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Securities Law Developments

COMPETITION *versus* FRAGMENTATION: A NEW CHAPTER IN THE MARKET STRUCTURE DEBATE

On February 23, 2000, the Securities and Exchange Commission ("Commission" or "SEC") issued a long awaited release ("Release") requesting public comments regarding a broad range of issues relating to market structure.[1] The Release has sparked a lively debate in academic, political and professional circles concerning how to minimize or eliminate the so-called "fragmentation" in today's marketplace and, at the same time, promote liquidity and price transparency as well as competition among market participants.[2] The Senate Banking Committee also held hearings about market structure in New York and heard testimony from the SEC and other regulators, as well as leading members of the securities industry.[3] More recently, in a speech on March 16, 2000 at the Northwestern University School of Law, Chairman Levitt commented that "the need for direct intermarket linkages is compelling," because they facilitate best execution and promote equilibrium across markets.[4] Thus far, however, the issue has generated much controversy and little consensus among market participants, who continue to debate the extent of the perceived problem and the merits of each proposed solution.

The lack of unity regarding how to re-structure competing market centers is evident in the open-ended approach taken by the Commission. In the Release, the Commission asks whether fragmentation of the equity markets is now, or may become in the future, a problem that significantly detracts from the fairness and efficiency of the U.S. markets and, if so, how to address the problem. The Release also addresses the proposed rescission of Rule 390 of the New York Stock Exchange

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1 Exchange Act Release No. 42450 (Feb. 23, 2000), 65 Fed. Reg. 10577 (Feb. 28, 2000). The release is also available at <http://www.sec.gov/rules/sros/ny9948n.htm>.

2 For example, former Commissioner Joseph Grundfest urged the agency to consider mandating the use of a cutting-edge technology solution based on the "application program interface," or API, to link different market centers. He provided his views at "SEC Speaks," a yearly event sponsored by the Practicing Law Institute at which members of the SEC's staff and various commentators provide views on important issues facing the securities markets.

3 For full text of the testimonies, *see* <http://banking.senate.gov/00_02hrg/022900/index.htm>.

4 For full text of the speech, *see* <http://www.sec.gov/news/speeches/spch355.htm>.

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("NYSE"),[5] which is presented as an opportunity to consider broader ramifications of fragmentation in general. To this end, the Commission identifies and requests comment on a variety of issues relating to market fragmentation, as well as six potential options for addressing fragmentation. Comments on this part of the Release are *due April 28, 2000*.

I. *Overview of Current Market Structure*

The Release describes how the secondary securities markets exist to facilitate the transactions of investors. The Commission believes that investors should have confidence that (1) their brokers will deal with them fairly; and (2) their orders will be routed to market centers where they will be executed efficiently and at prices that are set by vigorous competition.

A. *Competition, Internalization and Payment for Order Flow*

The Release outlines the basic ways in which the various market centers compete in the national market through internalization of trading and payment for order flow. Specifically, the Commission makes the following observations:

- **Agency v. Dealer Markets.** Market centers can be divided into two categories – agency and dealer. An agency market center provides a mechanism for bringing buyers and sellers together (such as by matching investor market orders to buy with investor limit orders to sell) and charges fees for its services. A dealer market center, in contrast, executes trades as principal against incoming orders and receives its compensation primarily in the form of trading profits;

- **Broker's Role.** In a market system with many competing market centers, brokers play a critical role in deciding where to route their customer orders. Market centers offering trading services compete to attract order flow from brokers, who generally have discretion to choose the market center because non-institutional customers rarely direct where their orders are to be executed. As a result, broker order-routing practices can decisively affect the terms of the competition among market centers; and

- **Internalization and Payment for Order Flow.** The competition among market centers can take many forms - *e.g.*, fast and reliable executions and low transaction fees. In addition, a market center may offer direct or indirect economic inducements to a broker in return for the broker agreeing to route all or part of its order flow to the market center. These inducements have taken many forms, but can be divided into two major categories – internalization[6] and payment for order

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[5] Subject to certain exceptions, NYSE Rule 390 prohibits members and their affiliates from effecting transactions in NYSE-listed securities away from a national securities exchanges. Comments on this part of the Release are *due March 20, 2000.*

[6] Internalization generally refers to the routing of order flow by a broker to a market maker that is an affiliate of the broker.

flow.[7] Under current internalization and payment for order flow arrangements, orders are routed to a particular market maker that may execute the orders as principal without facing significant competition from investors or other dealers to interact with the directed order flow.

B. *Current Market Structure Components that Address Fragmentation*

The Release notes that, to address the potentially adverse effects of fragmented buying and selling interest in individual securities, the national market system for equity securities currently incorporates three important regulatory components: (1) price transparency; (2) intermarket linkages to displayed prices; and (3) the duty of best execution.

- **Price Transparency.** Price transparency is a minimum essential component of a unified national market system. All significant market centers are required to make available to the public their best prices and the size associated with the prices. This information includes not only the best quotations of market makers, but also the price and size of customer limit orders that improve a market center's quotations.

- **Intermarket Linkages to Displayed Prices.** The market centers that trade listed equities currently are linked through the Intermarket Trading System ("ITS"), which, in turn, has a linkage to the NASD's Computer Assisted Execution System. The current market structure allows price-matching rather than requiring that orders be routed to the market center that is displaying the best price, thereby isolating the orders of different market centers.

- **Broker's Duty of Best Execution.** In accepting orders and routing them to a market center for execution, brokers act as agents for their customers and owe them a duty of best execution. A broker's duty of best execution applies to both customer market orders and customer limit orders.

II. ***Requests for Comment***

The Release identifies and requests comments on a variety of issues relating to market fragmentation, as well as six potential options for addressing fragmentation. After reviewing the comments submitted by the public, the Commission will consider whether it is necessary to take regulatory action to address market fragmentation.

A. *Effect of Fragmentation on the Markets*

1. Fragmentation in General

- To what extent is fragmentation of the buying and selling interest in individual securities among multiple market centers a problem in today's markets?

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[7] Payment for order flow refers to various economic inducements for a broker to route its orders to a particular market center.

- Is fragmentation in the listed equity markets likely to increase with the elimination of off-board trading restrictions, such as NYSE Rule 390? In the existing over-the-counter market, what are the incentives for investors and dealers to quote aggressively?

- If fragmentation is a problem, are competitive forces, combined with the existing components of market structure that help address fragmentation (price transparency, intermarket linkages to displayed prices, and a broker's duty of best execution), adequate to address the problem?

- Will the greater potential provided by advancing technology for the development of broker order-by-order routing systems, or for informed investors to route their own orders to specific market centers, address fragmentation problems without the need for Commission action?

2. Internalization and Payment for Order Flow

- What proportion of order flow currently is subject to internalization and payment for order flow arrangements in the listed and over-the-counter equity markets? Will the proportion increase in the listed equity markets as a result of the elimination of off-board trading restrictions?

- Is it possible for a non-dominant market center to compete successfully for order flow by price competition, without using internalization and payment for order flow arrangements? If not, is the inability to obtain access to order flow through price competition a substantial reason for the existence of internalization and payment for order flow arrangements?

- To what extent can brokers compete as effectively for retail business based on execution quality (or implicit transaction costs), as opposed to commissions (or explicit transaction costs) and other services?

- Do investor market orders that are routed pursuant to internalization and payment for order flow arrangements receive as favorable executions as orders not subject to such arrangements? Even if these orders subject to internalization and payment for order flow arrangements receive comparable executions, does the existence of such arrangements reduce the efficiency of the market as a whole so that *all* market orders receive less favorable executions than they otherwise would if there were no internalization or payment for order flow?

- Even if internalization and payment for order flow arrangements increase the fragmentation of the markets, are any negative effects of increased fragmentation outweighed by benefits provided to investors, such as speed, certainty, and cost of execution?

3. Best Execution of Investor Limit Orders

- Does increased fragmentation of trading interest reduce the opportunity for best execution of investor limit orders? Are brokers able to make effective judgments concerning where to route limit orders so as to obtain the highest probability of an execution?

- Does the opportunity for brokers to share in market maker profits through internalization or payment for order flow arrangements create an economic incentive to divide the flow of investor limit orders from investor market orders among different market centers? If so, does this adversely affect the opportunity for investor limit orders to be executed fairly and efficiently?

- Is it consistent with national market system objectives (such as efficiency, best execution of investor orders, and an opportunity for investor orders to meet without the participation of a dealer) for market makers to trade ahead of previously displayed investor limit orders held by another market center? Does this practice significantly reduce the likelihood of an execution for limit orders by reducing their opportunity to interact with the flow of orders on the other side of the market? Does the practice offer any benefits that outweigh whatever adverse effects it might have on limit order investors?

B. *Possible Options for Addressing Fragmentation*

In addition to posing the various questions concerning fragmentation, the Release also proposes six possible options for addressing the issue, to the extent that regulatory action is deemed necessary.

1. **Require Greater Disclosure by Market Centers and Brokers.** The Commission could require greater disclosure by market centers and brokers concerning their trade executions and order routing. Such disclosures could enable investors to make more informed judgments concerning the quality of executions provided by their brokers, as well as enable brokers and the general public to make more informed judgments concerning the quality of trade executions at all market centers.

2. **Restrict Internalization and Payment for Order Flow.** The Commission could restrict internalization and payment for order flow arrangements by reducing the extent to which market makers trade against customer order flow by matching other market center prices. Market makers would thereby be less assured of the profits that can be earned by trading against directed order flow and that are used to fund the economic inducements offered to brokers for their customers' order flow.

3. **Require Exposure of Market Orders to Price Competition.** As a means to enhance the interaction of trading interest, the Commission could require that all market centers expose their market and marketable limit orders in an acceptable way to price competition. As one example of acceptable exposure, an order

could be exposed in a system that provided price improvement to a specified percentage of similar orders over a specified period of time.

4. **Adopt an Intermarket Prohibition Against Market Makers Trading Ahead of Previously Displayed Investor Limit Orders.** The Commission also could establish intermarket trading priorities as a means to address fragmentation. One option would be to adopt an intermarket prohibition against market makers (including exchange specialists) using their access to directed order flow to trade ahead of investor limit orders that were previously displayed by any market center and accessible through automatic execution by other market centers. Under this option, each market center would be responsible for providing notice to other market centers of the price, size, and time of its investor limit orders that were entitled to priority, as well as participate in a linkage system that allowed automatic execution against the displayed trading interest.

5. **Provide Intermarket Time Priority for Limit Orders or Quotations that Improve the NBBO.** The Commission could establish intermarket trading priorities that granted time priority to the *first* limit order or dealer quotation that improved the NBBO for a security. To qualify for such priority, the limit order or quotation would have to be widely displayed and accessible through automatic execution. Only the first trading interest at the improved price ("Price Improver") would be entitled to priority. No market center could execute a trade at the improved or an inferior price unless it undertook to satisfy the Price Improver. Subsequent orders or quotations that merely matched the improved price would not be entitled to any enhanced priority. If, prior to satisfaction of the Price Improver, another order or quotation was displayed and accessible at an even better price, the existing Price Improver would be superseded and permanently lose its priority. The subsequent trading interest at the better price would be the new Price Improver.

6. **Establish Nationwide Price/Time Priority.** The Commission could order the establishment of a national market linkage system that provides price/time priority for all displayed trading interest. Under this option, the displayed orders and quotations of all market centers would be displayed in the national linkage system ("NLS"). All NLS orders and quotations would be fully transparent to all market participants, including the public. Orders and quotations displayed in the NLS would be accorded strict price/time priority. Market makers could execute transactions as principal only if they provided price improvement over the trading interest reflected in the NLS. Trading interest in the NLS could be executed automatically; however, the NLS would not be a market center itself. Public access to the NLS would be provided through self-regulatory organizations, alternative trading systems, and broker-dealers. The NLS could be administered and operated by a governing board made up of representatives from the public and relevant parts of the securities industry.

III. *Conclusion*

As previously pointed out by Chairman Levitt in his public remarks, today's marketplace faces unprecedented challenges in the long-standing quest to "realize the vision for a true national market system."[8] While advances in technology have spurred innovation in order execution services, they also have led to the emergence of multiple trading venues that are not directly connected in a meaningful way. Although it is too early to predict the outcome of the SEC's latest rulemaking initiative, it represents a unique opportunity for the public to participate in an important public debate about whether and how to reshape the existing "playing field" for competing market centers in furtherance of the national market system. If you would like a copy of the Release or have any questions, please call Brandon Becker (202.663.6979; bbecker@wilmer.com), Soo J. Yim (202.663.6958; syim@wilmer.com) or Chris Ehrman (202.663.6072; cehrman@wilmer.com).

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[8] Chairman Arthur Levitt, "Dynamic Markets, Timeless Principles," Remarks at Columbia Law School (Sept. 23, 1999) <http://www.sec.gov/news/speeches/spch295.htm>.

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