

MEMO# 17608

May 27, 2004

SEC EXTENDS COMMENT PERIOD FOR PROPOSED REGULATION NMS AND ISSUES SUPPLEMENTAL REQUEST FOR COMMENT

[17608] May 27, 2004 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 25-04 SEC RULES COMMITTEE No. 50-04 RE: SEC EXTENDS COMMENT PERIOD FOR PROPOSED REGULATION NMS AND ISSUES SUPPLEMENTAL REQUEST FOR COMMENT The Securities and Exchange Commission has formally extended the comment period for proposed Regulation NMS¹ and has issued a supplemental request for comment on the proposal to discuss developments raised by panelists at the recent SEC Regulation NMS hearing.² The most significant aspects of the supplemental request for comment are summarized below.

I. Trade-Through Proposal The Release requests comment on several aspects of Regulation NMS' proposed trade-through rule.

A. Exception for Manual Quotes The Release states that panelists at the SEC Regulation NMS hearing expressed a view that a distinction could, and perhaps should, be made between manual and automated quotes, rather than manual and automated markets. The Release therefore requests further comment on the operation of the proposed exception to Regulation NMS' trade-through rule for manual markets, specifically, whether the exception should apply to quotes that are not immediately accessible through an automatic execution facility (i.e., a manual or non-automated quote), rather than providing an overall exception for a manual market. In addition, the Release requests comment on whether narrowing the scope of the proposed exception to manual quotes would allow market centers and broker-dealers to more efficiently execute orders across markets, while at the same time preserving the protections of a trade-through rule, and whether 1

Proposed Regulation NMS can be found on the SEC's website at <http://www.sec.gov/rules/proposed/34-49325.htm>. See also Memorandum to SEC Rules Members No. 39-04 and Equity Markets Advisory Committee No. 6-04, dated March 12, 2004. The Regulation NMS comment period has been extended from May 24, 2004 until June 30, 2004. 2 Securities Exchange Act Release No. 49749 (May 20, 2004) ("Release"). The Release can be found on the SEC's website at <http://www.sec.gov/rules/proposed/34-49749.htm>. 2 by not forcing a market center into a rigid classification, would providing an exception for manual quotes provide more flexibility for market centers with different market structures to compete more fairly with each other. The Release also requests comment as to the best way to effectuate a quote-by-quote exception to the proposed trade-through rule for manual quotes. The Release notes that panelists at the Regulation NMS hearing stated that it would be possible to attach an identifier to manual quotes in the consolidated quote stream so that all market participants would know that a quote was a manual quote. The Release requests comment on the

feasibility of this approach, and how it would work in practice. In addition, the Release requests comment whether the SEC should explicitly require that (1) each market center, as part of its required policies and procedures, implement a process to identify any non-automated bid or offer that it posts in the consolidated quote stream as manual; (2) the NMS plans that govern the collection, consolidation and dissemination of quotes in NYSE, Amex and Nasdaq-listed stocks be amended to provide for this functionality with regard to the quotes sent to the processors for those plans; or (3) each SRO, as part of its policies and procedures for complying with the proposed trade-through rule, impose a requirement on its members that they identify their bids and offers as manual when submitting them to the SRO.³

B. Definition of an "Automated" Quote The Release states that several panelists at the Regulation NMS hearing expressed the view that the concept of an "automated" market or quote must encompass an immediate automated response to the order router as to what action was taken with respect to the order. The Release requests comment on whether the SEC should make explicit in the proposed definition of an automated market or automated quote that providing an immediate automated response would include immediately sending a report back to the market center that submitted the order, either reporting an execution or cancellation, or whether the SEC should make explicit that the automated market or quote must provide an automatic execution functionality for the whole order or provide an automatic cancellation for the remaining portion of an order not executed against the quote. The Release also requests further comment on whether it should impose performance standards on the total time for a market center to respond to an order in an automated manner, i.e., the time from when the order is received by the executing market center to the time that the executing market center sends a report back to the order router indicating the action taken with respect to the order. In addition, the Release requests comment on whether imposing a performance standard would alleviate concern that, because each market otherwise would be able to determine what "immediate" means with respect to its own bids and offers, a market participant might be required to access a better price on a market center that it did not believe provided an immediate response. Finally, the Release requests comment on whether there is a need to impose a response time of less than one second and whether investors would benefit significantly, or at all, from sub-second response times.⁴

³ Comment also is requested on whether a market center should be able to decide on a security-by-security basis whether its quotes will be automated or manual.

⁴ The Release also requests comment with regard to surveilling for and enforcing compliance with a performance standard, in particular, whether, if the SEC were to adopt a performance standard, it should require that each market

³ The Release states that one panelist at the Regulation NMS hearing expressed the view that a market center posting a bid or offer should be required to automatically update that quote, in order to be deemed an automated market. The Release states that the SEC agrees that providing an automatic update to the best bid or offer is important because market participants other than the participant whose order executed against the quote need to know whether a particular quote is still available. The Release therefore requests comment on whether, in order for a market center or quote to be considered automated, the market center posting the quote should be required to provide for an automated update to the quote it is executed against; whether the SEC should impose a performance standard on the time within which the order execution facility would be required to update its automated quote; and whether the SEC should require market centers to provide an automatic cancellation functionality that would allow a market participant that has put a limit order on the market center's limit order book to automatically cancel the limit order.

C. Allowable Trade-Through Amount The Release states that panelists at the Regulation NMS hearing expressed the view that a market center should be allowed to trade-through a manual market by an unlimited amount. The Release therefore requests further comment

as to the amount by which a market should be allowed to trade through a manual quote and, specifically, whether there should be no trade-through limit amount.

D. Opt-Out Exception The Release notes that panelists at the Regulation NMS hearing were split about the need for an opt-out exception from the trade-through rule. The Release therefore requests comment as to whether, if it were to adopt an exception to the trade-through rule for manual quotes, the proposed opt-out exception would still be necessary or desirable and whether there would be less of a need for the opt-out as a mechanism for market discipline if the SEC were to adopt explicit performance standards with regard to defining what an “immediate” automated response means under an exception for manual quotes.

E. Other Exceptions The Release requests further comment as to whether there are particular types of transactions the execution of which should be excepted from the proposed trade-through rule and that are not covered by the proposed exceptions in Regulation NMS. For example, among other things, the Release requests comment on whether there should be exceptions provided for basket or program trades that are executed at a single price distinct from current prices for each of the securities contained in the basket and for “intermarket sweep orders” by which a market participant can simultaneously route orders to interact with all best bids and offers displayed in the consolidated quote system. center publicly disclose the percentage of time, or each actual instance, that it did not provide a response in compliance with the standards required by the rule.

4 II. Market Access Proposal The Release notes that panelists at the Regulation NMS hearing indicated that market access under Regulation NMS’ proposed access standards could remain a problem at relatively inactive ATSS or market makers with little trading volume whose quotations were displayed only in Nasdaq’s Alternative Display Facility as market participants could obtain access to such quotations only through direct connections with the particular ATS or market maker. Panelists therefore suggested that such an entity should be required to publish its quotations in an SRO order execution facility, where access could be more easily obtained, at least until its share of trading reached a point where the cost of direct connections with multiple market participants would not be out of proportion to the entity’s level of trading. The Release requests comment on this issue. The Release also notes that the term “access fee” as used in proposed Regulation NMS encompasses both the specific fees charged by ATSS to non-subscribers for access to their quotations, as well as any other fees charged by SROs and ATSS to their members and subscribers that are based on the execution of orders against their displayed quotations. The Release requests comment on the definition of “access fees” and, specifically, whether it should be broadened to include order cancellation fees, fees for capacity usage, or any fee charged by the market center specific to a transaction. Comment also is requested on whether limitations to access fees under the proposed rule should apply to undisplayed orders at prices better than the best displayed quote, reserve size at the displayed quote, or quotes displayed or available at prices inferior to the displayed quote. Finally, the Release requests comment on alternative measures that potentially could be adopted if the SEC does not adopt any limitations on access fees. In particular, the Release requests comment on whether quotations with high fees should be treated differently than quotations with de minimis fees for purposes of the Regulation NMS proposals, i.e., whether such high-fee quotations could be excluded from protection under the trade-through rule, eliminated from the allocation of market data revenues, and subject to locking quotations from market centers with de minimis fees.

III. Market Data Proposal The Release states that at the Regulation NMS hearing, the market data panelists focused primarily on two issues - the level of market data fees and the complexity of the proposed formula for allocating market data revenues to the SROs. The Release requests additional comment on these issues and, specifically, whether only quotes that are accessible through an automatic execution facility should be considered in the allocation of market data revenues, thereby eliminating any need for the formula to include

an automatic cutoff applicable to manual quotes. Ari Burstein Associate Counsel

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