

Rents and the Floor Brokers

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Is there still a role for human interaction at the point of sale of securities? A YouTube clip of a slow day on the New York Stock Exchange floor casts doubt on this, as does the statistic that at present, floor brokers handle only 6% of the trading volume on the NYSE. The NYSE, however, continues to fight for its trading floor, most recently in the proposed rule changes establishing a "New Market Model" submitted to the SEC on July 15, 2008. In conjunction with technological changes intended to give floor brokers an additional edge in the competition with upstairs traders, and the change in the role of specialists on the exchange to "Designated Market Makers," NYSE officials appear to believe that the new rules will bring business back to the floor. Human beings do many things well, but computers also do some of those things well, and much quicker. Whether human judgment still has a place in the securities trading process will likely be determined soon, and with it the fate of the NYSE floor in lower Manhattan.

The revisions to the NYSE rules involve changes to the parity rules concerning incoming orders to the Display Book. At present, floor brokers compete with upstairs traders in responding to marketable orders. Floor brokers must make a convert and parity or "CAP" order which is then entered into the electronic trading system. Such conversion is cumbersome, and the handheld devices the floor brokers use have not accommodated the trading algorithms common among upstairs brokers. As a result, the floor brokers have fallen behind in the race to provide the best price to the market. Under the new system proposed, when a trade establishes the Best Bid or Offer, positions from floor brokers, DMMs, and the Display Book will all be on parity with one another. This means that all brokers off the floor will be aggregated together for purposes of the parity rules, providing floor brokers with the opportunity to take an increased share of the trades when they set or join the BBO. In conjunction with this change, the handheld trading devices used by the floor brokers are being upgraded to use an external algorithmic trading engine. This will allow floor brokers the automated order execution that upstairs brokers have already been enjoying. The hoped-for effect of the parity rule change and introduction of algorithmic trading capability is to increase the percentage of trades that occur on the floor.

In addition, the handheld devices have already been upgraded with BlockTalk. BlockTalk allows a broker to broadcast indications of interest to other brokers on the floor, sending only the broker's ID number and the ticker symbol of the stock the broker wishes to trade. Such communication technology, it is hoped, will facilitate large stock trades given the current reduced role of specialists on the floor.

If trading does move back to the floor, what economic benefits are supposed to accrue? As is well known, securities markets have become increasingly fragmented. The

NYSE itself currently handles only about 30% of the trading in NYSE-listed stocks, down from 80% in the early 2000s. And over 40 sites currently function as trading venues, including ECNs such as BATS and Direct Edge, dark pools such as Liquidnet and Pipeline, and the traditional exchanges. The competition between these sites has resulted in fragmentation, with no one site operating as an informational center to set prices. While this is mitigated by the fact that algorithmic trading programs can quickly survey these different venues on the part of a market participant, the lack of a central venue for trading can be expected to reduce the efficiency of the market as a price-setting mechanism. Liquidity concerns, however, are a greater problem in the current trading environment. As the amount of markets increases, the depth of the trading pools correspondingly decreases. Making block trades therefore becomes difficult—indeed, most orders on exchanges are now in the hundreds of shares, as algorithmic trading programs break up trades on behalf of sellers in order not to shift the price in the market.

The NYSE therefore proposes that by increasing traffic on the floor, the New Market Model will counteract the trend towards fragmentation and enhance price discovery for block trades. NYSE officials also believe that in times of uncertainty in the markets, human judgment is essential to reducing volatility. If the benefits of increased liquidity, improved price discovery and stability are real, there may be a sustainable business model behind the NYSE's updated trading floor. Ultimately, the prices buyers and sellers could realize through using floor brokers would have to incorporate such benefits in dollars and cents amounts that outweigh the costs of using human brokers who occupy valuable Manhattan real estate.

Of course, it should be remembered that the NYSE is not making any new arguments. The NYSE has long touted the benefits of a centralized market involving human traders, but transaction costs associated with its market structure have led to the current state of intense competition among trading venues. Admittedly, technological advancements and regulatory changes brought about by Regulation NMS have radically changed the trading environment, but to a skeptical observer, NYSE transaction costs appear to be an attempt on the part of a service provider to continue to extract an economic “rent” long after it has lost its monopoly position.

In its determination to preserve what remains of the open outcry trading system, the NYSE is a holdout among stock markets around the world. Stepping away from the trading floor, securities brokers of 40 or even 20 years ago would barely recognize the present practice of their trade. The development of the computer during our lifetimes has revolutionized finance just as it has most other areas of human endeavor. If the hoped-for benefits do not outweigh the costs associated with human trading, the floor brokers may not survive very long into the twenty-first century. The rents the NYSE extracts may come from new apartments or offices. Or perhaps that YouTube clip of the quiet stock exchange floor will be replaced by a virtual tour of the new NYSE museum in the historic financial district.

