

MEMO# 17502

May 12, 2004

DRAFT INSTITUTE LETTER ON SEC PROPOSED REGULATION NMS

[17502] May 12, 2004 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 21-04 SEC RULES COMMITTEE No. 44-04 RE: DRAFT INSTITUTE LETTER ON SEC PROPOSED REGULATION NMS

As we previously informed you,¹ the Securities and Exchange Commission has published for comment proposed Regulation NMS.² 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 Regulation NMS. The most significant aspects of the draft letter are summarized below and a copy of the draft letter is attached. Comments on Regulation NMS are due to the SEC no later than May 24, 2004. We have scheduled a conference call to discuss the Institute's draft comment letter for Monday, May 17 at 1:30 pm Eastern. The dial-in number for the call will be 888-889-6350 and the passcode for the call will be 19354. If you would like to participate on the call, please contact Monica Carter-Johnson by phone at 202-326-5823 or by e-mail at mcarter@ici.org. In the meantime, 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.

I. Trade-Through Proposal The trade-through proposal would create a uniform rule that would require an "order execution facility," national securities exchange and national securities association market, with regard to the trading of "NMS Stocks," to establish, maintain, and enforce policies and procedures reasonably designed to prevent the purchase or sale of an NMS Stock at a price that is inferior to a better price displayed on another market. The draft letter supports the establishment of a uniform trade-through rule for all market centers. The letter states that a uniform trade-through rule, by preventing one market

1 Memorandum to Equity Markets Advisory Committee No. 6-04 and SEC Rules Committee No. 23-04, dated March 12, 2004 [17206]. 2 Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004). 2 from executing an order at a price that is inferior to a better price displayed on another market, should encourage the display of limit orders, which in turn can improve the price discovery process and contribute to increased market liquidity and depth.³ The draft letter makes several recommendations regarding the scope of the proposed trade-through rule. Specifically, the draft letter supports the application of a uniform trade-through rule to all securities (currently, only exchange-listed securities, and not those listed on Nasdaq, are subject to a trade-through rule). In addition, in response to a request for comment on whether broker-dealer orders should be included within the scope of the rule, the draft letter states that the scope of the rule should not be determined by the market participant on whose behalf an order was placed and that broker-dealer orders therefore should be included. Finally, the proposed trade-through rule would apply only to the best bid and offer of any order execution facility

and would not apply to other limit orders or quotes that are also priced better than the order being executed. The draft letter states that in order to truly promote order interaction in the markets, all limit orders should be protected and that such an expansion of the rule would further encourage the placement of limit orders and, in turn, significantly increase market liquidity and depth. The Commission also requests comment on whether the policies and procedures requirement is reasonably designed to prevent the execution of trade-throughs or whether the Commission should instead, or in addition, explicitly prohibit trade-throughs absent an exception. The draft letter states that while explicitly prohibiting trade-throughs may raise concerns regarding holding a market responsible for a trade-through it could not have reasonably avoided, relying solely on a market establishing its own policies and procedures to prevent trade-throughs may not be sufficient to prevent them from occurring and may result in the formation of non-uniform trade-through procedures across markets. The draft letter therefore recommends that the Commission explicitly prohibit trade-throughs but include certain exceptions to the rule in order to address concerns regarding unavoidable trade-throughs.⁴ While the draft letter supports the proposed trade-through rule, it states that it is extremely important that the execution of orders entered into a market not be delayed by mandating that those orders be routed to a less efficient market where there is no guarantee that the orders will even be executed. The draft letter therefore supports the proposed exception to the trade-through rule that permits an “automated” market to trade through a better priced displayed bid or offer on a “non-automated” market. At the same time, the draft letter recommends that the Commission provide a stronger definition of what constitutes an “automated” market. Specifically, the draft letter recommends that the proposed definition of an “automated” market be amended in two ways: (1) the Commission should first ensure that effective linkages and access standards between markets are in place to support such a rule. 4 The draft letter states that an effective trade-through rule also will require methods to “satisfy” the order that was traded-through and recommends that markets be required to establish policies and procedures for making an investor “whole” if a trade-through occurs. 3 Commission should establish minimum performance standards with respect to response times and the times required to update or “refresh” a quote and (2) in order to be considered an “automated” market, a market should be required to provide automatic execution to its entire limit order book and not only to their best bid and offer.⁵ The trade-through rule’s other exception, the “opt-out” exception, would permit a person for whose account an order is entered to “opt-out” of the protections of the trade-through rule by providing informed consent to the execution of their orders, on an order-by-order basis, in one market without regard to the possibility of obtaining a better price in another market. The draft letter states that if the Commission strengthens its definition of an “automated” market as per the Institute’s recommendations, and creates strong linkages and access between automated markets, then the opt-out exception is unnecessary and the Institute would not support such an exception to the trade-through rule. The draft letter states that an ideal market structure should not provide the ability for any market participant to ignore better priced orders in the market. In addition, the opt-out exception is inconsistent with the principle of price protection for limit orders and therefore would negatively impact investors’ use of limit orders, would undermine investor confidence in the markets and would be antithetical to the goals of the trade-through proposal.⁶ The draft letter states that if the Commission determines, however, that an opt-out exception is necessary, the ability to opt-out should be extremely limited in scope. As proposed, the opt-out exception would permit a customer for the customer’s account as well as a broker-dealer for its own account to affirmatively

opt-out of the trade-through rule's protections with regard to a specific order. The draft letter recommends that the Commission narrow the scope of the opt-out exception to include only those orders entered by a customer for the customer's account.

II. Market Access Proposal

The market access proposal would establish rules that would modernize the terms of access to quotations and the execution of orders in the national market system. Specifically, the proposal would require market centers to permit all market participants access to their limit order books, at least indirectly, on a non-discriminatory basis; would limit any fees charged by market centers and broker-dealers for access to their quotations to a de minimis amount; and would require SROs to establish rules to reduce the incidence of intermarket locked and crossed quotations.

5 The automated market exception only would permit an "automated" market to trade through a "non-automated" market up to a "trade-through limit amount." Specifically, depending on the bid or offer of a stock, the allowable trade-through amount varies from one cent to five cents. The draft letter recommends that the Commission eliminate the proposed trade-through limit amount and permit an "automated" market to trade through a "non-automated" market for an unlimited amount.

6 If, however, the Commission adopts the definition of an "automated" market as proposed (i.e., with no minimum standards for the execution of orders and update of quotes, and requiring automation only at the best bid and offer), then the draft letter states that an "opt-out" exception may be necessary.

4 The draft letter supports the creation of minimum access standards that would provide market participants with non-discriminatory access to the best prices for a security, no matter where those prices are displayed, and that would reduce the current barriers to intermarket access. The draft letter states that fair and efficient access to the securities markets is critical to the efficient execution of orders as well as to an effective trade-through rule.

7 The draft letter also states that a de minimis fee standard is a logical approach to addressing concerns regarding ECN access fees. Specifically, the draft letter states that the proposed access fee standard would promote a common quoting convention and facilitate the ready comparison of quotes across the national market system.

8 Finally, the draft letter supports proposals that would require every SRO to establish and enforce rules requiring its members to avoid locking or crossing the quotations of quoting market centers and quoting market participants and to prohibit members from engaging in a pattern or practice of locking or crossing the quotations in any security. The draft letter states that locked and crossed markets can have a negative impact on the securities markets and can be a sign of an inefficient market structure. In addition, locked and crossed markets may create confusion for investors, as it is unclear under such circumstances what is the true value of a stock.

9 III. Subpenny Quoting Proposal

The subpenny quoting proposal would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment less than a penny. The draft letter strongly supports the subpenny quoting proposal. The draft letter states that the proposal would address concerns that have been raised regarding quoting securities in subpenny increments. For example, while the move to pricing in whole pennies has enhanced the ability of investors to more fully understand the prices at which securities are quoted, quoting securities in subpennies would make it more difficult for investors (as well as market participants executing orders for investors) to understand these prices. In addition, displaying consolidated quotes in subpenny increments would further reduce the displayed quote size and overall depth of the markets. The reduction in market transparency and depth that would occur in a subpenny environment also would adversely affect liquidity, especially for mutual funds and other institutional investors that need to execute relatively large-sized orders. Finally, permitting the entry of orders and the quoting of securities in subpennies would increase instances of "stepping ahead" of limit orders by

7 The draft letter also supports the flexible approach proposed by the Commission that seeks to ensure proper

access through linkages established by the markets and not through government-imposed linkages. 8 Under the proposed rule, an SRO's order interaction facility would be allowed to charge a maximum fee of \$0.001 per share for access to its market. Market makers, specialists, ATSS, and other broker-dealers that display attributable quotes through SROs also would be permitted to charge a maximum fee of \$0.001 per share for access to their quotes, and would be permitted to charge this access fee in addition to any access fee that the SRO also imposes on the transaction, with the accumulation of fees limited to no more than \$0.002 per share in any transaction. 9 The draft letter also supports the proposal to lower the "fair access" threshold in Regulation ATS from twenty percent to five percent and states that lowering the threshold should encourage fair competition between ATSS with significant internal trading volume. 5 allowing a trader to gain priority over another trader by bidding as little as \$0.001 more for the same security with almost no risk of loss. The draft letter also supports the aspect of the proposed rule that would permit an exchange or association to report or "print" a trade in a subpenny increment and that would not per se prohibit an exchange or association from printing a trade that was the result of a mid-point or volume-weighted pricing algorithm, as long as the exchange or association or its members did not otherwise violate the proposed rule with respect to the trading interest that resulted in the execution. The draft letter states that it should not be problematic for executions to take place in subpenny increments where the prices for these executions are determined through the application of a passive algorithm, as is the case where a trade is executed on a crossing network at the mid-point of a bid and offer. IV. Market Data Proposal The market data proposal would amend the rules and joint industry plans for disseminating market information to the public. Most significantly, the proposal would modify the formulas for allocating market data revenues to reward those market centers whose quotes reflect the best prices for the largest sizes and thereby contribute the most to public price discovery. The draft letter supports the revisions to the allocation of market data revenue, specifically, revisions that would discourage practices that currently exist solely to generate increased revenue. The draft letter states that the issues raised by market data are very important to the effective functioning of the markets as it is pursuant to these joint industry plans that market participants obtain real-time access to consolidated information regarding the best quotes for, and trades in, stocks. Thus, such information is an important means of enhancing the transparency of the buying and selling interest in a security, for addressing the fragmentation of buying and selling interest among different market centers, and for facilitating the best execution of customers' orders by their broker-dealers. The draft letter also supports other changes made to the joint industry plans under the market data proposal, specifically: (1) the amendment to the joint industry plans that would broaden participation in their governance and could help assure that the views of interested parties other than SROs have an opportunity to be heard on plan matters; (2) amendments relating to the independent distribution of market information that would permit individual market centers to have the freedom to distribute their own market data independently; and (3) the proposed rule to require SROs to act jointly pursuant to one or more national market system plans to disseminate consolidated information for NMS Stocks. Ari Burstein Associate Counsel Attachment (in .pdf format)

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