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CHADBOURNE & PARKE LLP

Client Alert

SEC Regulation NMS Pilot Effective July 9, 2007: Anticipated Effects on the Equity Trading Markets

On July 9, 2007, the Order Protection Rule of SEC Regulation NMS will go into effect for a pilot program of 250 securities. This Client Alert briefly describes the background of the Order Protection Rule and then analyzes the potential effects of the Rule on the equity trading markets.[1]

Regulation NMS

On April 6, 2005, the Securities and Exchange Commission (SEC), in a controversial 3-2 vote, adopted Regulation NMS, a series of initiatives designed to modernize and strengthen the national market system for securities.[2] The Rule has four major provisions: 1) Rule 610, which provides equal access to markets; 2) Rule 611, which prohibits trade-throughs of displayed and accessible quotations; 3) Rule 612, which prohibits subpenny quotations except in limited circumstances; and 4) amendments to the joint industry plans and rules governing the dissemination of market data.[3] Regulation NMS has been viewed as one of the most significant changes to the structure of the equity trading markets in the past 30 years.

Order Protection Rule

Rule 611, the Order Protection Rule, requires all market participants, including broker-dealers that execute, route or otherwise trade equity securities, to establish, maintain, and enforce written policies and procedures reasonably designed to protect against trade-throughs of protected quotations in Regulation NMS stocks. A trade-through is the purchase or sale of a Regulation NMS stock during regular trading hours at a price that is lower than a protected bid or higher than a protected offer. A protected quotation is the top of book quotation displayed by an automated trading center. The market participant may match those quotations, but must satisfy the best priced bid or offer at each of the automated market centers before executing a trade at a price inferior to those quotations. The Order Protection Rule requires market participants to conduct regular surveillance to ascertain the effectiveness of these policies and procedures, and to remedy any discovered deficiencies promptly.

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[1] Prior to joining Chadbourne & Parke LLP, the author managed the Regulation NMS implementation project for UBS Securities LLC and continues to advise various clients on Regulation NMS implementation issues.

[2] Securities Exchange Act Release No. 51808 (June 9, 2005) 70 FR 37496 (June 29, 2005). Two Commissioners, Paul Atkins and Cynthia Glassman, filed a lengthy dissenting opinion opposing adoption of the Order Protection Rule.

[3] 17 CFR §§242.600 - 612.

Implementation Schedule

By order, the SEC established a five-step process for implementation of the Order Protection Rule.[4] On October 16, 2006, all Exchanges and Trading Centers were obligated to post the specifications for their Regulation NMS compliant trading systems. Every Exchange and Trading Center met this requirement. On March 5, 2007, all Exchanges and Trading Centers were required to implement their new trading systems and be compliant with the Order Protection Rule. This implementation went reasonably smoothly with minor glitches worked out in the first few days of trading. On July 9, 2007, the third phase of the implementation of the Order Protection Rule will go live. This phase requires all market participants, including broker-dealers that execute, price or route NMS securities, to become compliant with the Order Protection Rule for a pilot program of 250 securities (100 NYSE; 100 NASD; 50 AMEX).[5] The industry appears ready to meet the July 9 deadline, and the SEC has stated that this is a firm go-live date. On August 9, 2007 all remaining NMS securities will become subject to the Order Protection Rule. The final implementation date is October 15, when all exchanges, trading centers and market participants must be compliant with all aspects of Regulation NMS.

Implementation Process

Implementation of the Order Protection Rule has been the subject of an unprecedented cooperative effort amongst the regulators, the securities information processors, the exchanges and trading centers, broker-dealers, and industry groups. The Securities Industry and Financial Markets Association (SIFMA) took a lead role in coordinating these efforts establishing numerous working groups to address various implementation issues. Through this process, a large number of interpretative and implementation questions have been raised and resolved. The SEC and the various SRO's have issued FAQs and other interpretations resolving many open questions.[6] Joint industry testing dates have been established. The Exchanges and Trading Centers have revamped their trading systems to accommodate the new rule. Each of the SRO's filed appropriate rule changes that were approved by the SEC. All broker-dealers and other market participants have been required to modify trading and sales systems to adjust to the new requirements and to adopt written policies and procedures reasonably designed to prevent trade-throughs in the market. Also, the securities industry and clients have been the target of various training and information sessions regarding implementation of the Rule.

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[4] Securities Exchange Act Release No. 53829 (May 18, 2006) 71 FR 30038 (May 24, 2006); Securities Exchange Act Release No. 55160 (Jan. 24, 2007) 72FR 4202 (Jan. 30, 2007).

[5] While broker-dealers are only required to comply with the Order Protection Rule for the 250 pilot securities, many large firms intend to implement the new procedures for all NMS securities as of that date because of the difficulty of running two parallel trading systems.

[6] "Division of Market Regulation: Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS," (June 8, 2007 Update).

Anticipated Effects of the Order Protection Rule on the Equity Trading Markets

As noted above, the first phase of implementation was effective March 5, 2007. The Rule has already begun to have an impact on the equity trading markets creating a more electronic and automated trading environment. Rollout to broker-dealers on July 9 will be the next big test for the Rule. The following are some of the anticipated effects on the market, but the true impact will not be known until the rule is fully effective and the markets have fully adjusted.

1. **Technology Will Dominate.** The firms with the best and most sophisticated order execution and routing technology will be the winners in the market garnering an increasingly greater share of order flow. Smart routers that emphasize speed, ability to access all market centers, and liquidity will be the ultimate winners. Firms with less sophisticated technology or who rely on outside vendors will not be able to distinguish their services. The current move toward consolidation of executions at a limited number of brokers, generated by soft dollar and best execution considerations, will accelerate. This trend may push out many of the middle and lower tier execution firms who simply will not be able to compete with the technological demands and the cost pressures in the new market place.

2. **Transparency Will Not Increase Significantly.** Although one of the stated purposes of Regulation NMS is to promote the display of limit orders by protecting displayed quotations, there is little likelihood that the rule will significantly increase transparency in the markets. Held retail orders under 10,000 shares must already be displayed unless the customer specifically requests otherwise. On the other hand, orders above 10,000 are not required to be displayed and clients rarely choose to display those orders. It is highly unlikely that institutional clients with large block orders will begin to display those orders in the post NMS world. Rather, as noted below, institutional investors will continue to seek anonymity for those orders and will seek out alternative crossing mechanisms for executing large block transactions.

3. **Accelerated Move to an Electronic Trading Market.** The introduction of the Order Protection Rule will accelerate the trend away from floor trading operations. Many firms have already cut their floor trading operations significantly and further cuts are expected. The question will be whether the NYSE and AMEX hybrid trading market, implemented to meet Regulation NMS requirements, will continue to play a significant role going forward. The specialists in those markets have a short time frame to adapt to the new market conditions and establish their continuing value. The difficulty they face is incorporating human interaction into an electronic market that trades in milliseconds. Speed of execution and technological efficiency may soon make human interaction obsolete.

4. **Break in the NYSE Dominance in Trading Listed Stocks.** One of the primary effects of the Order Protection Rule will be to open the market in NYSE listed securities to greater competition. Since all market participants will be required to execute against the best priced orders in the market place wherever posted, the NYSE will no longer be the default execution location. Instead, the NYSE will be one entry point to the market and will have to compete for order flow with other market centers, based on technology, quality of services and price of execution. There has already been a decrease in NYSE market share in execution of listed securities and a further decrease is likely.

5. **Proliferation of Crossing Networks.** Institutional investors will continue to seek anonymity for their order flow and methods of directly negotitiating block transactions. So-called dark pools will continue to proliferate. Even the NYSE and the Nasdaq are developing crossing mechanisms to meet this need. This will lead to a bifurcated market where smaller retail size

orders will be routed to the displayed NMS market and larger block size trades will be routed to the crossing networks. Price discovery will continue in the displayed marketplace but the bulk of block trading will be done in the crossing networks. While institutional traders will still access the electronic market through electronic trading systems, they will also seek alternative sources of liquidity. Firms will have to analyze which of these crossing networks that they should establish access to in order to tap into available liquidity.

6. **Move to Smaller Average Execution Size and Higher Volume of Trades.** Sweep requirements for execution of block orders will engender more transactions to execute the same quantity of stock. For example, to print a block transaction at a price above or below the market, a firm will have to print up to twelve trades (the block trade plus an ISO order for the top of book in each market). This will lead to smaller average execution size and higher volume of transactions. More importantly, the speed of execution will invite more rapid trading by automated trading systems and direct market access programs. Algorythmic trading may increase significantly. Capacity issues will become critical based on increased trade and quotation information available in the market.

7. **Impact on Negotiated Blocks and Agency Cross Transactions.** Negotiated blocks will be subject to the Order Protection Rule requirements unless they fall within a specific exception. The speed of the trading markets will make it more difficult to manually negotiate block orders and execute trades. On the other hand, provision of capital will become more important in the execution of large block transaction particularly in less liquid securities. And, the SEC has basically spelled the death knell for net trading by refusing to exempt the second leg of those trades from the Order Protection Rule. (The Nasdaq is close to implementing a method of pass through of commissions which will remove much of the need for net trades and accelerate the move away from net trading.) Thus, the nature of block trading and the role of block traders and institutional sales personnel will change significantly post NMS.

8. **Consolidation of Trading Markets.** As the trading markets evolve in a post NMS world, there will likely be a consolidation of markets centers. Institutional orders will move to the firms that can provide additional services in addition to execution, including research, advice, and other services. Thus, pure execution centers and exchanges will face increasing competition and cost pressures, with the inevitable result of consolidation.

9. **Use of the Self Help Remedy.** The market will have to figure out how and when to use the self help remedy to skip markets that are not responsive to orders or are otherwise having technical difficulties. Best practices will evolve over time but there may be some rough patches at the beginning. Questions that will need to be answered will be the scope of the self help (by stock, by sector, by entire market), the level of inquiry necessary before evoking self help and when to reestablish connection with the market.

Anticipated Effects of the Order Protection Rule on Legal and Compliance Functions

1. **Written Policies and Procedures.** The key to the Order Protection Rule is the adoption of written policies and procedures reasonably designed to assure compliance with the Rule. The first thing regulators will look for and evaluate are these procedures. As a result, firms should take the time and allocate adequate resources to draft, adopt, and implement detailed written compliance and supervisory procedures that meet the requirements of the rule.

2. **Regulatory Examinations and Enforcement.** The SEC and NASD have stated that they will initially apply a soft touch approach to enforcement giving the industry a chance to get used to new requirements and work out any unforeseen problems and issues. At first, they will look for written policies and procedures and will review those procedures for reasonableness. Over time, they will become more thorough in their review of the policies testing the actual effectiveness of the procedures in preventing trade-throughs. They expect that best practices will develop in the markets and that broker-dealers will adjust their procedures to meet those practices. The regulators continue to state, however, that Order Protection Rule will not be a trade-by-trade analysis of whether a violation occurred. Instead, enforcement action will continue to focus on the effectiveness of the written policies and procedures.

3. **Best Execution.** One of the key points emphasized by the SEC in adopting Regulation NMS is that compliance with the Order Protection Rule is not co-extensive with the firm's best execution obligation to customers. The question is what effect the Order Protection Rule will have on best execution obligations. The average speed of execution will trend downward toward sub-second timing. But, will price improvement retain any value as a concept since execution will take place rapidly across multiple markets at displayed prices? Firms will have to decide whether to ignore manual quotes or to seek execution against those quotes while running the risk that they will miss execution in the displayed market. Decisions on how to post limit orders will become much more complex, requiring consideration of whether you should seek to be top of book in a secondary market, or continue to post in the more liquid markets and possibly miss executions. Firms will need to closely monitor the effects of the new rule on best execution and modify their policies and procedures as appropriate.

4. **Surveillance and Monitoring.** One of the biggest impacts on the compliance function will be the need to develop and implement effective supervisory and surveillance programs to monitor compliance with the Order Protection Rule. This will entail capture and storage of necessary market data and evaluation of the firm's performance against that data. Compliance will have to monitor whether the firm's system are out of time synchronization with the market generally, whether the use of exceptions to the Order Protection Rule is appropriate, and whether the firm's systems and procedures are reasonably designed to prevent trade-throughs. The SEC continues to state that firms will only have to retain and review trading and market data for three days a month to meet these requirements.

5. **Use of Exceptions to the Rule.** There are numerous exceptions to the Order Protection Rule articulated in the Rule itself or in various interpretations and releases by the SEC. The exceptions will become a popular way of executing block transactions outside the scope of the Order Protection Rule. The question is whether traders will abuse the exception thereby undercutting the effectiveness of the Rule. Firms will be required to surveil the use of these exceptions to prevent such abuses.

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New York

Gerard Citera	+1 (212) 408-5176	gcitera@chadbourne.com