Federal Register

Wednesday,
September 23, 2009

Part II

Securities and Exchange Commission

17 CFR Part 242

Elimination of Flash Order Exception From Rule 602 of Regulation NMS; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34–60684; File No. S7–21–09]

RIN 3235–AK40

Elimination of Flash Order Exception From Rule 602 of Regulation NMS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is concerned that the exception for flash orders from quoting requirements under the Securities Exchange Act of 1934 (''Exchange Act''), which originated in the context of manual trading floors for quotations that were considered ''ephemeral,'' is no longer necessary or appropriate in today's highly automated trading environment. Accordingly, the Commission is proposing to amend Rule 602 of Regulation NMS under the Exchange Act to eliminate an exception for the use of flash orders by equity and options exchanges. In general, flash orders are communicated to certain market participants and either executed immediately or withdrawn immediately after communication. If the proposed amendment were adopted, the Commission would apply Rule 301(b) of Regulation ATS under the Exchange Act in a consistent manner with regard to the use of flash orders by alternative trading systems. The Commission also would apply the restrictions on locking or crossing quotations in Rule 610(d) of Regulation NMS in a consistent manner to prohibit the practice of displaying marketable flash orders.

DATES: Comments should be received on or before November 23, 2009.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File No. S7–21–09 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File No. S7–21–09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Theodore S. Venuti, Special Counsel, at (202) 551–5658, Arisa Tinaves, Special Counsel, at (202) 551–5676, Gary M. Rubin, Attorney, at (202) 551–5669, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–7010.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Introduction
II. Description of Flash Orders
III. Flash Order Exception From Quoting Requirements
IV. Proposed Elimination of Flash Order Exception
V. Request for Comments
VI. Paperwork Reduction Act
VII. Consideration of Costs and Benefits
VIII. Consideration of Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation
IX. Consideration of Impact on the Economy
X. Regulatory Flexibility Act
XI. Statutory Authority
XII. Text of Proposed Rule Amendment

I. Introduction

Rule 602 of Regulation NMS [1] and Rule 301(b) of Regulation ATS [2] require exchanges and alternative trading systems (''ATSs''), respectively, to provide their best-priced quotations to the consolidated quotation data that is widely disseminated to the public.[3] The Commission is proposing to amend Rule 602 to eliminate the exception for the use of flash orders by equity and options exchanges. If the proposed amendment were adopted, the Commission would apply Rule 301(b) in a consistent manner regarding the use of flash orders by ATSs. Finally, the Commission would also apply the restrictions on locking or crossing quotations in Rule 610(d) of Regulation NMS [4] in a consistent manner to prohibit the practice of displaying flash orders with marketable prices. The practical result of the proposal, if adopted, would be that any flash orders with non-marketable prices would need to be included in the consolidated quotation data and that the more frequently used practice of flashing orders with marketable prices to certain market participants would be prohibited. Exchanges and ATSs would be required to handle marketable orders that they are unable to execute at the best displayed prices in another manner, such as by routing marketable orders away to execute against the best displayed quotations at another exchange or ATS.

As discussed in section III below, Rule 602 generally requires exchanges to make their best bids and offers in U.S.-listed securities available in the consolidated quotation data that is widely disseminated to the public. Paragraph (a)(1)(i)(A) of Rule 602, however, excludes bids and offers communicated on an exchange that either are executed immediately after communication or cancelled or withdrawn if not executed immediately after communication. Rule 602 has included this language since the original adoption of its predecessor rule in 1978. The exception was intended to facilitate manual trading in the crowd on exchange floors by excluding quotations that then were considered ''ephemeral'' and impractical to include in the consolidated quotation data.[5] As securities trading became much more automated in recent years, automated markets began to disseminate information electronically concerning orders that either were to be executed immediately or withdrawn if not executed immediately. These electronically disseminated orders had a duration that was even shorter than the ephemeral manual quotations that were contemplated in 1978. The orders qualifying for the ''immediate execution or withdrawal'' exception from Rule 602 now are widely referred to as ''flash orders.''

The Commission is concerned that the exception for flash orders, whether manual or automated, from Exchange

[1] 17 CFR 242.602.

[2] 17 CFR 242.301(b).

[3] Consolidated quotation data captures the best-priced quotations from exchanges, ATSs, and other trading centers for listed equities and options. This core data for a security is consolidated and distributed to the public by a single central processor pursuant to Commission rules.

[4] 17 CFR 242.610(d).

[5] *See infra* note 19.

Act quoting requirements is no longer necessary or appropriate in today's highly automated trading environment. The consolidated quotation data is designed to provide investors with a single source of information for the best prices in a listed security, rather than forcing investors to obtain such information by subscribing to all of the data feeds of the many exchanges and ATSs that trade listed securities. The flashing of order information could lead to a two-tiered market in which the public does not have access, through the consolidated quotation data streams, to information about the best available prices for U.S.-listed securities that is available to some market participants through proprietary data feeds. In addition, flash orders may significantly detract from incentives for market participants to display their trading interest publicly, though flash orders do offer potential benefits to certain types of market participants.[6] The Commission therefore is proposing to eliminate the exception for flash orders from Exchange Act quoting requirements.

II. Description of Flash Orders

As noted in section IV.B.1 below, the phrases ''executed immediately'' or ''withdrawn if not executed immediately'' in Rule 602(a)(1)(i)(A) can cover a variety of different trading mechanisms on both a manual trading floor and an automated trading system. In general, however, the particular type of electronic flash order that equity and options markets now use the most has the following basic features:

First, the use of a flash order type is voluntary. Markets that offer flash order types also offer order types that provide order routers with the ability to access liquidity at the market without using a flash order type.[7]

Second, flash orders almost always are ''marketable'' [8]—they are buy orders that are immediately executable at the price of the national best offer and sell orders that are immediately executable at the price of the national best bid.[9] For example, if the national best bid and national best offer (''NBBO'') in a listed security are $20.10 and $20.15, respectively, marketable buy orders are executable at $20.15 and marketable sell orders are executable at $20.10. Marketable orders can be said to ''take'' liquidity. The submitter wants to trade immediately and is willing to pay the ''spread'' between the NBBO (in the example, the five cent difference between $20.10 and $20.15) for the opportunity to trade immediately. In contrast, non-marketable orders—for example, those orders that establish the national best bid and offer—are ''resting'' orders that seek to trade at better prices than those that are immediately available and to earn the NBBO spread rather than pay it. These resting orders provide quotation information for investors and add liquidity and depth to the market. Non-marketable orders run the risk, however, of missing an execution if they are unable to interact with contra side marketable order flow. That is why the Commission long has been concerned with promoting the opportunity for publicly displayed orders to interact with contra side marketable order flow.[10]

Third, on arrival at a market and prior to being flashed, flash orders first will interact immediately with any available contra side trading interest at the exchange that receives the order.[11] For example, a marketable flash order to buy can execute immediately against a displayed order at the receiving exchange that is priced at the national best offer. As a result, the public is able to interact with such orders at that market—prior to the order being flashed—by submitting a non-marketable resting order that is priced at the national best bid for buy orders and the national best offer for sell orders.

Fourth, if a market does not have available trading interest at the national best offer when a marketable flash order to buy arrives, or at the national best bid when a marketable flash order to sell arrives, the market will flash the order to its market participants at the national best offer for flash orders to buy and the national best bid for flash orders to sell.[12] The markets disseminate the order information as part of their data feeds. Some distribute the data only to members, and some provide the data to anyone who wants to receive it.[13]

Fifth, market participants that receive the flashed order information have a very brief period in which to respond with their own order to execute against the flashed order at a price that matches the NBBO price (that is, the national best offer for flash orders to buy and the national best bid for flash orders to sell).

[6] *See infra* notes 54–56 and accompanying text.

[7] The basic type of order that accesses a market's liquidity without the possibility of a flash is the ''immediate-or-cancel'' (''IOC'') order. An IOC order only seeks to take any liquidity that is currently available at a market when the order arrives with no possibility of further action by the market with the order. In contrast, a flash order is transmitted to other market participants in an effort to attract additional liquidity to the market. *See, e.g.,* Rule 600(b)(3) of Regulation NMS (for a quotation to qualify as an ''automated quotation'' that can be protected against trade-throughs, the trading center displaying the quotation must provide an immediate-or-cancel functionality); Chicago Board Stock Exchange (''CBSX'') Rule 52.6(a) (immediate-or-cancel orders will not be flashed).

[8] *See, e.g.,* Letter dated June 3, 2009 from William O'Brien, Chief Executive Officer, Direct Edge ECN LLC (''Direct Edge'') to Elizabeth M. Murphy, Secretary, Commission (''Direct Edge Letter'') at 1 (Direct Edge's Enhanced Liquidity Provider program provides optional display period for marketable orders); International Securities Exchange (''ISE'') Rule 803, Supplementary Material .02 (prior to sending a Linkage Order to another exchange, a Public Customer Order shall be exposed at the national best bid for a sell order or national best offer price for a buy order).

[9] The term ''national best bid and national best offer'' is defined in Rule 600(b)(42) of Regulation NMS as the highest priced bid and the lowest priced offer disseminated in the consolidated quotation data. The characteristics of marketable and non-marketable orders are discussed at length in the Commission's Concept Release on Market Fragmentation. Securities Exchange Act Release No. 42450 (February 23, 2000) 65 FR 10577 (February 28, 2000) (SR–NYSE–99–48) (''Concept Release on Market Fragmentation'').

[10] *See, e.g.,* Securities Exchange Act Release No. 51808 (June 9, 2005) 70 FR 37496, 37502 (June 29, 2005) (''NMS Release'') (''[T]he Commission believes that a rule establishing price protection on an order-by-order basis for all NMS stocks is needed to protect the interests of investors, promote the display of limit orders, and thereby improve the efficiency of the NMS as a whole.''); Concept Release on Market Fragmentation, *supra* note 9, at 10577 (''The Commission is concerned, however, that customer limit orders and dealer quotes may be isolated from full interaction with other buying and selling interest in today's markets. * * * To the extent that the price-setting customer's limit order remains unexecuted and subsequent buying interest is filled at the customer's price, the customer's order has been isolated, and the incentive of customers to improve prices potentially compromised.''); Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48297 (September 12, 1996) (''Order Handling Rules Release'') (''In 1975, Congress envisioned an NMS in which public limit orders in qualified securities would have a central role. Congress anticipated that the NMS would make all specialists and market makers aware of public customer limit orders held anywhere in the system, and provide enhanced protection and priority for limit orders in stocks qualified for trading in the national market system.''); *see also* S. Report No. 90–75, 94th Cong., 1st Sess. 18 (1975) (''The Committee is satisfied that S. 249 grants the Commission complete and effective authority to implement a system for the satisfaction of public limit orders.'').

[11] *See, e.g.,* CBSX Rule 52.6(a) (under CBSX flash order rule, the CBSX system will automatically attempt to match market orders against orders at the best price in the CBSX book unless filling the order would result in an execution of a trade-through of another exchange's protected quotation); Boston Options Exchange Rules, ch. 5, sec. 16(b)(iii)(2) (under BOX flash order rule, if there is a quote on BOX that is equal to the NBBO, then the order will be executed against the relevant quote).

[12] *See, e.g.,* CBSX Rule 52.6(a) (orders ''flashed to CBSX Traders at the NBBO price for a period of time not to exceed 500 milliseconds as determined by CBSX''); ISE Rule 803, Supplementary Material .02 (before a Linkage Order is sent to another exchange, ''a Public Customer Order shall be exposed at the current NBBO price to all Exchange Members for a time period established by the Exchange not to exceed one (1) second'').

[13] *See, e.g.,* Direct Edge Letter, *supra* note 8, at 4 (Direct Edge provides its data feed with flash order information at no charge to any recipient who wishes to receive the data).

The time periods vary in length, but generally are one second or less.[14] As a result, although all those who take a market's data feed will receive the flashed order information, only market participants with pre-programmed systems capable of responding very rapidly will have a realistic opportunity, as a practical matter, to respond to a flashed order. In other words, only those who have invested in sophisticated trading systems are able to effectively access flash orders.

Sixth, if there is an order responding to the flashed order, the flash order will execute against the response. If there is no response to the flashed order, markets generally will route orders away to execute against the best-priced quotations on other markets.[15]

III. Flash Order Exception From Quoting Requirements

Rule 602 generally requires exchanges to make available to vendors, including the central processors for the consolidated quotation data that is widely disseminated to the public, the best bids and best offers for listed securities that are communicated on an exchange by any responsible broker or dealer.[16] The consolidated quotation data streams are the primary vehicles for public price transparency in the U.S. equity and options markets. The central processors for these data streams collect the best bids and best offers from the exchanges and Financial Industry Regulatory Authority (''FINRA'')[17] and distribute them in consolidated data streams that are widely available to the public. The consolidated data streams are designed to assure that the public has affordable, accurate, and reliable real-time information on the best prices available for listed securities.[18]

Paragraph (a)(1)(i)(A) of Rule 602, however, excepts ''any bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication.'' This language was included in the predecessor to Rule 602 when it originally was adopted in 1978 and was intended to accommodate the ''ephemeral'' quotations of non-specialist participants in exchange crowds.[19] As a result, bids and offers that either are immediately executed or, if not executed, immediately cancelled or withdrawn are not required to be included in the consolidated quotation data.

By its terms, Rule 602(a)(1)(i)(A) applies only to exchanges. The relevant parts of Rule 602 in the over-the-counter context apply to national securities associations and OTC market makers. As a result, ATSs generally are not directly subject to Rule 602 requirements. Rule 301(b)(3)(ii) of Regulation ATS, however, requires certain ATSs to include their best priced orders displayed to more than one person in the consolidated quotation data made available to the public pursuant to Rule 602.[20] Consistent with the language in Rule 602 excepting exchanges from including flash orders in the consolidated quotation data, the Commission has not applied Rule 301 to require ATSs to include flash orders in the consolidated quotation data.

Similarly, the Commission has not applied the Rule 610(d) restrictions on displaying quotations that ''lock'' or ''cross'' another market's displayed quotation, to flash orders with marketable prices.[21] For many years, the restrictions on locking and crossing quotations for exchange-listed equities were imposed in the Intermarket Trading System (''ITS'') Plan.[22] In 2005, the Commission adopted Rule 610(d) of Regulation NMS to address locking and crossing quotations for NMS stocks. Among other things, Rule 610(d) requires the self-regulatory organizations (''SROs'') to adopt rules that prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross protected quotations in NMS stocks.[23]

In January 2004, the Commission approved an exchange rule filing for orders in listed options that were flashed electronically to market participants for a three-second period, rather than manually on the floor of an exchange.[24] The Commission generally has sought to interpret its rules in such a way that they promote fair competition between manual and automated markets.[25] The Commission noted that the electronic flash process was designed to protect against trading through better displayed prices at other

[14] *See, e.g.,* BOX Rules, ch. 5, sec. 16(b)(iii)(2(a) (one second); CBSX Rule 52.6(a) (no more than 500 milliseconds); ISE Rule 803, Supplementary Material .02 (not to exceed one second).

[15] *See, e.g.,* CBSX Rule 52.6(a) (''CBSX System shall route [intermarket sweep orders] on behalf of the market order to all Protected Quotations priced better than the CBSX disseminated price''); ISE Rule 803, Supplementary Material .02(d) (if an order cannot be executed in full after exposure, ''the Primary Market Maker will proceed to send a Linkage Order on the customer's behalf for the balance of the order'' if it is marketable against the then-current NBBO).

[16] The term ''responsible broker or dealer'' is defined in Rule 600(b)(65) of Regulation NMS.

[17] FINRA collects quotation data from over-the-counter market participants, including ATSs.

[18] The consolidated quotation data streams and their policy objectives are fully described in the Commission's Concept Release on Regulation of Market Information Fees and Revenues. Securities Exchange Act Release No. 42208 (December 9, 1999) 64 FR 70613 (December 17, 1999).

[19] *See* Securities Exchange Act Release No. 14415 (January 26, 1978), 43 FR 4342 (February 1, 1978) (''This determination is consistent with the Commission's intent in providing this exception for 'ephemeral' quotations in the 1977 Proposal; that is, that the Rule as adopted reflects the fact that certain non-specialist participants in exchange 'crowds' have bids and offers which, while narrowing the exchange quotation for an instant in time, never in fact become part of the quoted market on the exchange because they are withdrawn immediately if not accepted.''). Rule 602 originally was designated as Rule 11Ac1–1 under the Exchange Act. It was redesignated as Rule 602 as part of the adoption of Regulation NMS in 2005, but its substance was unchanged.

[20] In general, ATSs that meet a 5% volume threshold in NMS stocks are required to include their best-priced displayed orders in the consolidated quotation data. *See infra* note 64.

[21] A ''locking'' quotation has a price that equals the price of the previously displayed contra side NBBO. For example, if the national best offer to sell were $20, a subsequent bid to buy with a price of $20 would be a locking quotation. A ''crossing'' quotation has a price that is higher or lower than the price of the previously displayed contra side NBBO. For example, if the national best offer to sell were $20, a subsequent bid to buy with any price higher than $20 would be a crossing quotation. Conversely, if the national best bid to buy were $19, a subsequent offer to sell with any price lower than $19 would be a crossing quotation.

[22] All equities exchanges and the NASD were participants in the ITS Plan. The ITS Plan is described in the NMS Release, *supra* note 10, at 37501.

[23] Restrictions on locking and crossing quotations for exchange-listed options currently are imposed in the Options Linkage Plan. The Options Linkage Plan is a Commission-approved national market system plan. Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (Order Approving the National Market System Plan Relating to Options Order Protection and Locked/Crossed Markets Submitted by the Chicago Board Options Exchange, Incorporated, International Securities Exchange, LLC, The NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Inc., NYSE Amex LLC, and NYSE Arca, Inc.) (''Options Linkage Plan''). Similar to Rule 610(d), Section 6 of the Options Linkage Plan requires the options exchanges to adopt rules that prohibit their members from engaging in a pattern or practice of displaying locking or crossing quotations.

[24] The first exchange to use the flash order exception for electronically communicated orders was the Boston Options Exchange (''BOX'') facility of the Boston Stock Exchange (''BSE''). Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (SR–BSE–2002–15). BOX flashed orders as part of a process called an ''NBBO filter.''

[25] *See id.* at 2776–2777 (''Overall, the Commission believes that approving the BSE's proposal to establish trading rules for the BOX facility should confer important benefits to the public and provide U.S. market participants with a new market in which to trade standardized options. As a fully electronic options market with relatively lower barriers to access, BOX's entry into the options marketplace may potentially reduce the costs of trading to investors and market professionals, enhance innovation, and increase competition between and among the options exchanges, resulting in better prices and executions for investors.'') (citations omitted).

markets, and that the process would allow exchange participants to provide efficient and competitive executions for flashed orders.[26] Subsequently, other options exchanges adopted similar rules.[27]

In September 2006, the Commission approved an exchange rule filing for the use of flash orders on the equity trading platform of the Chicago Board Options Exchange (''CBOE'').[28] The Commission received no comments on the CBOE proposal. In May 2009, two more exchanges—Nasdaq and BATS—filed proposed rule changes to begin offering flash orders for equity trading.[29] The proposed rule changes of Nasdaq and BATS cited the Commission's previous approval of the CBSX filing and were filed as immediately effective pursuant to Exchange Act Rule 19b–4(f)(6).[30] In this regard, the Nasdaq and BATS filings fell within the interpretive guidance issued by the Commission last year that was designed to streamline the handling of SRO proposed rule changes, particularly for exchange trading rules.[31]

Commenters opposed to the Nasdaq and BATS filings raised serious concerns about the effect of flash orders on investors and on the integrity of the markets.[32] NYSE Euronext noted that in today's trading environment, ''where trading and reaction time are discussed in micro seconds, an order that is held for even 500 milliseconds cannot be deemed an ''immediate'' execution.'' [33] GETCO was concerned that flash orders reduce the incentive to display aggressively priced liquidity, noting that ''[m]arket participants interested in finding the best priced orders to execute against would be encouraged to join the disparate system of 'step-up' order display systems on the various exchanges so that they could execute against better priced 'step-up' orders without displaying limit orders on the public markets.'' [34] Similarly, Morgan Stanley stated that ''[w]e believe that the [proposed rule changes] will provide a material disincentive to publicly display limit orders on exchanges, thereby impairing price discovery.'' [35] Further, SIFMA sought a fuller public discussion of issues raised by the proposed rule changes, including ''the creation of essentially a two tiered market (with some able to pay for a non-public direct data feed to trade with better-priced quotes versus those quotes that are accessible to the general public), thus raising fair access issues and issues re: investor confidence, transparency and our market structure in general.'' [36]

In contrast, Direct Edge—an alternative trading system—submitted a comment letter supporting the proposed rule changes.[37] The letter noted that Direct Edge offers a pre-routing display product to its participants—the Enhanced Liquidity Provider (''ELP'') program—pursuant to which marketable orders are displayed to any of its participants who wish to receive the information in a data feed for which there is no charge.[38] It stated that ''[l]iquidity-aggregation products like Direct Edge's ELP program seek to bring together traditional and non-traditional liquidity in a consolidated, easy-to-access manner designed to maximize the potential for execution, reduce implicit and explicit transaction costs, and otherwise improve execution quality for our customers.'' [39] Another commenter, Woodbine Associates, was concerned that flash orders could have an ''undesirable impact'' if offered by market centers with a majority of order flow, but recommended that the Commission ''allow flash orders, monitor their use, and study the effect on the market.''[40]

For listed equities and listed options in July 2009, the Commission estimates that the total volume of flash orders that received an execution during the flash process was approximately 3.1% and 1.9%, respectively, of total trading volume.[41] BATS, Nasdaq, and Nasdaq OMX BX decided to discontinue offering a flash order type as of September 1, 2009.[42] Accordingly, the total volume of executed flash orders may have declined as of that date.

IV. Proposed Elimination of Flash Order Exception

A. Concerns About Flash Orders

The Commission is proposing to eliminate the flash order exception from Exchange Act quoting requirements. The Commission is concerned that the use of flash orders by exchanges and other markets, particularly if it were to expand in trading volume, could detract from the fairness and efficiency of the national market system.[43] In its analysis of flash order types, the Commission will consider the interests of long-term investors and the extent to which they are helped or harmed by these orders, rather than on the interests of professional short-term traders that may have invested in sophisticated trading systems capable of responding to flash orders. The interests of long-term investors and professional short-term traders in fair and efficient markets

[26] *Id.* at 2783.

[27] *See, e.g.,* Securities Exchange Act Release Nos. 51544 (April 14, 2005) 70 FR 20613 (April 20, 2005) (SR–Phlx-2005–03); 53167 (January 23, 2006) 71 FR 5094 (January 31, 2006) (SR–CBOE–2005–89); 57812 (May 12, 2008) 73 FR 28846 (May 19, 2008) (SR–ISE–2008–28).

[28] Securities Exchange Act Release No. 54422 (September 11, 2006) 71 FR 54537 (September 15, 2006) (SR–CBOE–2004–21).

[29] Securities Exchange Act Release Nos. 60040 (June 3, 2009) 74 FR 27577 (June 10, 2009) (SR–BATS–2009–014); 59875 (May 6, 2009) 74 FR 22794 (May 14, 2009) (SR–NASDAQ–2009–043); 60039 (June 3, 2009) 74 FR 27635 (June 9, 2009 (SR–NASDAQ–2009–050); and 60037 (June 3, 2009) 74 FR 27367 (June 9, 2009) (SR–NASDAQ–2009–048).

[30] Rule 19b–4(f)(6) permits a proposed rule change to become immediately effective so long as each policy issue raised by the proposed trading rule: (1) has been considered previously by the Commission when the Commission approved another exchange's trading rule; and (2) the rule change resolves such policy issue in a manner consistent with such prior approval. Securities Exchange Act Release No. 58092 (July 3, 2008) 73 FR 40144, 40147 (July 11, 2008).

[31] *See id.* at 40147 (''[T]he Commission recognizes that national securities exchanges registered under section 6(a) of the Exchange Act face increased competitive pressures from entities that trade the same or similar financial instruments—such as foreign exchanges, futures exchanges, ECNs, and ATSs. These competitors can change their trading rules or trade new products without filing them with the Commission.'').

[32] Letter dated May 28, 2009 from Janet M. Kissane, Senior Vice President—Legal & Corporate Secretary, Office of the General Counsel, NYSE Euronext to Elizabeth M. Murphy, Secretary, Commission (''NYSE Euronext Letter''); Letter dated June 4, 2009 from Stephen Schuler and Daniel Tierney, Managing Members, Global Electronic Trading Company to Elizabeth M. Murphy, Secretary, Commission (''GETCO Letter''); Letter dated June 4, 2009 from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association to Elizabeth M. Murphy, Secretary, Commission (''SIFMA Letter''); and Letter dated June 17, 2009 from William P. Neuberger and Andrew F. Silverman, Managing Directors, Global Co-Heads of Morgan Stanley Electronic Trading to Elizabeth M. Murphy, Secretary, Commission (''Morgan Stanley Letter'').

[33] NYSE Euronext Letter at 3; *see also* GETCO Letter at 3; Morgan Stanley Letter at 5–6.

[34] GETCO Letter at 4; *see also* NYSE Euronext Letter at 6 (''reducing publicly available liquidity in this way may impact bid-offer spreads and the execution costs to customers'').

[35] Morgan Stanley Letter at 4.

[36] SIFMA Letter at 2.

[37] *See* Direct Edge Letter, *supra* note 8.

[38] Direct Edge Letter at 4.

[39] Direct Edge Letter at 2.

[40] Letter dated June 30, 2009 from Woodbine Associates (''Woodbine Letter'') at 1, 2.

[41] The Commission's estimate of flash order trading volume in July 2009 reflects discussions with the markets that offered flash orders during that time—CBSX, Direct Edge, BATS, Nasdaq, and Nasdaq OMX BX for equity trading, and BOX, CBOE, and ISE for options trading. These volume estimates reflect executions by market participants in response to flashed order information.

[42] *See* Securities Exchange Act Release Nos. 60569 (August 26, 2009), 74 FR 45268 (September 1, 2009) (SR–BATS–2009–028); 60570 (August 26, 2009), 74 FR 45504 (September 2, 2009) (SR–NASDAQ–2009–079); 60571 (August 26, 2009), 74 FR 45502 (September 2, 2009) (SR–BX–2009–051). The Commission notes that, if the proposal is adopted, exchanges with flash order rules would need to file proposed rule changes to eliminate flash orders from their rule books.

[43] *See also supra* note 32.

often will coincide. Indeed, vigorous competition among professional short-term traders can itself lead to very important benefits for long-term investors, including narrower spreads and greater depth. If, however, the interests of long-term investors and professional short-term traders conflict, the Commission previously has emphasized that ''its clear responsibility is to uphold the interests of long-term investors.''[44] The Commission preliminarily believes that, in today's highly automated trading environment, the exception for flash orders from Exchange Act quoting requirements may no longer serve the interests of long-term investors and could detract from the efficiency of the national market system.

Today, the overwhelming majority of trading volume in listed equities and listed options is routed and executed through highly automated systems. Among other things, these sophisticated systems have dramatically reduced the time period for collecting and disseminating quotations.[45] In contrast to the primarily manual trading when the Commission originally adopted the exception for flash orders in 1978, flash orders no longer are clearly distinguishable from quotations that are disseminated in the consolidated quotation data. As a result, the rationale for requiring markets to include their best-priced quotations in the consolidated quotation data and for prohibiting the practice of displaying quotations with prices that lock previously displayed quotations would appear to apply equally to flash orders in today's trading environment.

The Commission also is concerned that flash orders may create a two-tiered market in which the public does not have access, through the consolidated quotation data streams, to information about the best available prices for listed securities. A flash order generally is displayed at a marketable price that will be better than the best displayed price for the security in the consolidated quotation data. For example, a flash order to buy would be displayed at a higher price than the national best bid, and a flash order to sell would be displayed at a lower price than the national best offer. Yet the public does not receive this flashed order information in the consolidated quotation data. Instead, only those market participants that receive a market's individual data feed have access to the improved price information. The consolidated quotation data streams are intended to provide a single source of information on the best prices for a listed security across all markets, rather than force the public to obtain data from many different exchanges and other markets to learn the best prices.[46] This objective would not be met if exchanges and ATSs disseminate pricing information that, due to the technological evolution of the markets, is functionally quite similar to quotations, yet is not required to be included in the consolidated quotation data.

In addition, the Commission is concerned about the extent to which flash orders may discourage the public display of trading interest and harm quote competition among markets. The Commission long has emphasized the need to encourage displayed liquidity in the form of publicly displayed limit orders.[47] Such orders establish the current ''market'' for a stock and thereby provide a critical reference point for investors. Flash orders, however, generally are executed by a market at prices that match the best displayed prices for a stock at another market. In this respect, flash orders potentially deprive those who publicly display their interest at the best price from receiving a speedy execution at that price. The opportunity to obtain the fastest possible execution at a price is the primary incentive for the display of trading interest.[48] Particularly if flash orders were offered by all major markets for a security and greatly expanded in trading volume, they could significantly undermine the incentives to display limit orders and to quote competitively, and thereby detract from the efficiency of the national market system.

For example, the flash process provides a vehicle for certain market participants to match displayed prices on an order-by-order basis by responding to flashes. It therefore gives these participants a ''last-mover'' advantage over displayed orders in other markets. Rather than displaying their orders or quotations in advance of incoming marketable order flow to attract an execution, these market participants can wait to receive the flashed order and program their systems to pick and choose when to execute. The availability of this ''flash'' alternative to quoting as a means to supply liquidity may reduce their incentives to display liquidity.

Moreover, the flash process diverts a certain amount of order flow that otherwise might be routed directly to execute against displayed quotations in other markets. The Commission recognizes that orders in listed equities may be routed to venues that do not display their trading interest in the consolidated quotation data.[49] Certain benefits, including adding liquidity, may result from routing orders to undisplayed venues. Given the importance of displayed quotations for market efficiency,[50] however, the Commission is particularly concerned about additional marketable order flow—orders that are immediately executable at the national best bid or offer—that may be diverted from the public quoting markets and that could further reduce the incentives for the public display of quotations.

The Commission also is concerned that the flashing of orders at marketable prices may undermine the purposes of Rule 610(d) of Regulation NMS, which is designed to protect displayed quotations from being locked by equal-priced contra side quotations.[51] Marketable prices are, by definition, prices that at least equal the best contra side quotation for a stock. For example,

[44] NMS Release, *supra* note 10, at 37500 (noting that ''it makes little sense to refer to someone as 'investing' in a company for a few seconds, minutes, or hours''). The Commission further noted that giving priority to the interests of long-term investors is consistent with both the legislative history of the Exchange Act and the strong policy goal to reduce the cost of capital for U.S.-listed companies. *Id.* at 37499–37500.

[45] *See* NYSE Euronext Letter at 4.

[46] *See* Rule 603(b) of Regulation NMS (providing for the dissemination of all consolidated information for an individual NMS stock through a single plan processor).

[47] *See, e.g.,* NMS Release, *supra* note 10, at 37527 (''The Commission believes, however, that the long-term strength of the NMS as a whole is best promoted by fostering greater depth and liquidity, and it follows from this that the Commission should examine the extent to which it can encourage the limit orders that provide this depth and liquidity to the market at the best prices.''); Order Handling Rules Release, *supra* note 10, at 48293 (''[T]he display of customer limit orders advances the national market system goal of the public availability of quotation information, as well as fair competition, market efficiency, best execution, and disintermediation.'').

[48] *See* NMS Release, *supra* note 10, at 37505.

[49] For example, some of these undisplayed venues are called ''dark pools,'' which are reported to execute approximately 8% of total trading volume in listed equities. *See, e.g.,* Nina Mehta, *Inching Toward Dark Pool Reporting Standards,* Traders Magazine Online News, June 26, 2009, *http://tradersmagazine.com/news/dark-pool-reporting-103943-1.html.* In addition, some exchanges, when they do not have available trading interest to execute marketable orders at the best displayed prices, give participants a choice of routing their orders in response to ''indications of interest'' from undisplayed venues that are not included in the consolidated quotation data. *See, e.g.,* NYSE Arca, ''Client Notice: NYSE Arca to Provide Indication of Interest (IOI) Routing'' (March 12, 2008) (routing service for ''non-displayed liquidity pools'').

[50] *See supra* note 10.

[51] As noted in note 23 *supra,* the Options Linkage Plan includes a prohibition on a pattern or practice of displaying locking or crossing quotations in listed options that is analogous to Rule 610(d).

a marketable flash order to buy will be displayed at the price of the national best offer and a marketable flash order to sell will be displayed at the price of the national best bid. In adopting Rule 610(d), the Commission emphasized that ''giving priority to the first-displayed quotation will encourage the posting of quotations and contribute to fair and orderly markets.'' [52] The Commission preliminarily believes that flash orders may be inconsistent with this policy. The flashing of orders is no longer distinguishable in today's highly automating trading from the dissemination of automated quotations. If marketable flash orders were included in the consolidated quotation data, for example, such orders clearly would be locking quotations in violation of Rule 610(d). The practical result of the Commission's proposal, therefore, would be that flash orders could no longer be displayed to anyone at prices that equal the best priced contra side quotation in a stock. A market that was unable to execute incoming marketable orders at the best prices would need to handle them in another fashion. Depending on the order router's wishes, a market could route the order away to access the best displayed prices on other exchanges, reprice and display the order at a permissible price, or cancel the order back to the order router. It also is possible, however, that the order may be routed to a dark venue.[53]

The proposed elimination of the exception for flash orders from Exchange Act quoting requirements also likely would affect the competition among exchanges and ATSs for trading volume. Much of a market's revenue is generated, directly or indirectly, through the execution of trades. Accordingly, markets have strong incentives to maximize their executed volume, both by attracting the largest possible volume of order flow and by executing as much of that order flow as possible. Flash orders give markets an additional opportunity to execute marketable orders even if they do not have available contra trading interest at the best displayed prices when the flash order arrives. In this respect, flash orders can be viewed as one competitive strategy to maximize a market's trading volume and revenues, which would be curtailed by adoption of the proposal.

The Commission preliminarily believes, however, that any limitation on a market's competitive choices would be justified by other effects of the proposal that would promote competition, protect investors, and enhance efficiency. As an initial matter, it is important to recognize that, both currently and if the proposal were adopted, all exchanges and ATSs would operate under the same rules for flash orders. Currently, the availability of the flash order type benefits markets that do not have available contra side trading interest at the best displayed prices when an order arrives by giving them a second chance to execute the order. In this respect, the current rule tends to benefit those markets that have the least available trading interest at the best prices, including displayed limit orders. If adopted, the proposal would give markets even greater incentives to attract trading interest at the best displayed prices, including displayed limit orders, in advance of the arrival of marketable orders, as well as better opportunities to attract marketable order flow by displaying the best prices. It thereby would promote competition for the displayed liquidity that is vital to the fairness and efficiency of the listed securities markets. In addition, the proposal would help protect the interests of investors who are willing to display their trading interest publicly.

Finally, the flashing of orders to many market participants creates a risk that recipients of the information could act in ways that disadvantage the flashed order. With today's sophisticated order handling and execution systems, those market participants with the fastest systems are able to react to information in a shorter time frame than the length of the flash order exposures. As a result, such a participant would be capable of receiving a flashed order and reacting to it before the flashed order, if it did not receive a fill in the flash process, could be executed elsewhere. For example, a recipient of a flash order that was quoting on another exchange would be capable of adjusting its quotes to avoid being hit by the flash order if it subsequently were routed to that exchange. Alternatively, a recipient would be capable of rapidly transmitting orders that would take out trading interest at other exchanges before an unfilled flash order could be routed to those exchanges. In both cases, a flashed order that did not receive an execution in the flash process would also be less likely to receive a quality execution elsewhere.

Of course, flash orders are voluntary on the part of order routers. They involve a willing decision on the part of order routers to disseminate the order information to a group that generally will include highly sophisticated professional traders. Those who choose to use the flash order type (which often will be a broker that owes a duty of best execution to its customer for the routing decision) probably already consider the extent to which flashed orders may contain significant information content that could lead the recipients of flash order information to act contrary to the interests of the orders. Stated another way, those who are highly concerned about information leakage generally would be unlikely to flash their order information to a large number of professional traders. As a result, there is an inverse relationship between the extent to which flash orders are used beneficially by order submitters and the extent to which the recipients of flash orders could gain an information advantage. If used beneficially by order submitters, the information leakage and information advantage would be minimized for the user of the flash order. If not used beneficially, however, the flash order type appears to raise particular risks for customers whose order information is flashed.

The Commission recognizes that flash orders offer potential benefits to certain types of market participants. For those seeking liquidity, the flash mechanism may attract additional liquidity from market participants who are not willing to display their trading interest publicly. Flash orders thereby may provide an opportunity for a better execution than if they were routed elsewhere.[54] There is no guarantee, for example, that an order routed to execute against a displayed quotation will, in fact, obtain an execution. The displayed quotation may already be executed against or cancelled before the routed order arrives. Of course, the delay in routing during a flash period may further decrease the likelihood of an execution in the displayed market for the flash order because prices at the displayed market may move away from the flash order during the flash process. Those who route flash orders, however, may use them selectively in those contexts where they believe an order is less likely to receive a full execution if routed elsewhere.

In addition, many markets that display quotations charge fees (often known as ''take'' fees) for accessing those quotations. Flash orders may be executed through the flash process for lower fees than the fees charged by many markets for accessing displayed quotations. Indeed, some markets have offered rebates on orders that are executed during a flash, so that the order, rather than paying a fee, will earn

[52] NMS Release, *supra* note 10, at 37547.

[53] As noted in section V below, the Commission's staff is reviewing other forms of dark trading interest that are not included in the consolidated public quotation data, and the Commission expects to consider initiatives in this area in the near future.

[54] *See* Direct Edge Letter at 2.

a rebate.[55] The combined difference between receiving a rebate for an executed flash order versus paying a fee for accessing a displayed quotation may be a significant incentive for traders to submit flash orders.[56]

Finally, some market participants that choose to receive and respond to flash orders may represent large institutional investors that are reluctant to display quotations publicly to avoid revealing their full trading interest to the market, but are willing to step up on an order-by-order basis and provide liquidity to flash orders. Such investors may have the sophisticated systems themselves to respond to flash orders or may rely on the systems of their brokers. Executions against flash orders could help lower the transaction costs of these institutional investors.

The Commission expects that any negative effect of the elimination of the exception for flash orders from Exchange Act quoting requirements would be mitigated by the ability of market participants to adapt their trading strategies to the new rules. In addition, higher incentives to display liquidity and alternative forms of competition for order flow could mitigate any negative effect of the proposal.

To summarize, the Commission recognizes that flash orders may have some benefits, but preliminarily believes that, in the context of today's highly automated trading environment, those benefits do not justify the negative aspects of flash orders. In reaching this preliminary view, the Commission also has considered the potential damage to public confidence in the securities markets caused by practices that may give professional short-term traders an unfair advantage over long-term investors. Professional short-term traders inevitably have advantages in the active trading of securities—that is, buying and selling securities repeatedly throughout the trading day. Active trading is a highly competitive endeavor, and many professional short-term traders devote substantial resources to develop the systems and expertise to trade successfully. Ultimately, this competition among professional short-term traders can greatly benefit long-term investors if it leads to better execution quality (such as narrower spreads and greater liquidity) when investors enter the market to establish or liquidate their positions in a security.

Practices that may give professional short-term traders undue advantages without creating sufficient corollary benefits to long-term investors, or that can undermine the goals of Commission rules, for example promoting displayed liquidity, may cause damage to public confidence in the fairness of the markets, and this must be considered by the Commission in fulfilling its regulatory responsibility under the Exchange Act. Indeed, the Congressional concern to maintain and promote public confidence in the fairness of the securities markets has been a hallmark of the federal securities laws for the last 75 years.[57]

The Commission also has considered the potential costs and benefits of flash orders at the level of individual transactions. When an order is flashed and receives an execution, three different market participants are most directly affected: (1) The submitter of the flash order that received an execution; (2) the receiver of the flashed information that supplied dark liquidity to the order; (3) and the market participant that was willing to supply liquidity through a publicly displayed quotation establishing the best price for a security, yet did not receive an execution at that price. Although the first two parties received the benefits of a desired trade, potentially with lower fees than they otherwise might have paid, the third party that established the best displayed price did not receive an execution and thereby suffered a cost. Moreover, displayed liquidity is a public good that benefits investors and traders generally.[58] When the market participants that generate this public good are harmed by a missed trading opportunity, it creates an externality that can detract from the efficiency of the securities markets.[59] Though the costs of failing to reward the public display of liquidity are difficult to quantify, the Commission's practical experience over the years with initiatives to promote the public display of liquidity have demonstrated their value for investors.[60]

Given all of these factors, the Commission preliminarily believes that the benefits of flash orders for some market participants do not justify their costs to other market participants, the national market system, and the public interest. It therefore is proposing to eliminate the exception for flash orders from Exchange Act quoting requirements.

B. Description of Proposal

1. Proposed Amendment of Rule 602

Under the proposal, paragraph (a)(1)(i)(A) of Rule 602 would be eliminated in its entirety. The Commission recognizes that a number of exchanges currently offer a variety of trading services other than flash orders that conceivably could be affected by the elimination of the paragraph. These may include price improvement auctions and various types of facilitation and exposure mechanisms for large orders.[61] The Commission preliminarily believes that the status of these trading mechanisms under Rule 602 would not be altered by the proposed amendment. For example, the Commission preliminarily believes that orders exposed as part of a competitive auction that provides an opportunity to obtain better prices than displayed quotations generally would not constitute bids and offers that must be provided to the consolidated quotation stream, nor would the responses to those orders if they were actionable only with respect to the exposed order. Comment is requested on the potential impact of the proposal on exchange trading services other than flash orders.

As noted in section III above, the language in Rule 602(a)(1)(i)(A) originally was adopted to accommodate ephemeral quotations on manual trading floors. Historically, exchange members located on trading floors have conducted on the spot discussions of price which could not practically be reflected in the published quotation and were generally understood to fall within the exemption of Rule 602(a)(1)(i)(A). Although trading floors have changed dramatically in recent years, some of the

[55] NASDAQ OMX, Flash Functionality, *http://www.nasdaqtrader.com/content/ProductsServices/Trading/Flash_factsheet.pdf* and BATS Global Markets, BATS Exchange Releases BOLT, *http://www.batstrading.com/resources/press_releases/BATS_Exchange_Announces_BOLT_FINAL.pdf.* As noted *supra* note 42, Nasdaq and BATS have announced that they will no longer offer a flash order functionality as of September 1, 2009.

[56] When it adopted Rule 610(d), the Commission specifically considered and disapproved the practice of deliberately locking a displayed quotation to obtain a liquidity rebate. NMS Release, *supra* note 10, at 37547 (restriction on locking quotations was intended to address a market participant that ''chooses to lock rather than execute the already-displayed quotation to receive a liquidity rebate'').

[57] *See, e.g.,* Section 2(a) of the Exchange Act (securities transactions are affected with a national public interest which makes it necessary to ''insure the maintenance of fair and honest markets in such transactions'').

[58] NMS Release, *supra* note 10, at 37516.

[59] *Id.*

[60] *See, e.g.,* Concept Release on Market Fragmentation, *supra* note 9, at 10584 n. 53 (citing academic studies finding that the required display of customer limit orders, by providing greater price transparency and enhancing public price discovery, led to substantial reductions in transaction costs for both retail and institutional investors).

[61] *See, e.g.,* BOX Rules, ch. V, sec. 18 (Price Improvement Mechanism); CBOE Rule 6.13A (Simple Auction Liaison); and ISE Rule 716(d) (Facilitation Mechanism).

historical practices may still be necessary for the effective functioning of a trading floor. For example, when floor brokers represent large discretionary orders they must be able to discuss terms of a prospective trade. If it were necessary to make such terms public, it would interfere with, and might make impossible, the effective representation of such large orders on a trading floor. Similarly, floor brokers can ''request a market'' in a security either hypothetically (or conditionally) or with a view to executing a particular order in hand. In either case, the response of the ''trading crowd'' can be different than the published quotation. It may be impractical to require such responses to be published. Even if publication were technically feasible, it could significantly impair floor brokers' ability to represent large orders effectively. There may be other examples as well of floor practices that are necessary for floors to function effectively, but that could be viewed as conflicting with Rule 602 as proposed to be amended.

The Commission preliminarily believes that the concerns about flash orders discussed above apply both with respect to the electronic flashing of orders and the manual flashing of orders to exchange crowds. These concerns include particularly the danger of a two-tiered market in which the public does not have access, through the consolidated quotation data streams, to information about the best available prices, and the effect on incentives to display trading interest publicly. In addition, the Commission has sought to establish a regulatory framework that maintains fair competition between automated markets and manual markets. The Commission requests comment on whether the elimination of the flash order exception for both automated trading systems and manual trading floors would seriously detract from the viability of trading floors in the modern, mostly electronic, trading environment. It also requests comment on whether Rule 602 should permit trading floors to continue manual ''flashing'' of orders if electronic ''flashing'' is prohibited and what, if any, conditions should apply.

In sum, the proposed amendment of Rule 602 conceivably could affect a number of practices of both electronic exchanges and manual trading floors. To the extent that particular practices do not raise the policy concerns of flash orders under specific circumstances, but would be constrained or eliminated by the proposed amendment, the Commission requests comment on whether it should adopt a narrower regulatory approach than the full elimination of the flash order exception.[62] In addition, the Commission could grant exemptions from the requirements of Rule 602, as necessary and appropriate, pursuant to Rule 602(d).[63]

2. Application of Rule 301(b)

If the Commission adopts the proposed elimination of the flash order exception from Rule 602, the Commission would apply Rule 301(b) of Regulation ATS in a consistent manner to ATSs that use flash orders. Rule 301(b) sets forth requirements for ATSs, one of which is order display and execution access. Paragraph (b)(3)(ii) of Rule 301 requires an ATS that meets a 5% volume threshold in an NMS stock[64] to provide to a national securities exchange or national securities association the prices and sizes of the orders at the highest buy price and the lowest sell price for such NMS stock, displayed to more than one person in the ATS, for inclusion in the quotation data made available by such exchange or association pursuant to Rule 602 of Regulation NMS. The Commission has sought to promote fair competition between exchanges and ATSs, consistent with their varying regulatory responsibilities.[65] The Commission has not applied Rule 301(b) in a manner inconsistent with Rule 602, with respect to flash orders or otherwise.

Accordingly, if the proposed amendment to Rule 602 is adopted, the Commission would consider orders that a threshold ATS displays to more than one person in the ATS that either are immediately executed or withdrawn if not immediately executed to be orders covered by Rule 301(b)(3)(ii) that must be provided to a national securities exchange or national securities association for inclusion in the consolidated quotation data. Such orders would be covered regardless of the particular term that an ATS might use to characterize the order, such as ''indication of interest.''[66]

3. Application of Rule 610(d)

Finally, if the Commission adopts the proposed amendment to Rule 602, the Commission would apply the restrictions on locking or crossing quotations in Rule 610(d) in a consistent manner to prohibit the practice of displaying marketable flash orders. Rule 610(d) requires each national securities exchange and national securities association to establish, maintain, and enforce rules that, among other things, prohibit members from engaging in a pattern or practice of displaying quotations that lock or cross any ''protected quotation,'' as defined in Rule 600(b)(57), in an NMS stock.[67] Under the proposed amendment of Rule 602, flash orders would no longer be excepted from the requirement to include best-priced quotations and orders in the consolidated quotation data. If that amendment is adopted, the Commission would consider the display by SRO members of quotations that either are immediately executed or withdrawn if not immediately executed to be the display of quotations that are subject to the locking and crossing restrictions of Rule 610(d), like any other quotation required by Rule 602(a) to be included in the consolidated quotation data. As a result, flash orders with non-marketable prices would not be locking or crossing quotations and would need to be included in the consolidated quotation data. Orders with marketable prices, however, could no longer be flashed, because if displayed they would be subject to the locking and crossing restrictions in Rule 610(d).

[62] *See* section V below for a more detailed discussion of alternative regulatory approaches.

[63] Rule 602(d) provides that such exemptions may be granted either unconditionally or on specified terms and conditions, if the Commission determined that such exemptions were consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system. *See, e.g.,* Letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, Commission, to Michael J. Simon, Senior Vice President and General Counsel, ISE, dated December 8, 2004 (Commission staff acting by delegated authority to grant ISE a limited exemption from its obligations under Rule 602(a) in connection with ISE's Price Improvement Mechanism).

[64] An ATS becomes subject to the Regulation ATS display requirement if, during at least four of the preceding six calendar months, it had an average daily trading volume of 5% or more of the aggregate average daily share volume for such NMS stock as reported by an effective transaction reporting plan. 17 CFR 242.301(b)(3)(i)(B).

[65] *See, e.g.,* Section 11A(a)(1)(c)(ii) of the Exchange Act (one of the objectives of the national market system is to assure fair competition ''between exchange markets and markets other than exchange markets'').

[66] *See* Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844, 70850 (December 22, 1998) (''Regulation ATS Adopting Release'') (''The label put on an order—'firm' or 'not firm'—is not dispositive. For example a system claiming it displays only ''indications of interest'' that are not orders, may be covered by the new interpretation of 'exchange' if those indications are, in fact, firm in practice.)

[67] As noted in note 23 *supra,* the Options Linkage Plan includes a prohibition of a pattern or practice of displaying locking or crossing quotations in listed options that is analogous to Rule 610(d). If flash orders for listed options were no longer excepted from Rule 602 and therefore required to be included in the OPRA quotations data, the Commission also would consider the Option Linkage Plan's restrictions on locking or crossing quotations to apply to the display of marketable flash orders.

V. Request for Comments

The Commission seeks comment and data on all aspects of the proposed amendment of Rule 602, including its implications for the application of Rule 301(b) and Rule 610(d). In particular, comment and data are requested on the effect of flash orders on the fairness and efficiency of the markets for listed securities and on the interests of long-term investors in these securities. If adopted, would the proposal promote investor confidence by addressing the potential for a two-tiered market with respect to access to information about the best prices for listed securities? Would the proposal help to promote the display of quotations in public markets by eliminating one type of trading in which ''dark'' liquidity is provided that matches the prices of previously displayed public quotations? Would the proposal reduce the potential for information leakage that could detract from the execution quality of marketable orders? Conversely, would the proposal deprive investors of a trading tool that, if used beneficially, can lead to improved quality of execution for marketable orders?

Comment and data also are requested on the following questions. What are some of the trading strategies that employ flash orders? Is the use of flash orders in the best interests of these traders and how would the inability to use flash orders affect these traders? Are there alternatives to using flash orders in such trading strategies? How are market participants likely to change their behavior if unable to use flash orders? What are the likely effects of these changes? Which market centers are likely to benefit from any changes in order routing practices? How would the proposal affect transaction costs incurred by various market participants? How would overall transaction costs change? In the absence of flash orders, would the limit orders setting the best displayed price benefit with faster or more probable executions?

Comment and data also are requested on the use of flash orders by exchanges for listed options and whether concerns about flash orders should be assessed differently in that context. For example, trades in listed options are required to be executed on an exchange that has public quoting responsibilities rather than at over-the-counter venues that are not required to publish quotations. In addition, the incentives for the display of liquidity for derivative instruments such as listed options may be different from such incentives for cash equities. Finally, listed options are priced largely on the value of the underlying securities; market participants typically update quotations prices as the underlying prices change. Given these differences and others between equity and options trading, should the Commission adopt a different approach for flash orders in listed options than for flash orders in listed equities?

The Commission also requests comment and data on narrower regulatory approaches than a complete elimination of the exception for flash orders from Exchange Act quoting requirements. Section IV.B.1 above, for example, requests comment on issues relating to manual trading floors and the extent to which such floors, as they currently operate, continue to need the exception for flash orders. In addition, are there additional features or limitations that could be added to the use of flash orders that would significantly alter the respective costs and benefits discussed in this release? For example, would requiring broader dissemination of flashed order information—such as in the consolidated quotation data—address concerns about two-tiered access to information about the best prices for listed securities? Could these concerns about two-tiered access be addressed by conditioning a market's provision of a flash order type on its making available flash order information to anyone without charge, even though the data would not be in a single consolidated feed? If flash order information were more broadly disseminated, how should the Commission assess the policy objectives behind existing restrictions on the display of locking quotations? Also, could exchanges address concerns about the misuse of flash order information through tailored surveillance or other regulatory procedures? Could concerns about information leakage be addressed by requiring brokers to provide detailed disclosure to a customer about the risks, or requiring the customer's affirmative consent, before allowing the customer's order to be flashed? Would requiring the recipient of a flash order to offer price improvement ameliorate any of the concerns discussed above?

The Commission further seeks comment on the application of Rule 301(b) of Regulation ATS and Rule 610(d) of Regulation NMS consistent with the proposed amendment to Rule 602, if adopted. Are there any special considerations applicable to ATSs that would justify applying a different standard from exchanges with respect to the inclusion of ATS orders in the consolidated quotation data? Are there any special considerations applicable to flash quotes that would justify applying a different standard from other types of displayed quotations for purposes of the locking and crossing restrictions?

The Commission strongly encourages commenters to respond within the designated comment period. It intends to act quickly in reviewing the comments and assessing further action. In this regard, the Commission also is actively reviewing other forms of ''dark'' trading interest (that is, trading interest that is not included in the consolidated public quotation data) that may be detrimental to the fairness and efficiency of the national market system. Dark trading interest, as well as the information that some undisplayed venues currently disseminate to market participants concerning such trading interest, is not generally available to the public.[68] Comment and data are requested on the use of flash orders as a mechanism to interact with dark liquidity and whether other mechanisms for accessing dark liquidity either do or do not raise policy concerns that are analogous to flash orders. The Commission is developing initiatives in this area, as well as reviewing other market structure issues, including those concerning Regulation ATS thresholds, direct market access, high frequency trading, and co-location.

VI. Paperwork Reduction Act

The Commission believes that eliminating the flash order exception, if adopted, would not substantively or materially change collection burdens under the requirements of Rule 602 of Regulation NMS. If adopted, the proposal would prohibit the practice of displaying marketable flash orders. Exchanges would be required to handle marketable orders that they are unable to execute at the best displayed prices in another manner, such as by routing marketable orders away to execute against the best displayed quotations at another exchange or ATS. Because exchanges would not be permitted to display these orders in the consolidated quotation data, no new collection of information would be required under Rule 602 with regard to marketable flash orders. In contrast, non-marketable flash orders would be required to be displayed in the consolidated quotation data. The Commission preliminarily

[68] *See, e.g., Oversight Hearing on Current State and Agenda, Hearing Before the Subcomm. on Capital Markets, Insurance and Government-Sponsored Enterprises of the House of Representatives Comm. on Financial Services,* 111th Cong. (July 14, 2009) (testimony of Mary L. Schapiro, Chairman, Commission); Mary L. Schapiro, Chairman, Commission, Address before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009) (transcript available at *http://www.sec.gov*).

believes, however, that the additional burden of including non-marketable flash orders with the large volume of quotations that exchanges already include in the consolidated quotation data under Rule 602 would not be material.[69]

In addition, the Commission does not believe that the application of Rule 301(b) of Regulation ATS and Rule 610(d) of Regulation NMS consistent with the proposed amendment to Rule 602 contain ''collection of information requirements'' within the meaning of the Paperwork Reduction Act of 1995.[70] Rule 301(b) of Regulation ATS would apply to the use of flash orders by alternative trading systems. The Commission believes that this would affect fewer than ten entities. Rule 610(d) of Regulation NMS would prohibit the practice of displaying flash orders with prices that lock or cross previously displayed quotations. The Commission believes that Rule 610(d) does not contain a collection of information requirement as defined by the Paperwork Reduction Act. Accordingly, the Commission believes that the application of Rule 301(b) of Regulation ATS and Rule 610(d) of Regulation NMS consistent with the proposed amendment to Rule 602 imposes no new collection of information requirements. The Commission encourages comments on this point.

VII. Consideration of Costs and Benefits

We are sensitive to the costs and benefits of our proposal to eliminate the exception for flash orders from Exchange Act quoting requirements. We request comment on the costs and benefits associated with the proposed amendment. The Commission has identified certain costs and benefits of the proposal and requests comment on all aspects of its preliminary cost-benefit analysis, including identification and assessments of any costs and benefits not discussed in this analysis. The Commission also seeks comments on the value of any of the benefits identified and welcomes comments on the accuracy of any of the costs described in each section of this cost-benefit analysis, as well as elsewhere in this release. Finally, the Commission requests that commenters provide data and any other information or statistics that the commenters relied on to reach any conclusions on such estimates.

A. Benefits

As discussed above, the proposal is intended to prevent a two-tiered market in which the public does not have access, through the consolidated quotation data streams, to information about the best available prices for listed securities, to promote the goals of the consolidated quotation system, and to help promote public confidence in the fairness of the listed securities markets.[71] A flash order generally is displayed at a marketable price that will be better than the best displayed price for the security in the consolidated quotation data. For example, a flash order to buy would be displayed at a higher price than the national best bid, and a flash order to sell would be displayed at a lower price than the national best offer. Yet the public does not receive this flash order information in the consolidated quotation data. Instead, only the participants of a particular market that receive the market's data feed have access to the improved price information. The consolidated quotation data streams are intended to provide a single source of information on the best prices from all markets, rather than force the public to obtain data from many different exchanges and other markets to learn the best prices. A single source of data facilitates investor access to the best prices in the national market system, and helps promote best execution.[72] This objective would be undermined if exchanges and ATSs disseminate pricing information that is functionally quite similar to quotations, yet is not required to be included in the consolidated quotation data.

The proposal is intended to promote the public display of trading interest and quote competition among markets. The Commission long has emphasized the need to encourage displayed liquidity in the form of publicly displayed limit orders.[73] Such orders establish the current ''market'' for a stock and thereby provide a critical reference point for investors. Flash orders, however, generally are executed by a market at prices that match the best displayed prices for a stock at another market. In this respect, flash orders potentially deprive those who publicly display their interest at the best prices from receiving a speedy execution, or any execution, at that price. The opportunity to obtain the fastest possible execution at a price is the primary incentive for the display of trading interest. Particularly if flash orders were offered by all major markets for a security and greatly expanded in trading volume, they could significantly undermine the incentives to display limit orders and to quote competitively, and thereby detract from the efficiency of the national market system.

For example, the flash process provides a vehicle for certain market participants to match displayed prices on an order-by-order basis by responding to flashes. It therefore gives these participants a ''last-mover'' advantage over displayed orders in other markets. Rather than displaying their orders or quotations in advance of incoming marketable order flow to attract an execution, these market participants can wait to receive the flashed order and program their systems to pick and choose when to execute. The availability of this ''flash'' alternative to quoting as a means to supply liquidity may reduce their incentives to display liquidity.

Moreover, the flash process diverts a certain amount of order flow that otherwise might be routed directly to execute against displayed orders and quotations in other markets. The Commission recognizes that some markets route orders to dark venues rather than to displayed trading venues.

Certain benefits, including adding liquidity, may result from routing orders to undisplayed venues. Given the importance of displayed quotations for market efficiency,[74] however, the Commission is particularly concerned about additional marketable order flow—orders that are immediately executable at the national best bid or offer—that may be diverted from the public quoting markets and that could further reduce the incentives for the public display of quotations.

The Commission also is concerned that the flashing of orders at marketable prices may undermine the purposes of Rule 610(d) of Regulation NMS, which is designed to protect displayed quotations from being locked by equal-priced contra side quotations. Marketable prices are, by definition, prices that at least equal the best contra side quotation for a stock. For example, a marketable flash order to buy will be displayed at the price of the national best offer and a marketable flash order to sell will be displayed at the price of the national best bid. In adopting Rule 610(d), the Commission emphasized that ''giving priority to the first-

[69] The information collection contained in Rule 602, entitled ''Dissemination of Quotations—Rule 11Ac1–1,'' the precursor to Rule 602, has been assigned control number 3235–0461. The Commission, however, will be updating the overall burden estimate for this collection of information to account for an increase in the number of exchanges subject to the Rule.

[70] 44 U.S.C. 3501, *et seq.*

[71] *See supra* notes 18 and 57.

[72] *See supra* note 18 and accompanying text.

[73] *See supra* note 47.

[74] *See supra* note 10.

displayed quotation will encourage the posting of quotations and contribute to fair and orderly markets.'' [75] The Commission preliminarily believes that flash orders may be inconsistent with this goal because the flashing of orders is no longer distinguishable, in certain key respects, from the dissemination of automated quotations. If marketable flash orders were included in the consolidated quotation data, for example, such orders clearly would be locking quotations in violation of Rule 610(d). The practical result of the proposal, therefore, would be that flash orders could no longer be displayed to anyone at prices that equal the best priced contra side quotation in a stock. A market that was unable to execute incoming marketable orders at the best prices would need to handle them in another fashion, such as by routing the order away to access the best displayed prices on other exchanges, or cancelling the order back to the submitter. It is also possible that the order may be routed to a dark venue.[76]

The elimination of flash orders would also change markets' competitive strategies to maximize trading volume and revenues. Currently, the availability of the flash order type benefits markets that do not have available contra side trading interest at the best displayed prices when an order arrives by giving them a second chance to execute the order. In this respect, the current rule tends to benefit those markets that have the least available trading interest at the best prices, including displayed limit orders. If adopted, the proposal would give markets even greater incentives to attract trading interest at the best displayed prices, including displayed limit orders, in advance of the arrival of marketable orders. It thereby would promote competition for the displayed liquidity that is so vital to the fairness and efficiency of the listed securities markets.

Finally, the flashing of orders to many market participants creates a risk that recipients of the information could act in ways that disadvantage the flashed order. With today's sophisticated order handling and execution systems, those market participants with the fastest systems are able to react to information in a shorter time frame than the length of the flash order exposures. As a result, such a participant would be capable of receiving a flashed order and reacting to it before the flashed order, if it did not receive a fill in the flash process, could be executed elsewhere. For example, a recipient of a flash order that was quoting on another exchange could adjust its quotes to avoid being hit by the flash order if it subsequently were routed to that exchange. Alternatively, a recipient rapidly could transmit orders that would take out trading interest at other exchanges before an unfilled flash order could be routed to those exchanges. In both cases, a flashed order that did not receive an execution in the flash process would also be less likely to receive a quality execution elsewhere.

At the same time, because flash orders are voluntary on the part of order routers, they involve a willing decision on the part of order routers to disseminate the order information to a group that generally will include highly sophisticated professional traders. Those who choose to use the flash order type (which often will be a broker that owes a duty of best execution to its customer for the routing decision) probably already consider the extent to which flashed orders may contain significant information content that could lead the recipients of flash order information to act contrary to the interests of the orders. Stated another way, those who are highly concerned about information leakage generally would be unlikely to flash their order information to a large number of professional traders. As a result, there is an inverse relationship between the extent to which flash orders are used beneficially by order submitters and the extent to which the recipients of flash orders could gain an information advantage. If used beneficially, the information leakage and information advantage would be minimized. If not used beneficially, however, the flash order type appears to raise particular risks for customers whose order information is flashed.

The Commission seeks comment on the anticipated benefits of the proposal, including whether the proposal will: (1) Help prevent a two-tiered market in terms of access to information about the best available prices for listed securities; (2) promote the public display of trading interest; (3) help prevent displayed quotations from being locked by equal-priced contra-side quotations; (4) promote competition among markets for displayed liquidity; (5) reduce the risk of detrimental information leakage about customer orders. The Commission further seeks comment on whether the anticipated benefits differ between the equity markets and the options markets.

B. Costs

The proposed elimination of the exception for flash orders from Exchange Act quoting requirements could preclude potential benefits that flash orders offer to certain market participants. For those seeking liquidity, the flash mechanism may attract additional liquidity from market participants who are not willing to display their interest publicly. Flash orders thereby may provide an opportunity for a better execution than if they were routed elsewhere. There is no guarantee, for example, that an order routed to execute against a displayed quotation will, in fact, obtain an execution. The displayed quotation may already be executed against or cancelled before the routed order arrives. Of course, the delay in routing during a flash period may further decrease the likelihood of an execution for the flash order elsewhere because prices may move away from the flash order during the flash process. Those who route flash orders, however, may use them selectively in those contexts where they believe an order is less likely to receive a full execution if routed elsewhere.

Another potential cost to market participants is that many markets that display quotations charge fees (often known as ''take'' fees) for accessing those quotations. Flash orders may be executed through the flash process for lower fees than the fees charged by many markets for accessing displayed quotations. Professional short-term traders with large trading volume may be particularly sensitive to the level of these fees.

For example, the Commission estimates an average daily volume in listed equities of 8.8 billion shares per day [77] and that flash volume accounts for 0.8% of this volume.[78] The Commission believes that access fees for executed flash orders in the equities markets range from $0.0010 per share to $0.0029 per share.[79] It estimates that the average access fee is $0.0015 per share. In contrast, it estimates that the average access fee for accessing a displayed quotation is $0.0029 per share.[80] The total cost from increased fees for all flash order users on a yearly basis in listed equities, therefore, would be approximately $24,837,120 (8.8 billion

[75] *See supra* note 52.

[76] As noted in section V above, the Commission's staff is reviewing other forms of dark trading interest that are not included in the consolidated public quotation data, and the Commission expects to consider initiatives in this area in the near future.

[77] *Source: www.arcavision.com* (consolidated volume in July 2009).

[78] The estimate of the volume of flash order trading is based on discussions with markets that continue to offer flash orders as of September 2009.

[79] *See* Direct Edge Fee Schedule, *http://www.directedge.com/fee_schedule.aspx;* CBSX Fee Schedule, *http://www.cboe.com/publish/cbsxfeeschedule/cbsxfeeschedule.pdf.*

[80] *Id.*

shares × .8% × $0.0014 per share increase in access fee × 252 trading days). The Commission believes this estimate is an upper bound since market participants would adapt their strategies to minimize transaction costs under the new conditions.

In addition, some options exchanges offer lower access fees for market participants using flash orders. The Commission estimates an average daily volume in listed options of 13,898,735 contracts per day [81] and that flash volume accounts for 1.9% of this volume.[82] The Commission believes that access fees for executed flash orders in the options markets range from $0.00 per contract to $0.15 per contract.[83] It estimates that an average access fee is $.01 per contract.[84] In contrast, the average access fee for accessing a displayed quotation costs the market participant $0.21 per contract.[85] The total cost from increased fees for all flash order users on a yearly basis in listed options, therefore, would be approximately $13,309,429 (13,898,735 contracts × 1.9% × $0.20 per contract increase in access fee × 252 trading days) . As noted above, the Commission expects the actual cost may be lower as market participants would minimize the impact by refining their trading strategies.

The Commission recognizes that some market participants that choose to receive and respond to flash orders may represent large institutional investors that are not willing to display their interest to avoid revealing their trading interest to the market, but are willing to step up on an order-by-order basis and provide liquidity to flash orders. Such investors may have the sophisticated systems themselves to respond to flash orders or may rely on the systems of their brokers. Executions against flash orders could help lower the transaction costs of these institutional investors. In addition, as discussed below in Section VIII, flash orders give markets an additional opportunity to execute marketable orders even if they do not have available contra trading interest at the best displayed prices when the flash order arrives. In this respect, flash orders can be viewed as a market's competitive strategy to maximize trading volume and revenues that would be eliminated by adoption of the proposed amendments.

The Commission expects that any negative effect of the elimination of the exception for flash orders from Exchange Act quoting requirements would be mitigated by the ability of market participants to adapt their trading strategies to the new rules. Also, higher incentives to display liquidity and alternative forms of competition for order flow additionally could mitigate any negative effect of the proposal.

The markets with five trading systems that offer an electronic flash order functionality would need to make systems changes to comply with the proposed elimination of the exception for flash orders from Exchange Act quoting requirements. The Commission estimates that a programming change for a market requires approximately 20–30 hours per market of coding [86] at an average hourly cost of $193 to eliminate the flash order functionality.[87] The Commission estimates that the aggregate cost of programming changes for these markets to be approximately $19,300–$28,950.

In addition, the Commission believes that three exchanges currently have rules in place that provide for flash orders on five trading systems. The Commission estimates that these markets will each need to file proposed rule changes to remove the flash order functionality from their respective rule books for each system, for a total of five rule changes. The Commission estimates that a routine rule change requires approximately 34 hours for an exchange to complete [88] at an average hourly cost of $305.[89] The Commission estimates that the aggregate cost of one proposed rule change for each trading system would total approximately $51,850.

Finally, the five exchanges that operate trading floors for equities or options may need to reflect manual trading interest at non-marketable prices in the consolidated quotation data if they currently rely on the flash order exception for any such floor activity. The Commission preliminarily believes that the five exchanges currently have systems and procedures for floor members to include trading interest in the exchanges' automated systems. Accordingly, the elimination of the flash order exception should not impose a material new systems burden on these exchanges.

The Commission requests comment on any direct or indirect costs of the proposed amendment and asks commenters to quantify those costs, where possible. Specifically, the Commission requests comments on the following questions:

- What are some of the trading strategies that employ flash orders? Is the use of flash orders in the best interest of these traders and how would the inability to use flash orders impact these traders?
- How are market participants likely to change their behavior in the absence of flash orders? What are the likely costs of these changes?
- How will the proposal impact transaction costs incurred by various market participants? On net, how will overall transaction costs change?
- How would the proposal affect competition between trading venues? What costs will be imposed as a result?
- In the absence of flash orders, will the limit orders setting the best price benefit with faster or more probable executions?

VIII. Consideration of Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation

Section 3(f) of the Exchange Act [90] requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition. Exchange Act Section 23(a)(2) also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[91] As discussed below, the Commission's preliminary view is that the proposed amendment should promote efficiency and competition and

[81] The Options Clearing Corporation, Volume Statistics, *http://www.optionsclearing.com/market/vol_data/2009/daily/jul_09.jsp.*

[82] The Commission estimates average daily volume of executed flash orders in July at 265,052 contracts. This figure reflects discussions with the relevant markets.

[83] *See* BOX, CBOE, and ISE fee schedules.

[84] *See* BOX, CBOE, and ISE fee schedules.

[85] This figure represents the approximate charge for a Linkage Order derived from discussions with the relevant markets.

[86] This figure reflects discussions with the relevant markets.

[87] $ 193 per hour figure for a Programmer Analyst is from SIFMA's *Management & Professional Earnings in the Securities Industry 2008,* modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[88] *See* Securities Exchange Act Release No. 50486 (October 4, 2004), 69 FR 60287, 60294 (October 8, 2004) (File No. S7–18–04) (adopting release requiring SROs to file proposed rule changes electronically with the Commission).

[89] $ 305 per hour figure for an Attorney is from SIFMA's *Management & Professional Earnings in the Securities Industry 2008,* modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[90] 15 U.S.C. 78c(f).

[91] 15 U.S.C. 78w(a)(2).

will have minimal impact, if any, on promotion of capital formation.

The proposed elimination of the exception for flash orders from Exchange Act quoting requirements would affect the competition among exchanges and ATSs for trading volume. Much of a market's revenue is generated, directly or indirectly, through the execution of trading volume. Accordingly, markets have strong incentives to maximize their volume, both by attracting the largest possible volume of order flow and by executing as much of that order flow as possible after it arrives at the exchange. Flash orders give markets an additional opportunity to execute marketable orders even if they do not have available contra trading interest at the best displayed prices when the flash order arrives. In this respect, flash orders can be viewed as a market's competitive strategy to maximize trading volume and revenues that would be eliminated by adoption of the proposed amendments.

The Commission preliminarily believes, however, that any limitation on a market's competitive choices would be justified by other effects of the proposal that would promote competition and enhance efficiency. As an initial matter, it is important to recognize that, both currently and if the proposal were adopted, all markets (including exchanges and ATSs) would operate under the same rules for flash orders. Currently, the availability of the flash order type benefits markets that do not have available contra side trading interest at the best displayed prices when an order arrives by giving them a second chance to execute the order. In this respect, the current rule tends to benefit those markets that have the least available trading interest at the best prices, including displayed limit orders. If adopted, the proposal would give markets even greater incentives to attract trading interest at the best displayed prices, including displayed limit orders, in advance of the arrival of marketable orders.[92] It thereby would promote competition for the displayed liquidity that is vital to the fairness and efficiency of the listed securities markets. Encouraging the use of displayed limit orders should help improve the price discovery process, and in turn, contribute to increased liquidity and depth in the markets.[93] The deeper and more liquid the markets are, the more willing the public may be to invest its capital, thus promoting capital formation.

The proposal also is designed to promote efficiency by giving a further incentive for markets to compete to attract displayed limit orders and generally to encourage the public display of trading interest.[94] Given that the overwhelming majority of trading volume in listed securities is routed and executed through highly automated systems, flash orders are no longer clearly distinguishable from the best bids and offers for listed securities that are required to be collected and disseminated in the consolidated quotation stream. There is little practical reason to treat flash orders differently from other bids and offers with respect to Exchange Act quoting requirements.

Yet those who display bids and offers appear to be harmed by the disparity in regulatory treatment between flash orders and displayed bids and offers. For example, the flash order process permits market participants to wait to receive the flashed orders and program their systems to pick and choose when to execute. The exception for flash orders may thereby undermine the incentives for market participants to display their trading interest. If adopted, the proposal could lead market participants to display more of their trading interest. Such a result would be consistent with the Commission's emphasis on the need to encourage displayed liquidity—a critical reference point for investors.[95] Additionally, because the flash order process diverts a certain amount of order flow that might otherwise be routed directly to execute against displayed quotations in other markets, the exception for flash orders may further reduce the incentives for the public display of quotations.[96] While some flash orders may be cancelled or routed to trading venues that do not display their trading interest in the consolidation quotation stream, the Commission preliminarily believes that eliminating the exception for flash orders would result in more order flow being routed to execute against displayed trading interest and would promote the fairness and efficiency of the listed securities markets.[97]

Based on the analysis above, the Commission preliminarily believes that the proposed elimination of the exception for flash orders from Exchange Act quoting requirements would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission requests comment on all aspects of this analysis and, in particular, on whether the proposed elimination of the exception for flash orders would place a burden on competition, as well as the effect of the proposal on efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views if possible.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA," [98] the Commission must advise the OMB as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation.

The Commission requests comment on the potential impact of the proposed rule amendment on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

X. Regulatory Flexibility Act

The Commission hereby certifies, pursuant to 5 U.S.C. 603(b), that the proposed amendment to the Exchange Act quoting requirements and consistent application of Rule 610(d), if adopted, would not have a significant economic impact on a substantial number of small entities to which it applies. The proposed amendment to Rule 602 and consistent application of Rule 610(d) would apply to national securities exchanges, none of which is a small entity as defined by Commission rules.[99] The consistent application of Rule 610(d) also would affect one national securities association, which is not a small entity as defined by 13 CFR

[92] *See* NMS Release, *supra* note 10, at 37516 ("Displayed limit orders benefit all market participants by establishing the best prices * * * ").

[93] *See supra* note 47.

[94] *See* Order Handling Rules Release, *supra* note 10, at 48293 ("[T]he display of customer limit orders advances the national market system goal of the public availability of quotation information, as well as fair competition, market efficiency, best execution, and disintermediation.").

[95] *See supra* note 58.

[96] *See supra* note 49.

[97] *See* NMS Release, *supra* note 10, at 37505 ("[M]arket orders need only be routed to markets displaying quotations that are truly accessible").

[98] Public Law No. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[99] *See* 17 CFR 240.0–10(e).

121.201. In addition, the consistent application of Rule 301(b) would only affect ATSs, none of which are small entities as defined by Commission Rules.[100]

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

XI. Statutory Authority

Pursuant to the Exchange Act and particularly, Sections 2, 3(b), 5, 6, 11, 11A, 15, 15A, 17(a) and (b), 19, 23(a), and 36 thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k, 78k–1, 78o, 78o–3, 78q(a) and (b), 78s, 78w(a), and 78mm, the Commission proposes to amend Rule 602 of Regulation NMS.

[100] *See* 17 CFR 240.0–10(c).

XII. Text of Proposed Rule Amendment

List of Subjects in 17 CFR Part 242

Brokers, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows.

PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. The authority citation for Part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 78mm, 80a–23, 80a–29, and 80a–37.

§ 242.602 [Amended]

2. Section 242.602 is amended by removing and reserving paragraph (a)(1)(i)(A).

By the Commission.

Dated: September 18, 2009.

Elizabeth M. Murphy,

Secretary.

[FR Doc. E9–22911 Filed 9–22–09; 8:45 am]

BILLING CODE 8010–01–P