

SEC PROPOSES TO BAN FLASH TRADING

The U.S. Securities and Exchange Commission has voted to propose a rule amendment to ban so-called “flash orders.”¹ The amendment would delete an exception from the Commission’s quotation rule, Rule 602 of Regulation NMS under the Securities Exchange Act of 1934 (the “Exchange Act”). In the proposing release (the “Release”), the Commission states that Rule 301(b) of Regulation ATS under the Exchange Act would be applied in a manner intended to ensure that trading through certain alternative trading systems (“ATSs”) also would be subject to the ban on flash orders.² In addition, the Commission would apply the restrictions on locking and crossing markets set out in Rule 610(d) of Regulation NMS so as to prohibit the display of flash orders with marketable prices. The comment period on the proposed amendment closes 60 days after the date of its publication in the Federal Register.

Flash Orders

“Flash orders” are types of orders that can be “executed immediately” or “withdrawn if not executed immediately,” as set out in Rule 602(a)(1)(i)(A) of Regulation NMS. Although a number of types of orders may fall within that description, the Commission states in the Release that flash orders have the following six basic attributes:

(1) use of flash orders is voluntary;

(2) flash orders typically are “marketable,” meaning that buy orders are immediately executable at the price of the national best offer and sell orders are immediately executable at the national best bid (in other words, the submitter wants to trade immediately and is willing to pay the “spread” between the national best bid and national best offer (“NBBO”) for that opportunity);³

¹ Elimination of Flash Order Exception from Rule 602 of Regulation NMS, Exchange Act Release No. 60684 (Sept. 18, 2009), available at <http://www.sec.gov/rules/proposed/2009/34-60684.pdf>. Please see the Commission’s press release at <http://www.sec.gov/news/press/2009/2009-201.htm>. The provision that would be deleted is subparagraph 602(a)(1)(i)(A). 17 CFR 242.602(a)(1)(i)(A) (2009).

² As noted below, Rule 301(b)(3)(i)(B) excepts from the quotation requirement in that rule an ATS that does not account in a given NMS security for 5% or more of the average daily trading volume in that security for four of the preceding six months. 17 CFR 242.301(b)(3)(i)(B) (2009). The Commission’s proposal to eliminate flash orders does not affect that exception.

³ In contrast, “non-marketable” orders that establish the NBBO are “resting” orders that seek to trade at better prices than those immediately available and to earn the NBBO spread, rather than pay it.

(3) on arrival at a market and before being flashed, flash orders will interact immediately with any available contra side trading interest at the exchange that receives the orders, meaning that the public may interact with the orders at that market, before the orders are flashed, by submitting non-marketable resting orders that are priced at the national best bid for buy orders and national best offer for sell orders;

(4) if a market does not have available trading interest at the NBBO when the flash orders arrive, the market will flash the orders to its market participants at the NBBO (some markets flash orders only to members, while others flash to anyone who wants to receive them);

(5) market participants that receive flash orders have a very brief period in which to respond with their own orders to execute against the flashed orders at prices that match the NBBO prices, generally a second or less. Therefore, only those with sophisticated trading systems could respond to flash orders; and

(6) if there are orders in response to the flash orders, the flash orders will execute; otherwise, the markets generally will route the orders away to execute against the best-priced quotations on other markets.

Inclusion of Flash Orders in Consolidated Quotation Data

Rule 602(a)(1)(i) of Regulation NMS requires a national securities exchange to “collect, process, and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed on an exchange or admitted to unlisted trading privileges which is communicated on any national securities exchange by any responsible broker or dealer.” These consolidated data quotation streams are made publicly available to participants in the equity and options markets. Under Rule 602(a)(1)(i)(A) of Regulation NMS, however, “[a]ny bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication” is not required to be collected, processed and made available to vendors. According to the Release, paragraph (a)(1)(i)(A) of Rule 602 was adopted in 1978 to accommodate “ephemeral” quotations of non-specialists in exchange crowds (i.e., on the floor of the exchange). The non-specialists on the exchange floor have bids and offers that narrow the spread, but those quotations never become part of the quoted market on the exchange because they are withdrawn immediately if they do not result in transactions. Rule 602(a)(1)(i)(A) was intended, therefore, to address issues associated with certain types of manual trading.

In proposing to delete that exception, the Commission asserts that, in contrast to the primarily manual trading that prevailed when paragraph (a)(1)(i)(A) was adopted, “flash orders no longer are clearly distinguishable from quotations that are disseminated in the consolidated quotation data.” Thus, the Commission believes that flash orders should be reflected in the consolidated quotation data and subject to the prohibition on displaying quotations with prices that lock previously displayed quotations.

The Commission also expresses concern that flash orders may create a two-tiered market that denies the public access to the best available prices for listed securities. According to the Commission, flash orders generally are displayed at marketable prices that are better than the best displayed prices in the consolidated quotation data. The public, however, does not see these better prices; only those market participants that receive a market's individual data feed will have access to those prices. The Commission believes that such a market is contrary to the intention of maintaining a consolidated quotation data stream, which is designed to provide a single source of information on the best prices for listed securities.

The Commission is concerned that flash orders may inhibit displayed liquidity and harm quote competition among markets. While publicly displayed limit orders set the current market for a stock, flash orders typically "are executed by a market at prices that match the best displayed prices for a stock at another market." Flash orders thus potentially deprive market participants who publicly display their interest in the best price from obtaining fast execution. According to the Commission, "[t]he opportunity to obtain the fastest possible execution at a price is the primary incentive for the display of trading interest."

Alternative Trading Systems

If the Commission adopts a ban on flash orders, it also would interpret Rule 301(b) of Regulation ATS in a manner consistent with that ban. Under Rule 301(b)(3)(ii), an ATS that, for at least four of the six preceding calendar months, has had an average daily trading volume of five percent or more of the aggregated daily share volume for an NMS stock,⁴ as reported by an effective transaction reporting plan,⁵ must provide to a national securities exchange the highest bid price and lowest offer price for such NMS stock, displayed to more than one person in the ATS, for inclusion by that exchange in consolidated quotation data required under Rule 602. Until now, the Commission has inserted into Rule 301(b) by interpretation an equivalent exception, with the result that orders that a threshold ATS displays to more than one person, and that are immediately executed or withdrawn, are not now subject to mandatory publication.

⁴ Under Rule 600(b)(47), an "NMS stock" is an "NMS security" other than an option. Rule 600(b)(46) defines an NMS security, in turn, as "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." 17 CFR 242.600(b)(46) & (47) (2009).

⁵ An "effective transaction reporting plan" is "any transaction reporting plan approved by the Commission pursuant to Rule 242.601." 17 CFR 242.600(b)(22) (2009). A "transaction reporting plan" is "any plan for collecting, processing, making available or disseminating transaction reports with respect to transactions in securities filed with the Commission pursuant to, and meeting the requirements of, Rule 242.601." 17 CFR 242.600(b)(82) (2009). Rule 601 requires a national securities exchange to file a transaction reporting plan with the Commission specifying, among other things, certain information about listed equity securities that a broker-dealer must provide to the exchange; the manner of collecting, processing, sequencing and making available transaction reports and last sale data under such plans; and standards intended to ensure prompt and accurate reporting. 17 CFR 242.601 (2009).

Upon deletion of the exception applicable to exchanges in Rule 602, the Commission would reinterpret Rule 301(b) so that ATSs that meet the 5% volume test would have to publish such orders irrespective of how the ATS describes the orders (for example, as indications of interest).

Locked Markets

Flashing of orders at marketable prices, which are at least equal to the best contra side quotation for a stock, may undermine one of the purposes of Rule 610(d) of Regulation NMS,⁶ which is intended to prevent displayed quotations from being locked by contra-side quotations of equal price.⁷ Rule 610(d) is intended to give “priority to the first-displayed quotation [to] encourage the posting of quotations and contribute to fair and orderly markets.” If a ban on flash orders is adopted, flash orders no longer would be excepted from the requirement that best-priced quotations and orders be included in consolidated quotation data; i.e., such orders would need to be displayed. If such orders were included in consolidated quotation data, they would lock the market in contravention of Rule 610(d) because they would be displayed at the NBBO. Incoming marketable orders would need to be routed to other exchanges to access the best displayed prices on those exchanges, repriced and displayed at the permissible price, canceled, or routed to a dark pool.

Request for Comments

The Commission seeks comment on a number of issues with respect to the proposed ban on flash orders and related issues. The Commission asks if the proposed ban would promote investor confidence by eliminating a potential two-tiered market with respect to market data and would promote the display of quotations in public markets by eliminating one type of “dark” liquidity, i.e., flash orders. The Release also seeks comment on the impact of the proposed ban on traders, how it might affect their trading strategies and whether there are alternatives to using flash orders in their trading strategies. Questions are posed as to whether certain market centers would likely benefit from changes in order routing practices and whether transaction costs would change.

The Commission also asks whether it should take a different approach for flash orders in listed options. It notes that trades in listed options must be executed on an exchange subject to public quoting obligations, whereas equity trades may be executed on over-the-counter venues not subject to quotation publication requirements. The Commission notes, moreover, that the incentives for displaying liquidity for options may be different from the incentives for displaying liquidity in cash equities. Options prices are based in large part on the value of the underlying securities; consequently, quoted options prices typically are updated as the prices of the underlying securities change.

⁶ Rule 610(d) requires a national securities exchange, among other things, “reasonably to avoid ... displaying any quotations that lock or cross any protected quotation in an NMS stock.” 17 CFR 242.610(d) (2009).

⁷ According to the Commission, “[a] ‘locking’ quotation has a price that equals the price of the previously displayed contra side NBBO.” If, for example, the national best offer to sell a security were \$40, a subsequent bid to buy the security at \$40 would lock the quotation.

The Commission seeks comment on whether it could take a narrower regulatory approach than a ban on flash orders. A market providing flash orders could, for example, make flash order information available for free to all who want it, albeit through that market's data feed. Another approach could be to require the recipient of a flash order to provide price improvement.

Potential Further Commission Action on Market Structure Issues

Finally, the Commission states that it is reviewing other forms of “‘dark’ trading interest,” noting that information regarding such trading interest is not generally available to the public. It specifically requests comment and data “on the use of flash orders as a mechanism to interact with dark liquidity and whether other mechanisms for accessing dark liquidity either do or do not raise policy concerns that are analogous to flash orders.” The Commission also states that it is reviewing related market structure issues, such as Regulation ATS thresholds, sponsored access, high frequency trading and co-location. In statements made during the open meeting at which the Release was proposed, the Commission indicated that it might initially address some of these market structure issues in a concept release that involves the solicitation of comments, followed by proposed rules and/or rule amendments.

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September 23, 2009

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