Proposed Ban of Flash Orders: A New Chapter in the Market Structure Debate

SEPTEMBER 22, 2009

On September 17, 2009, the Securities and Exchange Commission ("SEC" or "Commission") unanimously proposed a rule amendment that would prohibit the practice of so-called "flash orders" in all markets, including equity exchanges, options exchanges, and alternative trading systems.[1] As described in the Proposing Release, the term "flash orders" refers to orders that are electronically disseminated to market participants for immediate execution; if not executed immediately, they are withdrawn.[2] Typically, they are "marketable" orders – that is, buy orders priced at the national best offer and sell orders priced at the national best bid.

In general, market participants that receive the flash order information have one second or less to respond with their own orders for possible execution against the flash order.[3] As a result, only those with most sophisticated trading systems are effectively able to access flash orders. This is true even where the market data feed containing the flash order information is available to any investor who wants to receive it.[4]

This disparity in trading access between professional traders and ordinary investors has been a subject of intense policy debate lately. Earlier this year, Senators Charles Schumer and Ted Kaufman asked the Commission to ban flash orders, claiming that they give a select group of traders with powerful computers an "unfair" advantage over everyone else.[5] Senator Kaufman has even likened flash trading, which he calls an "unfair performance-enhancer," to using steroids in baseball games.[6]

Notwithstanding the colorful analogy, the Proposing Release makes it clear that the Securities Exchange Act of 1934 ("Exchange Act") rules under which flash orders operate have a long-standing history in the nation's market structure. Under the so-called "Quote Rule" (Rule 602 under Regulation NMS), exchanges historically have excluded from the public quotation data any bids and offers that are considered "ephemeral" because they are either executed immediately or canceled if not executed immediately.[7] This exception for immediate execution or withdrawal was first adopted in 1978 in order to facilitate manual trading in the crowd on exchange floors before the common use of automated trading.[8] In the days of floor-based trading, exchange members used to engage in face-to-face discussions of prices on the trading floor that, practically, could not be reflected in the public quotation data. However, there is no doubt that the market structure for trading equity securities looks vastly different today.

Indeed, the very notion of "immediacy" has evolved significantly in today's world of electronic trading, where the speed of execution is often measured in micro seconds. According to some critics of flash orders, therefore, even 500 milliseconds cannot be considered immediate under the Quote Rule.[9] Instead, they argue, flash orders are not clearly distinguishable from other computer-generated, rapidly changing bids and offers that are included in the consolidated quotation system.

The Proposing Release addresses a number of policy considerations implicated by the use of flash orders. As a preliminary matter, the

Commission believes that, "in today's highly automated trading environment, the exception for flash orders from Exchange Act quoting requirements may no longer serve the interests of long-term investors and could detract from the efficiency of the national market system." Specifically, the SEC is concerned that flash orders may (i) create a two-tiered market in which the public does not have access, through the consolidated quotation system, to information about the best available prices; (ii) discourage the public display of trading interest and harm quote competition through diversion of order flow to non-displayed markets; (iii) undermine the purposes of Rule 610(d) of Regulation NMS, which seeks to protect displayed quotations from being locked or crossed; and (iv) create a risk that recipients of the information could act in ways that are harmful to the submitter of the flashed order.[10]

Notwithstanding these concerns, the Commission also recognizes the benefits associated with flash orders. They include: (i) the submitter of the flash order may have an opportunity for a better execution than if the order was routed elsewhere; (ii) the flash order may be executed for lower fees and in some cases may result in a rebate; (iii) the recipient of the flash order information that supplies so-called "hidden" liquidity incurs lower transaction costs; (iv) flash orders provide liquidity from market participants who are not willing to display publicly their trading interest; and (v) flash orders offer a competitive strategy that helps maximize a particular market's transaction volume and thus its revenue.

These benefits, however, may not be sufficient in the Commission's view to offset the potential costs associated with flash orders. The Proposing Release suggests that the most harmful cost is borne by the market participant displaying the national best bid or offer who missed out on a trading opportunity to execute against the flash order because it got executed rather than being routed to the publicly displayed bid or offer. According to the SEC, this outcome results in a negative "externality" that harms the efficiency of markets in general because it penalizes the provider of displayed liquidity, an important public good.[11]

As proposed, the existing exception for immediate execution or withdrawal would be removed in its entirety from Rule 602 of Regulation NMS. This proposal includes a corresponding interpretive position that the inclusion of flash orders in the public quotation system would be subject to the locking and crossing restriction under Rule 610(d). Effectively, these proposed changes would prohibit the use of flash orders that are marketable orders on exchanges because display at the contra side quotation in a security would lock or cross the market. Rule 301(b) of Regulation ATS, which requires alternative trading systems that display and execute a significant volume of orders to display such orders publicly, would be applied in a manner similar to the amended Quote Rule so that the use of flash orders by alternative trading systems also would be prohibited.

The SEC is soliciting comments on a wide range of issues relating to flash orders, including how overall transaction costs would change in the absence of flash orders, whether flash orders should be evaluated differently in listed options markets than in other markets, and whether there are special considerations applicable to ATSs that would justify applying to them a different standard from exchanges. In his statement at the September 17 open meeting, Commissioner Troy Paredes cautioned that a "thorough and unbiased assessment of flash orders must account for the potential benefits of flash orders that are lost if a ban is imposed,"[12] and asked in particular that commenters provide data "demonstrating how the current low volume of flash order trading has impacted securities markets" as well as possible less restrictive alternatives to a ban that might "strike a more appropriate balance" between the benefits and costs associated with flash orders.[13]

The Proposing Release represents only the beginning of a much larger review of market structure issues. In its request for public comment, the SEC specifically asks for information on how flash orders may interact with other "dark" trading interest. Additional market structure issues under the SEC's consideration include direct market access, high frequency trading, and co-location, all of which involve an emphasis on reduced trading latencies and the use of superior technology to effectuate trading strategies. The SEC also states on more than one occasion in the Proposing Release its obligation to favor long-term investors over short-term investors when their interests conflict.[14] Clearly, much more beyond flash orders is at stake in the ongoing policy debate concerning the future of the nation's secondary market. Market participants interested in these issues should carefully monitor the SEC developments following the Proposing Release.

---

[1] Exchange Act Release No. 60,484 (Sep. 17, 2009), available here ("Proposing Release").

[2] Flash orders are distinguishable from "immediate-or-cancel" ("IOC") orders. An IOC order only seeks to access currently available liquidity at a particular market by seeking immediate execution at the NBBO with no possibility of any further interaction with the market. By contrast, a flash order is briefly exposed (that is, "flashed") to other market participants in an effort to elicit a response from them, thus seeking to draw additional liquidity to the market.

[3] The time periods vary in length. *See, e.g.,* CBSX Rule 52.6(a) (period of time not to exceed 500 milliseconds); ISE Rule 803, Supplementary Material .02 (period of time not to exceed one second); BOX Rules, ch. 5, sec. 16(b)(iii)(2)(a) (a period of one second).

[4] Direct Edge, a leading Electronic Communication Network ("ECN") that allows the use of flash orders, provides its data feed with flash order information at no charge to any participant who wishes to receive the data.

[5]*See* Letter dated July 24, 2009 from Senator Schumer to Chairman Schapiro urging the SEC to ban

flash orders, available here; and Letter dated August 24, 2009 from Senator Kaufman to Chairman Schapiro urging the SEC to undertake a comprehensive market structure study, including flash orders, available here.

[6] *See* September 14, 2009 Senator Kaufman Press Release, available here.

[7] Paragraph (a)(1)(i)(A) of Rule 602.

[8] *See* Exchange Act Release No. 14415 (Jan. 26, 1978), 43 FR 4342 (Feb. 1, 1978) ("[T]he Rule as adopted reflects the fact that certain non-specialist participants in exchange 'crowds' have bids and offers which, while narrowing the exchange quotation for an instant in time, never in fact become part of the quoted market on the exchange because they are withdrawn immediately if not accepted.").

[9] *See* Letter dated May 28, 2009 from Janet M. Kissane, Senior Vice President – Legal & Corporate Secretary, Office of the General Counsel, NYSE Euronext to Elizabeth M. Murphy, Secretary, SEC ("In today's trading environment, where trading and reaction time are discussed in micro seconds, an order that is held for even 500 milliseconds cannot be deemed an 'immediate' execution.").

[10] Flash orders create this risk because there is "an inverse relationship between the extent to which flash orders are used beneficially by order submitters and the extent to which the recipients of flash orders could gain an information advantage." Proposing Release at 22-24.

[11] *Id.* at 25-6.

[12] Troy A. Paredes, Statement at Open Meeting to Propose Amendments to Eliminate Flash Orders, Sept. 17, 2009, available here.

[13] *Id.*

[14] *See* Proposing Release at 16, 25.

Authors

Andre E. Owens

PARTNER

Chair, Broker-Dealer Compliance and Regulation Practice

Co-Chair, Securities and Financial Regulation Practice

andre.owens@wilmerhale.com

+1 202 663 6350

Wilmer Cutler Pickering Hale and Dorr LLP is a Delaware limited liability partnership. WilmerHale principal law offices: 60 State Street, Boston, Massachusetts 02109, +1 617 526 6000; 2100 Pennsylvania Avenue, NW, Washington, DC 20037, +1 202 663 6000. Our United Kingdom office is operated under a separate Delaware limited liability partnership of solicitors and registered foreign lawyers authorized and regulated by the Solicitors Regulation Authority (SRA No. 287488). Our professional rules can be found at www.sra.org.uk/solicitors/code-of-conduct.page. A list of partners and their professional qualifications is available for inspection at our UK office. In Beijing, we are registered to operate as a Foreign Law Firm Representative Office. This material is for general informational purposes only and does not represent our advice as to any particular set of facts; nor does it represent any undertaking to keep recipients advised of all legal developments. Prior results do not guarantee a similar outcome. © 2004-2024 Wilmer Cutler Pickering Hale and Dorr LLP