Commentary: FINRA's Song Without a Melody

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August 17, 2009, is turning out to be a red-letter day in rule-making history. First, the SEC unleashed its second round of proposals to introduce short sale price tests into the markets, this time proposing an "Alternative Uptick Rule, " as compared to the "Modified Uptick Rule" and the "Uptick Rule." We expect to have more to say about the Alternative Uptick Rule in future articles. Second, FINRA proposed to graft certain concepts pruned from Regulation NMS into the market for OTC equity securities.

The "NMS" in Regulation NMS stands for "National Market System," which was created by Congressional fiat in the Securities Acts Amendments of 1975. At that time, Congress was fed up with the monopolistic practices of the New York Stock Exchange and ordered the SEC to do something about it.

Monopolies charge higher prices than firms that have to worry about competitors, and true to form, the New York Stock Exchange mandated fixed commissions, a practice that ended on May 1, 1975. The rates charged at that time for a trade on the New York Stock Exchange became enshrined in history as the "May Day" rates, which induced tears of remembrance among NYSE traders for many years, but have now faded from memory.

Congress was mighty unhappy about fixed commissions, but it was especially irritated by what was widely believed to be a failure of the NYSE to innovate. It is a fact that the NYSE and its member firms were a tad slow to adopt the new high speed communications and data processing technologies that had taken American businesses by storm well over a decade earlier.

To break this monopoly and foster competition among trading venues, Congress required the SEC to designate certain stocks as "national market system securities." Initially, this included all of the stocks listed on national securities exchanges. During the 1980's, the rule was expanded to included stocks listed on Nasdaq, an expansion that is no longer necessary now that the Nasdaq Stock Market has become an exchange. Non-NMS stocks quoted or traded in American markets are "OTC equity securities." Regulation NMS, which represents the culmination of the work of Congress in 1975, applies to national market system securities, but does not apply to OTC equity securities.

Of course, nothing prevents the SEC from declaring all stocks traded anywhere in the United States as national market system securities, which would have the effect of extending Regulation NMS, as well as the other rules that pertain to national market system securities, to the market for OTC equity securities. So, one naturally wonders why FINRA should adopt a rule that extends the blessings of Regulation NMS to the OTC equity securities market when the SEC has been granted all necessary power by Congress to accomplish this task.

The confusion about FINRA's motives is increased by the fact that not all of the rules governing NMS securities instituted by Regulation NMS will apply to OTC equity securities.

The primary purpose of Regulation NMS was to establish a preference for automated orders submitted into an electronic marketplace, as compared to orders handled manually on the floor of the New York Stock Exchange. It is this rule that, more than anything, broke the remaining elements of the NYSE's control over orders in its listed securities. In the wake of Regulation NMS, less than half the orders for securities listed on the New York Stock Exchange actually trade there.

The second objective of Regulation NMS was to encourage investors to submit publicly displayed limit or priced orders, rather than market orders or non-displayed priced orders, into public quotation venues. To accomplish this purpose, Regulation NMS established a trade-through rule, which required orders displayed in a publicly available quotation medium to be executed before any other orders with an inferior price. This objective has not been successful. Institutions have preferred to submit their priced orders into non-displayed venues, sometimes called "dark pools," and an entire industry has been spawned to cater to this preference.

Neither of these objectives is addressed by FINRA's proposals. Instead, FINRA has picked four of Regulation NMS's lesser rules to apply to the world of OTC Equity Securities. The proposal would (i) establish a minimum pricing increment for OTC equity securities, (ii) prohibit locked and crossed markets, (iii) allow market participants to charge access fees and (iv) require the display of customer limit orders.

Two of FINRA's proposals might be considered a matched pair – the rules prohibiting locked and crossed markets and permitting access fees. Except for the occasional trading error, locked and crossed markets occur because traders, or their customers, do not wish to pay an access fee, or investors wish to receive a rebate for an order, rather than obtaining an immediate execution without a rebate. So, rather than hit a bid at a venue that will charge an access fee, or lose the opportunity to obtain a rebate, a trader will simply establish an offer at the same price and look for execution elsewhere. However, access fees currently are not

permitted in the market for OTC equity securities, a fact of life that also limits the ability to pay rebates for order flow. As a result, locked and crossed markets rarely occur in this market. This part of the proposal therefore amounts to swallowing the regulatory spider to catch the regulatory fly.

The fact is that the SEC seriously considered abolishing access fees at the time Regulation NMS was adopted. Access fees, combined with a duty of best execution, amount to requiring someone who is not your customer to pay your fees. Extortion of this nature is the dream of every businessman and is usually prohibited as an anti-competitive practice wherever it appears. If all industry participants are permitted to charge access fees, the result is a zero sum game that raises transactions costs without any benefit to the markets or the investing public. The SEC grudgingly permitted access fees under Regulation NMS, with limitations to prevent abuse, because of a long-standing Nasdaq practice. I do not believe that access fees would have been permitted under Regulation NMS if the SEC had started with a clean slate. It is indefensible to open the door to this deplorable practice in the uncontaminated OTC equity markets.

It is also odd that FINRA would require the display of limit orders without also imposing a trade-through rule that would provide some incentive to produce them. Even where there is a trade-through rule, institutions are very reluctant to display their interest for fear of abuse. In a market without a trade-through rule, a limit order is a sitting duck.

Regulation NMS is not sacred writ. It was designed as an incremental development in a chain of rule-making that extends back to Congressional directives issued thirty years ago. As with much of the other rule-making that preceded Regulation NMS, there were unintended consequences in the form of dark pools and fast trading, yielding abuses that will undoubtedly require further rule-making to correct. It is a mistake to extend pieces of it to the market for OTC equity securities without a better idea of what we hope to accomplish.

Worse yet, we have been down this road before. In the last twenty years or so, we have witnessed repeated regulatory efforts to encourage customers to produce limit orders. We have lived through access fees and their effects on markets. Why not learn from past mistakes, rather than continue to repeat them?

FINRA's regulatory initiative, however well-intended, brings to mind the immortal words of the late, great Billy Preston: This is a song "ain't got no melody . . . a story ain't got no moral." Inevitably, we are doomed to go round in circles.

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