



TALK BACK: The New NYSE: Just Like The Old Nasdaq

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These are the personal views of Joe Saluzzi and Sal Arnuk on the current trading conditions at the New York Stock Exchange. Saluzzi and Arnuk are co-heads of the equity trading desk at Themis Trading LLC, an independent, agency brokerage firm specializing in trading listed and OTC equities for institutions:

Everybody will surely praise John Thain for bringing the New York Stock Exchange into the electronic age. Nowadays, you can trade Big Board stocks faster, at lower commission rates and on more venues. At the end of the day, however, we believe history will see that Thain's biggest accomplishment was turning the NYSE into another NASDAQ.

Thain's changes have significantly reduced the role of the specialist system, which is what built the NYSE and made it special. NYSE stocks now trade in wider ranges at a faster pace during the day, and it has become much more time consuming to execute large institutional orders. The result: NYSE stocks are much more volatile, and trading them has become riskier.

In the "old days," as late as the early 2000s, NYSE stocks traded smoothly, if a little slowly. If you were an institutional investor with 100,000 or more shares to buy or sell, you gave the order to the block trading desk of one of the sellside firms with which you did business.

They gave it to one of their floor brokers, who would go to the specialist, and together they would work to fill the order.

The process might have taken 5-10 minutes instead of seconds, and the commission might have been 5 cents a share versus 1-2. In most cases, however, you were able to execute the entire order. The specialists were the primary place where you traded NYSE stocks and provided a central point of liquidity. Because commissions were a little higher, it was worth it for brokerage firms and specialists to commit a little capital to a trade to make it happen, further enhancing liquidity.

If you were a publicly traded company, the specialist system was why you chose the NYSE over the NASDAQ, why larger companies listed on the NYSE, and why the NYSE was considered the "gold standard" in exchanges.

Getting Fragmented

Today, it's a different story. There are more than 40 alternative trading systems (ATS) or other electronic communication networks (ECN) for trading NYSE stocks. These include the NYSE's own ARCA network and NASDAQ as well as dark pools such as LiquidNet, Pipeline, and ITG. While average daily NYSE volume totals around 4 billion, implying huge liquidity, more than 60% of it is spread among these non-NYSE venues, resulting in huge fragmentation. As a result, institutional investors with orders of any size have to execute them on several venues, instead of one.

As a further consequence, order flow in NYSE stocks is more hidden than ever before, defeating the purpose of Reg NMS. Fully implemented this fall, the new SEC regulation was intended to "level the playing field" between institutional and retail traders. Each market is required to display the best bid and ask price, and the shares available, for stocks trading on that venue. Because many institutional orders are spread across different venues, both big and small investors cannot see the full picture as to what is happening with each NYSE stock.

Whip Stock Effect

The electronic nature of these trading venues is creating another set of problems affecting institutional and retail investors.

To help execute large institutional orders, buy-side traders have increasingly turned to algorithmic, or "algo," trading systems. Algos, which are typically offered by sell-side firms, slice large block orders into smaller trades ranging from a couple hundred to a couple thousand shares.

Then these orders are fed into trading venues based on formulas that in most cases match the average weighted volume of trading for the stock. If 20% of the volume of the stock is historically executed between 9:30 am and 10:30 am, the algo feeds 20% of your order into the market during that period, regardless of what is happening.

As a result, many NYSE stocks are now subject to the same "Whip Stock Effect" that plagues NASDAQ stocks. By law of averages, some NYSE stocks are attracting a higher proportion of algo trades. While these stocks may have large volume and day-to-day price stability, and thus appear to be highly liquid, their intraday volatility is high, as the algo systems rapidly - and unrelentingly - execute their orders up and down the price ladder. This creates a whip-like effect on the price of the stock through the day.

Predatory Algos

No matter how sophisticated, algos follow patterns as they slice up orders and feed them in periodic waves into the market. As a result, they are often predictable. This predictability has given birth to a new style of proprietary trading, based on the use of "predatory algos." Predatory algos are designed to detect and trade ahead of real algo orders, further exaggerating the whip stock effect.

Toxic Order Flow

As an alternative to algos, some traders manually try to manage the trading of NYSE stocks across different electronic systems. In doing this, they often encounter "toxic order flow." These are computer-driven systems that are constantly pinging electronic markets with bids or offers, in order to drive the price of a stock higher or lower by a penny or two.

For example, if toxic trading systems determine there might be a real buyer of size in the stock, they try to quickly run up the price with a series of small, quick buys, and then sell the shares back to the real buyer. The goal is to make a profit of two to five cents on each of these series of trades.

While it sounds like a lot of effort for very little, toxic trading can be very profitable. These systems run continuously through the day, each one executing hundreds of thousands of trades. Moreover, many ECNs, such as ARCA, NASDAQ and BATS offer rebates on trades, significantly offsetting the cost of toxic trading.

The New NYSE

So welcome to the new NYSE - same as the old NASDAQ. It may be easier and cheaper than ever to trade. But fragmentation, the whip stock effect, predatory algos and toxic traders are increasing volatility and expanding the time it takes for institutions to execute block trades, exposing them to more risk from a more volatile NYSE.

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(TALK BACK comments may well be submitted by readers who have a financial interest in the securities that are being discussed.)

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