

# Time for a Fresh Look at the Trade Through Rule

Fundamental change may be coming to U.S. equity markets

December 20, 2016

Fundamental change may be coming to US equity markets, and it's not just because of the new Trump administration. In September, the SEC included Reg NMS in a list of regulations to be examined pursuant to the Regulatory Flexibility Act (RFA). Passed in 1980, the RFA requires government agencies to periodically review and assess the impact of regulation on US businesses.

Regulation NMS is one of the most significant and controversial pieces of equity market regulation, and the aftershocks still reverberate today, over 10 years after it was passed. There were four main components of the regulations:

- **The Access Rule** – which promoted fair and non-discriminatory access to quotations displayed regulated exchanges through private linkages, and set caps on the fees exchanges could charge.
- **The Order Protection Rule** – also known as the trade through rule, mandated that investors receive the best price on routed orders by requiring exchanges to route orders to other exchanges if they are displaying better prices.
- **Sub-Penny Rule** – which prohibited the quotation of prices in increments of less than one penny, unless the stock price is below \$1.00.
- **Market Data Rules** – related to the allocation of market data revenues to SROs/exchanges.

While I am in favor of a holistic review of market structure that encompasses all aspects of U.S. equity market structure, the Order Protection Rule deserves particular attention. This particular rule within Reg NMS was controversial from the beginning and two SEC commissioners voted against Reg NMS at the time focusing on the [Trade Through Rule in their dissent](#). One of the dissenting SEC Commissioners was Paul Atkins who is now a leading figure in President-Elect Trump's transition team; so it is instructive to look back on his original objections.

| REG NMS WARNINGS                                 | WHAT HAS HAPPENED SINCE  |
|--|--|
| Decreased Price Discovery and Quantity Discovery | Both have indeed happened: volume executed in dark venues (without price discovery) has increased while quantity discovery as measured by average execution size has decreased by 53% for Nasdaq stocks and 75% for NYSE stocks.[1]  |
| Increased Gaming Opportunities                   | Dissenters predicted that top of book order protection would lead to strategies that route orders based on achieving top of book.  |
| The Lowest Common Denominator Problem            | With the trade through rule requiring exchanges to route customer business to their competitors, dissenters felt that this would lead market centers to compete around this denominator. Indeed this has driven competition in the space with ECNs converting to exchanges (with protected quotes) and the development of order types and pricing strategies designed to help their clients manage execution priority. (e.g. hide-not slide, inverted exchanges). Indeed, most exchanges operate multiple order books because of the protected quotes. |
| Increased Market Fragmentation                   | This would be caused by liquidity being spread across venues looking for protected quote status. Reg NMS is widely considered to have increased fragmentation.   |
| Increased Volatility                             | Although it is difficult to say whether overall volatility has increased, as this depends on many other factors, it is clear that temporary dislocations such as the 2010 Flash Crash are more frequent post <u>Reg NMS</u> and can be attributed in large part to the fragmented liquidity and altered nature of liquidity provision.   |

While there is clearly correlation between the dissenters' warnings about Reg NMS and what has transpired, there are many other factors that may have contributed to causation. Nevertheless, the combination of ongoing dissatisfaction with equity market structure, Mr. Atkins' influence within a new administration looking to scale back financial regulations, and the review initiated via the Regulatory Flexibility Act mean that a fundamental review of equity market structure, including the trade through rule, is increasingly likely.

### Reforming The Trade Through Rule

Reform of the trade through could come about by outright abolishing it or implementing an opt out. (At the time reg NMS was being developed some commentators suggested an opt out to the rule for sophisticated investors, however this did not come to pass). In either case it would likely have significant impact on markets. The potential impact could be:

- **Defragmentation** – With top of book quotes no longer protected by law, exchanges may instead seek to consolidate liquidity on one or two order books. Note: BATS currently operates four order books, NYSE has three and Nasdaq has three, and additionally Nasdaq holds licenses to operate two more equity exchanges.
- **Reduction in Complexity** – There could well be some reduction in complexity as order types designed specifically for the order protection rule would go away – such as ISOs and price sliding order types. However, exchanges may well devise new order types to reflect the new regulatory regime.

- **Shifting Technology Requirements** – Much of the technology built to support this rule would become unnecessary. However, brokers will need to upgrade their routing technology to reflect the absence of the trade through rule.
- **Increase in locked and crossed market**– A locked market is where a bid on one exchange is at the same price as an ask on another exchange. A crossed market is where a bid on one exchange is at a higher price as an ask on another exchange. Under Reg NMS these are effectively banned as the trade through rule should ensure that these locking and crossing orders meet and execute. Without this requirement in place we will likely see an increase in locked and crossed markets. However, these types of situation should self-correct quickly driven by market forces.

It may seem that there are many advantages to reforming or abolishing the trade through rule. It would likely have strong support from electronic market makers who bemoan the complexity it adds to their business operations. Many institutional investors would also support getting rid of it or opting out; with sophisticated smart order routers and algos at their fingertips they may feel they do not require the proscriptive government mandated requirements to tell them how they should source liquidity and achieve best execution.

However the full impact of a repeal of this rule cannot be estimated. To ensure that we avoid mistakes of the past and minimize unintended consequences, a review of the Order Protection Rule should be undertaken in conjunction with a holistic review of equity market structure.

1. <http://www.capitalthinkingblog.com/2015/10/sec-equity-market-structure-advisory-committee/>

---

[www.greenwich.com](http://www.greenwich.com) | [ContactUs@greenwich.com](mailto:ContactUs@greenwich.com)

Coalition Greenwich, a division of CRISIL, an S&P Global Company, is a leading global provider of strategic benchmarking, analytics and insights to the financial services industry.

We specialize in providing unique, high-value and actionable information to help our clients improve their business performance.

Our suite of analytics and insights encompass all key performance metrics and drivers: market share, revenue performance, client relationship share and quality, operational excellence, return on equity, behavioral drivers, and industry evolution.

## About CRISIL

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better. It is majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics, and data to the capital and commodity markets worldwide.

CRISIL is India's foremost provider of ratings, data, research, analytics, and solutions with a strong record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights and efficient solutions to over 100,000 customers through businesses that operate from India, the U.S., the U.K., Argentina, Poland, China, Hong Kong, and Singapore.

For more information, visit [www.crisil.com](http://www.crisil.com)

## Disclaimer and Copyright

This Document is prepared by Coalition Greenwich, which is a part of CRISIL Ltd, an S&P Global company. All rights reserved. This Document may contain analysis of commercial data relating to revenues, productivity and headcount of financial services organisations (together with any other commercial information set out in the Document). The Document may also include statements, estimates and projections with respect to the anticipated future performance of certain companies and as to the market for those companies' products and services.

The Document does not constitute (or purport to constitute) an accurate or complete representation of past or future activities of the businesses or companies considered in it but rather is designed to only highlight the trends. This Document is not (and does not purport to be) a comprehensive Document on the financial state of any business or company. The Document represents the views of Coalition Greenwich as on the date of the Document and Coalition Greenwich has no obligation to update or change it in the light of new or additional information or changed circumstances after submission of the Document.

This Document is not (and does not purport to be) a credit assessment or investment advice and should not form basis of any lending, investment or credit decision. This Document does not constitute nor form part of an offer or invitation to subscribe for, underwrite or purchase securities in any company. Nor should this Document, or any part of it, form the basis to be relied upon in any way in connection with any contract relating to any securities. The Document is not an investment analysis or research and is not subject to regulatory or legal obligations on the production of, or content of, investment analysis or research.

The data in this Document may reflect the views reported to Coalition Greenwich by the research participants. Interviewees may be asked about their use of and demand for financial products and services and about investment practices in relevant financial markets. Coalition Greenwich compiles the data received, conducts statistical analysis and reviews for presentation purposes to produce the final results.

THE DOCUMENT IS COMPILED FROM SOURCES COALITION GREENWICH BELIEVES TO BE RELIABLE. COALITION GREENWICH DISCLAIMS ALL REPRESENTATIONS OR WARRANTIES, EXPRESSED OR IMPLIED, WITH RESPECT TO THIS DOCUMENT, INCLUDING AS TO THE VALIDITY, ACCURACY, REASONABLENESS OR COMPLETENESS OF THE INFORMATION, STATEMENTS, ASSESSMENTS, ESTIMATES AND PROJECTIONS, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE ARISING OUT OF THE USE OF ALL OR ANY OF THIS DOCUMENT. COALITION GREENWICH ACCEPTS NO LIABILITY WHATSOEVER FOR ANY DIRECT, INDIRECT OR CONSEQUENTIAL LOSS OR DAMAGE OF ANY KIND ARISING OUT OF THE USE OF ALL OR ANY OF THIS DOCUMENT.

Coalition Greenwich is a part of CRISIL Ltd, an S&P Global company. ©2024 CRISIL Ltd. All rights reserved.