BRIEFING BOOK

INTELLIGENT INVESTING WITH STEVE FORBES

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TIM MAHONEY

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ABOUT TIM MAHONEY

Intelligent Investing with Steve Forbes

Tim Mahoney is chief executive officer of BIDS Trading, an alternative trading system. He's also a board member of the New York Block Exchange.

Before BIDS, Mahoney was head of equity trading at Merrill Lynch Investment Managers for seven years where he was responsible for a 14-person, 24-hour trading desk that traded over $100 billion in equities. Mahoney worked in Merrill Lynch's unit investment trust department for 16 years holding various positions, including head of equity trading and chief investment officer. While at Merrill Lynch, he helped create the popular "Dogs of the Dow" series of investments. Mahoney began his career at Merrill Lynch in 1979 as a summer intern on the floor of the American Stock Exchange.

Mahoney has been a member of the New York Stock Exchange's institutional advisory committee and market performance committee. He also served on advisory committees at Nasdaq Stock Market, the Boston Stock Exchange and the Investment Company Institute.

Mahoney got his bachelor's in history from College of the Holy Cross and his MBA from New York University's Stern School of Business. He is a certified financial advisor.

DEBRIEFING MAHONEY

Intelligent Investing with Steve Forbes

Interview conducted by Alexandra Zendrian
October 26, 2009

Forbes: How would you explain what BIDS Trading is?

Tim Mahoney: Starting in 1997, as the market became more electronic-based and certainly after 2001 when it went to decimalization, it became increasingly difficult for institutions, which are primarily mutual funds and pension funds representing individuals, to trade stock. For example, a portfolio manager wants to make a change in their portfolio. He most likely will end up trading several million shares of stock and what happens is if you try to trade several million shares of stock, you could, by the act of trading that stock, be disruptive. Your returns, the actual returns that you as an investor get at the end of the day, are really predicated on not just picking the right stock, but being able to buy it effectively. So if the stock was $20, and the portfolio manager wanted to buy it because he thought eventually it would be worth $25, that's a very good return. He's making $5 on a $20 investment. If, however, in the act of buying it, he pushes the stock from $20 to $22, in the act of selling it, he takes it from $25 to $23, he will have only made $1 return on a $20 investment, which is not nearly as good.

So the institutional community for the last couple of years has tried to figure out, in an electronic marketplace, how do you create a venue where you can trade stock efficiently? And BIDS Trading was a response to that. We were originally formed by a consortium of sell-side firms in response to that and as a buy-side participant's need for a market where you can trade blocks of stock with both buy and sell-side participants. In our venue, what's fairly unique is we allow the buy-side to come in but we also allow the sell-side to come in. The sell-side tends to use a lot of algorithms to trade stock, so it provides the perfect environment where the buy-side participant can trade against algorithmic flow and you also have other buy-side participants. So we've created a venue where natural blocks can occur as well as virtual blocks trading from some sell-side sources.

Why did decimalization have such an effect on trading?

In a pre-decimalized world, we were trading in eighths and quarters. So if the market was 20 1/8 to 20 ¼ , you could bid out loud, so you could display your interest to buy stock at 20 1/8 and the most that would happen is that someone would sell you stock at 20 1/8 because the increment between the bid and the offer was an eighth of a point. But if the market is in decimals and you say I'd buy stock at $20.10, a participant could come in and say, "Oh, no, I'll pay $20.11." So, in fact, if you displayed a bid, there's a good chance that another participant could come in ahead of you because they realize there's a buyer around, taking advantage of the information that you have with your order. They could buy it at $20.11 and try to sell it to you at a higher price.

That's sometimes called penny jumping; the first complaint of it was against the specialist community at the New York Stock Exchange. What this actually did was disintermediate true buyers and sellers. That's gone away now. Now what they have is the truly best displayed bid and offer for you to trade at.

High frequency trading, and the complaints against high frequency trading, is that a high frequency trader will attempt to detect a buyer or a seller and in our scenario they would say there's a 10 cent bid for stock, they may try to buy stock at 11 and get ahead of you and take advantage of the fact that there's a buyer around in anticipation of that stock going higher. That is not legally front-running but it's information gathering that allows trading to occur in a way that betters someone other than yourself.

What do you say to counteract the public's negative view of dark pools?

It sounds nefarious but it certainly is not. Non-displayed liquidity has been around forever. If you read the minutes of the Securities and Exchange Commission open meeting, every one of the commissioners and all the staff recognize that this is not a new phenomenon. What's new is that it's taking place in an electronic marketplace. If you're trying to buy a block of stock or sell a block of stock; if you invest in mutual funds, this is a problem that your manager faces, you need to do it in a very efficient way. In an electronic marketplace, you need to a create a market where it's efficient whether you as an investor want to come in and buy 100 shares or 1,000 shares of stock, you want to do that very easily, but you also want to provide a mechanism for very large trades to occur.

The U.S. market structure is very complex for good reason, because it allows both to happen relatively easily. In a displayed marketplace like the New York Stock Exchange or Nasdaq OMX Group, people are able to go in very quickly and have a quick execution time for trading 100 shares of stock. For an institution, they have to take advantage of more complex strategies, so they can go to a broker-dealer and use an algorithm to slice the order into smaller pieces or they can come to non-displayed liquidity centers like BIDS where you can trade stock in a more institutional-like environment. Both of them are legitimate and they both make sense from a market structure perspective.

The name just sounds wrong, and I guess if I could do one thing I would change the name to just call it non-displayed liquidity rather than dark pools.

Can you trade large blocks and smaller amounts anywhere?

Inside of BIDS, for example, we allow both types of orders to exist because we give participants the ability to set up a minimum size. The important aspect is how you exchange that information. If, for example, you're the buyer of 100 shares of stock, you have a lot of 100 share prints, each time you buy 100 shares, you give out a little information to the market. Other participants in the market might take advantage of that information and trade against you. One of the ways you control that information is to say, "I'll buy stock, but I want to buy a certain minimum size. So I want to buy 10,000, 15,000 or 100,000 shares. And if I could buy 100,000 shares, I'd be glad to trade right then and there. But if I can't, I don't want to."

And in fact, one of the things we did when we created the New York Block Exchange is really say not only is the size important but occasionally size might be more important than the price. So, for example, with the 10 cent bid and the 12 cent offer, and I want to buy stock, I very well might be willing to pay 15 cents to buy 100,000 shares of stock because once I buy that, I've let information out into the marketplace, but if I buy 100,000 shares of stock or 200,000 shares of stock, that was worthwhile to me. Of course, you always want to start out trying to buy stock at the best available price, but each trade is different, each trade has a different sense of urgency attached to it.

So your portfolio trader at a mutual fund might come in as a value investor and he may say, "I want to buy a million shares of stock. I don't want to pay more than 10 cents and I don't care if it takes me two months to buy it. I'll accumulate it slowly over time, but what's most important to me, more than anything else, is price." On the other side, you can have a growth investor who says, "This company is going places; it's going places really quickly. I'm looking at my models and I've seen this happen before. I want to buy a million shares of stock but I want to buy it in five days, as quickly as I can." You as an institutional trader, ultimately on behalf of a bunch of retail customers, want to be able to do both. So a venue like BIDS allows you to do both, allows you to interact against the New York Block Exchange where you can interact against displayed liquidity, and also allows you to interact against institutional trading as well.

How is the New York Block Exchange doing?

The New York Block Exchange is less than a year old, so it's really hard to make any real substantive guesses over it, but we're very pleased with the early functioning of it. Volume takes a long time to build. It is meeting our expectations on the ramp up; it just takes a real long period of time.

In the context of BIDS and the New York Block Exchange, the combination of those two work very well. The BIDS product actually gives you, an institutional investor, the opportunity generally to trade within the national best bid or offer. That's where most currently existing dark pools do all their business. We believe you also have to give people the tools to trade outside of the NBBO. You have to give both. With the New York Block Exchange and BIDS in general, we're really providing a wide-range of services to our customers by allowing them to trade in a variety of different ways.

The end stories of new products play out, unfortunately, in not just days or weeks or months but they play out over years. And I think our investor base has built a lot of new products and they certainly understand that things like this take time to build. Connectivity, the usage, showing people how things are used, those little milestones along the way gauge what are people's responses, what the actual feedback you get from it. And I think at this point, looking at our projections, we're satisfied with where we're going.

What did you make of the SEC's recommendations on dark pools? [The SEC's proposes that actionable indications of interest should be treated like quotes and it wants to lower the threshold for displaying best-priced offers from 5% to 0.25%.]

There was very little surprise in there. I think if you're immersed in watching the SEC for the past couple of years, not just over the past several months, there's been very much some concern that dark liquidity makes perfect sense to the institutional investor but the dark has to be dark. So I would have said philosophically that was an obvious start for them. And it gets into a gray area for them, so if you have dark pools sending out actionable indications of interest only to certain participants, that's problematic for them because it can create a marketplace that's not fair and open to everybody. So I think they've been pretty fair and clear on that. I think if you look at the first of the three things they said, you're certainly redefining what a bid and offer is. And lowering the threshold for the display portion of the rule makes perfect sense because that is going to limit the ability to have actionable IOIs coming out of dark pools.

On the last thing they have, which is to have more disclosure, I think generally that makes sense too. I think over time, and certainly during the public comment period, you'll hear a bunch of institutional investors express their concern around that. Personally, having spent 20 something years as a buy-side trader, I think it's okay. I think the marketplace is pretty efficient. I think that while you may not want to disclose the venue you trade in, as a practical matter, most participants who want to know will figure that out. And you have to disclose the trade when it occurs. The only issue right now is do you not just disclose the traded amount, I traded 10,000 shares of stock, but that I traded 10,000 shares of stock in BIDS. I guess I don't think it's a big deal. We'll be glad to go whatever way the final rule comes out and we don't consider it to be critical. And we think the other two proposals on lowering the threshold and effectively defining what a bid and offer is makes perfect sense too in the context of the marketplace we're in right now.

MAHONEY IN *FORBES*

Intelligent Investing with Steve Forbes

Intelligent Investing Panel

The Wall Street Of The Future

Alexandra Zendrian, 08.17.09, 06:00 AM EDT

New technologies and rocket scientists will propel Wall Street into the future, but compensation and business models sorely need reform.

What a year Wall Street has had. Its name got dragged through the mud in the 2008 presidential election when everything was about Wall Street versus Main Street. The Bernie Madoff Ponzi scheme sapped confidence in even the most dependable advisers, and protests and public outcry erupted over Merrill Lynch and **American International Group** bonuses. The Street's got some growing up to do.

Tim Mahoney, chief executive officer of BIDS Trading, hearkens back to Mark Twain's words, "rumors of my demise were greatly exaggerated," when thinking about the future of Wall Street. He thinks of Wall Street as a "living organism that keeps changing" and believes that the rising education level of Wall Street's denizens, along with new technology, will catapult the financial sector to new highs.

Still, more regulation is a given. Mahoney anticipates over-the-counter derivatives to be closely watched in the future, possibly on an exchange such as the New York Stock Exchange, **The CME Group** or **The InterContinental Exchange**

Jonathan Corpina, senior managing partner at Meridian Equity Partners, wants to see a lower tolerance for traders who break the rules. "If they can take your license away for driving drunk, they should take away your license for breaking securities rules," he says. He urges higher penalties and longer suspensions to make sure that these rules are taken seriously.

Bill Singer, securities attorney and Wall Street sage, thinks that brokers should be judged on a strict point system the same way drivers are. Get too many points on your license, and it gets yanked. (See "Bringing Consistency To Wall Street.")

Incentives for traders and Wall Street executives will also need some work. "If the incentives stay the same, which as of today, they look like they are staying the same, which is people are working with other people's money and taking risks on other people's behalf and being paid for it today," says Ken Shubin Stein, head of Spencer Capital Management. He adds that pay needs to be tied to a longer period of time, as risk takes a while to be born out.

Gary Shilling, president of A. Gary Shilling & Co., yearns for the business model of yore. "You know, the classic spread lender. They take deposits. They lend them out. They hold the loans. They have the risk. They have incentive to make sure that the borrowers are going to be able to pay the money back. That model, of course, went out with high-button shoes," he says.

The amount of leverage that was used in our financial system will also need to be cut down tremendously. Shilling notes the economy increased its leverage for the past 30 years and that now the Street will consolidate as firms pay off debts and shrink balance sheets.

"We have a market structure right now that caters to traders and disenfranchises investors," says David Weild, senior adviser at Grant Thorton LLP. His firm encourages creating a parallel market structure that companies can opt into, which will be more focused on creating revenue for research and value for the retail investor. As spreads have tightened and compensation has changed, the quality of research available to retail investors and offered by research firms has declined, Weild says. The average tenure for an analyst on the Street is three years, and the present compensation system favors the buy-side, he says. "As a result, the quality of research available to the retail investor has deteriorated," he says.

Weild would also like to see real-time reporting of trades done by high frequency traders so that there can be better monitoring of trading. Bernie McSherry, senior vice president of strategic initiatives at Cuttone & Co., also foresees a public backlash against high-frequency traders who step in front of retail orders.

Since the big brokerages, such as **Morgan Stanley** and **Bank of America**, have had to focus on maintaining their businesses, independent boutiques have been on the rise. "Regional and boutique brokers could get stronger as brokerage houses are distracted by mending their fences," McSherry says.

Others hold out less hope for the future of the Street. "The main concern I have about the future of Wall Street is that I just hope that the United States has learned some lessons. And that we have the political will to make the reforms we need. Because the world isn't going to wait for us," says Bill Singer, shareholder at Stark & Stark law firm. He anticipates that Americans will be saving much more and investing less as a result of the recession and lack of trust in Wall Street. "I think our generation is going to become like our grandparents, who all they talked about was how they lost everything in the Great Depression. And that affected everything they did from there forward."

The Future Wall Street

Forbes: This may be a broad question, but what the heck. This was sent in by Bill Singer. What is the future of Wall Street? Do you think that Wall Street will fully recover its stature from this recent recession and various affairs, including affair de Madoff? What will likely be the future of Wall Street on the economic stage? And what will the financial marketplace look like in five to 10 years out? Fairly big topic, of course, but what the heck? We've got some great brains on the phone. And I wanted to see what you guys thought of that.

Gary Shilling: First of all, greed has not gone out of style. I mean, it's been temporarily tempered with fear. And with big losses and regulators and government coming down the throat of Wall Street. But I don't think that we can count on the change in human nature. And I was very much impressed by Ken's point that there's been no genetic pressure to change psychology in thousands of years. I think that's a wonderful point. And the way I put it, human nature doesn't change over time, if at all, only slowly. The same idea.

But in any event, yeah, I think that you can expect recurring cycles. So, the question is, though, how long is this one going to be dampened. And the reality is our analysis shows that the financial structure of this economy was expanding its leverage for literally 30 years. This was in a matter of a couple of years, it really went back three decades. You know, culminated in the dot-com blow off in 2000. And then, of course, things shifted over to the real estate area. But also to private equity and commodities and emerging market and equity. All these old terms that everybody thought were going to give them diversification and improve their returns. Neither of which worked, by the way, last year, of course. Because everybody was on the same side of the same trade, at the same time, when they were bailing out of stocks. They were bailing out of all these other one of investments.

But the point is that it just, you know, I think for the next five to ten years, we're probably going to be in a consolidation mode. A deleveraging mode in the financial structure. The people who are embarrassed are not going to go back to wild speculations. The regulators are going to make it very hard for them to do that. And as a result, Wall Street is not going to be the way it was.

The only remnant that we still have of the good old days, let's say, are the bonus levels. But they're so huge that one way or the other Washington is going to take the fun out of that game. So, I rather suspect that we're going to see a period of years here, where the best and brightest from, you know, Harvard Business School, Stanford are not going to head to Wall Street. I'm not sure where they're going to go. Now, that's an interesting question. But I think that we're going to see probably five to 10 years where the action is somehow going to be elsewhere. And the ability to come and in a couple of years make, you know, $10 to $20 million a year is just not going to be there.

Kenneth Shubin Stein: Can I comment on this?

Forbes: Please, yeah.

Shubin Stein: First I would start by I agree with everything that Gary said. One thing I would add as a thought of what might continue to be true is given that incentives drive behavior, as long as the banks are set up such that the incentives for the traders and people who work at the bank are to do things where they get paid today, but the risk is ultimately born by the company over a longer period of time, I think that will continue to drive some of the behavior we've seen in the past. Although I completely agree with Gary. It's going to be at a lower level.

One of the reasons it will be at a lower level is the banks will probably give people less leverage to work within their proprietary trading pools. And the banks, hopefully, will reign people in a little more than they used to. But largely, if the incentives stay the same, which as of today, they look like they are staying the same, which is people are working with other people's money and taking risks on other people's behalf and being paid for it today.

And, you know, that's exactly the problem with most insurance underwriters. Which is why Greenlight Re is such a special company. Because they solve for that problem. So what would be great is if more banks looked to the model that Greenlight Re has to try to solve for that problem. Because it's a very, very well-known problem on Wall Street. That people take risks on the bank's behalf and get paid today for risks that stretch out many years.

Shilling: You know, that's a very good point. When you look at banks, if you go back to Jimmy Stewart's Bailey Building and Loan. You know, the classic spread lender. They take deposits. They lend them out. They hold the loans. They have the risk. They have incentive to make sure that the borrowers are going to be able to pay the money back. That model, of course, went out with high-button shoes. And we now have the banks who, you know, they're not content to make a decent return and pay a nice dividend to spread lenders. They want to be growth companies.

And as you point out, their access to capital has been pretty much unlimited. And you give proprietary traders and other people involved in this kind of thing the ability to leverage tremendously. You know, if you leverage at 21, hey, you make 5% on the gross, you make a 100% on the net. Of course, if you lose 5%, you're out of capital. But the point is, the banks have obviously expanded well beyond spread lenders.

I think the real question is when we get all through here, as you're suggesting, are they going to be reigned in? Is fear among the participants, plus the regulators, going to simply push them back into spread lending? And sure, the risk will be taken whether it's in private equity or hedge funds or elsewhere remains to be seen. But the point is, when you're dealing with depositors' money. And direct or indirectly using that to fund tremendous amount of speculation. And then the whole thing goes up in smoke. It creates a very problematic situation for the banks.

Forbes: As Ken would say, it creates in incentive to go back to spread lending.

Shilling: Yeah, right.

Forbes: I'm putting words in your mouth, Ken. Maybe you don't believe that. Another point, George Bailey today would be trying to get a federal bailout. He'd get bailed out by the townspeople. Bill, what are your thoughts, as it was your question, initially?

Bill Singer: Well, I just think that a lot of people fail to appreciate how significant the geopolitical change is that we're going through. And what I at least believe is going to be. I think that we tend to forget that although history can be cyclical, that civilizations and empires come and go. There's no more Mayan and Aztec empires. There's no more Roman or Holy Roman Empire. And the British Empire is certainly either nonexistent or a shadow of itself. And I think to some extent, Pax America, which was the postwar prosperity that the United States led, I think, to some degree, is over.

I don't think the United States will ever become a secondary power in my lifetime. But I certainly don't think we will be the sole, dominant superpower. And certainly, I think, what Wall Street has to understand, and I think the investing public will come to understand, is that the investing world is beginning to move East. And to the extent that we are moving, in some degree, in a power sharing mode. We're going to be going to societies and cultures that have different religions, different philosophies, different medicines. And certainly China is a communist country. And India and Brazil have somewhat different economies and fiscal idea than the United States. And I think that is going to need to be made accommodations.

So, at the end of the day, I think that many of the changes that we're witnessing in the United States today are going to be generational. I, for one, believe there will be less spending compared to what we used to do. I think there will be a higher savings rate. I think our generation is going to become like our grandparents, who all they talked about was how they lost everything in the Great Depression. And that affected everything they did from then forward.

I think this generation that's lived through this recession is going to be very materially changed. And as a result, the caution I would give to most people is that the Wall Street of the past, which was solipsistic, everything revolved around the United States. I think that's over. And I don't think that necessarily means the demise of our country. I don't think that's correct. But I think we have to become more international in scope. And we probably have to accept the fact that the prism that we see everything through, not only may it not be correct, but it's certainly not the same prism that China and India and Brazil and other countries are going to look through the future. And it's certainly going to be exciting times.

So, I think that the future will be for nimble minds. And there will be tremendous opportunities for people to profit worldwide and probably in the United States. And I guess the main concern I have about the future of Wall Street is that I just hope that the United States has learned some lessons. And that we have the political will to make the reforms that we need.

Because the world isn't going to wait for us. And if we don't get our house in order, I just think things are going to move on without us.

Intelligent Investing Panel

Wall Street's Hiring Again

Alexandra Zendrian, 09.01.09, 04:00 PM EDT

Morgan Stanley is hiring hundreds of new traders, showing that Wall Street is once again taking risks and expanding.

Once again **Morgan Stanley** is on the hiring path, looking to lure 300 to 400 new traders and sales staff globally. While this move may appear far removed from your bottom line, the actions of one of the few remaining Wall Street titans bears scrutiny. It not only means that the firm sees flusher times ahead, but that your trades could become cheaper and easier. Perhaps most importantly, though, it signals that Wall Street has regained its appetite for risk.

This new **Morgan Stanley** staff will be focused on foreign exchange, emerging markets, sales and equity derivatives. These traders will be hired through the end of this year; about half of these traders have been hired already, according to a person familiar with the hiring. These are new positions, not replacements.

It's a flush signal, says Greg Ghodsi, the head of the 360 Wealth Management Group at Raymond James. As Morgan Stanley hires more traders, it is also putting more capital into the market, he says. This additional money will increase liquidity, tighten spreads and lower costs for investors. An additional thought: Hiring people in these areas also shows that the market's appetite for risk is coming back.

These new hires are part of the cycle on Wall Street of firing too many in downturns and hiring back when the market seems stronger, Ghodsi says. Raymond James has also done some hiring this year, with 400 financial advisers being hired in the past year, he says. The firm has also hired some research analysts and investment bankers. Firms hire people when they are confident that more business will be coming their way to sustain the new employees, so Morgan Stanley and Raymond James are among firms that are stepping out.

Retail investors could reap the benefit of more trading help in the foreign exchange and emerging markets areas. With more professionals giving advice on these investments, it could mean a better opportunity to diversify into areas that a retail investor might not have previously considered, says Matt Samelson, Woodbine Associates founder.

More traders also equals a greater chance of achieving best execution on your trades, says Matt Lloyd, chief investment strategist at Advisors Asset Management. Also, with more traders and more capital in the market, investors will have more opportunities to get their investments at a cheaper price.

Newly hired traders will also likely have smaller salaries and other compensation benefits than they would have been a few years ago, pointing to one way Wall Street is dealing with its new reality. "The wake-up call with regard to the bonuses will cause a shift in some unemployed qualified personnel to work for less, thus potentially accelerating the recovery in the financial industry," Lloyd says.

These new traders might make half what they would have a few years ago, says John Osbon, founder of Osbon Capital Management. Still, he is skeptical of the need for more trading talent right now. "Rehiring 400 traders at Morgan Stanley to me is a little like **General Motors** calling back its assembly-line workers to meet the demand from the Cash for Clunkers program," he says.

Vince Farrell, chief investment strategist at Soleil Securities, sees these Morgan Stanley hires as a way for the firm to better compete with **Goldman Sachs**. The two firms are often mentioned in the same breath as two of the stronger firms on the Street in the wake of **Lehman Brothers** and Bear Stearns. Goldman Sachs reported $13.8 billion in net revenue in the second quarter and Morgan Stanley reported $5.4 billion in net revenue that quarter. Despite this Morgan Stanley still reported a loss overall of $159 million. Both firms repaid the $10 billion they were granted through the Troubled Asset Relief Program in June.

In the middle of the market downturn, as jobs were being shed at the larger firms, a lot of the smaller trading shops picked up talent. With Morgan Stanley hiring aggressively, that trend could be reversing, with more trading professionals being scooped up by the bulge brackets. Tim Mahoney, chief executive officer of BIDS Trading, anticipates large firms like **Credit Suisse Group** AG, **UBS** AG, **JPMorgan Chase** & Co., Goldman Sachs and Morgan Stanley, gaining market share for the next 12 to 18 months. Buy-side firms want a wider array of goods and services for the commission dollars that they send to sell-side firms which some smaller trading shops can't provide, he says.

Greg Treacy, head of U.S. sales at broker firm Neonet, foresees many firms in the same category at Morgan Stanley, including **Citigroup Inc.**, **Bank of America Corporation** and **Deutsche Bank AG** hiring more traders because with trading risk often comes profit.

"These firms will be making risky choices, some out of necessity," he says. Firms that shed a lot of people, such as Bank of America with its acquisition of Merrill Lynch, have begun rehiring, sometimes some of the same people that were let go, he says. Firms will look at trading as a source of profits despite the potential risks. "Particularly in finance, we have short memories," he says.

Ride The Wave

Forbes: In the news, Morgan Stanley is hiring 400 traders. What do you make of this and do you think that this is the start of a big hiring push in trading?

Also, to what end should the retail client care that the trading firm that they use, or another trading firm, is hiring traders?

Matt Lloyd: The market making and liquidity in the capital markets was one of the most impacted of all the areas in finance, but got very little publicity. Those involved knew the impact, and since some are beginning to see the return to normalcy (again, relatively speaking), many are capitalizing on this market disruption. It is a very important signal in a return to a healthier capital market and should be well received by investors.

Every investor of every size should care about the firm they use for their trading. In the future, a more regulated market (though we are still unclear on how far the new regulations will go) will assist investors in their choices.

More importantly, a rising number of competitive choices may potentially assist investors of all types in attempts to get best execution. That is good for all parties.

John Osbon: Financial firms are in a highly cyclical business, almost commodity-like. Rehiring 400 traders at Morgan Stanley to me is a little like General Motors calling back its assembly-line workers to meet the demand from the cash-for-clunkers program. The industry needs to shrink dramatically.

Morgan Stanley is being opportunistic, since I would bet the salaries are 50% lower, and with fewer incentive clauses. I believe this event, and others like it that are sure to follow, has no significance except for the people hired. I am glad they have jobs.

On the second question, a retail client should care first about security, and second about costs. It costs close to zero to trade, so those retail clients who are paying commissions are paying too much.

On security as long as clients don't exceed SIPC insurance limits--$500k I believe, then they are OK at any SIPC protected firm. If one has more assets, than one needs to do research and vetting proportional to the size of the assets.

Forbes: Speaking of compensation, thanks for mentioning it John, do you think that might be the way to go from here on out, firing the trader who's bonus is really overinflated and replacing him with someone cheaper? That seems like a common practice in other industries, particularly in tough economic times. Can that be done in this industry?

Osbon: It's about time. You have a bright future in Morgan Stanley management, because that is exactly what management is thinking I would guess. People are more fungible than they believe themselves to be.

Lloyd: Capitalism will seek out those people and processes that are inefficient and build a better mousetrap. So long as the reward is tangible, this will always be the case. Finance will be no different. The wake-up call with regard to the bonuses will cause a shift in some unemployed qualified personnel to work for less, thus potentially accelerating the recovery in the financial industry. When financial based companies believe they will be able to potentially grab a larger share of trading profits that previously had gone to bonuses, one may see an increase in the capital willing to be at risk.

Forbes: But to what extent can they lower these traders' salaries? Some people get into that business in part because of the large salary that isn't found in other areas. And lots of people argue, both with trading and in other areas, that to get the best and the brightest you need to pay salaries to obtain the best and the brightest.

Osbon: It pains me to say it, since I like to see people making money, but Wall Street is absurdly overcompensated. I would go so far as to say that anyone who is making over $1 million and believes he or she is worth it is simply breathing their own exhaust. It used to be that doctors, lawyers, professionals, traders and so on made about the same amount of money, and the successful ones in each area were able to do quite well. Then something happened. Wall Street disconnected sometime in the '80s with comp and will reconnect in the 'teens, I predict. To claim that the top pros in each field are not worth about the same--maybe $250k for the managers, maybe $500k for the artists, and so on--is an illusion, in my view.

I would bet that if you held a new MBA trader's job auction, with the lowest qualified bidder getting the job, that you could cut compensation by at least 50%. If the winner doesn't work out, the runner-up gets the next chance. I would also bet that you would have a line of qualified people out the door bidding for those positions. I know this sounds radical. I also know that as the organizer of the event I would be the most unpopular person in the room.

Lloyd: Being the optimist, I believe this is going to occur; either radically or organically. Markets cannot remain inefficient for any great period of time. Just as we witnessed the transformation in the Accounting/Consulting companies from the Tech Boom in the late 1990s, so too will we see transformation in the financial industry as a whole. It is a very healthy transformation.

Forbes: Are there any other firms looking to hire that you guys are aware of? Or, conversely, firms looking, even now, to let traders go?

Osbon: I know of no one who is hiring in the financial area. Some firms, however, are materially increasing their investment in the business, with an eye toward raising standards, and gaining market share.

Lloyd: I cannot comment on this specific question for a multitude of reasons. Sorry guys.

Forbes: OK. Can you think of any firms that maybe aren't hiring now but are probably in the right position to hire people? I know a lot of traders have talked about boutique research and trading firms being the new fad from people being laid off. Or the larger firms that have been more safeguarded from this financial downturn I would think are more apt to hire. What do you think?

Osbon: My amateur opinion is that if you are going to work in the industry smaller is better.

Lloyd: I don't think the overall transformation in the financial service industry would alter our investment strategy. We see far too many long term opportunities in various markets to defer investment dollars from any of the strategies that we discussed earlier to a few select firms that may or may not benefit from this shift.

I think our emphasis on foreign equity markets, just as John recommended, would be a higher priority for the above average risk profile. The globalization shift will be far more impactful than an adjustment with the financial industry.

Financial Regulation

Curb Your Naked Shorts

Alexandra Zendrian, 07.29.09, 11:00 AM EDT

Traders applaud the SEC's measures to deter naked short selling.

On Monday the Securities and Exchange Commission made what was previously a temporary rule about failing to locate a stock before shorting it permanent yesterday. This rule was put in place at the end of the last year in the midst of high market volatility to hinder naked short selling and bear raids. Naked short selling occurs when a trader doesn't borrow or locate the stock that he intends to short before he completes the transaction. This practice led to "failures to deliver," or stocks not being produced after the shorting transaction was completed, for long periods of time.

The now permanent rule regarding naked short selling, called rule 204, requires traders to produce the stock that they shorted within 3 days. If the stock is not produced, then the shorting transaction will be null and void and the broker will have to purchase the stock, says Jamie Selway, managing director at White Cap Trading.

He likes this new permanent rule more than the previous temporary one, which included a threshold list of stocks that had too many fails to deliver. Selway notes that the permanent rule is a much simpler version of its predecessor.

One area where this current rule might be lacking is that it doesn't protect against intra-day bear raids. These raids could allow traders to short a stock down to nothing in one day and three days later find the security to cover themselves, Selway points out.

Having to purchase the security, or "buy in", can be rather painful, as the stock isn't usually bought at the optimal price, says John Jacobs, chief operations officer at Lime Brokerage.

Traders were accused or orchestrating successful, rumor driven raids on Bear Stearns, **AIG** and **Lehman Brothers** as well as taking down the share price of **Citigroup** and **Bank of America**. No one has determined if bear raids caused the massive declines in those stocks of if traders were simply reacting to deteriorating fundamentals on Wall Street. A temporary ban on shorting financial stocks didn't seem to be effective as stock prices fell anyway.

The SEC will be hosting a roundtable discussion on Sept. 30 to discuss securities lending, pre-borrowing and possible additional short sale disclosures. Denise Valentine, senior analyst at Aite Group, says that one area the Commission is looking into is whether there should be a "hard locate" where traders earmark or otherwise secure the stock before they short it. Under this new rule, traders simply have to show that they have found the stock. Having an earmark placed on the stock could drive up the price of it, because it would be considered taken out of the market and thus affect supply and demand, she notes.

Firms could use hard locates more often as a result of this rule, which could drive the price of borrowing the stock up, says Keith Bliss, director of sales and marketing at Cuttone & Co. Securities lending could also become a bigger market with more third parties becoming middle men between buyers and sellers of stock, he says.

Though trading in general will be minimally impacted by this new shorting rule, some firms that made their money doing this will have to find another way to profit, says Jonathan Corpina, senior managing partner at Meridian Equity Partners.

The SEC's Office of Economic Analysis found that fails to deliver in the fall of 2008 were reduced by 57%. "This rule has clearly been a home run in being effective and we support it," says John Giesea, president of the Security Traders Association. The temporary rule was set to expire on July 31.

This naked short selling ban doesn't and shouldn't affect short selling, which is a legitimate practice to sell overvalued stocks, says Tim Mahoney, chief executive officer of BIDS Trading. "This helps to bring accountability to the market," he adds. Mahoney hopes this permanent naked shorting ban will restore investor confidence and bring more discipline to the market.

Along with the permanent ban, the Commission is also going to working with some of the industry's self-regulatory organizations to make short sale volume and other transaction data available. With the next few weeks, SROs will publish aggregated short sale volume on their websites daily. To increase transparency, the SEC will publish a twice monthly public of fails to deliver. Making this information available was part of another temporary rule which was set to expire on Aug. 1.

Intelligent Investing Panel

Don't Be Afraid Of The Dark Pools

Alexandra Zendrian, 05.18.09, 04:00 PM EDT

While the term dark pool might sound mysterious, they can provide price improvement and better quality trades for retail investors.

Dark pools are venues where trading is done off of an exchange to obtain price improvement and not move the price if a large block of stocks is being traded. While the term dark pool conjures up visions of dark alleys and one broker passing another broker stocks in a silver suitcase, they can be helpful for moving tough-to-trade securities. Still, why should dark pools matter to you?

One reason is since dark pools trade off of the traditional exchanges and often execute at the midpoint between the bid and the ask price, they can be a way to save you money.

"Although the term dark pool sounds very sinister, retail investors have nothing to fear," said Jamil Nazarali, head of Knight Capital Group's dark pool, called Knight Link. "Although the term dark pool is relatively new, the concept of crossing off exchange liquidity has been with us since the beginning of stock trading. Institutions have always crossed large blocks off exchange and the large sell side firms have facilitated this."

The executions done in dark pools are only hidden from the public and other brokers before and during trading. "I think it is important to remember that dark only refers to a pre-trade state. Once a trade occurs, regardless of the venue, it is reported to the consolidated tape," said Tim Mahoney, chief executive of BIDS Trading and co-developer of the New York Block Exchange, a joint venture between BIDS and the New York Stock Exchange.

Dark pools have been traditionally been used by institutional traders, who use them to execute large stock transactions without moving the market against themselves. But dark pools have evolved to give retail investors and smaller orders a crack at price improvement and better liquidity.

For example, some dark pools offer ways to trade portfolios of securities, such as Investment Technology Group's POSIT Marketplace. This dark pool features sector balancing, cash constraints and other offerings that help money managers maintain the balance in customers' portfolios. Sometimes when portfolios are traded on standard exchanges they can lose their exposure to certain sectors, such as automobiles, when brokers try to get a cheaper execution in another sector. By using cash constraints and sector balancing, a portfolio that was supposed to be long on tech stocks, for example, is more likely to remain so.

Retail investors should tune into dark pools as they may help their brokers benefit from lower hidden trading costs, said James Ross, head of NYSE MatchPoint, which aggregates brokers together to trade in the dark. Ross said dark pools could offer price improvement for retail investors with mutual funds and 401 (k) programs, as compared with standard stock market trades. "Because these funds bundle these investment interests into single trading decisions, they are extremely focused on trading costs," he said. "The size of their orders and … and their visibility in the marketplace can incur massive trading costs which ultimately are negative performance for the fund."

Dark Pools have some risks too. When information is leaked out of a dark pool it can lead to gaming -- such as when a broker discovers what securities are within a pool and is then able to step ahead of dark pool participants. Because of this dark pool users have to be aware of when they are sending out information that could cause their order to be pre-empted by another trader.

So while the average retail investor may not typically use a dark pool for their own trades, their broker may. And since dark pools can lead to orders being gamed, traders working on behalf of retail investors should ask the dark pools they use what kind of safety measures are in place.

In The Dark?

Forbes: Many buy-side traders are concerned about gaming in dark pools. Is this a legitimate concern now, and what are dark pools doing to reduce gaming?

Jamil Nazarali: I think gaming is a legitimate concern in that is does sometimes happen and buy-side traders should take precautions to detect and stop it. However, I think dark pool operators are getting better and better at detecting and throwing out the gamers. I'm not saying that gaming doesn't exist, just that it is probably much less prevalent than people think. Let's also remember that gaming also happens in exchanges, ECNs and other liquidity venues, so a buy-side trader can't stop worrying about gaming just because they are not using dark pools.

Forbes: Do you think fears of gaming should increase or decrease depending on whether pools use indications of interest or immediate or cancel orders? And for readers who don't necessarily know what IOIs and IOCs are, can you explain that?

Jamil Nazarali: Sure, first an explanation, IOI stands for indications of interest, they are often used to determine if there is available liquidity that can be crossed with your order. For example, if you enter a buy order for 100,000 shares of Stock XYZ into Dark Pool A, Dark Pool A may send indications of interest to Dark Pools B and C to tell them it is interested is trading stock XYZ, if either pool has a crossable order. Typically Dark Pool A will not disclose whether it is a buyer or a seller or how many shares are available to buy or sell. IOI's are typically used for large non-marketable orders.

IOC's stand for Immediate or Cancel. IOCs are used for small marketable orders. So, for example, if you want to buy 1,000 shares of stock XYZ and you send the order to Dark Pool A, if there is not a crossable order in Dark Pool A, it may send an IOC to buy 1,000 shares of stock XYZ to Dark Pools B and C. If Dark Pools B or C have a crossable order, they will execute the IOC and the customer will get a fill, if not the order will be canceled back to Dark Pool A and it will route this order to a public market for a fill.

In terms of gaming, although the use of IOC's disseminates more information (stock, size and side), it is much less susceptible to gaming because one, the orders tend to be small so the information is less useful to any gamer, and two, within milliseconds of the dark pool rejecting the order, it will be routed to a public venue for execution and not much is going to happen in that time.

The IOI on the other hand lends itself more to gaming, if I am dark pool B or C and dark pool flashes me an IOI in stock XYZ, I have a pretty good idea that there is a large buyer or seller in the market and that their actions will move the price up or down over time. If I am nefarious I could pretend that I am a seller of 500 shares, if Dark Pool A fills me, then I will know there is a big buyer in the market and I could start buying in anticipation that the big buyer will push the price up. This will hurt the buyer because he will end up paying more for his purchases since my actions in and of themselves drive up the price. On the other hand, again if I am nefarious and pretend that I am a seller of 500 shares and Dark Pool A does not give me a fill, I have a pretty good idea there is a big seller out there and I can equally manipulate the situation to my advantage.

Of course there are protections to prevent this, but yes the use of IOIs does increase the risk of gaming. I don't think the IOCs increase the risk very much.

James Ross: Jamil's points are well made. I do think there are two elements to address gaming. The first starts at the dark pool design level … often times how a dark pool is designed can minimize or increase the risks of being gamed. Like Jamil said, it is the trader's responsibility [or best interest] to understand these risks. Second, there is the surveillance, oversight and enforcement layer that is also critical to identifying abuse not just within a single dark pool but across ATSs, ECNs and exchanges.

To be sure, the dark pools that are broker-owned have a vested business interest to make sure they surveil and address abuse. Otherwise traders would not go to them. Exchanges, though, do have a more robust and independent surveillance and oversight process. And the enforcement can be, well, career changing for those caught contravening Exchange rules and securities laws.

Forbes: So speaking of regulation, do you anticipate regulation regarding IOIs and IOCs? Would that be helpful? Is there a good reason to use IOIs or IOCs?

Jamil Nazarali: I don't anticipate any new regulation in the near term, regulators have their hands full right now with a number of more important things. I actually don't think that regulations would help in this area. It is in the best interest of Dark Pool operators to stamp out gaming in every form, and in general they are doing a great job, but it is very difficult to get rid of it completely. I don't think regulators are going to be able to find any magic bullet to stop this, and if they could the Dark Pools would gladly implement it without the need for regulation.

James Ross: Regulation of dark pools. This is a very important issue. There are two areas that I feel demand reform and they revolve around the ATS (Alternative Trading System) industry. As I said earlier, it is imperative for traders and investors to be able to understand the particular benefits and costs of a dark pool so that they can make an informed decision about participating in it.

Currently there is no regulatory requirement for an ATS to exactly disclose how it operates and processes its orders. There is no requirement for the public disclosure of how an ATS dark pool works. From an Exchange facility front, before a share is traded it must go through a rule-writing process with the Securities and Exchange Commission, which lays out how the system works. Once a "draft" version of the rules is agreed upon between the SEC staff and the exchange, the SEC posts these rules for public comment and response. Only after that can the exchange formally adopt the rules, publish them on their Web site and begin operations. This is the level of operational transparency that the ATS industry needs right now.

And then second and equally important … ATS dark pool trades are printed on FINRA "Trade Report Facilities" (TRF) sponsored by exchanges. Today over 35% of ALL U.S. equity trading prints on TRFs and all ATS dark pools print there. Problem is there is no way to distinguish one ATS dark pool trade from another! Millions of trades occur in over 50 different and unique dark pools, internalizers and ECNS (all of whom have different (undisclosed) operating and business models) and no one can determine which dark pool did the trade. For this reason alone, no one can do comparative analysis between dark pool trades, get a real understanding of dark pool volumes or even do their own trading cost analysis.

Anonymity and order opacity benefit all investors but not disclosing operational models and hiding ATS dark pool trades "in plain sight" on a TRF undermines our marketplace and impacts investors negatively and unnecessarily. Operational transparency and trade attribution are "must haves" for all ATS, ECN and Exchange markets!

Information has value. Dark pools are "dark" or non-displayed in order to not disclose information about the trader's identity or, in varying degrees, the order information. All dark pools do not disclose the identities, but after that there is a wide range of ways dark pools handle order information. NYSE MatchPoint, which is an NYSE exchange dark crossing facility, does not disclose any order information. Other dark pools may show symbol and side, send single or market-wide IOIs or set criteria such as minimum participation requirements so that when an IOI message is distributed either to a single contra-side or a marketplace, there are ways of "reading" into the order information.

I particularly like the fact that MatchPoint, as a point-in-time crossing network, aggregates multiple buyers and sellers in a single trading moment … so that even the users do not know if they traded against one or many contra-side users. Whether reading the tape, getting IOIs or seeing partial order information all of these have informational value and a COST to the trader but these "disclosures" can also bring needed liquidity when immediacy is critical … as long as the trader understands how these dark pools work and their associated costs for their value. That is very important.

Forbes: Do either of you think there is something to be gained from sending out IOIs or IOCs, namely that a trade that maybe couldn't be completed otherwise because a trader can't find the other side, can now be completed?

Jamil Nazarali: Absolutely IOIs and IOCs have value. If dark pools send an IOI out to multiple venues, they will often source liquidity that would otherwise be unavailable. Also, the trader always has the choice, typically dark pools give you the option of not having your IOI sent out or if they don't you can decide not to use that dark pool. So there are risks but also great benefits; it is really up to the trader to decide if the right trade-off between benefit and risk.

BIDS Trading

Steve Forbes: Well, Tim, good to have you with us.

Tim Mahoney: Thanks very much, Steve.

Forbes: You have BIDS Trading.

Mahoney: That's correct.

Forbes: What is BIDS Trading and how is it different from a firm such as Direct Edge and BATS and some of these other exchange alternatives?

Mahoney: So, BIDS Trading would be a non-displayed ATS, generally referred to as a dark pool. And the genesis of non-displayed liquidity comes from the changes that's happened in our market structure over the last 10 years.

Forbes: Now, can you tell us -- non-displayed liquidity for the general investor?

Mahoney: Sure. So, if you think about it, here's what we try to solve a problem for, and you'll understand the differences. The displayed marketplace is what we're all familiar with where you can actually see a bid or an offer. Non-displayed, that doesn't exist, you don't know what's there. And what it does is allow the institutional investor to trade size. So think about this -- if it was in a displayed marketplace, if you had to trade a hundred shares of stock, it's great to know that the market is a 10 cent bid, 12 cent offer because you're going to go buy a stock at 12 cents.

Forbes: So, if you wanted to buy XYZ at $20 and the bid is $20.10, you know there's a 10 cent spread.

Mahoney: And that's great for you. So, as an individual investor, that's great. The individual investors who've chosen to use a mutual fund to invest in, the mutual fund investor, that was my background, I worked for a long time for a mutual fund.

Forbes: So there you might do a million shares.

Mahoney: Yeah. So my portfolio manager would run $20 billion, he was a very smart guy, he would want to put a 3% position on a stock, he'd need to buy or sell 20 million shares of stock. If you go to a displayed marketplace, where everybody can see what you were doing, and you said you had 20 million shares of stock to buy, you'd be disruptive to the supply and demand equilibrium.

And in fact, what would happen is you would not just attract sellers because that's okay, but you might attract buyers who said, "Oh, there's a big buyer around, I'm going to buy in front of him and sell him stock at a higher price." So, for my friend who's a portfolio manager, the challenge was not just having a good idea, but actualizing it. And how do you actualize it? Well, the displayed market is one venue, but for an institutional investor, particularly after 2001. In 2001, the industry made a major transformation; we went to decimalization. So, in markets where you had a quarter spread, if the market was $20 bid, $20.25 offer, I could, as an institutional investor, which I was a the time, go to the floor of the exchange and bid $20 out loud, to some extent, because it was very hard for somebody to get ahead of me. And I would actually attract people as a seller.

And people wouldn't be trying to buy, it depended on how much was I trying to buy, but it was very expensive for people to pay up a quarter to take advantage of me, knowing there was a buyer in the marketplace. When it went to decimalization, if it was $20 and $20 and a penny.

Pennies Make It Easy

Forbes: A penny is very easy to do.

Mahoney: Very easy and very inexpensive for somebody to take advantage of the information embedded in my trade and my investors suffered. Again, my friend, the portfolio manager had this great idea. I'm going to buy the stock at $20 and sell it at $25. Well, it's really good if I can buy it at $20 and sell it at $25. It's less good if I buy it and costs me $22 and I sell at $24. He goes from making a dollar on $20, you know, from five dollars on $20 to a dollar on $20.

So, market structure, places like BIDS, have been formed to create the opportunity to use non-displayed liquidity, which means that in BIDS he can come in and say, "I'd buy a million shares at $20, but you can't tell anybody. And I'm only going to buy a minimum of 100,000 shares." That means that if a small participant came in the marketplace and tried to probe the market to determine where the institutional buyer or seller is, they can't find him. It's not displayed, and it costs them 100,000 shares to figure out there's a buyer around. So what happens then is you only find other natural buyers or sellers of the big blocks trade. So a venue like BIDS allows that to occur. And I think what's really fascinating about the equity market structure is how well it's worked over the last 18 months. If you look throughout the world, we've been in a crisis, yet every day, you come in and the equity markets, you know the value of your stock.

It's because, you know, 30-something years ago, in 1975, we made changes to the Exchange Act where we had a consolidated tape and we had centralized clearing. And we all recognized the SEC as our regulator. So, what that means is whether you trade in BIDS or the New York Stock Exchange or Arca or BATS, the moment that trade happens, you display it to the marketplace. And you all settle in the same place; there's no counterparty risk. And the SEC has jurisdiction over everything you do. Take a look at what's happened in derivatives. The problem is we don't know who the regulator is. You don't know the value of what you have in there is.

Forbes: You don't have the volume.

Mahoney: You can't settle it. So, a dark pool has pre-trade lack of transparency. So, there's dark before the trade occurs. But once the trade occurs, you display it to the world. I think it's a very legitimate way to go in a very complex world that we live in.

Forbes: So, in essence, the cards get shown?

Mahoney: After the trade, which is only fair. So, I'm glad to tell you I just bought 100,000 shares of a stock, I just don't want you to buy 100,000 before I can. And in fact, by telling you I bought 100,000 shares of stock, that's legitimate information that the market should have.

Dark Is Hideous

Forbes: Hideous word, define, you know, having things like dark pools or other things. Is there a better way to describe it that's more benign? Like helping the investor exchange?

Mahoney: Yeah, so there's quoted markets and there's non-displayed markets. And they both serve different purposes. So, a quoted market, if you want to buy 100 shares, it's very efficient to know where I could buy 100 shares. If you're trying to trade more complex situations, being able to not display the entire amount until after your trade is very helpful.

So, I think about the world breaks into, Erik Sirri, a former head of the SEC's markets and structure who has said there's a quoted market that has as part of the business practice, quoting. And then, there's a non-displayed market where that's not part of their business model. So, I thinking about it as quoted and non-displayed makes perfect sense. In that way, you can facilitate both the institutional investor and the retail investor. And again, the institutions, people who use non-displayed liquidity, are you and I. If you invest in a mutual fund, your mutual fund manager has an enormous challenge in front of him. Not only does he have to be smarter than the market, smarter than his peer group, then he has to actually go and do that trade in a very complex market.

And I think dark pool, as you said, just a terrible -- you expect it to be the next Harry Potter novel. Harry Potter and the Dark Pools. There's something nefarious about it. And in fact, it's not. It's not an official term, it's one that people have given it. It's analogous from my background in soft dollars. So, as I look back over time, people always thought soft dollars inside a mutual fund area was terrible. And really what it was was a way to separate content from execution. Over time, the SEC's done a wonderful job of better defining that. And that practice now, once people were suspicious of it, it's clearly recognized in the industry now as being beneficial to the mutual fund investor.

Forbes: So, how is BIDS different from things like Arca, BATS, Direct Edge?

Mahoney: Yeah. So I think what we've done is we've tried to create a open marketplace where we allow both the buy-side institutional investors and the sell-side institutional investors come in. We've tried to create a very flexible market that allows for a variety of different order types. And we tried to create a very low-cost venue. So, in a non-displayed world, as we think about our competition, what we've tried to do is create a unique opportunity, a new pool of liquidity that didn't exist anywhere else. We try to do it for a very low cost. And we recognize that the end user, we live in a world where customization is such an incredible part of the consumer story if you think about it. And I grew up, I loved to have my own songs, but I used to listen to albums. Now, I listen to on my iPod, it's the exact songs I want in the order I want them in.

So, if I can make customization easy enough, people will do it. If we allow people to have the flexibility inside of how they use systems, it'll be much more successful. Clearly, we cater towards an institutional community, to sophisticated people who have to use a lot of complex strategies to accomplish their goals.

Don't Lose Sleep

Forbes: So, retail investors shouldn't be losing sleep at nights about dark pools?

Mahoney: No, and in fact, most retail investors, I would think, they would probably own a mutual fund somewhere, and a 401(k) if not in a direct account. And without dark pools, a mutual fund investor wouldn't be able to accomplish their goals. That portfolio manager is not trying to buy 100 shares, he's trying to buy 20 million shares of stock. And if you think about it, the worst thing he could do is he has that great idea and go say, "Hey, guess everybody, I'm buying 20 million shares of a stock." He's going to lose all the advantage he had in that stock.

So, it's an incredibly important part of that structure.

Forbes: Now, what portion of trading is dark pools these days?

Mahoney: So, it's often hard to get at a number, but I'd say it's somewhere around seven to 9% based on guys like Rosenblatt who do the studies in this space. Maybe it goes to 10 to 12 depending on what you take into account. But let's think back what that means. If you go back to block trading in its hayday in the New York Stock Exchange in the mid '90s. Block trading accounted for more than 50% of the trades on the New York Stock Exchange. Some big portion of that were trades that were negotiated off the floor that just occurred on the floor.

So, dark is not a new concept. Not telling people what you're doing before you do it in trading is actually an important part of it. I started in the business in 1979. I was working as a clerk on the floor of the American Stock Exchange. It was the first time I saw a dark order. And I'll never forget the entire experience. It was one of the most very comical things you look back on in life. I took an order and my dad had worked in, I was at Merrill Lynch, my dad worked there. And I took an order from one of his friends, and he called down and said, "Buy 100,000 shares of whatever the stock was." So, I was really nervous. I was 18-years-old. I'm taking the report, I'm writing it down. And I hand it to the floor broker. And at the time in '79, Wall Street wasn't attracting a lot of Harvard MBAs. In fact, there weren't a lot of people going to college. And the brokers used to call me "the college kid."

Like, here's some college kid working in the summers, just what we need. And I start saying, you know, here's the order, buy 100. He goes, "I see it." He puts it inside his pad and writes 50,000 shares or 25,000 shares. And I look kind of questioning. I go to say something. He goes, "What do you want?" I go, "Well, you saw what it was." He goes, "I know I saw what it was. But if I walked into the crowd and they saw buy 100,000 shares of this stock, everybody's going to buy the stock in front of me. So, I'm going to put it in the pad." And I go, "What if you just held it close?" He goes, "Don't say hold it close to your vest. Don't you know what that means?" He goes, "Everybody's going to see me do that too." So, if I put a little piece on top and I keep writing the reports, nobody's going to add up how much I bought. So, I'm buying the stock, I'm keeping track of it. I'm not tipping my hand to anybody."

So that non-displayed liquidity is a critical, essential part of trading, and it always has been. We've just made it in an electronic marketplace that, quite frankly, is much more democratized. So in the '80s or '90s, if you wanted to find a block trade and you were an institutional investor, you had to have a relationship with the brokers, with the Goldmans, the Morgans, the Merrills. Now, you just have to know which venue to use. It's fully electronic. You go in there, it's completely anonymous. It's much easier to use and more efficient.

SEC Steps In

Forbes: Now, what is the SEC proposing to do?

Mahoney: So I think the SEC's has been very thoughtful on this, has spent an enormous amount of time on it, and has some very good proposals. What they're suggesting is that if you're going to be dark, then you should be dark. But if you're going to display to selected people, that's problematic. So what they've tried to do in rules they've just suggested is really three things. One is that there are some dark pools, so they would characterize there are 30 dark pools out there.

About a third of those, around 10 of those, take advantage of actionable IOIs. And what that means is that dark pool isn't really dark, it sends out information to selected counterparties that say, "Hey, look, there's a buying by venue for 100 shares or 1,000 shares or whatever it is trying to attract people in." So, if you want to send a message to people to attract them in, you should use the public quoted marketplace. And that's the moral of the SEC. They're saying, "Look, if you're going to try to bring in people to your venue, and the way you get it is by saying there's a bid or offer in my venue, then you really need to display that bid or offer to everybody, to make it fair." Information exchange is critically important. In a venue like BIDS, we don't give information outside of the pool, we keep it inside of it. So, you don't know there's a buyer in there unless you come in and you're willing to trade.

If you're trying to attract people, then I think you should be quoting. That's really what they've tried to accomplish. And I also think on a post-trade basis, you should attribute trades to the venues where they occurred.

Forbes: What's the practice now?

Mahoney: So on a post-trade basis, every venue has to report to the consolidated tape immediately, but you don't have to say what venue it came from unless you're an exchange. So, if a trade occurs on the New York Stock Exchange, there's a, you can tell, it's a dot-N. It says it occurs in New York.

If it occurs in BIDS, it just gets reported to the tape with no delineation where it came from. What they're suggesting is that if it trades in BIDS, you should say it trades in BIDS. If it trades in the New York, it's trading in the New York.

Forbes: So, right now, outside of, say, Nasdaq and the New York Stock Exchange, people don't know where these trades are done?

Mahoney: Yeah, and BATS and Direct Edge. So, I think well, certainly, BATS because that's an exchange. So, any of the exchanges clearly have it. The marketplace is very sophisticated.

There may be 30 different venues, but sophisticated institutional investors, and this is really what you're talking about. I think for the retail investor, the speed and efficiency of the market is critically important. The level we're talking about now is really for more complex trades. So, if you're a big institutional investor and you're trying to not disclose your intent on a pre-trade basis, and in fact, you're trying to represent those investors in your fund, you should be trying to do that. And I think that the public marketplace, clearly, you show where that trades, and then in the non-displayed liquidity, in ATS's, you don't.

Forbes: What does the SEC mean by threshold 5% or a quarter of a percent?

Mahoney: Yeah, so you have to put rules around how things work. So, what they were saying is that, so Reg ATS transformed the marketplace in 1997, and I guess it finally came into effect in '98, that allowed for competition to the existing exchanges. So, there was really a duopoly previous to that. In '97, they said, "We want to encourage competition." And competition's a very American concept, and we led the world with this. And in order to encourage competition, you have to make it easier for these pools to start up. So, exchanges have a lot of regulation, and it's very difficult to do. And at the time it was very hard to get approved as an exchange. So, how do you encourage competition? Well, you're going to make a venue where people can compete, you're going to make it easier for them to form, you're going to lower the barriers of entry.

But around that, you want to put some constraints on it and say, "Well, if you get too big, we want to have more control over you." So, if you're just a brand new guy and you're starting out, we want to give you the flexibility to be dynamic and to encourage competition. And in fact, the experience of Reg ATS from '97 to now has created the greatest market structure in the world. We've lowered costs for both the institutional investor and for the retail investor. So, it's worked wonderfully. All these thresholds and constraints are ways of the SEC controlling, "Hey, if that venue gets too big, we want to put more constraints around it because it's great to have competition, but when you get to be X percent of the market, we want other put a little more control over the way you do stuff."

And in this specific conversation they had and the regulations they're suggesting is that if you go now above 0.25% of the marketplace and you're a venue that displays liquidity to anybody, so, if you're a quoting market, then you've got to quote to everybody. And it seems reasonable. Like, so the threshold is just a percentage where they enforce the rules that make you more look like an exchange, than you look like not an exchange.

Forbes: On the surface, going for five to a quarter of a percent sounds quite drastic.

Mahoney: Yeah, and I think that the statement they're making is that philosophically is that we talked about the value of non-displayed liquidity being clearly in the institutional's best interest.

And I think what they're trying to suggest is that if you're doing something that's not dark, so if you're actually giving information to certain participants, so it's very related back to flash. So, they're being very consistent in their views, is that flash orders have a lot of similarity to the actionable IOIs.

Flash Trading

Forbes: Can you define flash orders?

Mahoney: So, a flash order is when the market is 10 cents at 12 cents, and you send a market to a venue and at 12 cents, they might not have the best offer. So, the national best bid or offer is 10 to 12, and you're in a venue, you know, ATS, whatever, you're and some venue, I don't want to use the name of the place, but you send an order to take the offer side. Rather than go to the best available offer away from them, or rather them allowing you to trade on the New York instead of in their venue, they flash your order to their participants and say, "Hey, look, there's some guy who wants to buy a stock at 12 cents, so any of you want to sell a stock at 12 cents. Because if you don't do it, I'm going to go ship it away to a different venue."

So the issue with that from the SEC's perspective is that you're exchanging information that to certain participants and not to others. You're telling a handful of people or a dozen people, it doesn't really matter, it's not everybody, that I have a guy who's willing to pay 12 cents for stock. There's a 12 cents offer in another marketplace. I'm not sending it there under the rule, I'm going to try and trade it internally. So the SEC's been very clear about two-tiered markets. So two-tiered markets are detrimental to market structure. If you get in orders and some people have information others don't, it's very difficult to do. If you're completely non-displayed, like you would be in BIDS, there's no information to be shared with anybody. And there's a reason for that, because if you're trying to buy or sell a million shares of stock, you don't want to tell anybody you've done it until you have to.

Forbes: So, in terms of better disclosure, again, this wouldn't force you to disclose what's happening before it's done?

Mahoney: Yeah, so, again, I think that the SEC's been very clear on this. They see the importance of non-displayed liquidity inside of the total market structure. But what they want to do is enforce the way people act inside of those pools. And it's much more about information exchange. So we would not be affected by those particular rules that have been suggested because we don't display to anybody. It's a very technical piece of legislation, but it fills a specific problem. Like, if you think about all the challenges that we have in market structure, both in equities and fixed income and derivatives, this is a small piece of it, but it's critically important. And we applaud the SEC for focusing on details.

These details, if you're not in, in fact, I would argue, if you're in the industry before this rule came out, most people didn't understand what it meant. It wasn't until you sat and listened to it and you read it and you read. Very few people on their leisure time over the weekends read Reg ATS rule 301(b)3. You know, I confess, sadly, that I have. But I wouldn't think it would be something you'd do sitting around a fireplace.

Derivatives Exchange

Forbes: You don't see too many scars on your face. Talking about derivatives, why hasn't there been more progress in mandating a clearinghouse, some sort of form of standardization, an exchange? I mean, puts and calls like we did in the early 1970s.

Mahoney: I think you're absolutely right. It's astonishing given that the amount of problems we had both in fixed income and derivatives that we haven't quite solved that problem yet. I think that we've made a lot of progress. So, I go back, I think there are four pieces to market structure that are important.

Price discovery, which is clearly an art form, so I would always encourage that you want to give the most flexibility of determining what 100 shares is worth versus a million shares, what this order's worth at this time. But I think that once the trade occurs, once you and I agree on a price, however we do that price discovery process, everybody should know about it. It's got to be publicly displayed. And there has to be a consolidated way to do that. It actually doesn't happen in Europe. I think Europe's been hampered in its ability for competition to come into marketplace because they don't link the marketplaces. So, they have an experiment much like our Reg ATS, but they don't link them, and they don't force centralized reporting, and they don't have centralized clearing. So, if you can have centralized clearing and you have centralized reporting, you can have a very good market structure.

And I think over time, hopefully, the other venues look at how successful the U.S. equity markets were. As I said, like, we might not have liked it, but at the end of every day in that horrible period of time this time last year, you knew precisely what the value of your stock portfolio was. There was no doubt in your mind what it was worth. You couldn't say that about derivatives or fixed income.

Forbes: So, who's against having credit default swaps clear in a central place?

Mahoney: So it's always hard to tell. I think it takes a long time to get regulation done. And I think people are trying to figure out the most efficient way.

I mean, by nature, I don't know anybody who says, "Oh, yeah, I want more regulation." Right? It's just not our natural state. So, clearly it's going to happen and it's going to take time, and I think we want to do it in the right way. But there has to be a centralized clearing, and I think there has to be some centralized reporting. And I can't imagine that we end some period of time. I know there's a couple bills now they're trying to get through either the Senate or House on derivatives. So, I think there will be some resolution to it and I think that's what you're going to see. It's got to be about clearing, and it's got to be about post-trade disclosure. And how you do it, whether it's on trading itself, whether it's on an exchange or off an exchange, as long as you know who your regulator is too, which is also a big deal.

Dogs Of The Dow

Forbes: You helped develop Dogs of the Dow.

Mahoney: Oh, yeah.

Forbes: From your days at Merrill Lynch. What are the dogs of the Dow now? Bow wow.

Mahoney: So, that was a wonderful period of time in my life, that was such a simple idea that worked very, very well. Value investing in general fell out of favor in the early 2000s I think.

Really, where we started stumbling a little bit. And I don't know how it's performed recently, but certainly, the amount of dividend cuts and the basic premise is that, so, as we explained it to a person, we'd say, "Look, you know, General Motors might have good days and bad days, but it's not going away." I don't know whether in this environment you have such confidence in making those statements. Now, as a practical matter, the underlying performance can still be good, and I don't know exactly how it is, but the philosophy behind it, it may not be as compelling because that's really what it was. It was like, look, these are the Dow Industrial Average, they've been around for 80 years. These companies are going to have good times and bad times, you want to buy them on the bad times knowing that there'll be good times to come. And dividends are an important part of it.

So, I think that you find anomalies in any strategy, and I don't know how this last 18 months would have looked like that in that strategy.

Bullish On The Future

Forbes: So best to keep the dogs quiet. Are there any regulations on the horizon that concern you?

Mahoney: No. I think, clearly, the SEC's done a wonderful job at this. Right? And so, I go back and look at the equity market structure, and again, all our business is in equities, it's been a clearly well-defined structure that we've all clearly understood. And we're making more than nuance, but making changes that are important, but they're rational. I can't believe that there's anybody who does what I do who's really surprised at what the SEC has done. There'll be a concept release coming out in January.

And this is all very boring. Like, this is not very interesting stuff. This is all very highly technical about how micro-market structure works. It is what I do for a living, and it affects every aspect of what they do will have some effect on us, but philosophically, there's plenty of room in this marketplace for different experimentation in the price discovery process. I think you'll always have a displayed market, I think you're always going to have exchanges. And the competition that's come out of the ATS world has made the markets better. It's such a better place now than it was 10 years ago. And so, I guess that whatever happens, if you listen closely to Chairman Schapiro or Commissioner Casey, that they recognize the importance of competition in the marketplace and are making markets better.

Forbes: And what's your bold prediction for the future?

Mahoney: So, I'm incredibly bullish. I think that, you know, we've come through a very difficult period of time in America, and if you just think about it, we've done extremely well. Like, some history professor once told me that the hardest part of teaching history is to convince people it didn't have to be that way. And when you look through this period of time, you realize there's lots of decisions we can make now, go back and think about, but it all worked, right? You know, the steps the government took might have been unprecedented, but it all got us to a much better spot now. And I think corrections in the marketplace happen all the time.

So I actually think we've come through the worst, and we've stood up and we can all look back with pride in how we all conducted ourselves, particularly in the equity markets I think. If I think about it, the amount of volume that traded during this period of time, it tested the limits of the infrastructure we built, and the infrastructure worked. So I'm really proud having been a participant in that, and helping come through with Reg NMS in 2005 and owning a non-displayed liquidity ATS. And it just worked extremely well. So, I remain incredibly optimistic. I feel like it was really the hardest thing we could face, and yet, we're here now to talk about it on a post-basis.

Forbes: Tim, thank you.

Mahoney: Thank you very much, Steve. It was a pleasure.