MEMO# 18998

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SEC ADOPTS REGULATION NMS

 [18998] July 27, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 26-05 RE: SEC ADOPTS REGULATION NMS The Securities and Exchange Commission has adopted Regulation NMS.1 Regulation NMS contains four interrelated rules that are designed to modernize and strengthen the regulatory structure of the U.S. equity markets – the "Order Protection Rule," the "Access Rule," the "Sub-Penny Rule," and the "Market Data Rules." The most significant aspects of the new rules are summarized below. I. Order Protection Rule The Order Protection Rule establishes a uniform trade-through rule for all market centers that, subject to certain exceptions, requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent "trade-throughs," i.e., the execution of an order at a price that is inferior to a price displayed in another market. Protected Quotations The Order Protection Rule protects only quotations that are immediately accessible through "automatic" execution.2 In particular, the Rule requires that the trading center displaying an automated quotation must provide an "immediate-or-cancel" ("IOC") functionality for an incoming order to execute immediately and automatically against a quotation up to its full size, and must immediately and automatically respond to the sender of an IOC order.3 To qualify as an "automatic" quotation, no human discretion exercised after the 1 Securities Exchange Act Release No. 51808 (June 9, 2005) ("Release"). The Release can be found on the SEC's website at http://www.sec.gov/rules/final/34-51808.pdf. Commissioners Cynthia A. Glassman and Paul S. Atkins wrote a dissenting opinion to the adoption of Regulation NMS that can be found on the SEC's website at http://www.sec.gov/rules/final/34-51808-dissent.pdf. 2 The Release notes that the Commission agreed with commenters, including the ICI, that providing protection to manual quotations potentially would lead to undue delays in the routing of investor orders. 3 The Release notes that the definition of automated quotation does not set forth a specific time standard for responding to an incoming order. The Release states that rather than fixing a specific time standard that may become obsolete as systems improve over time, the Rule addresses the problem of slow trading centers by providing an 2 time an order is received is permissible in determining any action taken with respect to an order. Finally, trading centers are required to immediately and automatically update their automated quotations to reflect any change to their material terms. The Order Protection Rule will protect only the best bids and offers ("BBOs") of the nine self-regulatory organizations and The Nasdaq Stock Market whose members currently trade NMS stocks. According to the Release, the Commission decided not to adopt a "depth of book alternative"4 because it believes that protecting only BBOs: (1) strikes an appropriate balance between competition among markets and competition among orders; and (2) will be less difficult and costly to implement than a depth of book alternative. Exceptions to Order Protection Rule The Order

Protection Rule contains several exceptions addressing transactions that may fall within the definition of a trade-through, but which are not subject to the operative requirements of the Rule.5 The Release notes that the exceptions primarily are designed to achieve workable intermarket price protection and to facilitate certain trading strategies and order types that are useful to investors, but also are consistent with the principle of price protection. The Rule includes an exception for a transaction if the trading center displaying the protected quotation that was traded through was experiencing a failure, material delay, or malfunction of its systems or equipment when the trade-through occurred.6 The Rule provides a “self help” remedy that will allow trading centers to bypass the quotations of a trading center that fails to meet the immediate response requirement. To implement this exception consistent with the requirements of the Rule, trading centers must adopt policies and procedures reasonably designed to comply with the self-help remedy. To address the problem of flickering quotations, the Rule sets forth an exception that allows trading centers a one second “window” prior to a transaction for trading centers to evaluate the quotations at another trading center. exception (discussed below) for quotations displayed by trading centers that are experiencing, among other things, a material delay in responding to incoming orders. 4 As proposed by the Commission, the “depth of book alternative” would similarly protect the BBOs of the various SROs and Nasdaq, but also would protect quotations below a market’s best bid or above a market’s best offer for markets that choose to voluntarily disseminate these quotes. 5 The Release notes that the Commission had originally proposed a general “opt out” exception that would have allowed market participants to disregard displayed quotations. The Release states that while the opt-out proposal was intended to provide flexibility to market participants, such an exception would have left a gap in protection of the best displayed prices and thereby reduced the proposal’s potential benefits to investors. According to the Release, the elimination of any protection for manual quotations is the principal reason that this broad exception is no longer necessary in the Order Protection Rule as adopted. 6 The Release notes that given current industry conditions, the Commission believes that repeatedly failing to respond within one second after receipt of an order would constitute a material delay. 3 To respond to the need of market participants to access multiple levels simultaneously at different trading centers, the Rule includes an “intermarket sweep order” exception.7 The intermarket sweep order exception allows the entire size of a large order to be executed immediately at any price, so long as the broker-dealer handling the order routes orders seeking to execute against the full displayed size of better-priced protected quotations. The Release notes the Institute’s comment that this exception would allow institutional investors to continue to execute large-sized orders in an efficient manner. The Rule also includes an exception for certain types of “benchmark” orders. Specifically, the Rule excepts the execution of an order at a price that was not based, directly or indirectly, on the quoted price of an NMS stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made. The Release notes that a common example of a benchmark order is a VWAP order. Finally, in response to recommendations from commenters, the Commission adopted a separate exception for the execution of stopped orders. The Release notes that the exception is narrowly drawn to prevent abuse, while also facilitating the continued use of stopped orders by institutional customers. As suggested by commenters, this exception will apply to the execution of so-called “underwater” stops. Specifically, the exception applies to the execution by a trading center of a stopped order when the price of the execution of the order was, for a stopped buy order, lower than the national best bid in the stock at the time of execution or, for a stopped sell order, higher than the national best offer in the stock at the time of execution. To qualify for the exception, the stopped order must be for the account of a customer and the customer must have agreed to the stop price on an order-by-order basis. II. Access Rule The Access Rule sets forth new standards governing access to quotations in NMS stocks. The Release states that the Rule is designed to promote access to quotations in three ways. First, it enables the use of private linkages offered by a variety of connectivity providers, rather than mandating a collective linkage facility such as the ITS, to facilitate the necessary access to quotations. To promote this type of indirect access, the Rule prohibits a trading center from imposing unfairly discriminatory terms that would prevent or inhibit the access of any person through members, subscribers, or customers of a trading center. Second, the Rule limits the fees that any trading center can charge (or allow to be charged) for accessing its protected quotations to no more than $0.003 per share. Finally, the Rule requires SROs to establish, maintain, and enforce written rules that, among other things, prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross the automated quotations of other trading centers. 7 An intermarket sweep order is defined as a limit order that meets the following requirements: (1) when routed to a trading center, the limit order is identified as an intermarket sweep order, and (2) simultaneously with the routing of the limit order identified as an intermarket sweep order, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of all protected quotations with a superior price. 4 III. Sub-Penny Rule The Sub-Penny Rule prohibits market participants from displaying, ranking, or accepting quotations in NMS stocks that are priced in an increment of less than $0.01, unless the price of the quotation is less than $1.00. The Rule does not prohibit a sub-penny execution resulting from a midpoint or volume-weighted algorithm or from price improvement, so long as the execution did not result from the impermissible sub-penny order or quotation. IV. Market Data Rules According to the Release, the adopted amendments to the Market Data Rules and joint industry plans are designed to promote the wide availability of market data and to allocate revenues to SROs that produce the most useful data for investors. The changes fall into three categories: (1) modifying the current formulas for allocating market data revenues to the SROs to more appropriately reflect the usefulness to investors of each SRO’s market information; (2) establishing non-voting advisory committees to broaden participation in plan governance; and (3) authorizing markets to distribute their own data independently (while still providing their best quotations and trades for consolidated dissemination through the joint industry plans) and streamlining outdated requirements for the display of market data to investors. Jane G. Heinrichs Assistant Counsel