrosive effect on the willingness of market participants to display limit orders, which are the building blocks of price discovery. This corrosion carries a significant and greater cost to market integrity relative to the small benefits accruing to the retail investor from the (at best) nominal price improvement gained from internalization of their orders.

As a result, the 'toxicity' of the exchange will increase as the order flow routed to exchanges will increasingly consist of informed, often high-frequency, order flow. This, in turn, will lead to fewer limit orders and hence, lower market depth and wider bid-offer spreads. Specifically, to compensate the risk to market makers from "adversely selecting" (or interacting with) this informed order flow, quoted spreads may widen[2] and the depth of interest at which market makers are willing to trade would likely decline. A possible implication of this is for institutional investors to increasingly seek out liquidity in dark pools to avoid the poorer quality of executions offered on exchanges. The likely result is a deterioration of market quality. Further, given that the displayed market acts as a reference market that supports price formation in the dark or off-exchange markets, trading costs could increase in those markets as well. That is, the initial loss of displayed liquidity creates a negative feedback loop that hurts all types of investors.

---

[2] See, for example, Easley, Kiefer, and O'Hara, 1996, *Cream-Skimming or Profit-Sharing? The Curious Role of Purchased Order Flow*, Journal of Finance (July). The authors examine purchased order flow and the concept of broker/dealers "cream skimming" uninformed liquidity trades, leaving the information-based trades to established exchanges. They find a significant difference in the information content of the different types of stock trades and conclude that this difference is consistent with "cream-skimming." The authors find that as more uninformed orders are preferenced (or internalized), the worse prices become on the remaining orders. Wider on-exchange spreads give greater scope for off-exchange transactions to be more profitable; they enable brokers to extract higher rents from customers since they can deal within a wider spread.

See also Larrymore and Murphy, 2009, *Internalization and Market Quality: An Empirical Investigation*, Journal of Financial Research (Fall). The authors again note that in markets with high levels of internalized retail order flow, the adverse selection component of the bid-offer spread increases, to reflect the greater risk of market makers trading against informed order flow. The authors examine the implementation of the Toronto Stock Exchange's Price Improvement Rule in 1998, and find that following this rule, market quality improved as reflected by, among others, declining spreads, reduced variance of pricing error, and greater depth. The outcome of improved market quality implies that market makers could compete more aggressively for order flow following the rule change, as more limit orders came back on to the order book, thereby reducing adverse selection risk as reflected in the narrowing of spreads.

In short, a reduction in displayed trading interest (through loss of incentives) has wider adverse consequences for market integrity beyond the initial loss of transparency.

Additionally, by segmenting order flow in the manner proposed, the proposal would also seem inconsistent with the principles of fair and open access and non-discretionary execution, which are fundamental underpinnings of the operation of an exchange.

We therefore urge the SEC to reject these proposals.

Specific comments

Our responses to the SEC's specific questions are set out below.

Q: A stated purpose of this proposal is to attract retail order flow, a significant percentage of which is currently executed over-the-counter, to the exchange. What are the benefits, if any, of executing marketable retail orders on an exchange instead of over-the-counter? To what extent, if any, would this proposal realize those benefits? What other effects, if any, would this proposal have upon the overall market?

One of the key economic functions of an exchange is to facilitate price discovery by providing a public marketplace to gather and display trading intentions. Executing marketable orders on-exchange, instead of over-the-counter, acts as an incentive for market participants to publicly display more of their trading intentions, a process that encourages other market participants to do likewise (liquidity begets liquidity). In other words, execution of marketable orders on-exchange creates a wider benefit in terms of amassing more displayed liquidity and underpinning robust public price discovery. The wider benefit to the market as a whole outweighs any particular benefit accruing to an individual retail investor from having his/her order filled off-exchange.

This proposal would not realize the stated benefits because retail orders would be executed in a non-displayed pool that in substance is akin to the off-exchange internalization pools run by broker/dealers. As noted in the preceding discussion, we believe this proposal would have adverse consequences for overall market integrity.

Q: The proposal contemplates that Retail Liquidity Providers may offer price improvement to Retail Orders in sub-penny amounts. In its proposal, the exchange notes that it is concurrently requesting an exemption from the sub-penny rule, Rule 612 of Regulation NMS, to permit the exchange to accept and rank Retail Price Improvement Orders. If the Commission were to approve this proposal and grant the exemption, what impact, positive or negative, would the proposal have upon the market? Would this proposal, if approved, produce a significantly larger volume of sub-penny trades than is currently the case, or would it primarily shift sub-penny trades away from non-exchange venues to the exchange?

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. This opportunity cost is compounded by the subsequent disincentive to post limit orders, which in turn has wider adverse consequences as we have discussed above. Moreover, sub-penny trading and pricing further fragments liquidity and in doing so can increase frictional trading costs.

The NYSE itself is cognizant of the potential negative impact of its proposal. As it notes in its filing, “The Exchange recognizes that sub-penny trading and pricing could potentially result in undesirable market behavior. The Exchange will monitor the Program in an effort to identify and address any such behavior.”

If the SEC were to approve this proposal, we believe that it would increase the overall volume of sub-penny trades, and might also shift sub-penny trades away from non-exchange venues to the exchange.

Concluding Comments

CFA Institute believes that price transparency is a core element of fair and efficient-functioning markets. Exchanges fulfill a key economic function in facilitating public price discovery; as such, they should be committed to practices that further transparency. The NYSE proposal, however, is a step in the opposite direction. We believe that it would set a dangerous precedent were it approved by the SEC.

If you or your staff have questions or seek clarification of our views, please feel free to contact either James Allen, CFA, at +1.434.951.5558 or james.allen@cfainstitute.org, or Rhodri Preece, CFA at +44.207.330.9522 or rhodri.preece@cfainstitute.org.

Sincerely,

/s/ Kurt Schacht

Kurt Schacht, CFA
Managing Director
CFA Institute

/s/ James Allen

James Allen, CFA
Head, Capital Markets Policy
CFA Institute

/s/ Rhodri Preece

Rhodri Preece, CFA
Director, Capital Markets Policy
CFA Institute