

MEMO# 17206

March 12, 2004

SEC PROPOSES REGULATION NMS

[17206] March 12, 2004 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 6-04 SEC RULES COMMITTEE No. 23-04 RE: SEC PROPOSES REGULATION NMS The Securities and Exchange Commission has published for comment proposed Regulation NMS.¹ Regulation NMS contains four interrelated proposals that are designed to modernize the regulatory structure of the U.S. equity markets. First, the Commission is proposing a uniform trade-through rule for all market centers that, subject to certain exceptions, would require a market center to establish, maintain, and enforce 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. Second, the Commission is proposing a uniform market access rule with a de minimis fee standard that would modernize the terms of access to quotations and execution of orders in the national market system. Third, the Commission is proposing to prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment less than a penny. Finally, the Commission is proposing amendments to the rules and joint industry plans for disseminating market information to the public. The most significant aspects of the proposals are summarized below. Comments on the proposals are due to the SEC no later than May 24, 2004. We have scheduled a conference call to discuss the proposals and the Institute’s comment letter for Wednesday, March 17 at 1 pm Eastern. The dial-in number for the call will be 877-601-3548 and the passcode for the call will be 14797. If you would like to participate on the call, please contact Monica Carter-Johnson by e-mail at mcarter@ici.org. In addition, if you have any questions or comments on the proposals, please contact the undersigned by e-mail at aburstein@ici.org or by phone at 202-371-5408.

I. Trade-Through Proposal Proposed Regulation NMS would establish a uniform trade-through rule that would require an order execution facility,² national securities exchange, and national securities 1 Securities Exchange Act Release No. 49325 (February 26, 2004) (“Release”). The Release can be found on the SEC’s website at <http://www.sec.gov/rules/proposed/34-49325.htm>. 2 The proposal defines “order execution facility” as any exchange market maker; OTC market maker; any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent; alternative trading 2 association to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of a trade-through in their markets.³ The proposed rule would not ban trade-throughs. The Release states that the Commission recognizes that unavoidable “false- positive” and “false-negative” trade-throughs may occur because quotes are updated and orders are executed more rapidly than information can be communicated and that an order execution facility should not be held responsible for protecting a better-priced quote that it cannot see because it has not yet received the quote.⁴

a. Scope of Proposed Rule The proposed rule would apply to a purchase or sale of an “NMS Stock,” i.e., all Nasdaq, NYSE, and Amex-listed stocks, during regular trading hours.⁵ In addition, the proposed rule would apply to orders for the account of a broker-

dealer as well as for the account of a customer. The Release states that excluding orders for the account of a broker-dealer would undermine the purpose of the proposed rule to provide price protection to displayed better-priced limit orders and quotes, as broker-dealer orders would be able to trade-through these better prices.⁶ The proposed rule would apply only to the best bid and best offer of any order execution facility that is disseminated pursuant to an effective national market system plan. It would not apply to other limit orders or quotes that are also priced better than the order being executed but are not disseminated pursuant to an effective national market system plan. The Release states that to expand price protection beyond the best bid and best offer for each market would entail the Commission requiring quoting market centers to make available, and provide access to, their entire depth of book to other markets. The Release further states that although the Commission believes that it would make sense to provide protection to any better-priced quote or order displayed in another quoting order execution facility, it questions whether protecting all displayed limit orders and quotes at this time would be feasible.⁷

system; or national securities exchange or national securities association that operates a facility that executes orders. The Commission requests comments on the advisability of including “non-quoting” markets within the scope of the rule. 3 The Commission requests comment on the minimum standards to which an order execution facility, national securities exchange, and national securities association should adhere when establishing, maintaining, and enforcing its required policies and procedures. 4 The Commission requests comment however on whether the proposed rule is sufficient to effectively deter and prevent trade-throughs and whether the Commission should instead, or in addition, explicitly prohibit trade-throughs absent an exception. 5 The current Intermarket Trading System (“ITS”) trade-through rule applies only to the trading of NYSE and Amex securities. The Commission’s proposed trade-through rule would expand the scope of trade through restrictions by including trading in Nasdaq securities. The Commission requests comment on applying the protections of the proposed rule to the trading of Nasdaq securities. 6 The Release notes that a broker-dealer may choose to opt-out of the rule’s protections with regard to orders for its own account under the proposed rule’s “opt-out” exception (discussed below). The Release requests comment on whether broker-dealer orders should be included within the scope of the rule. 7 The Commission requests comment on whether it should expand the scope of the proposed rule to include trade-through protection beyond the best-displayed bid and offer. In addition, the Commission requests comment whether the best bids and best offers of each individual registered market maker and ATS should be protected or whether the 3 The Release notes that the proposed rule would not treat large “block-sized” trades any differently than non-block trades, i.e., an order execution facility could not execute a block trade at a price inferior to the best bid or offer displayed on any other order execution facility, unless the order execution facility sent an order to trade at the price of the better-priced order. The Commission believes that an exception for block trades may not be necessary because the proposed rule’s “opt-out” exception (discussed below) would be available to a customer or broker-dealer that wishes to execute a block trade. The Commission requests comment on whether this is the appropriate way to handle block trades under the proposed rule. The Release also states that the Commission recognizes that it would not be reasonable to impose trade-through restrictions unless an order execution facility can see and have fair and efficient access to those prices and that an effective linkage between markets must be in place before implementing a trade-through rule. The Release further states that the Commission believes that the proposed uniform market access rule (discussed in greater detail below) would provide the necessary levels of access. Under the proposed access rules, an SRO would not be permitted to post quotes or orders for another market center through its facilities unless it has first made a determination that the market center has provided adequate access to its quotes and

orders under the proposed access standards. The Commission believes that this requirement is necessary to protect against inaccessible markets becoming part of the consolidated quote.⁸ b. Exceptions to Proposed Rule In order to provide flexibility for market centers with different market structures and to give investors more control over how their orders are executed, the proposed trade-through rule includes two exceptions. Specifically, the proposed rule would include an exception allowing customers to “opt-out” of the protections of the proposed rule and an exception allowing an automated market to trade through a non-automated market in limited circumstances.⁹ proposed rule should protect only the best bid and best offer of each national securities exchange and the aggregate best bid and best offer of each non-exchange “market.” ⁸ The Commission requests comment on whether existing market access for Nasdaq, Amex and NYSE securities is adequate to support the proposed trade-through rule, in light of the advances in technology and the proprietary linkages already in place today. If commenters believe that current market access is not adequate, the Commission requests comment on what access standards would be needed as a prerequisite to implementing the proposed trade-through rule. ⁹ In addition to the two exceptions to the proposed trade-through rule discussed above, the proposed rule would incorporate other exceptions to the current trade-through prohibitions. In addition, the Release notes that the proposed rule, unlike the current rule, does not include certain exceptions, such as the exception for trading through a 100-share bid or offer. The Commission is concerned that a de minimis exception, such as the 100-share exception, would provide an opportunity for market participants to circumvent the requirements of the proposed rule. The Commission requests comment on whether it is necessary to include an exception for a de minimis size, such as for 100 shares. ⁴ 1. Opt-Out Exception The proposed trade-through rule would contain an exception to allow an order execution facility to execute an order at a price that trades through a better-priced displayed bid or offer on another market if the person for whose account the order is entered makes an informed decision to affirmatively opt out of the trade-through rule’s protections.¹⁰ The proposed rule would require the broker-dealer to obtain the informed consent from each investor on an order-by-order basis.¹¹ The Release states that the Commission is not proposing to allow consent on a global basis, either by a written agreement or otherwise, because of a concern with the potential for abuse if consent can be obtained on a basis other than for each particular order.¹² Under the proposal, a broker-dealer would be required to disclose to its customers that have opted out the national best bid or offer, as applicable, at the time of execution for each execution for which a customer opted out. Such disclosure would be required to be provided as soon as possible, but in no event later than one month from the date on which the order was executed. The Release states that the bid or offer that would be required to be disclosed would need to be displayed in close proximity to, and no less prominently than, the execution price for the applicable transaction that is provided to the customer pursuant to the requirements of Rule 10b-10 under the Securities Exchange Act of 1934. The proposed rule would require the disclosure to be made on the confirmation for the transaction sent to the customer pursuant to Rule 10b-10, or on the monthly account statement relating to that trade sent to the customer pursuant to applicable SRO rules. Alternatively, the broker-dealer could provide the bid or offer information on another form of disclosure document, as long as it is clear to which transaction the bid or offer information refers. The Release notes that while the opt-out exception would provide greater execution flexibility to informed traders, the Commission recognizes that the exception is inconsistent with the principle of price protection for limit orders. The Commission therefore requests comment on whether the proposed opt-out exception is needed to enable informed traders to design their own trading strategies appropriate to their particular circumstances and the impact on investors’ use of limit orders, if the opt-out exception were to be implemented. ¹⁰ The

Release notes that broker-dealers would not have to provide their customers with the ability to opt out of the trade-through rule's protections. 11 The proposed rule does not prescribe a specific means for ensuring that the consent is informed, but at a minimum, the broker-dealer must explain in clear and concise terms each time it receives an opt-out order from a customer, that: (1) the customer's order would be executed in the market to which it is sent without regard to prices displayed in other markets, even if those prices are better; (2) the customer affirmatively would be agreeing to forego the possibility of obtaining a better price that may be available in another market at the time its order is executed; and (3) this could result in the customer's order receiving an execution at a price that is inferior to the best bid or offer displayed at the time his or her order is executed. 12 The Commission requests comment on the anticipated impact of the requirement to obtain informed consent on an order-by-order basis on the order handling and execution processes of each broker-dealer, and whether this requirement would be expected to significantly slow down that process. The Commission also requests comment on whether the ability to opt out should be available only to institutional or sophisticated investors, and, if so, how the Commission should define an institutional or sophisticated investor. 5

2. Automated Execution Alternative

The Commission requests comment on an alternative to the opt-out exception that would require market centers to provide an automated response to electronic orders at their quote. The Release states that to the extent that the need for trade-through flexibility is caused by the inability to trade efficiently with published quotations, this problem could be addressed more directly by such an alternative. The Release further states that an automatic execution requirement may address two of the potential flaws with the proposed opt-out exception. First, to the extent that the opt-out exception is inconsistent with the principle of price protection for limit orders, an automatic execution requirement at the best bid or offer for limit orders avoids this problem. Second, an automatic execution alternative supports the principle of price priority as it would not allow trades to occur at inferior prices, as could happen under the proposed opt-out exception. The Commission therefore requests comment whether there would be a continued need for the opt-out exception if it were to adopt an automatic execution requirement. 3.

Automated Order Execution Facility Exception

The Commission is proposing to permit an "automated order execution facility"¹³ to execute orders within its market without regard to a better price displayed on a "non-automated order execution facility," up to the "trade-through limit amount." Under the proposal, an automated order execution facility would not be allowed to trade through the prices of other automated order execution facilities. A non-automated order execution facility also would not be allowed to trade through any other market, whether or not it is automated. The Release states that the allowable trade-through amount should reflect the cost (including time value) of attempting to access another market. The Commission therefore is proposing to calculate the allowable "trade-through limit amount" by using the values of a thirty second option on stocks with a range of volatilities. Specifically, for a bid or offer up to \$10, the allowable trade-through amount would be one cent; for a bid or offer between \$10.01 and \$30, the allowable amount would be two cents; for a bid or offer between \$30.01 and \$50, the allowable amount would be three cents; for a bid or offer between \$50.01 and \$100, the allowable amount would be four cents; and for a bid or offer above \$100, the allowable amount would be five cents.¹⁴ 13 The proposal defines an "automated order execution facility" as an order execution facility that provides for an immediate automated response to all incoming orders for up to the full size of its best bid and offer disseminated pursuant to an effective national market system plan, without any restrictions on executions. The Commission requests comment on whether it should specify what "immediate" means in terms of providing an automated response, and if so, whether it would be appropriate to impose a minimum performance standard with respect to response times. 14 The Commission

requests comment on the feasibility and usefulness of this approach, and the reasonableness of the proposed trade-through limit amounts. The Commission also requests comment on other possible alternative approaches to determining the amount(s) by which an automated market should be allowed to trade through a non-automated market. Finally, the Commission requests comment on whether the proposed rule should provide for one trade-through limit amount, such as three cents, that would apply to all NMS Stocks, rather than the tiered amounts as proposed. 6 The Commission requests comment whether there are any restrictions that a market center should be allowed to impose and still be considered “automated” under the proposed definition of “automated order execution facility.” In addition, the Commission requests comment on how such an automated market exception would work in practice for a market that provides an automated response to its top-of-book but otherwise operates as a manual market and whether the definition of “automated order execution facility” should exclude a market that has the ability to, and does, implicitly or explicitly “turn off” its automated functionality to allow for manual executions of orders on the market.¹⁵ The Commission also requests comment on several alternative regulatory approaches to intermarket price protection. For example, the Commission states that one alternative would be to adopt the proposed trade-through rule with the automated market exception but not the opt-out exception. Another choice would be to adopt the proposed rule without the automated market exception and extend the existing three-cent de minimis exemption for ETFs to all securities covered by the proposed rule, either with or without the proposed opt-out exception. Another approach would be to eliminate the existing ITS trade-through rule and rely solely upon the principles of best execution for the execution of trades.

II. Market Access Proposal

The Release notes that currently there are few regulatory standards governing the manner of access among competing market centers. The Commission is therefore proposing a uniform market access rule that would modernize the terms of access to quotations and the execution of orders in the national market system. In general, the proposed new access standards would require market centers to permit all market participants access to their limit order books, at least indirectly, on a non-discriminatory basis. In addition, the proposed rule would limit any fees charged by market centers and broker-dealers for access to their quotations to a de minimis amount. Finally, the proposal would require SROs to establish rules to reduce the incidence of locked and crossed markets.

a. Non-Discriminatory Access

Under the proposed rule, “quoting market centers”¹⁶ and “quoting market participants”¹⁷ would not be permitted to impose unfairly discriminatory terms that inhibit non-members, non-¹⁵ The Commission requests comment on whether there would be a continued need for the proposed automated market exception if the Commission were to adopt an automatic execution requirement, as all market centers would be required to provide the same basic level of automatic execution functionality and there would be no distinction for purposes of the proposed rule between manual markets and automated markets. The Commission also requests comment on whether, if it were to require automatic execution, it would need to set performance standards governing the use of the automatic execution functionality to which all markets would be required to adhere, i.e., require that market participants’ systems respond to orders from other markets within certain time frames, and whether minimum performance standards would be essential to any consideration to not adopt an opt-out exception. ¹⁶ The proposal defines “quoting market center” as an order execution facility of any exchange or association that is required to make available to a quotation vendor its best bid or best offer in a security pursuant to the Quote Rule. ⁷ subscribers, or non-customers from obtaining access to quotations and the execution of orders through their members, subscribers, or customers. In addition, a quoting market participant would be required to make its quotations accessible to all quoting market centers and all other quoting market participants on terms as favorable as those it grants to its most preferred

member, customer, or subscriber. The Commission believes that the non-discriminatory access standards would permit market participants to avoid having to establish direct relationships with every quoting market center or quoting market participant in order to access the quotes of all markets. Instead, these participants would only need to have relationships with a member, customer, or subscriber of a quoting market participant or a member, customer, or subscriber of a quoting market center to obtain effective access to those quotes.

b. Access Fees The Release states that the Commission has considered various regulatory responses to the issues surrounding, and the problems concerning, access fees including reflecting the access fees in the displayed quote; rounding access fees to full-penny trading increments in the displayed quote; banning access fees outright; and establishing a de minimis fee standard. The Release discusses the pros and cons of each of these alternatives and states that, after considering all of the alternatives, it has determined to propose a de minimis fee standard. Specifically, under the proposed rule, all quoting market centers, quoting market participants, and broker-dealers that display attributable quotes through SROs would be permitted to impose fees for the execution of orders. The proposed rule would allow an SRO's order interaction facility 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 imposes on the transaction. The accumulation of these fees would be limited to no more than \$0.002 per share in any transaction. The Release states that the proposed access fee standard is designed to promote a common quoting convention that would harmonize quotations and facilitate the ready comparison of quotes across the national market system.

c. Locked and Crossed Markets The proposed rule 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. For example, the Release states that such rules may include so-called "ship and post" procedures that would require a market participant to attempt to execute against a displayed order before posting a quote that may lock or cross the market. Under the proposal, SRO rules also would be required to prohibit members from engaging in a pattern or practice of locking or crossing the quotations in any security. The Release states that the Commission recognizes that locked and crossed markets between competing market centers can occur.¹⁷ The proposal defines "quoting market participant" as any broker-dealer that provides its best bid or its best offer in a security to an exchange or association pursuant to the Quote Rule or Regulation ATS, and whose best bid or best offer is not otherwise available through a quoting market center.¹⁸ 8 accidentally, i.e., quotes may inadvertently lock or cross when two markets are changing their quotes simultaneously. The proposed rule therefore also would require each SRO to promulgate rules that would discourage market participants from engaging in locking and crossing, but that nonetheless would tolerate some minimal incidents of locked and crossed markets.¹⁸

III. Sub-Penny Quoting Proposal The Commission is proposing a rule that would prohibit every national securities exchange, national securities association, ATS (including ECNs), vendor, broker or dealer from ranking, displaying, or accepting from any person a bid or offer, an order, or an indication of interest in any NMS stock in an increment less than one penny. The proposed rule would exclude NMS stocks with a share price below \$1.00. The Release states that, in the Commission's view, the marginal benefits of a further reduction in the minimum pricing increment (currently one penny) are not likely to justify the costs to be incurred by such a move and that the markets' experience with sub-penny quoting indicates that the practice, if allowed to persist, could harm investors and the securities markets. In particular, the Release states that the Commission believes that much of the trading that currently takes place in sub-

pennies is the result of market participants attempting to “step ahead” of limit orders for the smallest economic increment possible; that the increase in “flickering” quotes that could result from widespread sub-penny pricing could make it more difficult for broker-dealers to satisfy their best execution obligations and other regulatory responsibilities; and that sub-penny pricing could harm compliance with short selling restrictions and could decrease depth available at the best displayed prices. The proposed rule would not prohibit an exchange or association from reporting or “printing” a trade in a sub-penny increment. A broker-dealer therefore could provide price improvement to a customer order in an amount that resulted in an execution in an increment below a penny as long as the broker-dealer did not accept orders that already were priced in increments below a penny. In addition, the proposed rule would not 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 Release states that the Commission is not proposing to prohibit trading in sub-pennies because it does not believe at this time that trading in sub-penny increments raises the same concerns as sub-penny quoting.¹⁹ 18 The Commission specifically requests comment on a number of issues relating to the proposed market access rule. Among other things, the Commission requests comment on whether reliance upon private, negotiated agreements between members and nonmembers is adequate to ensure intermarket access to competing pools of liquidity throughout the national market system; whether the proposed rules adequately address the concerns that have arisen with respect to access fees; whether the proposed de minimis standards interfere unnecessarily with the business models of ECNs, national securities associations, and national securities exchanges; and whether the proposed new access provisions, quotation standardization, and new SRO responsibilities with respect to locked and crossed markets would appropriately and effectively address the current problems with respect to locked and crossed markets. 19 The Release specifically requests comment on a number of issues relating to the sub-penny quoting proposal including whether the benefits of a prohibition justify the costs; whether there are differences in Nasdaq-listed and exchange-listed securities that might warrant different treatment with respect to sub-penny pricing; whether sub-

9 IV. Market Data Proposal

The Commission is proposing to amend the rules and joint industry plans relating to the dissemination of market information to the public. In particular, the Commission is proposing to amend the three joint-industry plans (the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan) to modify the current formulas for allocating the plans’ net income to their SRO participants. The new formula would, in general, divide market data revenues equally between trading and quoting activity, in order to reward markets that publish the best quotes. The Commission also is proposing an amendment to the joint industry plans that would broaden participation in their governance. In particular, the proposal would establish a non-voting advisory committee that would help assure that the views of interested parties other than SROs have an opportunity to be heard on plan matters, and that their views are heard prior to any decision on a matter by the plan’s operating committee. Currently, operating committees, composed of one representative from each SRO participant, govern the plans. Members of the advisory committee would be selected for two-year terms and the operating committee of a plan would select, by majority vote, at least one representative from each of the following five categories: (1) a broker-dealer with a substantial retail investor customer base; (2) a broker-dealer with a substantial institutional investor customer base; (3) an ATS; (4) a data vendor; and (5) an investor. In addition, each SRO participant would have the right to select one committee member that is not employed by or affiliated with any participant. The proposal also would amend rules relating to the independent distribution of market information. In particular, the Commission is proposing

amendments to Exchange Act rules to implement the recommendations of the SEC's Advisory Committee on Market Information. First, individual market centers would have the freedom to distribute their own market data independently.²⁰ Second, the Commission would make the consolidated display requirement more flexible, again in order to promote wider distribution of data by individual market centers. Finally, to confirm by Exchange Act rule that both existing and any new SROs will be required to continue to participate in joint-SRO plans, the proposal would require SROs to act jointly pursuant to one or more national market system plans to disseminate consolidated information for NMS Stocks. In addition, the national market system plans would have to provide for the dissemination of all consolidated information for an individual NMS Stock through a single processor. Ari Burstein Associate Counsel penny pricing in low-priced securities raises the same concerns that have been raised about such pricing generally; and whether there are other types of securities that should be excluded from the proposed rule (e.g., ETFs). ²⁰ Such data could include "core information" – the trades and best quotes of a market center – which would continue to be transmitted to the Networks, but also additional information such as depth of order book.

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