

## PERSPECTIVES

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# Why Some Dealers and Exchanges Have Been Slow to Automate

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**O**ver the past three decades, virtually all of U.S. industry has been engaged in a headlong rush to automate as many of its business processes as it possibly can. Rapidly expanding computer processing power at lower and lower prices has meant that businesses of all sorts have been able to cut their costs and increase their profitability by wide-scale deployment of computer hardware and software. Efficiency and cost improvements typically are realized by analyzing the functions traditionally performed by various workers in the enterprise and automating any function that can be more quickly and reliably performed by a computer. This obviously causes some dislocation for the affected workers, but viewing it positively, the real result should be that human capital is freed to engage in other, more productive endeavors, such as creating new projects or businesses. The process of automation, productivity increase, and business reinvention has been the driving force behind the tremendous, low-inflation growth of the U.S. economy over the past decades. Indeed, it has been the driving force behind the growth of the world economy over the past three millennia.

There is an ongoing mystery, however, regarding the securities (and futures) industry. Namely, while many aspects of the business have been automated over the past 20 or 30 years, the central function of handling and executing orders is still surprisingly manual. The nation's predominant equity markets and four of its five existing option markets still have largely human-intermediated

order-handling and -matching mechanisms. This situation is particularly remarkable in that handling and executing securities and futures orders is, at its core, a recordkeeping process that is almost ideally suited to be done by computers, which are cheaper, faster, less prone to mistakes, and much less open to fraud than we humans are.

Having said all this, there are several very good reasons why traditional exchanges and broker/dealers have resisted complete automation and why we may now be at something of a standstill in the evolution of our market structure. This paper attempts to outline some of those reasons and to suggest a few possible approaches. In short, the problem appears to be that a variety of well-intentioned, sometimes necessary, rule initiatives over recent years, including enactment of customer priority rules, trade-through rules, limit-order display and handling rules, and other rules designed to protect customers, may now be working in a roundabout way to achieve the opposite of their intended effect. Because of decimalization, if these rules and others were followed to the minutest detail, it would be dramatically more difficult, or even impossible, for dealers and exchange professionals to trade profitably. Designated liquidity providers, therefore, have had to rely on their inherent time and place advantage in the manual marketplace—specifically, that they can see orders before others can see them and can take their time (sometimes up to 90 seconds) to decide whether to interact with those orders or not—in order to reap a reward for the services they provide. Having this discretion even for a few seconds, creating a “gradient of firmness” of quotes, is enough to generate substantial profits. But complete automation of order handling and execution, by eliminating latency and creating a perfectly clear time sequence of trading events, would eliminate this advantage. Even if it ultimately would be in the public interest, exchanges and their constituents understandably are reluctant to hand over large satchels of money for technology that may reduce profits and eliminate certain market participants altogether.

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Since the established dealer and exchange structures may have little to gain from more complete automation of the order-handling and -execution process under the current rules, we are all stuck unless two things happen (the first a carrot and the other a stick). First, we must think of innovative ways to restore the economic incentives for existing exchanges and their professional traders to provide liquidity to the marketplace [for example, by eliminating or reversing customer priority rules, which create only an illusion of customer benefit; by eliminating the Intermarket Trading System (ITS) and replacing exchange-level trade-through rules with augmented best execution duties; or by enhancing liquidity payments and specialist participation rights in electronic trades]. Second, we must not impede the development of new electronic markets that will force existing players to automate in order to compete with the speed, certainty, and cheaper trade-processing costs that these new markets offer.

## An Ideal Market Structure

The SEC's last comprehensive look at market structure was its concept release calling for comments on market fragmentation, issued in February 2000 (Market Fragmentation Release).<sup>1</sup> The Market Fragmentation Release was prompted by, among other things, some market participants calling for the creation of a single, nationwide central limit-order book (CLOB) that would centralize execution of orders in a single regulated monopoly facility. While the goals of the CLOB proposal were laudable (i.e., automatic execution and nationwide price/time priority), it was broadly and rightly opposed on a number of grounds. Like ITS or the much-delayed option market linkage, a CLOB would have been unwieldy and difficult to administer. It would have reduced or eliminated the vitality of competing market centers, and it would have eliminated incentives for developing new services and innovative products. It also would have created a capacity choke point and a single point of failure in the national market system.

On the other hand, a number of commenters, and perhaps some members of the Commission staff, seemed to agree that many of the benefits that might have been afforded by a central limit-order book could be duplicated and enhanced by expanding and improving current market structures. Under this alternate scenario, there would continue to be multiple liquidity centers competing on price but these liquidity centers would be linked not via a CLOB mechanism but by "smart" systems operated by brokers and market centers that would

route each order to the market, posting the best electronically accessible price. In the two years that have elapsed since the issuance of the Market Fragmentation Release, it has become even clearer that this simple approach is workable and would provide great benefit to the national market system.

In this ideal market structure, liquidity centers would maintain electronically accessible limit-order books operated according to clearly formulated and equitable rules based upon principles of price/time priority. As these rules would be completely codified in software, there would be no room for subjective interpretation. Broker/dealers, pursuant to their fiduciary duty of best execution, would route each of their orders (for instant, automatic execution) based on a composite view of the order books of the liquidity centers.

This market structure would put all market participants on a level playing field, it would assure transparency and price competition, and it would provide best execution of customer orders. Automated routing and execution of orders would not only increase fairness and transparency but also dramatically lower costs of execution because of the inherent efficiency and cost advantage of computerized processes (the relatively high brokerage and execution costs—hidden and not hidden—arising under the current system are, of course, passed on to customers and other users of the capital markets).

If the market structure just outlined is technologically feasible and would offer significant benefits to the public, why hasn't it happened? In the two years since the issuance of the Market Fragmentation Release, there has been too little movement toward further opening and automation of the nation's securities markets—the increased prominence of the International Securities Exchange for options trading being an exception. In fact, in the equity markets, there are troubling signs recently that the "dead hands" of existing market structure bureaucracies like the ITS and the CTA/CQ (Consolidated Tape Association/Consolidated Quotation) market data plans are stifling the competitive promise of the ECNs (electronic communications networks), the regional exchanges, and other upstarts. This illustrates one of the central points of this discussion: the unfortunate fact that well-intended rules and structures imposed on market participants (in this case, dealers and exchanges) to protect the public usually end up years later as a rationale to avoid further innovation or to stave off new competitors.

## Economic and Regulatory Disincentives to Automation

The reason that conventional brokers and exchanges have not embraced the model of open, fully electronic liquidity centers linked by automated order-routing systems is that they have no economic incentive to do so. Unlike almost any other business one can think of, under the rules as they are now, dealers, exchanges, and their constituents have good reason to fear that they will make less money and become less profitable if they automate. Because of the ill-defined time sequences and communication latencies inherent in manual order execution, professionals who have been granted market maker privileges in exchange for the associated burdens can see orders before others can see them and can take seconds or minutes to decide whether to interact with these orders or other orders that are available. Although there are rules that describe what can be done and when, given the known sequence of events in time, nonetheless, the market and the regulators seem to acknowledge that within some time window, the precise timing of events may be interpreted by the subjective experience of the participants in place. Indeed, this imprecision and the resulting informational advantages to certain inside market participants have repeatedly been woven into the very fabric of the market structure, and manual mechanisms like ITS, the planned option market linkage, 30- or 90-second trade-reporting rules, and the like, create relative oceans of time in which events, prices, and transactions are subject to discretion.

On the other hand, the more computerized these processes become, the less room there is for subjective interpretation, and computers following the rules strictly as they are will eliminate much of the profits that are generated by the current "give" in the system. Thus, asking the exchanges and their constituents fully to automate the order-handling and -execution process amounts to asking them to spend money in order to lose money.

The situation for the dealers and the exchanges is made worse by the fact that rules and structures have been agreed to by or imposed on them over the years that, now, in a decimalized environment, make it hard for them to profit other than through the informational and time and place advantages created by an inefficient trade-matching mechanism. Customer priority rules, trade-through rules, linkage rules, order-handling and -display rules, firm-quote rules, and other market rules are all examples of this. Some of these rules are essential and benefit customers, but some of them have simply forced market makers to earn (justified) trading profits by less transparent means.

Customer priority rules on option exchanges are a good example of this phenomenon. Under these rules, customer orders are always given priority over professional orders at the same price. The customer benefit is illusory, however, because in order to compensate for the structural disadvantage suffered by members due to the customer priority policy, option orders that are handled on the floor are subject to, shall we say, somewhat uneven treatment. Moreover, to compensate for the customer priority rules, option exchanges have passed a host of other, often vague rules that make their markets less fair, less transparent, and less automated for customers. These include

- rules prohibiting customers from creating and transmitting orders electronically (requiring artificial manual delays in order processing),
- rules kicking customer orders out of automatic execution systems and to the floor for manual handling in various ill-defined circumstances,
- rules purporting to require customers to express all of their trading interest in a single order rather than working a trade through multiple small orders (leading to more manual processing of the resulting larger orders),
- rules prohibiting customers from sending in orders on the same side of the market in the same option class faster than 15 seconds apart,
- rules preventing customers from sending two-sided orders, and on and on.

Most or all of these rules have been justified on the grounds that they are necessary in light of the fact that customers are given trading priority over professionals. Thus, rather than having a level playing field, we get a playing field half of which is tilted toward customers and half of which is tilted toward market makers, and the net cost or benefit, and to whom, is impossible to ascertain. All we know is that we all bear the cost of the lack of clarity and lack of automation.

Another example of a well-intended rule with unintended consequences is the ITS trade-through rule. Under the current structure, nonautomated exchanges that participate in ITS may post artificially attractive quotes (or may be slow in updating their quotes so that their quotes become artificially attractive), which, through the operation of the trade-through rule, blocks away exchanges from posting quotes or executing orders that would lock or cross the first exchange's market. The specialist on the away exchange is forced to choose between three unappealing options when this happens: (1) It can execute an incoming order at the first exchange's price (risking a loss, which it must then pass on to other customers on other trades); (2) it can execute

the order at its own price (and risk having to compensate the first exchange for a trade-through, which cost again will be passed on to other customers on other trades); or (3) it can use ITS to send a firm commitment to trade to the first exchange. If the specialist on the away exchange chooses to send a commitment to trade, this essentially becomes a free option, lasting up to two minutes, against the sender and in favor of the recipient. Again, the specialist on the losing end of this option will pass the cost of it to other customers on other trades.

ITS and the trade-through rule punish market center participants that offer automatic execution and place them at an inherent disadvantage to slower, less automated markets. First, automatic execution markets cannot tolerate a 30-second to 2-minute delay in execution while an away market offering a seemingly better fill is tested through the transmission of a commitment to trade. And by virtue of the fact that its quotes are updated faster, the automatic execution market may often seem to be trading through another market, when in fact that other market is in the process of updating its quotes. Finally, automatic execution markets are unable to take advantage of the “free options” discussed above that are enjoyed by the less automated exchanges.

This dilemma is now having an impact on those ECNs that trade a substantial volume of exchange-traded fund (ETF) products. As a lower-cost surrogate for mutual funds, ETFs are extremely useful products for small investors, and over the past several years, these investors have been able to use ECNs to get immediate, certain, low-cost execution of ETF orders. This apparently is coming to an end as the ECNs face a choice of either removing their quotes from the national market system or being stuck participating in ITS and being blocked by other ITS participants who post quotes that are not immediately and electronically accessible, if they are real at all.

Although a provisional 3 cent *de minimis* exemption to the trade-through rule has been created—but only for certain ETFs—this is not sufficient to address this problem. It may be true that the recipient of the ETF order via ITS gets a free option and that the value of that option is between 1 cent and 2.5 cents.<sup>2</sup> It is not clear, however, how a particular broker/dealer’s customer who desires to buy or sell a security can be certain to do so when the only electronically accessible price is more than 3 cents away from the manually displayed one. The customer is now faced with a choice of not trading or sending an order to an exchange that a minute or two later will either give him a fill or, more likely, return the order unfilled.

Telling the customer that the value of the free option that he would be giving away if he sends the order to a manual market is less than 3 cents does not really speak to his predicament. He wants to trade and has no way of getting a sure fill. The regulatory structure thus continues to reward the traditional exchanges for not being fully automated and at the same time prevents customers from deciding that they are willing to pay extra to get a real, immediate execution.<sup>3</sup>

In sum, since dealers and exchange professionals are forced to abide by customer priority and other rules that make it difficult for them to earn a profit, they are forced to exploit the profit opportunities that arise from the frictions and inefficiencies of a nonautomated market. We fear that by forcing them to yield these advantages, we may harm the system altogether and suffer a loss of liquidity. Likewise, the logic of mechanisms like ITS creates an active disincentive for marketplaces to automate and to offer instant, computerized execution. Thus are we stuck with a status quo in which order execution is inefficient, uncertain, and slow and it is impossible even for sophisticated customers to predict what will happen to any particular order if it gets handled manually. Moreover, trading costs are far higher than they should be, and the hodgepodge of rules and execution mechanisms and linkage structures and market data plans and fees and rebates and quote-display montages and order-execution statistics and everything else is all so complicated that no one can really tell what is going on. We need to find a way forward.

## Creating Incentives to Automate: Carrot and Stick

As noted above, although we all know it must happen sooner or later, the dealer and exchange community have much to fear from more complete automation of the order-handling and -execution process. It will be costly, it will be complex, it will require a great deal of legal and regulatory work drafting new rules and getting them approved, and it will displace certain firms and workers who will not be able to adapt to a more electronic marketplace. And given the rules as they stand today, the reward at the end for the insiders for all this work and expense is that they will largely lose their inside status and their ability to profit therefrom. Unless this incentive scenario is altered, we can expect the traditional players (quite reasonably) to continue to use regulatory and political processes to preserve the status quo and to make only painstaking and grudging concessions toward automation.

If the marketplace expects the dealer and exchange community to automate and, therefore, to provide the resulting benefits of faster, more certain order handling and execution at much lower costs, the marketplace must give something in return. Regulators and consumers of exchange and dealer services must think of ways to allow the liquidity providers to profit in return for the obligation imposed upon them to maintain stable markets. Elimination of customer priority rules is certainly one change that should be explored. In fact, we should consider giving market makers priority or partial priority in exchange for their liquidity guarantees.

Another change that must be examined is elimination of intermarket trade-through rules (and elimination of the associated linkage systems or retention of them merely as mechanisms for intermarket principal trading). As noted above, trade-through rules slow the markets, create unfair advantages for certain participants, and punish marketplaces that wish to offer immediate, automatic execution. Moreover, it is simpler and more consistent with general legal and regulatory principles to place the burden of best execution solely on brokers—the fiduciary agents of the customers—rather than on the service bureaus, whose responsibilities should be simply to execute matching trades in a fair and consistent manner. Thus, elimination of exchange-level trade-through rules should be accompanied by an enhanced emphasis on the duty of broker/dealers to seek best execution of their customers' orders, either explicitly requiring order-by-order routing or at least requiring a simplified disclosure of execution quality statistics that would allow customers to judge more easily the overall quality of executions offered by their brokers [in addition to the current statistics required under Rule 11Ac1-6, the Commission should consider requiring each broker prominently to publish two numbers each quarter: (1) a single volume-weighted average realized spread for all orders executed by the broker calculated by marking trades to the mid-price of the market one half hour after the trade and (2) a single volume-weighted average spread between the daily volume-weighted average price (VWAP) of each stock bought or sold for customers by the broker and the marketwide end-of-day VWAP price].<sup>4</sup>

Another change that might be adopted to create incentives for dealers and exchange professionals to give up their time and place advantages in favor of

automating their markets is to change execution cost structures so as to clearly charge liquidity takers and reward liquidity providers, perhaps even paying specialists a premium over other liquidity providers to recompense them for their duty to provide continuous, stable markets. In any event, whatever the particular changes are, the goal should be to create liquidity incentives that can be seen and evaluated, as opposed to the current "informal" advantages exercised by dealers and exchange professionals, which are difficult to measure.

In addition to the positive incentives that must be created for the traditional players to automate, negative incentives will help as well. Specifically, regulators and politicians should not block the development of new markets and market mechanisms that will act as powerful catalysts for change even in existing markets. In both the securities and the futures markets, new electronic marketplaces—and sometimes even just the mere threat of new electronic marketplaces—arguably have been the main driving force in the market structure progress that has been made in the past decade. While federal regulators, such as the SEC and the Commodities Futures Trading Commission, have a duty to ensure that new marketplaces are fundamentally sound and offer protection to the public, the commissions must continue to be careful not to allow traditional constituencies to defeat nascent competition by misusing their self-regulatory powers. Nor should regulators and self-regulating organizations insist that new market centers with new market structures strictly comply with timeworn rules that make no sense for those new markets.

## Conclusion

For all the progress that has been made in automating certain aspects of the securities business, the essential function of order handling and execution is still largely mysterious to the public and is still very often subject to the discretion of costly human intermediaries who operate under rules and mechanisms that are little changed from three decades ago. Only by reexamining certain of the rules under which the dealer and exchange communities operate so as to restore some of their profit opportunity, yet at the same time declining to protect these players from competition from new entrants, may it be hoped that the industry and the investing public will soon reap the same productivity increases and cost reductions that have been enjoyed by other American industries as a result of automation and increased deployment of technology.

## Postscript

The original paper we presented to the SEC in November 2002 was an attempt to outline some structural problems that we had observed in the listed stock and option markets and to suggest some possible solutions. For many years, we had seen, both in our proprietary trading and in our agency trading on behalf of customers, that orders sent to the NYSE and other floor-based exchanges were often subject to unusual delays in execution and also to a form of adverse selection. Limit orders that would result in profitable trades for us or our customers tended to be executed less often by the specialists, and orders that would result in unprofitable trades for us or our customers tended to be executed more often by them. In addition to the bid-ask spread, we appeared to be paying a hidden toll to the specialists on manual exchanges for the liquidity that they controlled through their regulated monopoly franchises.

Of course, these circumstances were relatively well known in the trading community, but they were not—at the time we submitted our paper to the SEC—of foremost concern to the press or the securities enforcement community. What a difference a year makes! In April 2003, the *Wall Street Journal* reported that the Enforcement Division of the NYSE, possibly at the behest of the SEC, had begun investigating several major specialist firms for apparent front running and other mishandling of customer orders. Several months later, in September 2003, a cascading series of revelations about NYSE Chairman Richard Grasso's recent compensation—totaling about \$140 million—forced his resignation. Recently, the press has reported that the scale of the investigation of trading irregularities at the NYSE is much larger than previously thought and that the SEC and the NYSE Enforcement staff have examined trades that resulted in at least \$150 million in allegedly improper profits to specialists.

These events form an interesting coda to the paper. A good argument can be made that the primary service provided by Grasso to the NYSE in recent years was to use his formidable political and marketing skills to maintain the exchange's human-intermediated market structure in the face of more automated competitors. The substantial rents he extracted from exchange membership for this service—some \$140 million—may be a small percentage of the rents the specialists have garnered from the NYSE's customers over the years through continuation of an inefficient order-execution mechanism.

We asked that our November 2002 paper appear in the *Financial Analysts Journal* in its original form because the paper forms, we hope, a small part of the historical record on the changes sweeping the NYSE and the option markets. Nonetheless, certain issues require further comment and clarification.

**Are Specialists and Special Rewards for Them Needed?** We assumed in the paper submitted to the SEC that the markets need a class of exchange-designated, professional liquidity providers (specialists and market makers), who must be given various structural incentives (beyond simply the bid-ask spread) to maintain orderly and liquid markets. We argued that these incentives should be objective and transparent (such as rebates to the liquidity provider) rather than undefined and covert (such as front running or interpositioning).

The staff of the Division of Market Regulation at the SEC certainly believes that designated specialists/market makers should receive various perks in exchange for assuming various responsibilities, but significant debate is going on in the academic community about the utility provided by these market actors and about whether they need to be given structural advantages over others in the market. Although addressing this debate was beyond the scope of the paper, we can say with confidence that the SEC does not seem receptive to any exchange market structure that does not provide for (1) specialists/market makers with an affirmative obligation to quote and to maintain orderly markets and (2) structural rewards for those specialists/market makers.

The SEC seems to believe that having a pure “flat and open” exchange market where liquidity takers and liquidity providers trade with each other and lose or profit purely on the basis of their posted prices would not provide for continuous liquidity, or would not provide liquidity in less popular products or in conditions of market turbulence or for difficult orders. The SEC's conservative position on this point is understandable: They know the costs and benefits of the current specialist/market maker system, and they know that it at least works—even with its warts. They do not know exactly what a securities exchange would look like or how it would function without any market makers or specialist entitlements, and therefore, the rest of us are unlikely to learn the answer to this question anytime soon.<sup>5</sup>

**The Perils of “Customer Protection.”** A major theme of the paper is that regulatory market structures that are imposed initially for salutary purposes tend to long outlive their usefulness and

tend to be used by entrenched market players to preserve their franchises. One example cited in the paper is customer priority rules on listed option exchanges. In the interests of protecting public customers, these rules were enacted to guarantee that customer orders would trade first, before professional orders, at any given price level. From a micro, trade-by-trade standpoint, these rules do indeed protect customers. A particular customer order at a particular price will trade before a particular professional order. From a broader perspective, however, it is not at all clear that customers, as a group and over time, benefit from this rule. To compensate for the structural disadvantage suffered by specialists and market makers because of the customer priority policy, option orders handled on the exchange floors are often subject to delayed execution, selective execution, and various other questionable practices. In addition, option exchanges have passed many other rules that make their markets less fair, less transparent, and less automated for customers, and the exchanges have claimed that these other rules are necessary to offset the customer priority rules.

The ITS is another example of a well-intentioned idea gone awry. Under the current operation of the ITS trade-through rule, an exchange generally is not allowed to execute a customer order sent to it if a better price is posted on another exchange against which the customer order theoretically could trade. Although intended to guarantee best prices to customers, this rule (perversely) puts floor-based exchanges at an advantage relative to their electronic counterparts because floor-based exchanges can post attractive quotes that either are stale or may not be honored by the specialists if an order is actually sent to them. If an electronic exchange offering surefire firm quotes and automatic execution is posting a real quote that is priced worse than an illusory quote at the manual exchange, the electronic exchange cannot execute the order. Customers, therefore, get slower and less certain fills of their orders. This situation is made worse by the fact that if a market maker on an electronic exchange wishes to test the validity of the better-priced away quote by sending an order to trade with it (sending a “commitment to trade” in ITS parlance), the away exchange specialist can use the commitment to trade as a free option against the sender.

The specialist does so as follows: Say the specialist’s offer for ABC stock is \$58.50 and another ITS participant seeks to trade with that offer by sending a commitment to trade. Once it is sent, the commitment to trade is firm against the sender for some fixed period of time (at least 30 seconds under

ITS procedures). But because ITS is not an automated system, the commitment to trade is not automatically executed by the receiving market; it must be manually filled, if at all, by the specialist. Under ITS rules, the specialist receiving a commitment to trade is supposed to execute it, but an exception exists if the specialist’s posted price was exhausted by a prior order and if the specialist was in the process of updating his quote when the specialist received the commitment to trade.<sup>6</sup> Thus, in this example, if the market in ABC stock moves up to \$58.55 after the commitment to trade is sent to the specialist to buy at the offer of \$58.50, the specialist may simply fail to execute against the commitment at \$58.50 and, instead, sell to someone else at \$58.55.<sup>7</sup> If the price of ABC moves down to \$58.45, the specialist almost surely will execute against the incoming commitment to trade and will sell stock at \$58.50 that is worth \$58.45. As this example illustrates, in the ITS system, the sender of an order is truly held firm but the recipient has wiggle room to decide whether to trade or not on the basis of how the market moves after the recipient receives the order.<sup>8</sup>

The good news is that on 9 March 2004, the SEC published a new rule proposal—proposed Regulation NMS—to address some of the problems with ITS and the trade-through rule.<sup>9</sup> The Commission’s proposal would create a marketwide trade-through rule that would supplant the ITS trade-through rule and would cover NASDAQ and the ECNs in addition to the NYSE. The commission would designate certain market centers as manual and certain market centers as automated, and a limited *de minimis* exemption to the trade-through rule would allow automated markets to trade through better prices on manual markets by anywhere from 1 cent to 5 cents (depending on the price of the underlying stock). In addition, customers who did not want their brokers to take the time and risk of trying to access a manual quote and who preferred immediate electronic execution could opt out of trade-through protection altogether on an order-by-order basis.

The proposed new rule would alleviate some of the problems caused by the current ITS trade-through rule, and the authors strongly support its adoption, although we would like to see the SEC amend the proposed rule in two respects: First, the exception to the trade-through rule that would allow an automated exchange to trade through a manual exchange in certain situations should be amended to focus not on whether an exchange is manual or automated but on whether a particular quote disseminated by that exchange is manual or automated—an automated quote being one that is

immediately electronically executable. This flexible approach would eliminate the need for the Commission to make an all-or-nothing judgment about whether an exchange is automated or not. Instead, those quotes that were immediately electronically executable would get full trade-through protection and those quotes that were not electronically executable would not. Second, the ability of a customer to opt out of trade-through protection

should be limited to situations in which a better quote in another market is not electronically executable; in other words, a market center should never be able to execute a customer order when there is a better quote on another market that could be hit or lifted electronically.

Public comments on the SEC's proposals were due by 24 May 2004, and these issues will be hotly debated for months or years to come.

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## Notes

1. See Commission Request for Comment on Issues Relating to Market Fragmentation, Exch. Act. Rel. 34-42450, 65 Fed. Reg. at 10577 (23 February 2000): [www.sec.gov/rules/sro/ny9948n.htm](http://www.sec.gov/rules/sro/ny9948n.htm).
2. ETFs, representing baskets of stocks, are much less volatile than individual equities. The value of the free option would be higher than 3 cents for individual stocks with higher volatility.
3. As outlined below, we suggest that the Commission eliminate the trade-through rule altogether and instead make it easier for customers to determine if their brokers are, on the whole, obtaining best execution for their orders.
4. In any event, it is too simplistic to focus on trade-throughs to the exclusion of other important determinants of execution quality. There are many situations in which certainty of execution (along with other factors) is more important than execution price, at least within a certain range. Customers and their brokers should be able to decide the relative importance of various factors so long as customers are fully informed about the decisions they make.
5. The SEC has allowed a pure flat and open market structure without specialists and market makers in the context of ECNs, but this experiment is somewhat limited because ECNs exist only as an appendage to (not as a substitute for) more heavily regulated exchange and dealer markets. In addition, ECNs cannot trade options.
6. We use the masculine gender in this example purely for brevity.
7. In the unlikely event that the specialist is challenged for failing to execute against the commitment to trade, he will claim he was "in the process of updating his quote" and, therefore, relieved of his firm-quote obligations.
8. The NASDAQ market has evolved without a formal trade-through rule, and private links and smart-routing software used by brokers have evolved to provide best execution of customer orders on NASDAQ.
9. See 69 Fed. Reg. 11126 (9 March 2004).