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On the Issues

Let Stock Exchanges Compete without Price Regulation

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The current proposal from the Securities and Exchange Commission for market structure reform would extend the "trade-through" rule to the Nasdaq market, but instead the rule should be eliminated altogether to promote competition and innovation.

The SEC cannot seem to give up the idea of regulating what prices investors can pay in the U.S. equity markets. Its new version of market structure reform, called Regulation NMS and voted out for comment by a split commission in mid-December, offers market participants two choices—one bad, the other worse. The one choice not offered is eliminating price regulation entirely, yet that—as two commissioners pointed out in their statements at the December 15 commission meeting—is the most effective way to promote competition among market centers, meet the desires of investors and issuers, and assure that the markets keep pace with changing technology.

The key issue in the SEC's proposal involves the so-called trade-through rule, which prohibits bypassing—or "trading through"—existing orders to buy or sell a stock at a particular price. In effect, the rule requires that orders for stocks listed on the New York Stock Exchange and other regulated exchanges be sent to the market that has the best posted price. This sounds good, except that the rule prevents electronic market centers, known as ECNs, from trading NYSE securities and thus competing with the NYSE for investor trading interest. Among other things, the ECNs offer virtually immediate execution of orders, and waiting up to thirty seconds to find out whether the trade was executed by a NYSE specialist would vitiate this ECN advantage. This is not a problem in the Nasdaq market, where the trade-through rule does not apply. There, the ECNs and traditional Nasdaq market makers are in vigorous competition, to the benefit of investors.

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Trade-Through Choices

The SEC's new idea, instead of opening up competition between the ECNs and the NYSE by eliminating the trade-through rule, would extend the rule to the Nasdaq market, thus subjecting to regulation the one market where investors can freely choose what trades to make. The new trade-through rule would apply only to electronic markets and would take one of two forms. Under the first option, all posted bids or offers that are accessible electronically in any market or posted by any market maker would be "protected" in the sense that they would have to be executed before the market could move—either up or down—through that price. In the second option, only the best posted price in any market would be protected.

The difference in how the two trade-through choices would operate can be illustrated by examples. The first option, known as depth-of-book, would require an investor's bid to interact with all electronically accessible offers that are the best anywhere in the market at the time the investor makes his bid. Thus, let us assume that an investor wants to buy 10,000 shares of company A and finds that the market looks like this: 500 shares are offered on the NYSE at $20, 1,000 are offered on an ECN at $20.10, another 500 are offered on the same ECN at $20.20, and 8,000 shares are offered on the NYSE at $20.30. Under the depth-of-book option, the investor must buy all 2,000 shares before he can purchase the remaining 8,000 shares on the NYSE at $20.30. In this transaction, both the best and second best offers on the ECN are "protected" and must be executed before trading can move on.

Under the second option, known as top-of-book, only the 1,000-share offer at $20.10 on the ECN would be protected, since that is at the top of the ECN's book. The next best price, 500 shares at $20.20, would not be protected, and the investor would be able to purchase the 8,000 shares on the NYSE at $20.30, even though the second offer on the ECN—500 shares at $20.20—is a better price.

It may seem counterintuitive that an investor would want to bypass the 500 shares at $20.20 when—after the offer of $20.10 has been taken up—it is the next best price in the market. However, the investor may be concerned that while he is acquiring the 500 shares at $20.20, the price of company A shares will move away, and the 8,000 shares he was hoping to buy on the NYSE at $20.30 will no longer be available. By the same logic, the investor might prefer to take the whole lot of 10,000 at $20.30 in the first place. That is one of the reasons why, although top-of-book would be better than depth-of-book if one had to choose, no trade-through rule at all would be best.

The example illustrates that the price of a stock is not the only consideration for investors; the volume investors can acquire at a price they consider favorable can also be a consideration, and forcing investors to buy small amounts of shares—even at the best price—can produce unfavorable results for them overall.

Future Effects on the Markets

This may sound like tedious technical detail, until one considers its effect on the markets and their future. To be sure, there is some good in the proposal: by applying the trade-through rule only to electronically accessible orders, it would force the NYSE to begin serious electronic trading and thus allow competition by the ECNs. But it has a very serious long-term downside. Both SEC trade-through rule ideas would create a form of centralized market structure known as a central limit order book, or CLOB—an idea that seems to spring forth from the SEC staff whenever market structure reform is discussed. And the trouble with the CLOB, as many have noted in the past, is that it will stifle competition and innovation—the very elements that created the electronic markets in the first place.

Think of it this way. All the market centers—the NYSE, Nasdaq, and the ECNs—are competing for liquidity, that is, investor orders to buy or sell. It is through increasing the number of transactions on their trading systems that these markets make money for their shareholders or members. Assuming the government does not require trading to go to one or another place through a regulation such as the trade-through rule, each of these market centers will try to innovate or otherwise offer better service and narrower spreads between bid and offer prices in order to attract investor trading interest. That is what has been happening in the Nasdaq market, where studies show that spreads are lower than on the NYSE for large cap stocks and for large orders to buy and sell.

Now along comes a SEC-mandated CLOB, requiring that all orders go to the market center that has the best price at any given moment. In this structure, service and innovation do not count. The only thing that counts is the price of the bid or offer that is posted. In such a market structure, investors would be indifferent about where they post their orders, since the government has mandated that if the investor has posted the best price in the market that order must be executed before the market may move through that price. The effect of such a system will be to drive the cost of posting an order with a broker-dealer to the lowest possible level and eliminate the incentive—and perhaps even the financial capability—of market centers such as the NYSE, Nasdaq, and the ECNs to offer the improved services and innovation that are essential to competing for investor trading interest.

Thus, in offering a rule that is intended to protect one class of market participants—those that post limit orders to buy or sell securities at a particular price—the SEC may end up weakening or eliminating another vital class: the market centers that drive innovation and change. The U.S. securities markets, now the most vigorous and innovative in the world, would be frozen in time, a victim of unnecessary bureaucratic regulation.

Instead of extending the trade-through rule even further, the SEC would do better to eliminate it entirely, opening the NYSE to competition by the ECNs. As shown by the competitive Nasdaq market, all investors, all market participants, and the U.S. economy as a whole would be far better off. Although the SEC has not offered this choice, market participants should insist on it.

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