INSTINET®

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To Our Clients,

Much has been made in the press recently about high-frequency trading (HFT) and the effect it has had on both the retail and institutional investor. As with most issues raised in the press, understanding the motives of the individuals participating in the debate will expose their biases and provide a better understanding of the issues at hand. It is apparent that this debate is being put forth in an attempt to influence public sentiment and push regulation in a direction that will further the interests of certain market participants rather than out of an altruistic concern for investors. As a pure agency broker to our clients for 40 years, we approach this latest innovation as we do all market changes – with a singular focus on helping our clients achieve their execution goals. This focus allows us to provide an unbiased opinion and clear direction to our clients on how best to handle their orders.

The principal areas of contention in this debate are "flash" order types and HFT's alleged technology advantage, including the ability to co-locate.

Flash Orders

Flash order types work as follows: When a market center has an order that will cross the spread and must be routed out to a competing market center under Regulation NMS, it will first send out either a flash quote (NASDAQ and BATS) or notification (Direct Edge) to liquidity providers that an order is about to be routed. Any participant listening for that message has a very short time to respond with the other side of the trade back to the market center, where it will then be executed. This enables the market center to save routing charges while protecting market share and associated revenue. If the execution cost savings are passed on to the end-client and there is no real value to the information the order contains, then this order type and technology can clearly serve a bona fide purpose.

Instinet does not utilize flash order types for the orders we send to market centers on behalf of our institutional clients. Although flash orders are estimated to comprise 2-3 percent of overall market volume, we do not believe they benefit the orders entrusted to us by our institutional clients, whether sent to our traders or through our electronic systems. We do, however, listen for these "flashes" and respond to the originating market center if it makes sense in the context of our clients' orders.

High-frequency Trading

The term "high-frequency trading" has been used as a broad generalization for many types of technology-leveraged trading strategies, some of which have been used in one form or another for many years. From the earliest days of index arbitrage trading to statistical arbitrage and all the way to pure electronic market-making, the use of these strategies has increased. Over the past few months the market share of the HFT community has grown to north of 50 percent of all trading in the U.S (and as much as 73 percent, according to some estimates). This growth is due in part to technological advances, regulatory changes and the decrease in institutional market participation caused by the market downturn.

As a result of this shift, many times the only players on the other side of an institutional order are high-frequency traders. This is not necessarily a bad thing. First of all, HFT provides liquidity which may not be there otherwise – and if no market participant is willing to take the contra side of a trade at the prevailing price, any single order would most definitely have greater market impact. Second, it is important to understand that not all high-frequency traders have the same time horizon or trade motivation. One may be trading equities as a hedge for a futures or options position while another may be trading based on a short-period momentum or other alpha signal. This liquidity could be valuable depending on the motivation of any given trade. This is not to say that we are always willing to trade against HFT, but our job as an agency broker is to determine the right price and liquidity opportunities with which to interact in executing trades on behalf of our clients.

Regarding co-location, although superior speed clearly allows high-frequency traders to get "in line" before most institutional and retail investors, this is not the tipping point nor should it be the focal point of how HFT can negatively impact the typical investor. HFT technology and analytics can be superior even at a distance from the market center. Co-location is primarily about the HFT community competing with itself. In the end, whether a bid or offer is from a machine co-located within an exchange's data center or routed from a far-off location, we still need to make sure we are interacting at the price, size and time we want.

In all cases, Instinet's job as a broker is to interact with the market in a manner that produces an execution designed to match our clients' motives. Best execution is not just about trading within the national best bid or offer. We must be wary of any information we are giving to market participants not only through prints on our executed shares but also through signals they can detect from our unfilled orders. But best execution is also about finding liquidity, whether it's lifting a 100 share offer or hitting a discount bid on a large block. It is for this reason that Instinet invests heavily in our people, technology and quantitative infrastructure. All three working together allow us to determine the right price, the right time and ultimately the optimal destinations for our client's orders. In this way, we protect our clients' information and dictate how we interact with players in the market.

We are happy to discuss any of these topics in more detail and look forward to feedback from our client community.

Sincerely,

Jonathan Kellner

Jonathan Kellner
President
Instinet, LLC