

**MEMO# 18427**

January 19, 2005

## **DRAFT INSTITUTE LETTER ON REPROPOSED SEC REGULATION NMS**

[18427] January 19, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 6-05 SEC RULES COMMITTEE No. 5-05 RE: DRAFT INSTITUTE LETTER ON REPROPOSED SEC REGULATION NMS As we previously informed you,<sup>1</sup> the Securities and Exchange Commission has repropoed Regulation NMS for further public comment.<sup>2</sup> Regulation NMS consists of four proposals – the trade-through proposal, the market access proposal, the subpenny quoting proposal and the market data proposal – which, collectively, are intended to enhance and modernize the regulatory structure of the U.S. equity markets. The Institute has prepared a draft comment letter on the reproposal. The most significant aspects of the draft letter are summarized below and a copy of the draft letter is attached. Comments on the Regulation NMS reproposal are due to the SEC no later than January 26, 2005. If you have any comments on the draft letter, please contact the undersigned by phone at 202-371-5408 or by e-mail at [aburstein@ici.org](mailto:aburstein@ici.org).

**Trade-Through Rule Proposal** The draft letter notes that, in view of the fact that the majority of changes in the reproposal center on the trade-through rule proposal, the letter focuses on that proposed rule, specifically whether there is a need for a trade-through rule and the scope of such a rule.

**Need for Trade-Through Rule** The draft letter strongly supports the establishment of a marketwide trade-through rule. The letter notes that, by affirming the principle of price priority, such a rule should encourage the display of limit orders, which in turn would improve the price discovery process and contribute to increased market liquidity and depth; would increase investor confidence in the securities markets by helping to eliminate the perception of unfairness when an investor's order

<sup>1</sup> Memorandum to Equity Markets Advisory Committee No. 1-05 and SEC Rules Members No. 1-05, dated January 4, 2005 [18383]. <sup>2</sup> Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004).

**Application of Trade-Through Rule to Nasdaq-Listed Securities** The draft letter strongly supports the application of the repropoed trade-through rule uniformly to all market centers and to all NMS securities, including Nasdaq-listed securities. The draft letter states that there is significant value in protecting a displayed price from trades occurring at inferior prices across all markets. Specifically, a uniform trade-through rule would affirm the principle of price priority and the protection of the best prices for all markets. In addition, such a rule would provide an additional layer of protection for investors in the execution of their orders on top of a broker's best execution obligation, which is inherently an imprecise and subjective standard and can be difficult to apply on a trade-by-trade basis. Finally, because trade-throughs do occur in Nasdaq-listed securities, a uniform rule could prevent such trade-throughs from occurring and, if they do occur, could provide effective policies and procedures for obtaining restitution. "Top of Book" and "Depth of Book" Alternatives The draft letter discusses the two alternatives to

the proposed trade-through rule set forth in the reproposal - the “top-of-book” alternative, which would protect only the best bids and offers (“BBOs”) of the exchange SROs, Nasdaq, and the NASD’s Alternative Display Facility (“ADF”), and the “depth-of-book” alternative, which also would protect the BBOs of the various exchange SROs, Nasdaq and the ADF, but, in addition, would protect the depth of book quotations at prices beyond the best bid and offer that a market voluntarily disseminates in the consolidated quotations stream. The draft letter strongly supports the goals of the depth of book alternative (i.e., full protection for all displayed limit orders, strong linkages between markets and the opportunity for automated executions at the best available prices). The letter notes, however, that it is unclear which alternative provides the most optimal path towards achieving these goals. The draft letter states that several Institute members believe that the Commission should adopt the depth of book alternative, as this alternative would best advance the principle of limit order protection, thereby increasing the benefits of the proposed trade-through rule. In addition, the depth of book alternative would eliminate situations which would arise under the top of book alternative where liquidity in certain markets would be bypassed, which would run counter to the Commission’s goal of providing incentive for investors to place limit orders into the securities markets. The draft letter further states that other Institute members believe that the best way to support the goals of the depth of book alternative is for the Commission to take the incremental step of adopting the top of book alternative. The letter states that these members believe that inexperience with depth of book intermarket trade through protection raises uncertainties concerning the impact of the depth of book alternative on institutional trading. In addition, competition created by the top of book alternative ultimately will drive the securities markets to implement the features of a depth of book market structure, which is more favorable to achieving this result than through a specific government mandate. 3 The draft letter states that while it is evident that there are strong arguments for both of the proposed alternatives, regardless of which alternative the Commission ultimately chooses, it should adopt one of these approaches, as either alternative is preferable to the status quo, which does not protect, or provide incentive to display, limit orders in the national market system.

**Proposed Exceptions to Trade-Through Rule** The draft letter strongly supports the exceptions to the trade-through rule for “benchmark” orders and “intermarket sweep” orders, which are designed to help ensure that the trade-through rule is workable for institutional orders. The letter notes that the benchmark order exception would include a volume weighted average (“VWAP”) order. The letter notes, however, that members report that while they execute trades on a VWAP basis, they also often execute other types of average price trades, including variations on a VWAP trade (e.g., trades that improve upon the VWAP price by a certain amount), which would comply with the general requirements of the benchmark order exception. The draft letter therefore seeks clarification that this exception would provide flexibility for institutions to execute other types of average price trades outside of the provisions of the trade-through rule. Members: Are there other types of similar orders for which we should seek clarification? Ari Burstein Associate Counsel Attachment (in .pdf format)