Commentary: Trading Ahead in OTC Equities, Round Two

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Last week, the SEC approved a FINRA proposal to amend NASD Interpretive Material (IM) 2110-2, which deals with trading ahead of a customer limit order. The amendment follows rapidly on the heels of the original IM, which has only been effective for two months.

IM-2110-2 extended the “Manning” rule, named after a famous case against Charles Schwab, to the market for OTC Equity Securities. The *Manning* case brought limit order protection, and its corollary price improvement, into the NASDAQ marketplace, when NASDAQ was an over-the-counter market before it registered as an exchange.

The Manning rule introduced an aspect of the agency-auction market -- the market structure used by the New York Stock Exchange – to the NASDAQ dealer market as it existed in the late 1990s. Exchange specialists were always required to yield to the crowd, or limit orders left on their books, before executing orders for their own proprietary accounts. In turn, no other dealer was permitted to compete with them; all other traders on the floor were agents representing orders from their customers. The NASDAQ dealer market featured competitive dealers vying for executions, a market structure thought to render the rule unnecessary. The *Manning* court, advised by the SEC, disagreed, and the rest is history.

IM-2110-2 prohibits a dealer in OTC Equity Securities from executing an order for its own account at a price that would satisfy a customer’s limit order on its books. The IM also provides the minimum level of price improvement that a market maker must provide to trade ahead of the customer’s limit order without triggering the obligation to execute it. So, for example, for stocks quoted at prices greater than $1.00, the dealer generally must execute an incoming offer to sell at a price that is one cent greater (or, if less, one-half of the existing spread), than an existing limit order to buy, or alternatively, the dealer must execute the customer limit order.

Since the limit order necessarily will be equal to or less than the price paid by the dealer to execute the incoming offer to sell, the dealer must lose money, or at least not make any money, or make less money by paying a higher price for the incoming sell order, whenever IM-2110-2 is applied. To say the least, the Manning rule has never been popular with over-the-counter traders.

Last week's amendment concerns the dealer's obligation to provide price improvement when two quotes do not exist, a situation unique to the market for OTC Equity Securities. In that case, the dealer must obtain quotes from at least two unaffiliated dealers to calculate an inside market and then apply the Manning rule. This situation could not exist in NASDAQ because, in its pre-exchange days, every stock was quoted by at least four market makers who were each required to submit two-sided quotes.

As is the case with the three-quote rule, FINRA members must document the name of each dealer contacted and the quotes that were used to determine an inside market.

IM-2110-2 represents the most recent development in the evolution of market structure set in motion by the Securities Acts Amendments of 1975. This legislation required the SEC to promote market structures where customers would trade without the intervention of a dealer. For exchanges, Reg NMS effectively eliminated the intervention of specialists in the execution of exchange orders by making their business unprofitable. In the OTC markets, limit order protection provides a powerful incentive for a trader in OTC Equity Securities to handle orders as an agent (or riskless principal), rather than for its own account. Market order protection, almost certainly the next domino to fall, will surely drive the last vestiges of the dealer market into extinction.

The Congressional preference for agency markets seems puzzling at first blush. Securities markets cannot function without intermediaries. For one thing, fast, liquid markets cannot wait for credit checks. Instead, everyone who plays must be checked out in advance so that all participants know for certain that the other side will pay for their trades. Intermediaries provide the necessary function of checking the credit of the customers before they are permitted to submit quotations and thereby become market participants.

Since the market intermediary function cannot be eliminated, the difference between the agency trader (also called a "broker") and the dealer is more a matter of form than substance. The agency trader represents the customer order in the marketplace, while the dealer buys directly from the customer and represents itself in the marketplace. The broker does not incur any risk on a trade, while a dealer assumes the risk that it will not be able to resell profitably. In either case, the execution of customer orders cannot occur without the intervention of a broker or a dealer.

As we look out into the world at large, dealer markets are far and away the more common form. The grocer, the clothing store and the pharmacist are all dealers – they buy from the manufacturer, risking a loss if the product will not sell. Agents ordinarily sell real estate, but consignment shops are relatively rare. Yet, Congress has not acted to eliminate dealer markets in groceries, clothing or pharmacies. Indeed, significant legislation has been enacted over the years to protect customers of real estate agents from fraudulent activities. So, there is nothing particularly pernicious about dealer markets in general, or any assurance that customers are treated more fairly in agency markets.

Agency markets are more transparent than dealer markets. The agent's customer is provided with disclosure regarding the commission earned by the agent on each trade. The amount of the dealer's markup generally is a closely guarded secret. Of course, if greater transparency is the goal, this can be accomplished by methods less drastic than extermination.

In exchange for the additional transparency of agency markets, we give up some aspects of a ready market. Customer interest may not exist for some time for certain securities. In an effort to attract business, dealers will post quotes during these periods. These quotes support the existence of a market during temporary voids in customer interest.

This fact of life suggests that dealer market structures may be appropriate where customer interest is less frequent, while agency markets should be the norm in more liquid securities. But, that is not the Congressional mandate.

While the dealer market structure is an endangered species in equities, the credit markets are almost entirely dealer markets. Nonetheless, the handwriting is on the wall, and the River Euphrates is being drained.

The demise of dealer markets in equities is the dying canary in the bond trader's coal mine.

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