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SEC REPROPOSES REGULATION NMS

[18383] January 4, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 1-05 SEC RULES MEMBERS No. 1-05 RE: SEC REPROPOSES REGULATION NMS The Securities and Exchange Commission has reproposed Regulation NMS for further public comment.1 Regulation NMS consists of four interrelated proposals that are designed to modernize the regulatory structure of the U.S. equity markets – the trade-through proposal, the market access proposal, the sub-penny quoting proposal, and the market data proposal. The Release states that the reproposal will afford the public with an opportunity to review and comment on changes to proposed Regulation NMS since its original publication. The most significant aspects of the reproposal are summarized below. Trade-Through Proposal Proposed Regulation NMS would establish 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. Protected Quotations The reproposed trade-through rule only would protect quotations that are "automated." The proposed rule would define an automated quotation as one that is displayed and immediately accessible through automatic execution. In particular, the reproposal would require 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 for any unexecuted portion of the order to be cancelled immediately and automatically without being routed elsewhere. The trading 1 Securities Exchange Act Release No. 50870 (December 15, 2004), 69 FR 77423 (December 27, 2004) ("Release"). The Release can be found on the SEC's website at http://www.sec.gov/rules/proposed/34-50870.pdf. Comments on the reproposal must be received by the SEC no later than January 26, 2005. For further information on proposed Regulation NMS, see Memorandum to SEC Rules Members No. 39-04 and Equity Markets Advisory Committee No. 6-04, dated March 12, 2004 [17208]. 2 center also must immediately and automatically respond to the sender of an IOC order.2 To qualify as an "automatic" quotation, no human discretion exercised after the time an order is received would be permissible in determining any action taken with respect to an order. Finally, trading centers would be required to immediately and automatically update their automated quotations to reflect any change to their material terms.3 Exceptions to Trade-Through Rule The reproposed trade-through rule contains several exceptions designed to limit the application of the proposed rule to quotations that are truly automated and accessible, including exceptions for intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and flickering quotations. While the reproposed trade-through rule does not provide a general exception for block orders, the Release notes that it seeks to address the interest of investors in obtaining an immediate execution in large size by including in the rule an "intermarket sweep order" exception.4 The intermarket sweep order exception would allow

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 states that by both allowing the immediate execution of large orders and protecting better-priced quotations, the exception is designed to appropriately balance the interests for investors on both sides of the market. The reproposal also would include an exception for certain types of “benchmark” orders. Specifically, the proposed rule would except 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. The benchmark exception also would include the execution of an order that is benchmarked to a market’s single-priced opening, as the Release states the Commission would not interpret such an opening price to be the “quoted price” of the NMS stock at the time of execution. 2 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 proposed rule would address the problem of slow trading centers by providing an exception (discussed below) for quotations displayed by trading centers that are experiencing, among other things, a material delay in responding to incoming orders. 3 The proposed rule sets forth requirements for a trading center to qualify as an “automated trading center.” Specifically, a trading center must have implemented such systems and rules as are necessary to render it capable of displaying quotations that meet the action, response, and updating requirements set forth in the definition of an automated quotation. In addition, an automated trading center must adopt reasonable standards limiting when its quotations change from automated quotations to manual quotations, and vice versa, to specifically defined circumstances. 4 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. 3 The reproposal also would except a transaction from the trade-through rule 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. Specifically, the reproposal excepts a transaction if the trading center displaying the protected quotation that was traded through had displayed, within one second prior to execution of the trade-through, a best bid or best offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade through transaction. To implement this exception consistent with the requirements of the rule, trading centers would have to adopt policies and procedures reasonably designed to avoid dealing with problem trading centers. Finally, to address the problem of flickering quotations, the reproposal 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.5 Depth of Book Alternative The Release notes that many commenters on the original proposal, particularly large institutional investors, strongly supported the need for enhanced protection of limit orders against trade-throughs. In response to these commenters, the Release states that the Commission has decided to repropose the trade-through rule to strengthen the protection of displayed and automatically accessible quotations in NMS stocks. Specifically, the SEC is proposing two alternatives for the trade-through rule. The first alternative would 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. The second alternative (“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. The Commission requests comment on several aspects of these two alternatives. Specifically, comment is requested on whether extending trade-through protection to the depth of book would significantly increase the benefits of the reproposed trade-through rule by, for example, further encouraging the display of limit orders and thereby enhancing depth and liquidity in the NMS. The Release states that in assessing the potential benefits of depth of book protection, commenters should consider the effect of the reserve size function that many trading centers offer investors. Comment also is requested on whether the depth of book alternative could be implemented in a practical and cost-effective manner. The Release notes that in order to comply with the provisions of this alternative, trading centers would need to monitor a significantly larger number of protected quotations displayed by other markets and route orders to execute against such quotations. Finally, the Commission requests comment on the effect that adoption of the depth of book alternative would have on competition among markets, specifically, whether protecting depth of book quotations would inappropriately limit the terms of market competition so as to harm investors and the efficiency of the NMS. Market Access Proposal 5 The Release states that the Commission has decided to eliminate the proposed opt-out exception from the reproposal because it believes it could severely detract from the benefits of intermarket order protection and that commenters overstated the risk that competition would be dampened by adoption of a trade-through rule without a general opt-out exception. 4 The Commission is 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. The Release states that the proposed rule is designed to promote access to quotations in three ways. First, it would enable 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 proposed rule would prohibit 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 proposed rule would limit 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 proposal would require SROs to establish and enforce 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. The reproposal is substantially similar to the market access rule as originally proposed. The reproposal, however, simplifies the proposed limitation on fees which, under the original proposal, would have limited the fees of individual market participants to $0.001 per share, with an accumulated cap of $0.002 per share. The Release states that the single, uniform fee limitation of $0.003 per share under the reproposal would be the fairest and most appropriate resolution of the access fee issue. The Commission also has modified the restrictions on displaying locking or crossing quotations to allow automated quotations to lock or cross manual quotations. Sub-Penny Quoting Proposal The sub-penny quoting proposal would prohibit any national securities exchange, national securities association, ATS (including ECNs), vendor, or broker-dealer from displaying, ranking, or accepting from any person a bid, offer, order, or indication of interest in any NMS stock priced in an increment less than one penny. The prohibition on sub-penny quoting would apply only to bids, offers, orders, and indications of interest priced $1.00 or greater. The Release notes that several commenters on the original proposal suggested that the Commission allow quotations below $1.00 to extend to four decimal places. The Release states that the Commission agrees with these commenters.

The reproposal therefore would prohibit bids, offers, orders, and indications of interest priced less than $1.00 in an increment smaller than $0.0001. The original proposal requested comment whether there are other types of securities that should be excluded from the proposed rule, such as ETFs. The Release notes that after further consideration, the Commission believes that a basis likely may exist to grant an exemption from the sub-penny quoting prohibition for certain actively traded ETFs. The Release states that the Commission intends to consider this matter further during the phase-in period for Regulation NMS, if Regulation NMS is adopted. Market Data Proposal 5 The Commission is proposing to amend the rules and joint industry plans relating to the dissemination of market information to the public. The changes fall into three categories: (1) modifying the current formulas for allocating market data revenues to the SROs to more appropriately reflect their contributions to public price discovery, (2) establishing non-voting advisory committees to broaden participation in plan governance, and (3) updating and streamlining the various Exchange Act rules that govern the distribution and display of market information. The Commission is reproposing with certain changes the proposed formula for allocating market data revenue. The reproposed formula reflects a two-step process. First, the distributable revenues would be allocated among the individual securities included in the market data stream. Second, the revenues that are allocated to an individual security then would be allocated among the SROs based on measures of the usefulness to investors of their trades and quotes in the security. The plan governance amendment and the amendment that would rescind the prohibition on SROs and their members from disseminating their trade reports independently are reproposed substantially as proposed. Ari Burstein Associate Counsel

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