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Securities Law Developments

SEC ISSUES REPORT CONCERNING DISPLAY OF CUSTOMER LIMIT ORDERS

On May 4, 2000, the U.S. Securities and Exchange Commission ("SEC" or "Commission") issued a report on the display of customer limit orders in the equities and options markets, and the adequacy of the markets' surveillance and disciplinary programs for limit order display ("Report").[1] The Report was prepared by the SEC staff in the Office of Compliance Inspections and Examinations ("OCIE"), together with the Office of Economic Analysis. To evaluate the effectiveness of limit order display requirements, the OCIE staff undertook a series of inspections of self-regulatory organization ("SRO") surveillance and disciplinary programs, and reviewed the quality of limit order display by several large over-the-counter market makers and in the options markets. Overall, the staff found that while considerable improvements have been made in the area of customer limit order display, in particular through the automation of order routing and surveillance programs, significant weaknesses still exist. These improvements and weaknesses discussed in the Report are summarized below.

Background: Limit Order Display and Market Transparency

Investors generally enter two types of orders: limit orders and market orders.[2] Limit orders serve a critical market function by increasing the information available to the market and allowing all market participants to determine prices. They also contribute to leveling the playing field between dealers and the investing public by promoting investors' ability to trade without dealer intervention. In 1994, in its Market 2000 Study,[3] the staff of the SEC's Division of Market Regulation noted concerns that the failure to display limit orders might artificially widen spreads and result in inferior executions

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[1] "Special Study: Report Concerning Display of Customer Limit Orders," Office of Compliance Inspections and Examinations and Office of Economic Analysis (May 4, 2000) <http://www.sec.gov/news/studies/limitorm.htm>.

[2] A limit order is an order to buy or sell a security at or better than a specified price. In contrast, when an investor places a market order, a broker executes the trade at the best current price in the market.

[3] Securities and Exchange Commission, Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments (January 1994).

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for small customer orders. The Market 2000 Study recommended that all market makers display limit orders that better the best intermarket quotes.

The SEC adopted order handling rules, including the Display Rule, in 1996.[4] The Display Rule requires exchange specialists and OTC market makers, subject to various exemptions, to display in their quotes eligible customer limit orders that improve the price or add to the size of their quotes. Specialists and market makers must either: (1) display the price and full size of a customer limit order in their quote; (2) execute the limit order; or (3) send the limit order to another broker-dealer, exchange, or electronic communications network ("ECN") which will display it. In general, the eligible limit order must be displayed "as soon as is practicable after receipt which, under normal market conditions, would require display no later than 30 seconds after receipt."[5] The 30-second limit is an "outer limit under normal market conditions and is not [intended] as a 30-second safe harbor."[6]

In adopting the Display Rule, the SEC identified two reasons for OTC market makers' reluctance to immediately display eligible customer limit orders. First, a market maker might want to execute the order on a proprietary basis without allowing other market participants to interact with the order. While the market maker holds the limit order, it has, in effect, a private option to execute the order as principal. The longer it holds the order, the more time it has to determine whether it can profit thereby. This can be detrimental to execution opportunities for the limit order. Second, the market maker has an incentive not to display a customer limit order that would narrow the market maker's spread, thereby decreasing the profitability of the market maker's proprietary trading activity.

As summarized in the Report, limit orders, if displayed, allow the investors who submit them to compete for trades and in setting better prices. This results in a more level playing field between the dealer and the investing public. The Report further notes that recent economic studies confirm the importance of limit order display in promoting competition, providing liquidity, and increasing transparency: spreads appear to be narrowest when set by limit orders, and a large decrease in spreads in NASDAQ can be attributed to the implementation of the Display Rule.

Limit Order Display in the Equities and Options Markets

1. Equities Markets

Order Routing, Execution and Display Systems. All exchanges and most large OTC market makers have automated order routing systems through which orders are received and handled electronically. Some exchanges and most OTC market makers have automated display systems that provide for the immediate display of certain eligible customer limit orders upon receipt. The staff found that these systems enhance compliance with the Display Rule.

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[4] Order Execution Obligations, Exchange Act Release No. 37619A, 61 Fed. Reg. 48,290 (1996) (Display Rule is codified at 17 C.F.R. 240.11Ac1-4).

[5] Order Execution Obligations, 61 Fed. Reg. at 48,304.

[6] Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Chicago Stock Exchange, Exchange Act Release No. 40066, 63 Fed. Reg. 31,817, 31,818 n.14 (1998).

Some exchanges and most OTC market makers' automatic display systems provide specialists and traders with a predetermined period of time to interact with eligible customer limit orders after receipt. A countdown ranging from 0 to 30 seconds begins on receipt of the order; if the trader or specialist has not executed, displayed, or routed the order to another market center by the end of the period, the system automatically displays the customer limit order in the specialist's or trader's quotation. Although this feature improves compliance with the Display Rule, the Report notes that specialists and market makers who routinely rely on automated display systems that wait 30 seconds after receipt to display eligible limit orders are not in compliance with the rule. All exchanges allow their specialists to override their automatic display systems under some circumstances (for example, during "fast markets"). The Report notes that the use of overrides increases the likelihood of Display Rule violations.

The automated routing systems of exchanges and most OTC market makers are designed to route certain types of orders upon initial receipt for manual handling by exchange specialists or OTC traders (for example, larger-sized orders, orders that could create locked or crossed markets if displayed upon receipt, and orders that could result in a violation of short sale rules upon execution). In addition, some exchanges allow specialists to remove any incoming order from the automated system for manual handling, including limit orders that improve their quotation. Some regional specialists routinely exclude customer limit orders from their own exchange's automated systems in order to "lay off" the orders to other exchanges for display and execution. And some OTC market makers' systems do not provide for the automatic display or execution of customer limit orders, but place responsibility for display, execution or routing to another exchange with the individual trader, who must perform those functions manually.

The Report notes that while manual handling of orders is necessary in some circumstances, it also provides opportunities for abuse of the Display Rule. While eligible customer limit orders are being manually handled, the orders may not be placed on the limit order book or displayed in the quotation. This may prevent a recently arrived limit order from narrowing the spread, or otherwise reduce the execution opportunities for the order. The Report therefore recommends that exchanges and market makers should take steps to more fully automate the order routing, display and execution processes and, where manual intervention is required, to implement surveillance programs for the proper display of customer limit orders.

Limit Order Display Data. In connection with the Report, the staff requested that each SRO and a number of OTC market makers submit data on the handling of eligible customer limit orders received during December 1999. The data reviewed by the staff indicates numerous problems with limit order display. For example:

- Samples of limit orders received by three large OTC market makers showed that significant limit order volume was manually handled, resulting in Display Rule violation rates of 92%, 58%, and 46% of the samples reviewed. Violations included failure to display proper order size, failure to display within 30 seconds after receipt, and failure to properly transfer the order display obligation to another exchange system or member.

- One large OTC market maker's traders turned off the firm's automated display system for an entire day, resulting in the manual handling of over 1,000 customer limit orders.

One trader failed to properly display 83% of eligible customer limit orders that he manually handled.

- A firm employee of another OTC market maker turned off the automated display feature for the firm's OTC trading desk for a period of several months without detection by the firm. A sample of eligible limit orders received during that time showed a Display Rule violation rate of 46%.

- An earlier examination of the same market maker revealed that prior to implementing an automated display system, the firm failed to properly display 78% of a sample of customer limit orders. After implementation of an automated display system with extensive opportunities for manual intervention, an examination revealed an apparent Display Rule violation rate of 22%.

- System programming deficiencies at two large, more fully automated OTC market makers resulted in apparent Display Rule violation rates of 19% and 11%.

Overall, progress has been made since the Display Rule was adopted, especially with the wider use of automated display and surveillance technology. Nonetheless, the Report notes that even the most automated exchange specialists and OTC market makers have some level of non-compliance with the Rule.

SRO Surveillance Programs. The staff found a wide disparity among the SROs in their Display Rule surveillance programs and procedures. Some SROs have not fully automated their surveillance, and rely on a manual sampling of undisplayed orders. Some of these sampling methods use overinclusive parameters, resulting in reports that include customer limit orders that are not eligible for display. Other SROs have automated surveillance that creates exception reports tracking each customer limit order received, and produce monthly surveillance reports that reveal numbers and percentages of all eligible customer limit orders displayed and/or executed by individual specialists in accordance with the Display Rule.

The Report details a number of improvements needed in surveillance programs. First, the sampling method of surveillance is extremely time-consuming and often results in an incomplete review. Because sampling is so manually intensive, some SROs only review a small percentage of excluded orders. One SRO reviewed only 0.45% of manually excluded orders during a seven-day period. Another reviewed only a sample of limit orders for roughly 5% of its specialists per day. In addition, SROs using the sampling method sometimes fail to refer even egregious single violations of the Display Rule to their investigatory or enforcement staff, pursuing disciplinary action only after a pattern of violations has emerged. Because they review only a small sample of limit orders, it may be difficult to identify such a pattern.

Other areas where improvement is needed in surveillance programs include the following:

- Only two SROs surveil for overreliance by specialists on automated quotation systems. This may result in specialists routinely allowing automated systems to display customer limit orders at the 30th second after receipt even when they may be able to display the eligible order more quickly, which constitutes a violation of the Display Rule.

- Some SROs do not surveil for the proper display of customer limit orders that reside on the limit order book and become displayable during the course of the day as the market moves. The Display Rule requires that these orders then be displayed immediately.

- Until the staff's inspections in early 1999, some SROs considered customer limit orders that would result in locked or crossed markets, or in violations of the short sale rules, to be exempt from the Display Rule. These orders, however, may subsequently become eligible for display. These SROs failed to review for the proper display of such orders.

SRO Disciplinary Programs. Sanctioning guidelines for Display Rule violations vary widely among the SROs. First and second violations may result in a cautionary letter at one SRO, while another SRO may impose a $1,000 fine for a single violation. The Report notes that some SROs have not been aggressive in imposing sanctions for Display Rule violations. Two SROs had never imposed monetary sanctions, and some failed to conduct their disciplinary processes in a timely manner. All of the SROs, however, have moved to enhance discipline for Display Rule violations. The staff found that SROs with more fully automated surveillance procedures tend to also establish more objective disciplinary practices and to apply them more consistently.

2. Options Markets

The Display Rule applies only to equities; there is currently no comparable rule that applies to trading in options. While the options markets each have rules or policies governing the handling of limit orders, none currently require the immediate display of customer limit orders. Each options exchange has indicated that it is formulating rules requiring the immediate display or execution of customer limit orders.

The staff found that the automated execution and order routing systems of several options exchanges may disadvantage some customer limit orders. Many incoming orders are routed for manual handling instead of automatic execution against the limit order book. As with the equities markets, manual handling increases the potential for limit orders to be concealed.

The Report emphasizes that, as with the equities markets, the options exchanges should take steps to track customer limit order information in order to conduct surveillance for proper handling of limit order display and execution. The staff found that the options exchanges generally conduct very limited surveillance of limit order display. All of the exchanges stated that they intend to enhance this surveillance, and to develop and implement automated limit order display surveillance programs. Finally, the Report recommends that, as they adopt rules and enhance surveillance for proper limit order display, all of the options exchanges should discipline their members more aggressively for rule violations.

Conclusion

The Report concludes that limit orders are increasingly driving market prices and narrowing spreads, and that proper limit order display and handling is therefore critical. As order routing and surveillance has become more automated, compliance with the limit order display and handling obligations has been enhanced. The findings detailed in the Report, however, indicate areas where improvement is needed. Market participants should renew their efforts to ensure compliance with the

Display Rule in the future because limit order display and handling will remain a priority for SEC examiners.

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If you would like a copy of the Report or have any questions, please contact Brandon Becker (202-663-6979 or bbecker@wilmer.com), Soo J. Yim (202-663-6958 or syim@wilmer.com) or Elizabeth Derbes (202-663-6124 or ederbes@wilmer.com).

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