

MEMO# 23876

October 15, 2009

SEC Proposal to Eliminate "Flash Order" Exception from Regulation NMS

[23876]

October 15, 2009

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
SEC RULES MEMBERS No. 109-09 RE: SEC PROPOSAL TO ELIMINATE "FLASH ORDER"
EXCEPTION FROM REGULATION NMS

The Securities and Exchange Commission has issued a proposal to amend Rule 602 of Regulation NMS to eliminate an exception for the use of "flash orders" by equity and options exchanges. [\[1\]](#) 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venue to certain market participants (and not initially to the market as a whole) and either executed immediately or withdrawn immediately after communication. The Release states that the SEC is concerned that the exception for flash orders from quoting requirements under the Securities Exchange Act of 1934 is no longer necessary or appropriate in today's highly automated trading environment.

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 ("ATSs"), 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bids and offers communicated on an exchange that either are executed immediately after communication or cancelled or withdrawn if not executed immediately after communication. The Release states that the exception was originally intended to facilitate manual trading in the crowd on exchange floors by

excluding quotations that then were considered “ephemeral” and impractical to include in the consolidated quotation data. As securities trading became much more automated, trading venues began to disseminate information electronically concerning orders that either were to be executed immediately or withdrawn if not executed immediately. The orders qualifying for the “immediate execution or withdrawal” exception became known as “flash orders.” [2] The practical 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.

SEC Concerns About Flash Orders

The Release cites several concerns about flash orders that has prompted the SEC to issue the proposal. In particular, the Release states that the SEC is concerned that the use of flash orders by exchanges and other markets, particularly if it were to expand in trading volume, could detract from the fairness and efficiency of the national market system. The SEC also is concerned that flash orders may create a two-tiered market in which the public does not have access, through the consolidated quotation data streams, to information about the best available prices for listed securities. [3] In addition, the SEC is concerned about the extent to which flash orders may discourage the public display of trading interest and harm quote competition among markets and that the flash process diverts a certain amount of order flow that otherwise might be routed directly to execute against displayed quotations in other markets. Finally, the SEC is concerned that the flashing of orders to many market participants creates a risk that recipients of the information could act in ways that disadvantage the flashed order.

The Release notes that in its analysis of flash order types, the SEC will consider the interests of long-term investors and the extent to which they are helped or harmed by these orders, rather than on the interests of professional short-term traders that may have invested in sophisticated trading systems capable of responding to flash orders. The SEC preliminarily believes that the exception for flash orders from Exchange Act quoting requirements may no longer serve the interests of long-term investors and could detract from the efficiency of the national market system.

The Release states that the SEC recognizes that flash orders offer potential benefits to certain types of market participants. Among other things, some market participants that choose to receive and respond to flash orders may represent large institutional investors that are reluctant to display quotations publicly to avoid revealing their full trading interest to the market but are willing to provide liquidity to flash orders and that executions against flash orders could help lower the transaction costs of these institutional investors.

Requests for Comment

The SEC requests comment on several aspects of flash orders and their impact on the securities markets. Among other things, the Release requests comment on:

- the effect of flash orders on the fairness and efficiency of the markets for listed securities and on the interests of long-term investors in these securities
- whether the proposal would promote investor confidence by addressing the potential for a two-tiered market with respect to access to information about the best prices for listed securities
- whether the proposal would help promote the display of quotations in public markets by eliminating one type of trading in which “dark” liquidity is provided that matches the prices of previously displayed public quotations
- whether the proposal would reduce the potential for information leakage that could detract from the execution quality of marketable orders
- whether the proposal would deprive investors of a trading tool that, if used beneficially, can lead to improved quality of execution for marketable orders

The Release notes that the SEC also is actively reviewing other forms of “dark” trading interest that may be detrimental to the fairness and efficiency of the national market system. The Release explains that dark trading interest, as well as the information that some undisplayed venues currently disseminate to market participants concerning such trading interest, is not generally available to the public. The SEC therefore requests comment on the use of flash orders as a mechanism to interact with dark liquidity and whether other mechanisms for accessing dark liquidity either do or do not raise policy concerns that are analogous to flash orders.

Ari Burstein
Senior Counsel - Securities Regulation

endnotes

[1] See Elimination of Flash Order Exception from Rule 602 of Regulation NMS, SEC Release No. 34-60684 (September 22, 2009) (“Release”). The Release can be found on the SEC’s website at <http://www.sec.gov/rules/proposed/2009/34-60684.pdf>. Comments on the proposal should be received by the SEC no later than November 23, 2009.

[2] The Release explains that the particular type of electronic flash order that equity and options markets now use the most has the following basic features: the use of a flash order type is voluntary; flash orders almost always are marketable; on arrival at a market and prior to being flashed, flash orders first will interact immediately with any available contra side trading interest at the market that receives the order; if a market does not have available trading interest for the flash order to interact with when it arrives, the market will flash the order to its market participants; market participants that receive the flashed order information have a very brief period in which to respond with their own order to execute against the flashed order at a price that matches the NBBO price; if there is an order responding to the flashed order, the flash order will execute against the response and if there is no response to the flashed order, markets generally will route orders away to execute against the best-priced quotations on other markets.

[3] A flash order generally is displayed at a marketable price that will be better than the best displayed price for the security in the consolidated quotation data but the public does not receive this flashed order information in the consolidated quotation data - only those

market participants that receive a market's individual data feed have access to the improved price information.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.