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Securities Law Developments

SEC MARKET STRUCTURE INITIATIVES: MORE DISCLOSURE FOR EQUITIES, NEW LINKAGE FOR OPTIONS

On July 25, 2000, the Securities and Exchange Commission (SEC) approved an intermarket linkage plan for the options markets[1] and proposed two new rules to reduce intermarket trade-throughs in these markets -- a trade-through disclosure rule and a firm quote requirement for options.[2] For equities trading, the SEC proposed two more rules requiring disclosure of order routing practices and execution quality.[3] For now, SEC consideration of the issues raised in its February 2000 market fragmentation release[4] is limited to these disclosure proposals. The SEC has not required price/time priority for either the equities or the options markets and has deferred consideration of internalization and payment for order flow until its Office of Economic Analysis completes a study on trading in NYSE and Nasdaq equities. *Comments on the options proposals are due September 18, 2000; comments on the equity disclosure proposals are due September 22, 2000.*

I. <u>Approval of the Options Market Linkage</u>

As the number of multiply traded options has grown, the absence of either firm quotes or intermarket linkages in the options markets has made it increasingly difficult for broker-dealers to obtain best execution of customer orders for these options. Last fall, the SEC ordered the options exchanges to submit linkage plans addressing the issues of intermarket trade-throughs[5] and firm quote

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[1] Joint Industry Plan; Order Approving Options Intermarket Linkage Plan, Exchange Act Release No. 43086 (July 28, 2000), 65 Fed. Reg. 48023 (Aug. 4, 2000) ("Joint Linkage Plan").

[2] Firm Quote and Trade-Through Disclosure Rules for Options, Exchange Act Release No. 43085 (July 28, 2000), 65 Fed. Reg. 47918 (Aug. 4, 2000) ("Options Proposals").

[3] Disclosure of Order Routing and Execution Practices, Exchange Act Release No. 43084 (July 28, 2000), 65 Fed. Reg. 48406 (Aug. 8, 2000) ("Equities Proposals").

[4] Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42450 (Feb. 23, 2000); 65 FR 10577 (Feb. 28, 2000) ("Fragmentation Release").

[5] An intermarket trade-through is the execution of an order at a price inferior to the best-published price at the time of execution. The SEC's Office of Economic Analysis reviewed data showing intermarket trade-throughs in 5% of all trades of the 50 most active multiply listed options.

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obligations. The American Stock Exchange (AMEX), the Chicago Board of Exchange (CBOE) and the International Stock Exchange (ISE) each submitted identical plans on January 24, 2000; the Pacific Exchange (PCX) and the Philadelphia Stock Exchange (Phlx) submitted separate individual plans.

On July 25, 2000, the SEC approved the Joint Linkage Plan jointly submitted by AMEX, CBOE, and ISE.[6] In order to keep the plan from becoming obsolete or serving as a barrier to entry for new markets, and to allow for new forms of trade-through protection and market linkage, the SEC did not make participation mandatory. Notwithstanding the SEC statement that it may approve other joint linkage plans in the future, it is expected that the two remaining exchanges will join the plan, thereby reducing the likelihood of multiple linkage plans.[7] Customer limit order protection and price/time priority were deliberately left out of the plan. While the SEC believes that such rules could be beneficial, it did not want to postpone implementation of a linkage while it evaluated these issues.

Access to the linkage is limited to eligible market makers for both customer and proprietary trades; broker-dealers that are not market makers cannot access the linkage. To prevent market makers from using the plan to avoid the costs of exchange membership of an away market, the plan limits the number of principal orders that can be sent from one exchange to another through the linkage. The plan also stipulates that the linkage should not be used as an order delivery system for executing all or most of a participant's customer orders.

The plan links markets for three types of orders: (1) customer orders where the market maker chooses not to "step up" to match a better price displayed on an away market; (2) principal orders of eligible market makers;[8] and (3) "satisfaction orders," which are orders intended to satisfy trade-through liability.

<u>Customer Orders</u>

The plan allows an eligible market maker representing a customer order to transmit a new type of order through the linkage -- a principal acting as agent order (P/A Order). An eligible market maker can choose to route a P/A Order that is no bigger than the Firm Customer Quote Size[9] through the linkage for execution in the automatic execution system of a participating exchange at the national best bid and offer (NBBO) -- which, since there is no consolidated NBBO for the options markets, is defined as the NBBO calculated by a participating exchange in the series of an eligible option class. The receiving exchange must execute the order in its automatic execution system if its disseminated quote is equal to or better than the limit price attached to the P/A Order (reference price) at the time it arrives at the receiving exchange.[10] If the receiving exchange does not execute the entire order, it must

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[6] Joint Linkage Plan (see note 1).

[7] On August 2, 2000, the Pacific Stock Exchange (PCX) announced that it intends to participate in the approved plan, leaving the Phlx as the only options exchange that has not indicated its intent to participate in the plan.

[8] An eligible market maker is a dealer who maintains firm bid and offer prices in a given security by standing ready to buy or sell round lots at publicly quoted prices.

[9] The Firm Customer Quote Size is the number of contracts the exchange sending the P/A Order guarantees it will automatically execute for customer orders that are entered directly in that market, or the number of contracts the exchange receiving the P/A Order guarantees it will automatically execute for customer orders that are directly entered in that market. It must be at least 10 contracts.

[10] If the P/A Order is bigger than the Firm Customer Quote Size, an eligible market maker can either send a P/A Order representing the entire customer order through the linkage, or send as a P/A Order that portion equal to the Firm Customer Quote Size. If the entire P/A Order is sent, and if the receiving exchange's disseminated quote is equal or better

move its quote to a price inferior to the P/A Order reference price. If the sender does not receive a reply within 30 seconds, it may reject any response later received, if it does so within 15 seconds.

Principal Orders

The plan allows eligible market makers to send proprietary orders through the linkage if they are at the NBBO. Access for principal orders is limited to less than 20% of the sender's market maker volume for the last quarter. Senders that exceed the limit will be barred from sending principal orders (which do not include P/A Orders) through the linkage in the next quarter. Where the principal order sent by an eligible market maker is smaller than the Firm Principal Quote Size,[11] the exchange receiving such an order through the linkage must execute it in its automatic execution system, as long as its disseminated quote is equal to or better than the reference price at the time the order arrives. If the principal order exceeds the Firm Principal Quote Size, the receiving exchange must execute it in its automatic execution system for at least the Firm Principal Quote Size. The receiving exchange has 15 seconds from the time of receipt to inform the sending exchange of the amount executed and the amount cancelled. If the receiving exchange does not execute the entire order, it must move its quote to a price inferior to the reference price of the principal order. An eligible market maker cannot send a second principal order in same options class for at least 15 seconds after sending the first order, unless the receiving exchange changes its quote and that quote is at the NBBO.[12]

Satisfaction Orders (Trade-Through Liability)

A plan participant that trades through a quote will be liable to market makers who complain that their quotes were traded through. Proposed exceptions to trade-through liability include cases of systems malfunction, failure of a receiving market to respond within 30 seconds, and complex trades such as spreads or straddles. To satisfy a traded-through market, the member that initiated the trade-through would have to adjust its price or cancel the trade and would be responsible for the difference. If customer orders were part of the trade-through, the customer would get either the trade-through price or the satisfaction price, whichever is most beneficial. The plan limits the size of the satisfaction of a trade-through to the number of customer contracts included in the disseminated bid or offer of each exchange that was traded-through, subject to certain limitations, such as the size of the transaction that caused the trade-through.

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than the reference price of the order, the receiving exchange must execute the order for at least the Firm Customer Quote Size and, within 15 seconds of receiving the order, inform the sender of the amount executed and the amount canceled. If a portion of the P/A Order is sent, the sender can send a second order (which must not exceed 100 contracts) 15 seconds after the receiving exchange reported the execution, if the receiving exchange is still disseminating the same quote and that quote is at the NBBO.

[11] The Firm Principal Quote Size is the size guaranteed by a participant for incoming principal orders. It must be at least 10 contracts.

[12] If the receiving exchange's disseminated quote does not change for one minute after execution, the exchange that initially sent the principal order may send only principal orders for greater than the Firm Principal Quote Size. As with P/A Orders sent through the linkage, if the eligible market maker does not receive a reply within 30 seconds, it may reject any later responses if it so informs the receiving exchange within 15 seconds.

II. Proposed Options Rules

The SEC proposed two new rules designed to work with the intermarket linkage to reduce intermarket trade-throughs and help customers evaluate their brokers.[13] Proposed Rule 11Ac1-7 would require broker-dealers to disclose on customer confirmation statements when an order was executed at a price inferior to the best-published quote, unless the order was effectuated on a market participating in an approved linkage plan. The SEC has also proposed an amendment to Rule 11Ac1-1, the "Quote Rule," requiring options exchanges and market makers to publish firm quotes. SEC Chairman Arthur Levitt commented that the two proposed rules "would reaffirm the commitment to price priority embodied in the 1975 National Market System legislation."

A. Trade-Through Disclosure

To help customers evaluate execution quality and to encourage markets to find ways to limit trade-throughs, the SEC has proposed Rule 11Ac1-7, which would require broker-dealers to disclose on customers' Rule 10b-10 confirmations that an order was executed at a price inferior to the best published quote and what the better quote was. The disclosure would have to be as prominent as the transaction price on the customers' confirmation. The disclosure requirement would *not* apply to trades effectuated on an exchange that was a member of a linkage plan reasonably designed to limit trade-throughs.[14] The SEC has noted that if Rule 11Ac1-7 is adopted as proposed, the Joint Linkage Plan would need to be amended before broker-dealers routing orders to participating exchanges, such as AMEX, CBOE, and ISE, could take advantage of this exclusion.

Generally, a trade-through occurs when a customer order is executed at a price worse than the best published quote at time of execution. The proposed rule provides that an inferior or short execution would not be considered a trade-through and need not be disclosed when:

- the quote is stale because the Options Price Reporting Authority (OPRA) is queuing;
- unusual market conditions prevent quotes from being accurately collected or disseminated;
- the inferior price is published by a market conducting a trading rotation for that options class;
- the customer order is executed as part of a trading rotation for that options class;
- the quoting market fails to respond within 30 seconds;
- the market publishing the better price has a system malfunction that results in inaccessible quotes; and

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[13] Options Proposals (see note 2).

[14] A linkage plan "reasonably designed to limit trade-throughs" should have provisions which: (1) limit trade-throughs on markets of exchanges that are plan participants as well as those that are not; (2) require participants to actively surveil their markets for inferior trades; and (3) emphasizes that the failure of a market with a better quote to complain within a specified time period that its quote was traded-through may affect potential liability but does not negate the occurrence of the trade-through. The SEC seeks comment on whether a reasonable plan might only limit trade-throughs of member quotes, and on how to effectively limit trade-throughs of non-linked markets.

- the transaction is executed as part of a complex trade involving two or more transactions that are contingent on each other, such as a spread or a straddle.[15]

The SEC seeks comments on these exceptions, and on whether it should add a disclosure exception for broker-dealers whose policy is systematically to route orders to the exchange with the best price. The SEC also emphasizes that the proposed rule would not replace a broker-dealer's duty of best execution. Information gathered under the rule could be used by the SEC and the options markets for enforcement inquiries, investigations, inspections and examinations by broker-dealers.

B. Firm Quote Rule for Options

To support the proposed Trade-Through Disclosure Rule and the Joint Linkage Plan, the SEC proposes to amend the Quote Rule (Rule 11Ac1-1) to require the national options exchanges and their market makers' quotes to be firm up to their published quote size. Currently, the Quote Rule, which requires national securities exchanges and associations to establish procedures to collect bids, offers and quotation sizes in reported securities from market makers and to be firm (with certain exceptions) up to the published quote size, does not apply to the options markets.[16]

The SEC proposes to amend the Quote Rule's definition of "reported security" to include listed options, which would obligate options exchanges and market makers to publish their quotes and to be firm for these quotes. It also proposes to amend the definition of "consolidated system" to include a transaction reporting system pursuant to an effective national market plan.

<u>Quotation Size</u>

For equity orders, the Quote Rule requires the broker-dealers responsible for quotes to be firm up to their published size. This is impractical for options orders because size is not published as a part of options quotes. Instead, the SEC would require each options exchange to set and periodically publish a firm size for its best bid or offer in each security. If the rules of an options exchange do not require members to communicate quote sizes for listed options, a responsible broker or dealer member of that exchange would not have to provide a firm quote size; it could satisfy its firm quote obligation by executing options orders up to the size established by the exchange's rules.

The SEC requests comment on whether to require the exchange's firm quote size to be the same for all orders, or to allow different sizes for customer and broker-dealer proprietary orders (and on whether it should matter if orders are executed through an exchange's automatic execution system). The SEC also seeks comment on whether it should require a minimum number of contracts for which quotes must be firm and whether it should mandate that quotes be disseminated with size.

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[15] A "spread" is a simultaneous purchase or sale of options on some underlying stock with different strike price, expiration dates, or both. A "straddle" is a simultaneous purchase and sale of equal number of calls and puts on some underlying security with identical strike prices and expiration dates.

[16] Presently, each of the five options markets requires its own market makers to have firm quotes for some types of orders, but do not extend these rules to other market participants.

30 Second Response Time

The SEC has attempted to balance the need for price priority against the need for efficient execution of orders by proposing that each broker-dealer be required to respond to an order to buy or sell a listed option within 30 seconds by either executing the entire order, or executing the amount of the order equal to the applicable firm quote size and moving its bid or offer to an inferior price. It requests comment on the need for a time frame and the appropriateness of the 30-second limit.

III. Proposed Equity Disclosure Rules

Earlier this year, the SEC's Fragmentation Release presented various proposals designed to reduce fragmentation in the equity markets, ranging from increased disclosure of order routing and execution practices to the creation of a single national market linkage requiring price/time priority for all displayed trading interest.[17] Commenters disagreed on the merits and timing of these proposals and on the severity of fragmentation in general, but most supported some form of increased disclosure. In response, the SEC has proposed two new disclosure rules for the equity markets -- Rule 11Ac1-5, which is designed to measure the quality of execution at market centers, and Rule 11Ac1-6, which is meant to shed light on the order routing practices of broker-dealers.[18]

A. Execution Quality Report by Market Centers

Proposed Rule 11Ac1-5 would require equity market centers to release monthly electronic reports that present uniform statistical measures of execution quality of "covered orders" for each national market system security that they trade. The reports would contain many categories of information that would probably require analysis by market professionals before they are distilled to a form useful to the general public. The SEC requests comment on the cost and feasibility of such a broad reporting requirement, and on whether there is enough third-party interest in analyzing the information to make it clear to the public. The proposals asks the self-regulatory organizations (SROs) to develop a joint plan to set procedures for uniform, accessible distribution of reports.

Scope of the Reporting Requirement

Market centers subject to the proposed rule would include exchange and over-the-counter market makers, specialists, alternative trading systems, national securities exchanges, and the NASD. The SEC requests comment on whether certain markets that trade a low volume of nationally traded securities (or certain thinly traded securities themselves) should be exempt from the rule because they represent too few orders to justify the cost of reporting.

Orders covered by the proposed rule would consist of those the SEC believes amenable to uniform measures of execution quality -- that is, any customer market or limit orders received during regular trading hours while there is a consolidated best bid or offer (CBBO),[19] which the rule uses to

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[17] Fragmentation Release (see note 4).

[18] Equities Proposals (see note 3).

[19] The CBBO is defined as the highest firm bid and lowest firm offer for a security that is calculated and disseminated on a current and continuous basis under a national market system plan. Currently, the only such plans are the Consolidated Quotation Plan for listed equities and the Nasdaq National Market System for Nasdaq equities.

calculate price improvement. Orders subject to special handling requests that might skew the statistics would be excluded. Examples of excluded orders would include market opening and closing orders, stops, short sales, "not helds," orders for other than regular settlement, and orders to be executed on a particular tick or bid or away from the market price. Because of concerns about the quality of market opening orders on Nasdaq, the SEC requests comment on whether these orders should be excluded, and whether there is a different way to measure their execution quality. It also requests comment on how to apply the rule when the CBBO is locked or crossed.

Only national market system securities would be covered by the proposed rule. Nasdaq SmallCap and OTCBB securities would be excluded. Although the proposed rule would apply only to equities, the SEC also requests comment on whether there is a way to disclose execution quality for listed options in the absence of a CBBO, and on whether to require a CBBO for the options markets.

Measures of Execution Quality

The SEC proposes to set uniform measures of execution quality that are detailed enough to reveal good-quality execution of hard-to-fill orders. Otherwise, the disclosure requirement might discourage markets from accepting hard-to-fill orders by pressuring them to increase their reported speed of execution. The SEC requests comment on whether it should propose an alternative rule requiring release of raw order data, instead of execution quality reports, and if so, whether such an alternative should apply to all markets, or to small markets only.

The proposed rule would require order information for each individual security to be broken down into five order types and four order sizes, so that execution quality could be reported for each. The proposed categories of order types are "market orders," "marketable limit orders," "inside the quote" limits, "at the quote" limits, and "near the quote" limits (which are defined as orders that are ten cents below the bid at receipt time for a buy order and ten cents above for a sell order). The SEC chose not to require disclosure of data for limit orders that are more than 10 cents outside the CBBO when received, because execution of these orders depends more on limit price than handling. The order sizes are categories of 100-499 shares, 500-1999 shares, 2000-4999 shares, and 5000 shares and up.

For all covered order types, the report would show:

- The number of covered orders.
- The cumulative number of shares of covered orders cancelled before execution; executed at the receiving market center; or executed at another venue. All categories of data reported by a market center would include both orders that it executes itself and orders that it receives but routes away. Comment is requested on whether the market center should report separately with respect to orders routed away, even though this would have the effect of doubling the reporting burden.
- The cumulative number of shares executed in one of the following five categories of time after order receipt: 0-9 seconds, 10-29 seconds, 30-59 seconds, 60-299 seconds, and 5-30 minutes. Although this information would be required for all covered orders, the SEC believes that it would be most useful for evaluating the execution of non-marketable limit orders. Alternative measures that the SEC has proposed for comment are the time that an order spends on the market center's book while its limit price is at

or better than the CBBO, and the number of trades or the share volume on the consolidated tape at prices equal to or worse than the limit price of the order.

- The average *realized* spread for executions of covered orders, which is defined as two times the absolute value of half the difference between the execution price and the midpoint of the national best bid or offer *30 minutes after the order is received.* This measure is designed to measure the flow of uninformed market and marketable limit orders (which should show higher realized spreads), and to show both the costs of stepping ahead of nonmarketable limit orders and the likelihood that they will be executed when the market is moving against them.

For market and marketable limit orders, the report would also show:

- The average *effective* spread for executions of covered orders, which is defined as two times the absolute value of half the difference between the execution price and the midpoint of the NBBO *at the time of receipt*. This measure of price improvement could serve as a single measure of the liquidity premium on market and marketable limit orders. The SEC requests comment on whether the rule should also require statistics based on the time of execution.
- Other price improvement measures, which are designed to help weigh liquidity enhancement and the trade off between speed and price. These would include the cumulative number of shares of covered orders executed with price improvement; the share-weighted average amount of price improvement per share for these shares; and the share-weighted average period from order receipt to execution for these shares.
- For at-the-quote orders, the cumulative number of shares of covered orders executed at the quote, and the share-weighted average period from order receipt to execution.
- For outside-the-quote orders, the cumulative number of shares of covered orders executed outside the quote; the share-weighted average amount per share that execution prices were outside the quote; and the share-weighted average period from order receipt to execution.

B. Order Routing Disclosure by Broker-Dealers

Designed to make best execution decisions more transparent to customers, proposed Rule 11Ac1-6 would require broker-dealers that route orders on behalf of customers to post quarterly reports on their web sites describing and analyzing their order routing practices. Broker-dealers would also be required to disclose individualized order routing information to customers on request. The SEC requests comment on whether the rule should exclude broker-dealers that route relatively few customer orders. It also requests comment on whether, if the rule is adopted, it should change the confirm and statement rules (Rules 10b-10 and 11Ac1-3 under the Exchange Act) to reflect these new order flow disclosures.

Covered Securities and Orders

Broader in scope than the market data disclosure rule, the order routing disclosure rule would cover all nationally traded securities, including Nasdaq SmallCap securities and exchange-listed options. The SEC requests comment on the scope of the rule, particularly whether the rule should include OTCBB or other over-the-counter securities. The disclosure requirement would apply to any customer market or limit order that is not directed at the customer's request to a particular venue. Large orders, defined as orders whose market value is at least $200,000 for stocks or $50,000 for options, would be exempt from the disclosure requirements. Pre-opening orders, although they are not covered by the proposed reporting rule for market centers, would be included in the order routing disclosure.

Reporting Items

Broker-dealers would have two months from the end of the quarter to post their quarterly order routing reports on the Internet. Unlike the market center reports, these reports would be designed to be read directly by the public. The reports would include:

- The percentage of customer orders that are not directed to a particular market at the customer's request, and of these, the percentage that were market orders, limit orders, and other types.
- The venues to which non-directed orders were sent; the percentage of non-directed orders routed to each venue; and the percentage of (non-directed) market orders, limit orders, and other orders routed to each venue.
- A discussion of the material aspects of the broker-dealer's relationship with each venue to which non-directed orders were routed, including a description of any payment for order flow or profit-sharing arrangement (including internalization of orders that the broker-dealer executes as principal). Currently, the proposed report need not quantify payment for order flow or shared trading profits. Comment is requested on whether it should.
- A discussion of order routing practices, including significant objectives considered in routing the orders, the extent to which the objectives were achieved, comparison of the quality of execution actually obtained with execution quality for comparable orders in other venues during that time period, and any material changes in order routing policy that have been made or are contemplated. If an opportunity for price improvement was not taken, that should be explained.

Individualized Customer Disclosure

At the customer's request, the broker-dealer would be required to disclose where that customer's orders were routed over the last six months; whether the orders were directed or non-directed; and the time of execution that resulted. Broker-dealers would have to notify their customers at least once a year that they could request this information. The SEC requests comment on the cost and utility of this disclosure, and in particular, whether broker-dealers currently maintain information sufficient to respond to such requests.

C. Proposals to Improve Price Competition and Price Priority

While the SEC remains concerned about the impact on price competition of internalizing customer orders and payment for order flow, it has deferred its consideration of these issues for fear that rulemaking now could interfere with the competitive development of new market structures.[20] Before taking further steps to address internalization and payment for order flow, the SEC is considering the following proposals to strengthen price priority across markets and to encourage limit orders, which contribute to price competition.

Penny Jumping

Once the markets are fully converted to decimal pricing, it will be cheaper for market makers to step ahead of customer limit orders, because they will be able to trade in penny increments instead of eighths or sixteenths. The SEC requests comment on whether it should respond to this risk by preventing stepping ahead of limit orders in one cent increments without previously quoting at the limit price, in the hope that such a rule would encourage limit orders and promote price competition. It also requests comment on whether such protection should apply only to the limit orders of small retail customers.

ECN Prices in the Quote

The SEC believes that prices available on electronic communications networks (ECNs) should be included in the national quote. Since ECN prices may be misleading without consideration of the access fees required to trade on the ECN, the SEC seeks comment on the best way to make them comparable to other markets' quotes. One possibility is that ECN access fees could appear as part of the quote, either in all circumstances, or only when they are material in relation to the quoting increment.

Market Linkage

The SEC requests comment on whether it can expect the markets, acting on their own initiative, to develop linkages that protect price priority for displayed quotes. Types of linkages for discussion include multilateral linkages like that of the Intermarket Trading System (ITS); bilateral linkages between markets; linkages through broker-dealers; and plans to make an internal linkage available to other markets, as in the case of current links between SelectNet and the Chicago Stock Exchange or between ITS and the Nasdaq's Computer Assisted Execution System.

Equity Trade-Through Disclosure Rule

The SEC requests comment on whether it should adopt a rule requiring disclosure of trade-throughs of equity orders similar to that proposed for options -- that is, a rule under which no disclosure would be required if the market participated in a linkage plan reasonably designed to reduce trade-throughs. Related questions include whether such a rule would require changing or replacing the ITS Plan; whether there should be a materiality requirement for disclosure; how fees should be taken into account; and whether there should be an exception to the disclosure requirement for large block orders.

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[20] The SEC is awaiting the results of a study by its Office of Economic Analysis of execution quality in samples of Nasdaq and NYSE equities. The SEC has also established a formal advisory committee to advise it on the consolidation of market data for equities and options markets.

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