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## What to expect when exchanges comply

*Despite attempts to reduce red tape, new regulations continue to filter into the market. Among them is Regulation National Market System, or Reg NMS, which will affect how exchanges and retail brokers utilize IT. The SEC has extended the trading-phase date of the regulation to March 5 and the pilot-stocks-phase date to July 9. By Aug. 20, all stocks will be phased in. IDD asked Joe Saluzzi, co-head of equity trading at independent agency broker Themis Trading, a few questions about what investors can expect.*

**IDD:** *One of the main components of Reg NMS is the trade-through rule. What exactly does it accomplish? And what will be its impact?*



**Saluzzi:** The trade-through rule will protect any visible order that resides on the top of the book of any market center. This has the biggest effect on Nasdaq-listed securities, since the NYSE has already been operating under a trade-through rule. Under Reg NMS, though, in order to be protected, the top of book orders must be automated and have no human intervention. The NYSE hybrid model effectively makes their quotes automated or "fast" now.

*Could any problems occur such as unexpected results or things the SEC might not have taken into account?*

**Saluzzi:** As with any new regulation, some problems may arise when the new rules take effect. We think that there may be some issues with the depth of book orders that reside in a particular market center. Since only the visible portion of the top of book orders on a market center are protected, an order that is not the best price on that market center but is priced better than the next visible order will not be protected.

We think that this may create trading situations that could possibly disadvantage some market participants. But as with any new rule, discrepancies are usually found quickly, and the situation will tend to correct itself quickly.

*Will we see a shift of volume between exchanges following Reg NMS?*

**Saluzzi:** Reg NMS does level the playing field for the exchanges since orders can't be traded through by other market centers. However, we still expect the exchanges with the most liquidity to dominate for large, institutional order flow that may not be as commission-cost sensitive.

If a stock is trading tightly with a penny spread, then the exchange with the most liquidity will dominate and other smaller exchanges may have a tough time getting much order flow in these issues.

*How does this change things for smaller exchanges?*

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**Saluzzi:** Smaller exchanges, which offer a low commission cost as well as a fast execution time, should be able to increase their business. The days of "having a floor broker in the crowd" in order not to miss any trades are gone. For most stocks now, the physical location of a broker will not matter.

*What new strategies will exchanges develop to adapt?*

**Saluzzi:** In addition to the trade-through rule, Reg NMS alters the market data revenue calculation. The formula for calculating market data revenue has changed not only to pay for transactions but now also to rebate for quotes. This will create a new revenue stream for some market centers, and they'll be able to pass along this new revenue to their clients with lower fees. Therefore, if a new market center wants to gain market share quickly, it will offer a very aggressive pricing schedule to its clients and may not necessarily lose money. The market centers able to retain the most order flow will be the winners.

We have already seen an example of this type of strategy in January of this year. BATS, one of the newest ECNs, inverted their fee schedule for one month in order to grab more market share. Their strategy apparently worked, as they reported having a record day during the month when they matched 10% of Nasdaq volume. The question is whether they can retain these new volumes when they revert back to a noninverted fee schedule.

*What opportunities does Reg NMS create, and who will find the largest advantage?*

**Saluzzi:** The trade-through rule may create some trading opportunities for some sophisticated day traders and arbitrageurs. For instance, when an ISO [intermarket sweep order] is used, it'll sweep all visible pools of liquidity up to its limit price. However, any nondisplayed liquidity or any order that is not part of the top of book of a particular market center will not be protected. Therefore, price disparities may exist for a brief moment. We expect these to be arbitrated away quickly.

*How long will it take the industry to become Reg NMS savvy?*

**Saluzzi:** We are expecting about six months of growing pains with the new rules. We also expect new systems and vendors will be formed from the byproducts of Reg NMS. If the industry is struggling with any aspect of the rule, expect smart firms to create products to fill the void.

*Why has the deadline been extended a few times? Is compliance difficult or time-consuming?*

**Saluzzi:** I'm not an expert on technology and systems, but it seems that under Reg NMS, the volume of information that needs to be handled will explode dramatically. The exchanges needed more time to make sure that their systems can handle the new volumes. They also needed to code for new order types, such as the intermarket sweep order.