INVESTMENT COMPANY INSTITUTE

MEMO# 24414

July 12, 2010

SEC Reopens Comment Period on Proposal to Eliminate "Flash Order" Exception from Regulation NMS

[24414]

July 12, 2010

TO: EQUITY MARKETS ADVISORY COMMITTEE No. 25-10
SEC RULES MEMBERS No. 62-10 RE: SEC REOPENS COMMENT PERIOD ON PROPOSAL TO ELIMINATE "FLASH ORDER" EXCEPTION FROM REGULATION NMS

The Securities and Exchange Commission is reopening the comment period, until August 9, on its proposal to eliminate the exception for “flash orders” [1] from the quoting requirements of the Securities Exchange Act of 1934. [2] The Commission is seeking comment specifically on eliminating the flash order exception with respect to listed options.

Proposal to Eliminate the Flash Order Exception

Rule 602 of Regulation NMS and Rule 301(b) of Regulation ATS require exchanges and alternative trading systems, respectively, to provide their best-priced quotations to the consolidated quotation data that is widely disseminated to the public. Paragraph (a)(1)(i)(A) of Rule 602, however, excludes bids and offers communicated on an exchange that either are executed immediately after communication or cancelled or withdrawn if not executed immediately after communication. Flash orders qualify for the “immediate execution or withdrawal” exception. The result of eliminating the exception would be that any flash orders with non-marketable prices would need to be included in the consolidated quotation data and that the more frequently used practice of flashing orders with marketable prices to certain market participants would be prohibited. [3]

Request for Comment

The Commission is requesting comment on several aspects of flash orders with respect to listed options. Among other things, the Commission seeks comment on:

- Whether a cap on access fees for listed options would remove the need for exchanges to use flash orders to prevent their customers from incurring high access fees;
- The execution quality that flash orders receive in the options markets;
- The extent to which flash orders, if they fail to receive an execution in the flash process, "miss the market" by either receiving an inferior price through an execution against a displayed quotation or no execution at all;
- The extent to which liquidity providers on "maker/taker" [4] options exchanges quote more aggressively than other exchanges once their displayed quotations are adjusted to account for the effect of access fees on the "all in" cost to the investor; and
- Whether the availability of the flash mechanism at payment for order flow options exchanges plays a significant role in enabling such exchanges to compete for order flow through broker payments, rather than through offering better prices for the execution of investor orders.

Heather L. Traeger
Associate Counsel

endnotes

[1] In general, flash orders are orders communicated by a trading venue to certain market participants (and not initially to the market as a whole) and either executed immediately or withdrawn immediately after communication.

[2] See Securities Exchange Act Release No. 34-62445 (July 2, 2010), 75 FR 39626 (July 9, 2010), available at http://www.sec.gov/rules/proposed/2010/34-62445.pdf and Memorandum to Closed-End Investment Company Members No. 45-09, ETF Advisory Committee No. 34-09, ETF (Exchange Traded Funds) Committee No. 9-09, Equity Markets Advisory Committee No. 43-09, and SEC Rules Members No. 109-09 [23876], dated October 15, 2009.

[3] In its comment letter to the Commission, the Institute supported the proposal to eliminate the exception for flash orders from the quoting requirements. In particular, the Institute voiced its concerns that flash orders negatively impact the public display of trading interest in general and the specific orders that are flashed, as well as the possibility that flash orders create a "two-tiered" market. See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated November 23, 2009, available at http://www.ici.org/pdf/23973.pdf.

[4] The maker/taker pricing model rewards liquidity providers by giving them rebates, and it charges customers who remove liquidity from the exchange.