**December 2014**

**Trade-At: Reducing Competition, Increasing Complexity and Channeling Profits to**

*By Larry Tabb, Founder/CEO, TABB Group*

***The Trade-At provision in the SEC’s third nickel pilot scenario will increase trading costs, increase order routing complexity, reduce competition, and reduce accessible liquidity. By most measures, Trade-At will benefit few and harm many.***

A Trade-At provision, simply stated, is intended to force liquidity to the protected market with the best posted quote. The idea is to reward the aggressive liquidity providers by ensuring that they are the first to trade; and that brokers, internalizers, dark pools, or hidden exchange liquidity cannot trade before a posted quote, unless there is “significant” price improvement, which is defined as a full minimum price variation, or MPV (tick increment = $0.005), or half the MPV ($0.025) in a one-MPV market.

Today, even though there is top-of-book order protection, a broker does not need to route an order to the market displaying the best bid if it can match the best bid/offer or provide any level of price improvement over the posted quote to fulfill the client’s order. Under a Trade-At regime, however, the broker – as well as the exchange – will have little flexibility in how that order is executed. The broker, if unable to match the client’s order with “significant” price improvement, will be forced to route the order to the market with the best protected displayed price.

Exchanges will have similar mandates. Trade-At forces exchanges to route orders to the most aggressive quote and prevents them from leveraging their un-displayed liquidity. Once an order is received, an exchange only can match that order against visible liquidity before being forced to route the order out.

*And why is this a problem?*

Trade-At poses a number of challenges. Even if brokers have the other side of the trade, Trade-At forces the broker to route both buyer and seller to the exchange to trade (unless they agree to substantial price improvement). This forces brokers to forgo low-cost internal executions and pay additional matching

fees to a displayed and protected venue (exchange). Further, routing pre-matched orders to an exchange jeopardizes locked-in executions, as the exchange will need to treat each order separately, routing the buy to the venue showing the best offer and the sell to the one showing the best bid. Finally, dark executions will be forced onto lit venues, subjecting investors to information leakage.

Trade-At also will change the price improvement process. Currently, wholesalers internalize retail clients’ marketable orders and provide price improvement of 15%-20% of the spread. Under Trade-At, price improvement is mandated to be at least 10% of a nickel spread, or $0.05. But there are significant caveats. The biggest caveat is that retail brokerage firms need to attest that their flow is manually generated and not automated or algorithmic. This actually is harder to determine than one might think.

What is an automated order? Increasingly, brokers are developing investor tools that make it harder to determine what is electronically generated, and more and more brokers are supporting front-end trading platforms that make it harder to tell whether the orders are generated manually or from automated models.

But even outside of complex investment tools or sophisticated front ends, what about a simple trading model? How would you classify an order generated from a model to buy a stock once it crossed its 10-, 20-, or 200-day moving average? Is there a difference between receiving an alert, providing a pre-populated buy or sell ticket, or automatically generating an order from the same signal? The Trade-At rule forces brokers to differentiate these scenarios, as an alert or pre-populated ticket would be open for potential price improvement, while an automated trade would not.

**From dark to light**

An integral part of Trade-At is the distinct separation between displayed and non-displayed liquidity provisions. However, nowhere in the proposal does it equate displayed liquidity with exchanges. If this continues throughout the final rule, there would be incentives for brokers to re-provision, startup or migrate their dark pool flow to lit off-exchange trading facilities, such as ECNs. While ECNs, as opposed to dark pools, match buyers with sellers in a lit environment, these pools can be harder to access and are not as transparent with filings, pricing, and order types as exchanges. While ECNs may need to quote through an exchange with a protected quote (similar to the way that LavaFlow quoted through NSX and now

the FINRA ADF), getting to these venues can be problematic, as I am aware of no exchanges that deliver orders since the deactivation of NSX.

**Complexity**

Trade-At is most notably a more extensive set of order protection rules. Order protection rules have created a series of complex exchange order types, including the notorious Hide-Not-Slide, DAY ISOs, and others that confuse and complicate market structure in the desire to streamline messaging. Trade-At will spawn a whole new generation of complex order types, increasing the gulf between those that properly implement these messages and those that don’t.

Speed, rather than being mitigated by the new rules, will become increasingly important. Spreads will widen as a result of the tick-size pilot. Instead of fighting over a penny, we will be fighting over a nickel – a 500% increase. The top of book also will become increasing important, as internalizing or matching orders in ATSs at the bid/offer will be eliminated.

So spreads will widen. Top-of-book queue position will increase its importance. And knowledge and use of new orders types will become more critical. All of these factors will increase the value of speed both to be first, and to know when to get out of the way. None of these factors will make the market simpler to negotiate.

In addition, the amount of programing needed to make these changes is not insignificant. Besides managing the symbol list, there will be new attestation, internalization, routing, matching, and execution rules that will need to be coded. As these new rules are implemented, new order types for managing retail order flow, new quoting mechanisms, and new order interaction policies will need to be developed, increasing systemic risk and order routing complexity.

Further, while most market structure rules are smoothly translated into programing logic, the testing and turnover risk cannot be underappreciated or underestimated, as we have experienced significant rule-change-instigated broker pricing, routing and execution logic errors. Given the nature and magnitude of these changes, market testing and the software turnover process should not be taken lightly.

**Reduced Competition**

One of the intended consequences of a Trade-At rule is to reduce matching competition. Since displayed liquidity is preferenced over internalized and dark liquidity, we can assume that more of this flow will be matched by lit venues and subsequently, exchanges. While centralizing flow on exchanges helps with price discovery and reduces the odds of breaking though liquidity veneers, as occurred in the flash crash, it also can hurt the ability to develop new, innovative matching models that move the state-of-the-art forward. While massive fragmentation and too much dark liquidity can be problematic, we need to manage the balance between centralization and fragmentation to ensure we continue to innovate, have healthy competition, and allow new platforms to succeed or fail on their merits and not because of regulatory fiat.

**Bottom line**

While the goal of de-fragmenting our insanely complex equity execution infrastructure is laudatory, we need to understand that we can’t go back to the simple markets of the past, when traditional market makers posted size and were rewarded with trading opportunities. Capital restrictions, spread reductions, and leverage constraints have changed this market – mostly for the better. Traditional market makers have disappeared, and newer technology-driven providers stepped in using speed instead of size to facilitate trading. This shifts risk from dealers and traditional market makers to investors and creates a quandary: How do we incentivize size and maintain a low-cost market for “retail” and a more liquid market for institutions?

Trade-At attempts to solve this problem by increasing the importance of the lit quote, incentivizing size, and reducing internalization and dark trading. Trade-At, however, increases routing complexity, reduces the effectiveness of dark liquidity (both on- and off-exchange), makes retail internalization and price improvement more difficult, and in conjunction with the nickel pilot, proposes to make it less expensive to trade by increasing trading friction instead of reducing it.

As proposed, Trade-At will widen the quote and provide greater incentives for market makers to be at the top of the book. This will make it more difficult to avoid the market maker, exchange fees, and information leakage. It will also increase the profitability of providing liquidity, driving up trading costs for everyone, especially retail investors.

The increasing importance of displayed liquidity and the widening of the quote also will, perhaps counter-intuitively, increase the importance of speed, increase the incentives to develop lit ATSs (ECNs), and funnel greater profits to market makers.

And these profits will no doubt come from the pockets of both retail and institutional investors.

# # #