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The Trade-Through Rule

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Summary

The trade-through rule mandates that when a stock is for sale on more than one exchange, transactions may not occur in one market if a better price is offered on another market. Defenders of the rule portray it as an essential protection for investors, particularly small investors who find it difficult to monitor their brokers' performance. Opponents argue that its principal effect is anti-competitive; that it protects traditional exchanges – where brokers and dealers meet face to face on trading floors – from newer forms of trading based on automatic matching of buy and sell orders. The Securities and Exchange Commission (SEC) has proposed new regulations that would modify the trade-through rule, which it describes as antiquated, by allowing investors to "opt out" of the rule voluntarily and by permitting traders on "fast" markets to trade through (that is, ignore) better prices offered on non-automated exchanges. The securities industry is divided on the SEC's proposal, but there is a consensus that amending the trade-through rule could force dramatic changes in the way stocks are traded, especially on the world's largest market, the New York Stock Exchange (NYSE). Committees in both the House and Senate have held hearings on this and other market structure issues, most recently in the House Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises on May 18, 2004. This report will be updated as events warrant.

The trade-through rule, on its face, is very simple: stocks traded on more than one exchange cannot be bought and sold for prices that are worse than other prices on offer. When this happens, the superior price offer is said to be "traded-through," or ignored. From the customer's pont of view, the rule is common sense – one would certainly not want one's broker to buy shares for $40 in one market when there was a seller elsewhere asking $39.90.

Nevertheless, the SEC has proposed regulations that would modify the trade-through rule, citing a need to modernize a rule that has become antiquated as stock markets have been transformed by technology and other factors.[1] The proposed regulation would extend the trade-through rule from exchange-traded stocks to all markets,[2] but would permit two significant exceptions to the rule: certain investors would be allowed to voluntarily "opt out" from trade-through protections, and automated "fast" markets (where orders are executed by computers) would be permitted to trade through superior prices offered on "slow" markets (principally the New York Stock Exchange (NYSE)), where most transactions pass through the human hands of specialists and floor brokers.

Changes to the trade-through rule have the potential to change the way stocks are traded in U.S. markets. The stakes are not small: in the short run, the question is who will handle a business worth billions of dollars a year. In the long run, the issue is whether we have a stock market structure that provides the maximum benefits to the economy as an engine for capital formation, investment, and growth. The proposed Regulation NMS (national market system) is a response to changes in market structure that have been driven by new technology and the increasing dominance of large institutional investors (such as pension plans and mutual funds).

There are three types of stock markets in the United States (although the distinctions become less clear all the time).[3] First, there are the traditional exchanges, where most of the action takes place on a trading floor where brokers and dealers meet face to face. Second, there is the Nasdaq, where traders are physically dispersed and dealers' offers to buy and sell are displayed and executed on computer screens. Finally, there are the alternative trading systems (ATSs[4]), which are essentially computers that match customers' orders to buy and sell without the intermediation of a dealer.

For "traditional exchange" we may, for practical purposes, substitute "New York Stock Exchange." The NYSE accounts for 99% of the volume of all registered stock exchanges; its only significant domestic competitor is Nasdaq, which (as noted above) is not technically an exchange. The controversy over the trade-through rule, however, is not primarily a matter of rivalry between NYSE and Nasdaq. Instead, a major issue is whether trading in NYSE-listed stocks will migrate from the NYSE floor to the ATSs, which now account for over half the trading volume in Nasdaq stocks, but only a small fraction of NYSE volume.

Inet, the largest ATS, handles about 25% of trading volume in shares listed on Nasdaq, but only 1% of trading in NYSE-listed shares. (Companies do not list their shares on ATSs as they do on the NYSE and Nasdaq; ATSs are purely trading mechanisms.) This disparity, and the trade-through rule's relation to it, is at the center of the controversy over the proposed Regulation NMS. Opponents of the trade-through rule argue that the rule essentially confers monopoly status on the NYSE trading floor by requiring that orders in NYSE shares be "exposed" to the floor for 30 seconds to see if a

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[1] The SEC's proposed Regulation NMS, together with comments received, is available online: [http://www.sec.gov/rules/proposed/34-49325.htm].

[2] Nasdaq is legally not a stock exchange, but a "national securities association."

[3] For a more detailed treatment of market structure, see CRS Report RL30602, *The Electronic Stock Market*, by Mark Jickling.

[4] Also known as ECNs, or electronic communications networks.

better price can be found (called "price improvement") before they can be executed in other markets, including ATSs. In this view, the trade-through rule negates the advantages of ATS trading, which are speed, anonymity, and certainty of execution.

On the other hand, the NYSE and its supporters claim that the NYSE floor in most cases offers the best price, and that abolishing the trade-through rule would raise trading costs to investors. Both these arguments appear to be correct, but in different contexts, depending on the type of transaction involved. The preferences and needs (and market power) of large institutional investors are the key to understanding the dispute.

ATSs came into being to serve the needs of institutional investors. They offer extremely fast execution and usually match buyers and sellers directly. Unlike Nasdaq market makers and NYSE specialists – who stand ready to buy or sell at any time – an ATS does not bring its own capital to the market. ATS dealing can lower transaction costs by cutting out these middlemen, and in other ways. When a pension fund, for example, wishes to sell a large block of stock, brokerage commissions and dealer spreads are only part of the costs it faces. It must also consider the market impact of the order when it reaches the NYSE floor or a Nasdaq dealer – if the amount of stock to be sold exceeds current buying interest in the market, the price will fall, perhaps significantly, before the transaction is complete. An ATS offers the possibility of finding an institutional buyer, so that market impact will not be a factor.[5]

Other reasons why an institutional investor might prefer to trade through a superior price offered on the NYSE floor have to do with execution speed and certainty. Where an ATS may offer immediate execution, the better price offered on the NYSE may cover only a portion of the institution's order. In that case, the price is not "delivered" and the order is not executed. The trade-through rule requires that orders in NYSE stocks be sent to the floor for interaction with traders physically present there, during which time the market price may be moving against the institutional buyer or seller. Problems of speed and certainty of execution have worsened for institutional traders with the conversion to decimal pricing. When stocks are priced in pennies rather than eighths, there is less buying or selling interest at any given price, which both magnifies the market impact of large orders and increases the probability that prices will move before a trade is completed.

Large institutional traders expect to benefit if the ATSs can capture significant volumes of NYSE trading, as they have in Nasdaq stocks. These benefits, for the most part, would not be shared by individual investors, or (in many cases) by smaller institutions. Small traders generally approach the market through multiple intermediaries, so a few seconds in execution time makes little difference to them. Their orders do not affect the market price. Their abiding concern is that their transactions costs will be higher than those paid by large traders and market insiders. For such market participants, the trade-through rule is a significant protection against collusion between brokers and

[5] The "upstairs market" at the NYSE has for many years served this same function: brokers known as block positioners match institutional buyers and sellers, so that neither order will languish on the floor as prices deteriorate. The first ATSs replicated this function for Nasdaq stocks, and – with modifications to the trade-through rule – could plausibly attract many institutional trades that now go to the NYSE upstairs market.

dealers and other situations in which market insiders may take advantage of their public customers. However, because the largest institutions include pension funds and mutual funds representing millions of small investors, the trade-through issue cannot be framed purely as a conflict between large and small shareholders.

The issue can also be framed as speed versus price. Certain traders wish to be assured of receiving the best available price at any given moment, regardless of venue, while for others, speed is paramount, and (especially for large trades) the "best" price on offer may no longer be there by the time their order has been shopped around, as the trade-through rule requires. The SEC in its proposed rule changes has attempted to balance the interests of all market participants.

The Proposed Regulation NMS

The SEC proposal would first of all extend the trade-through rule to all markets. At present, it applies only to exchange-listed stock. Thus, it would apply to Nasdaq stocks, whether traded by Nasdaq dealers, or market makers, on ATSs, or in other venues.[6] (Because Nasdaq brokers and dealers are now bound by a duty of "best execution," obliging them to get the best price reasonably available for their customers, the extension of the trade-through rule to them would not cause a major change in how they do business.)

The revised trade-through rule would require all markets to establish policies and procedures reasonably designed to prevent trade-throughs. The SEC proposal would not simply prohibit trade-throughs, in part because of the inevitability of inadvertent trade-throughs when market prices are moving very rapidly, and the best price may change several times a second. The SEC hopes to encourage price competition across markets and to create a presumption that orders are filled at the best available price, which is crucial to maintaining investor confidence in the market.

To accommodate the needs of institutional traders who view the current trade-through rule as an impediment to full competition, the proposed SEC rule contains two major exceptions to the general trade-through rule. First, informed investors would be allowed to "opt out" of the trade-through rule. If they agreed in advance, their broker could fill their order in a particular market, even though a better price was quoted elsewhere. If this exception is adopted by the SEC, many observers expect that many institutions will choose to opt out and that significant amounts of NYSE volume will flow to the ATSs.

The second exception would allow automated (or "fast") markets to execute orders without regard to a better price displayed on a non-automated market. (An "automated market" would be defined as one providing for an immediate automated response to all

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[6] For example, the SEC proposes to apply the trade-through rule to orders that are filled internally by a broker or a dealer who fills a customer order by acting as a principal to the trade. The SEC would use the broad term "order execution facility" to mean essentially any venue in which stocks are traded.

incoming orders, without any restriction on executions.[7]) A better price on a non-automated market could be traded through only if the price improvement offered were less than a certain dollar amount, according to a sliding scale. A price difference of one cent could be traded through for shares priced at less than $10, and so on up to a five-cent per share difference for stocks priced over $100.

The extent to which this exception would allow ATSs to bypass the NYSE is uncertain. Various estimates exist for the difference in spreads for shares quoted on the NYSE floor and elsewhere;[8] as a result it is hard to anticipate the impact of the 1-5 cent limit. In addition, the NYSE has indicated that it may upgrade or reconfigure some of its automated systems in order to meet the definition of automated market.

On May 20, 2004, the SEC extended the comment period for Regulation NMS until June 30, 2004.[9] In this release, the SEC acknowledged several difficulties attending the original proposals, including the definition of "fast" market, the definition of an automated price quote, the sliding scale for the amount by which fast markets would be allowed to trade through non-automated market prices, and other matters. The second release suggests that the final rules may differ significantly from what the SEC originally proposed.

Pro and Con Arguments

The arguments in favor of the SEC proposed regulation have been outlined in the discussion of institutional trading above. Large institutional investors want to have the full range of choices as to where and how to execute their trades. They view the current trade-through rule as an archaism which fails to consider two important factors: speed and certainty of execution. Effectively, according to supporters of the SEC proposal, the current trade-through rule acts as a barrier to competition whose major impact is to allow the NYSE to avoid adopting automatic market structures and mechanisms that have lowered trading costs in other markets. They point to the ETF market,[10] where the trade-through rule has been waived in an SEC pilot program, and NYSE and the ATSs compete

[7] Under this definition, the NYSE would not qualify because it places limits on the number of shares that can be traded over its automated transaction systems and requires that 30 seconds elapse between a single participant's trades. In addition, automated systems may be shut down briefly when there is an imbalance of buy and sell orders, and the specialist must intervene to determine a new market-clearing price.

[8] A recent NYSE study finds that there is an average difference of 4.21 cents per share, but there are serious measurement difficulties. See *Potential Costs of Weakening the Trade-Through Rule*, NYSE Research, Feb. 2004; and the SEC study *Report on the Comparison of Order Executions Across Equity Market Structures*, Jan. 8, 2001, p. i: "There is no single all-encompassing measure of execution quality."

[9] Text of release at [http://www.sec.gov/rules/proposed/34-49749.htm].

[10] ETFs, or exchange-traded funds, are instruments that replicate popular stock indices, allowing traders to buy or sell the S&P 500 or the Dow Industrials in a single package.

head-to-head. It is reported that the NYSE floor handles only 5% of ETF volume, suggesting that significant volumes in listed shares would move to the ATSs as well.[11]

Supporters of the trade-through rule in its present form focus on the fact that the NYSE trading floor, though often characterized as a technological dinosaur, does produce better prices and narrower spreads than other markets. An array of academic studies does provide evidence for this claim,[12] although there is no consensus as to why it should be true. Opponents of the SEC proposal argue that this pricing advantage translates into savings for investors, and that these savings may be lost if trading in NYSE stocks moves to other venues.

A related concern is the possible loss of liquidity if NYSE floor volume declines. The traders and dealers who stand ready to buy and sell in all market conditions are a resource that may be jeopardized if trading is fragmented among many market centers. In normal times, a computerized market may be an acceptable substitute for a trading floor, but when markets are under stress, a central market may be better able to provide a steady stream of price information, without gaps and wild swings that can lead to panic. Advocates of ATSs and other automated systems are skeptical about this argument, but they have been making dire predictions about the obsolescence and imminent demise of the NYSE (and the trading floors on the Chicago futures exchanges) for many years.

The adoption of the SEC proposal would stimulate the spread – already very rapid – of automated systems in the stock market. However, market structures, trading strategies, and investor preferences are already so complex and various that it is hard to predict with any certainty how shares will be traded a decade from now. Congress has exercised oversight: committees in both the House and Senate have held hearings on market structure issues, most recently in the House Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises on May 18, 2004.

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[11] "Test by SEC Supports 'Trade-Through' Critics," *Newark Star-Ledger*, Apr. 18, 2004, p. 8.

[12] These are cited in Appendix A of the SEC study noted above.