Reg NMS: A Retrospective Review & Practical Reforms for Improvement

FIA Principal Traders Group

September 2018

Executive Summary

In this paper, the FIA Principal Traders Group ("FIA PTG")[1] presents practical reforms to elements of the U.S. Securities and Exchange Commission's Regulation National Market System ("Reg NMS") regarding: the Order Protection Rule (Rule 611), the Access Rule (Rule 610), the minimum pricing increment (Rule 612), and national market system ("NMS") plans (Rule 608). Specifically, FIA PTG's suggested reforms include:

- Rule 611: Repeal Rule 611, restate the importance of a robust, principles-based "best execution" framework, and vigorously enforce "best execution."
- Rule 610: Repeal Rule 610's prohibition on locked and crossed markets, and approve and implement the SEC's July 2016 Order Handling Information Disclosure Proposal.
- Rule 612: Issue an SEC concept release to examine possible changes to the minimum pricing increment to create a flexible tick size regime, and propose a $.005 tick size for highly liquid securities.
- Rule 608: Modify: (i) Rule 608 to require industry and investor representation on NMS Plan Operating Committees; and (ii) Market Data Plans to allow competing securities information processors to collect and disseminate market data. Use SEC-direct NMS Plans sparingly (*i.e.,* primarily for technical, rather than commercial matters) in favor of direct SEC rulemaking.

In addition to the proposed reforms described above, FIA PTG offers perspective on off-exchange activity, order routing and execution disclosure, and market quality for less liquid securities. FIA PTG believes that Reg NMS reform is timely and important and that there is no need to wait for further holistic review.

Introduction

In a July 12, 2017, speech at the Economic Club of New York, Chairman Jay Clayton set forth eight principles to guide the work of the U.S. Securities and Exchange Commission ("SEC" or the

[1] FIA PTG is an association of firms that trade their own capital on exchanges in futures, options and equities markets worldwide. FIA PTG members engage in manual, automated, and hybrid methods of trading, and they are active in a wide variety of asset classes, including equities, fixed income, foreign exchange and commodities. FIA PTG member firms serve as a critical source of liquidity, allowing those who use the markets, including individual investors, to manage their risks and invest effectively. FIA PTG advocates for open access to markets, transparency, and data-driven policy. FIA PTG has previously provided recommendations on a number of equity market structure related issues and policymaking initiatives, which are available at https://ptg.fia.org/keywords/equity-market-structure.

"Commission") under his leadership.[2] From the perspective of equity market structure, notable among these eight principles were the fourth—"regulatory actions drive change, and change can have lasting effects"—and the sixth—"effective rulemaking does not end with rule adoption." The SEC's Reg NMS has had a far-reaching impact on equity trading since its implementation in 2007 and is foremost among examples of Chairman Clayton's fourth principle. While much of its impact has been positive, Reg NMS has also produced negative, unintended consequences over the past decade. As such, Reg NMS is a prime candidate for the retroactive review encouraged by Chairman Clayton's sixth principle.

In that spirit, the FIA Principal Traders Group presents practical reforms to improve Reg NMS. As detailed below, FIA PTG recommends changes to Reg NMS Rules 610 and 611, a study of potential changes to Rule 612, and changes to existing Reg NMS Plans. Rather than calling for additional "holistic review" that would further delay progress, FIA PTG believes that discrete, actionable reforms can be evaluated independently and that the time for such a review is now. Because of the pervasive effect of Reg NMS, FIA PTG also addresses relevant policymaking initiatives such as dark pool activity, order and execution disclosure, and market quality enhancement for less liquid securities.

Reg NMS Rule 611: Order Protection

Reg NMS Rule 611, the "Order Protection Rule," prohibits market centers from trading at prices inferior to those made available by automated markets, subject to certain restrictions. By creating a protected National Best Bid and Offer ("NBBO") Rule 611 endeavors to both ensure that incoming marketable orders receive the best price and also that standing limit orders at the best price are satisfied before those at inferior prices execute.

Although Rule 611's notion of "best price" seems appealing, it is essentially a proscriptive version of a broker-dealer's fiduciary duty of "best execution," which requires broker-dealers to execute client orders in a fashion that best serves client interests, subject to considerations of price, size, and speed, among others.[3] Rule 611 has produced unintended consequences, such as a need to protect various "speed bump" marketplaces, despite questionable value and comparability to traditional automated venues.[4] Rule 611 has raised costs, as market participants are compelled

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[2] *See* Jay Clayton, Chairman, U.S. Securities and Exchange Commission, "Remarks at the Economic Club of New York" (July 12, 2017), *available at* https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[3] *See* FIA PTG, Addressing Complexity from the Trade-Through Rule (Apr. 30, 2015), *available at* https://ptg.fia.org/articles/addressing-complexity-trade-through-rule.

[4] *See, e.g.,* Letter from Joanna Mallers, Secretary, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (Oct. 13, 2016), *available at* https://fia.org/sites/default/files/2016-10-13_SEC_CHX_LTAD.pdf.

to build connectivity to thirteen protected venues, irrespective of available liquidity.[5] Rule 611 has made markets more fragile and less resilient by requiring all markets to interconnect on rigid terms, increasing the risk of market disruptions.[6] And Rule 611 has reduced the incentive for exchanges to innovate by declaring price the most important component of execution, as opposed to liquidity or anonymity or other considerations deemed valuable by competitive forces.

FIA PTG believes that Rule 611 is both redundant to "best execution" and is an overly-proscriptive requirement for marketplace connectivity that is no longer needed in today's environment. Rule 611 should be repealed and robust "best execution" standards, and related concepts, should be promoted as a more flexible, effective means to protect investors. FIA PTG notes that the NBBO would continue to be calculated and publicly disseminated as it is today—and would continue to serve as a foundational benchmark for "best execution" analysis. FIA PTG also believes that market centers should also be encouraged to offer optional order modifiers which, when selected, would immediately cancel any marketable order that would execute at a price inferior to the prevailing NBBO. While FIA PTG appreciates that repeal of Rule 611 raises certain mechanical questions, we believe such questions can be addressed in the context of a robust "best execution" framework.[7]

Finally, FIA PTG believes that in the absence of Rule 611, competition would determine the number of exchange venues, rather than the so-called "regulatory subsidy" that Rule 611 currently facilitates. FIA PTG believes that absent Rule 611 the number of exchange venues would likely decrease, thereby reducing marketplace complexity and the costs borne by investors.

Suggested Reforms

- Repeal Reg NMS Rule 611.
- Restate the importance of a robust, principles-based "best execution" framework. Vigorously enforce "best execution" as part of the regular regulatory examination cycle.

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[5] *See* FIA PTG, Addressing Complexity from the Trade-Through Rule (Apr. 30, 2015), *available at* https://ptg.fia.org/articles/addressing-complexity-trade-through-rule.

[6] *See* Letter from Joanna Mallers, Secretary, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (Dec. 7, 2017), *available at* https://ptg.fia.org/sites/default/files/content_attachments/2017-12-07_CHX_LEAD_Proposal.pdf.

[7] For example, a broker-dealer that displays customer non-marketable limit orders on a venue that is often traded-through by competing venues—because of high access fees, slow response times, or other reasons—would need to consider "best execution" obligations to its customer, much in the fashion it does today in determining which venue will likely deliver the fastest execution of a non-marketable limit order. As another example, a venue that offers "pegged" orders at prices that use reference prices other than the NBBO would need to justify such choices within a "best execution" framework.

Reg NMS Rule 610: Access to Quotations

Reg NMS Rule 610, the "Access Rule," sets out accessibility requirements for market centers that display public quotations. Specifically, Rule 610 prohibits "unfairly discriminatory" terms that prevent or limit access to displayed quotations, imposes a fee cap of $.003/share for access to displayed quotations (or 0.3% of a displayed price that is less than $1), and prohibits locked and crossed markets. (A "locked market" occurs when the bid and offer price are the same; a "crossed market" occurs when the bid is greater than the offer.)

In part, the underlying logic of Rule 610 flows from Rule 611: if competing markets are forced to access each other to protect the best displayed price, then the means by which that access is provided must also be regulated. Rule 610's promotion of non-discriminatory access to public prices has served the industry well and has created a level playing field that benefits investors. The Commission is currently evaluating changes to the access fee cap component of Rule 610 on a pilot basis, primarily to determine if the current $.003/share level induces conflicts of interest in order routing decisions.[8]

FIA PTG believes that the prohibition of locked and crossed markets within Rule 610 has created unnecessary market complexity.[9] Specifically, the prohibition has engendered a vast array of special exchange order types designed to comply with the prohibition, in which exchanges generally accept and hold such orders until they can be displayed without creating a locked or crossed market.[10] Furthermore, FIA PTG does not believe that locked and crossed markets are problematic. To the contrary, a locked market represents a spread of zero—a lower-cost market for investors—and a crossed market represents an arbitrage that market participants will typically resolve fairly simply and quickly. FIA PTG expects that a market participant would choose to lock or cross a displayed quote—as opposed to attempting to execute against it—infrequently and only in circumstances consistent with "best execution" standards.

Finally, should the Commission determine to proceed with the proposed Transaction Fee Pilot, it should do so with the understanding that although the program may reduce conflicts, it will not

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[8] Securities Exchange Act Release No. 82873 (Mar. 14, 2018), 83 FR 13008 ("Transaction Fee Pilot"). *See* Letter from Joanna Mallers, Secretary, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (May 24, 2018), *available at* https://ptg.fia.org/sites/default/files/content_attachments/2018-05-24_SEC_Transaction_Fee_Pilot_Proposal.pdf.

[9] *See* Letter from Mary Ann Burns, Chief Operating Officer, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (Oct. 20, 2015), *available at* https://ptg.fia.org/sites/default/files/content_attachments/2015-10-20%20SEC%20MSAC%20Submission.pdf.

[10] *See* Letter from Joanna Mallers, Secretary, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (Apr. 5, 2017), *available at* https://ptg.fia.org/sites/default/files/content_attachments/2017-04-05_SEC_RegNMS.pdf.

eliminate them.[11] As long as exchanges compete on execution fees, conflicts will remain for brokers who make routing decisions. In the continued presence of such conflicts, detailed order routing and execution disclosures that inform a robust, principles-based "best execution" framework are critically important.[12] FIA PTG further notes that if the Commission repeals Rule 610's prohibition on locked and crossed markets, the need for an access fee cap would no longer exist—allowing market forces to fully determine the cost of displayed liquidity.

Suggested Reforms

- Repeal Rule 610's prohibition on locked and crossed markets.[13]
- Approve and implement the July 2016 Disclosure Proposal. Ensure that enhanced routing and execution disclosures are an important component of a robust, principles-based "best execution" framework.
- Ensure that market venues continue to offer non-discriminatory access to displayed liquidity.

Reg NMS Rule 612: Minimum Pricing Increment

Reg NMS Rule 612 sets the minimum increment for an order price at $.01 for securities priced at $1 or higher and $.0001 for those priced below $1. Despite the fact that securities vary considerably in terms of price level and liquidity, this "one-size-fits-all" tick size regime is a central characteristic of the marketplace. In October 2016, the Commission implemented an NMS Plan designed by the self-regulatory organizations ("SROs") to raise the increment to $.05 for a group of less liquid securities on a pilot basis.[14] In April 2010, three major exchanges also petitioned the Commission to reduce the tick size to $.005 for a pilot of liquid securities priced between $1 and $20.[15]

[11] *See* Letter from Joanna Mallers, Secretary, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (May 24, 2018), *available at* https://ptg.fia.org/sites/default/files/content_attachments/2018-05-24_SEC_Transaction_Fee_Pilot_Proposal.pdf.

[12] Securities Exchange Act Release No. 78309 (July 13, 2016), 81 FR 49432 ("Disclosure Proposal").

[13] FIA PTG notes that the prohibition of crossed markets is consistent with Reg NMS Rule 611. Should the Commission leave Rule 611 in place, therefore, FIA PTG would propose repeal of Rule 610's prohibition on locked markets only; the prohibition on crossed markets could remain in place.

[14] Securities Exchange Act Release No. 74892 (May 6, 2015), 80 FR 27514 ("Tick Size Pilot").

[15] *See* Letter from Chris Isaacson, Chief Operating Officer, BATS Exchange, Inc., Eric Noll, Executive Vice President, NASDAQ OMX Group, Inc., and Larry Leibowitz, Chief Operating Officer, NYSE Euronext, Inc. to Elizabeth Murphy,

FIA PTG believes that the minimum increment for pricing orders is a critical component of market structure. Unlike other major global markets, the U.S. maintains an inflexible "one-size-fits-all" tick regime that does not account for differences in price level and liquidity across thousands of listed securities. FIA PTG appreciates that creating a flexible tick size regime is a challenge; the approach must properly balance the benefits of market efficiency with the costs of complexity to produce the optimal outcome for investors.

FIA PTG appreciates the Commission's efforts with the Tick Size Pilot, but agrees with those who believe it has not met its objectives.[16] While we agree with the termination of the Tick Size Pilot at the end of the month, the program has provided valuable data that can be analyzed. The Commission should issue a concept release to collect ideas for a flexible tick size regime based on data from the Tick Size Pilot and other analyses, as well as experiences of other major global markets. Should the concept release produce a flexible tick size regime, the Commission should implement these changes via modifications to Rule 612 and not via an NMS Plan written by the SROs. Separately, the Commission should implement a $.005 tick size for highly liquid securities, which currently trade at the minimum $.01 spread continuously throughout the day.

Suggested Reforms

- Implement a $.005 tick size for highly liquid securities.

- Issue a concept release to examine possible changes to Rule 612 that would create a flexible tick size regime.

Reg NMS Rule 608: NMS Plans

Under Reg NMS, certain policy initiatives are implemented via NMS Plans, pursuant to Rule 608. NMS Plans are jointly filed by all SROs, which include the exchanges and FINRA. Some NMS Plans are required by specific rules, such as Rule 609 (creating the securities information processor ("SIP") which functions to collect and disseminate market data) and Rule 613 (creating the consolidated audit trail ("CAT"). Other NMS Plans implement cross-market policy initiatives, such as the Tick Size Pilot and the "limit up/limit down" regime created after the "Flash Crash" of May 6, 2010.

Secretary, U.S. Securities and Exchange Commission (Apr. 30, 2010), *available at* http://cdn.batstrading.com/resources/comment_letters/BATS_Exchange_CL_04_30_10.pdf.

[16] *See* Brett Redfearn, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, "Remarks at the Equity Market Structure Symposium Sponsored by the University of Chicago and the STA Foundation" (Apr. 10, 2018), *available at* https://www.sec.gov/news/speech/speech-redfearn-2018-04-10.

Among the most important NMS Plans are the CTA/CQ Plan and the Nasdaq UTP Plan ("Market Data Plans"),[17] which set forth the collection and distribution of market data via a SIP chosen and managed by the Market Data Plans. Historically, market participants have criticized the performance of the Market Data Plans in terms of service, price, and possible competitive issues because, in addition to governing the Market Data Plans, the exchange SROs provide competitive proprietary market data products that compete with the SIPs in the marketplace.

Recently, the SIPs have improved technological performance substantially and provided incremental financial transparency.[18] FIA PTG welcomes these developments; however, more can be accomplished. FIA PTG believes that allowing multiple, competing SIPs, will provide benefit to investors by way of reduced cost, improved service, and structural resilience.[19] At a minimum, the existing equity SIPs—provided by Nasdaq for Nasdaq listings and NYSE for all other NMS securities—should compete with one another. FIA PTG also believes that, while investors benefit from exchange competition and innovation via proprietary market data products, the Commission should be mindful that such products are often required for market participants to meet demands, including regulatory requirements, in a highly competitive environment.[20]

More generally, FIA PTG agrees with many other market participants that existing NMS Plans are poorly governed.[21] Too often, policymaking initiatives could be undertaken directly via SEC rulemaking, as opposed to outsourced to SRO-controlled NMS Plans. These governance frailties are particularly problematic where commercial issues are concerned (*e.g.*, rates charged for market data), as opposed to technical issues (*e.g.*, design of a limit up/limit down framework to reduce volatility).

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[17] Formally, the "CTA/CQ Plan" is the combination of the Consolidated Tape Association Plan and the Consolidated Quotation Plan, and the "Nasdaq UTP Plan" is the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis.

[18] *See* FIA PTG, Equity Market Structure Position Paper (Sept. 30, 2014), *available at* https://ptg.fia.org/documents/fia-ptg-equity-market-structure-postion-paper-finalpdf.

[19] *See* FIA PTG, Consensus on Equity Market Reform (Jan. 22, 2015), *available at* https://ptg.fia.org/articles/consensus-equity-market-reform.

[20] *See* Letter from Joanna Mallers, Secretary, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (September 17, 2018), *available at* https://fia.org/sites/default/files/FIA%20PTG%20Letter%20in%20Support%20of%20MFA-AIMA%20Petition.pdf.

[21] *See, e.g.,* Testimony of David Cushing, Director of Trading and Market Strategies, Wellington Management Company to the U.S. Securities and Exchange Commission Equity Market Structure Advisory Committee (Apr. 26, 2016), *available at* https://www.sec.gov/spotlight/emsac/emsac-042616-transcript.txt.

Suggested Reforms

- Modify Rule 608 to require industry and investor representation on NMS Plan Operating Committees, similar to requirements for SRO Boards of Directors.
- Use SEC-direct NMS Plans sparingly, in favor of direct SEC rulemaking. When used, restrict NMS Plans to technical, as opposed to commercial, matters.
- Modify Market Data Plans to allow competing SIPs to collect and disseminate market data in order to further improve quality, reduce risk, and facilitate price competition.

Related Issues

In addition to the foregoing recommendations regarding Reg NMS, FIA PTG offers perspective on three important aspects of equity market structure below.

Off-Exchange Activity

FIA PTG notes that exchanges are the foundation of public price discovery and we support initiatives designed to facilitate that critical function. As such, FIA PTG believes that the level of trading activity on alternative trading systems ("ATSs") and non-ATS over-the-counter ("OTC") venues should be set by fair competition. FIA PTG applauds the Commission's recent approval of improvements to enhance Reg ATS with increased ATS disclosure.[22] FIA PTG encourages the SEC and FINRA to continue to improve the transparency of ATS and non-ATS OTC venues and to study the influence of off-exchange activity (if any) on the critical price discovery function of exchanges. FIA PTG believes that competition, not undue regulatory advantage or burden, should determine the appropriate balance between off and on-exchange trading activity.

Order Routing & Execution Disclosure

FIA PTG believes in the importance of transparency and data-driven policymaking; these principles are critical to investor protection. The importance of a robust "best execution" framework cannot be understated, and detailed disclosures of execution performance are the foundation of such a framework.[23] To this end, FIA PTG believes that Reg NMS Rules 605 and 606 should be improved and continues to support the Commission's Disclosure Proposal to enhance order routing and

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[22] Securities Exchange Act Release No. 83663 (July 18, 2018).

[23] *See* Letter from Joanna Mallers, Secretary, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (Sept. 23, 2016), *available at* https://fia.org/sites/default/files/content_attachments/2016-09-23_SEC_Order_Handling_Proposal.pdf.

execution disclosure.[24] FIA PTG believes these enhanced disclosures will be particularly important before the Commission proceeds with the Transaction Fee Pilot.

Less Liquid Securities

FIA PTG believes that U.S. market quality is the best in the world, particularly for highly liquid securities. Concerns about market quality for less liquid securities have been voiced, but FIA PTG agrees with those who believe that these challenges cannot be easily solved by changes to market structure.[25] FIA PTG is open to proposals to improve market quality for less liquid securities, but believes that such proposals must not harm market quality for highly liquid securities, must be grounded in transparency and competition, and must have well-defined and realistic goals. FIA PTG also believes that the aforementioned reforms to Reg NMS, particularly changes to Rule 611, could benefit the market quality of less liquid securities.

Conclusion

Reg NMS has been a central feature of the equity trading landscape for over a decade. Although it has brought benefits to the marketplace, it has also produced negative, unintended consequences. These can be cured through practical reforms in the spirit of Chairman Clayton's emphasis on the need for retroactive review of past policymaking efforts. Reg NMS reform is timely and important; there is no need to wait for further holistic review.

FIA PTG appreciates the opportunity to present its perspective and practical reforms to improve Reg NMS. FIA PTG would be pleased to engage with policymakers and other interested parties to discuss these reforms at any time.

[24] *See* Letter from Mary Ann Burns, Chief Operating Officer, FIA PTG, to Brent Fields, Secretary, U.S. Securities and Exchange Commission (Oct. 20, 2015), *available at* https://ptg.fia.org/sites/default/files/content_attachments/2015-10-20%20SEC%20MSAC%20Submission.pdf.

[25] *See, e.g.*, Testimony of Steve Cavoli, Senior Vice President, Virtu Financial, at U.S. Securities and Exchange Commission Roundtable on Market Structure for Thinly-Traded Securities (Apr. 23, 2018), *available at* https://www.sec.gov/spotlight/equity-market-structure-roundtables/thinly-traded-securities-rountable-042318-transcript.txt.