MEMO# 18474

January 27, 2005

INSTITUTE LETTER ON REPROPOSED SEC REGULATION NMS

[18474] January 27, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 8-05 SEC RULES MEMBERS No. 15-05 RE: INSTITUTE LETTER ON REPROPOSED SEC REGULATION NMS The Institute has filed a comment letter with the Securities and Exchange Commission on reproposed Regulation NMS,1 which is intended to enhance and modernize the regulatory structure of the U.S. equity markets. The letter notes that, given the majority of changes in the reproposal center on the trade-through rule, 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. The most significant aspects of the comment letter are summarized below and a copy of the letter is attached. Need for Trade-Through Rule The letter strongly supports the establishment of a marketwide trade-through rule. The letter states that, by affirming the principle of price priority, a trade-through rule should encourage the display of limit orders, which in turn would improve the price discovery process and contribute to increased market depth and liquidity. The letter also states that a trade- through rule would increase investor confidence in the securities markets by helping to eliminate an impression of unfairness when an investor's order executes at a price worse than the displayed quote. Application of Trade-Through Rule to Nasdaq-Listed Securities The letter supports the application of the reproposed trade-through rule uniformly to all market centers and to all types of securities, including Nasdaq-listed securities. The 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, a uniform trade-through rule would provide an additional layer of protection for investors in the 1 Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004). See Memorandum to Equity Markets Advisory Committee No. 1-05 and SEC Rules Members No. 1-05, dated January 4, 2005 [18383]. 2 execution of their orders over and above a broker's best execution obligations. Finally, because trade throughs do occur in Nasdaq-listed securities, a uniform trade-through 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 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, and would additionally protect the depth of book quotations at prices beyond the BBO that a market voluntarily disseminates in the consolidated quotations stream. The 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 Institute members have differing views on whether the optimal path towards achieving those goals is through adoption of the proposed top of book or depth of book alternative. The letter states that several members believe that the Commission should adopt the depth of book alternative, as this alternative would best advance the principle of limit order protection and would eliminate situations which would arise under the top of book alternative where liquidity in certain markets would be bypassed. The letter further states that other 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. The letter also states that these members believe that the 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. The letter states that while there are strong arguments for both of the proposed alternatives, it is imperative that the Commission adopt one of these approaches, as either alternative is preferable to the status quo. Ari Burstein Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 18474, or call the ICI Library at (202) 326-8304 and request the attachment for memo 18474.