

## **Introduction**

### Conference on Market Shock and Trading Efficiency

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This conference is another in an AEI series in which several of my colleagues and I are studying securities market structure and various proposals for reform.

In late February, the SEC published Regulation NMS, a long-awaited market structure reform proposal. The proposed regulation would: (1) modify the application of the so-called “trade-through” rule in the trading of both New York Stock Exchange listed securities and Nasdaq securities; (2) impose a ceiling on the market access fees used by electronic communications networks (ECNs); (3) prohibit sub-penny bids and offers; and (4) change the method for the sharing of revenue from the sale of market data.

Although all of these proposals have significance for various aspects of securities market structure, the changes proposed in the trade-through rule have raised the most serious questions about what the SEC has in mind.

Briefly, the trade-through rule—by requiring that trades be sent to the market that is posting the best price—reinforces the tendency of markets to concentrate liquidity in a single place. This is because the best prices are likely to be present in the market with the most liquidity. Thus, the existence of the trade-through rule supports the dominant position of the New York Stock Exchange in the trading of NYSE securities. If one thinks a centralized market like the NYSE is the best market for trading securities—and there are many proponents of this view—then it would be reasonable to favor the continued existence of the trade-through rule.

On the other hand, many market participants argue that the trade-through rule, by concentrating trading in a central market, stifles the competition among markets that can produce innovation and better service for investors. The proponents of this view urge the elimination of the trade-through rule, so that many markets—particularly Nasdaq and the ECNs—would be able to compete with the NYSE for the trading of NYSE securities. They note that the trade-through rule does not apply to the trading of Nasdaq securities, and as a result a vigorous competitive market has developed in the trading of Nasdaq securities.

Thus, before the publication of Regulation NMS many observers anticipated that the SEC would eventually have to decide whether to retain the trade-through rule or to eliminate it, and that in turn would suggest whether the SEC's market reform proposal would move in the direction of encouraging a centralized market like the NYSE for all securities trading, or a competitive market—like the Nasdaq market—where trading venues compete with one another.

But when Regulation NMS was published, it turned out that it was completely *ad hoc*. It did not seem to be based on any vision of what would be the best market for investors. It proposed to allow investors—probably institutional investors—to opt out of the trade-through rule, which suggested that the SEC favored competitive markets; but then it also proposed to apply the trade-through rule to the Nasdaq market, where it had not been applicable before.

It is important to recognize that there can be no rational basis for allowing NYSE securities to be traded in one kind of market and Nasdaq securities to be traded in another. One of these structures is best. The SEC has simply refused to make a choice.

The only sensible theory for what the SEC was doing in Regulation NMS is that the agency was attempting to placate the various parties in the debate—giving the institutional investors and the ECNs a limited opportunity to trade NYSE securities in the electronic markets, while telling those who favor a centralized market and the trade-through rule that all the benefits of the rule will now be available to investors in Nasdaq securities. But it doesn't work. If institutional investors take advantage of the opt-out provision, it will substantially reduce the role of the NYSE as a central market, and thus the benefits a central market is supposed to confer. And if applying the trade-through rule to Nasdaq securities has any effect, it will destroy the benefits that many see in the competitive Nasdaq marketplace.

Not surprisingly, the proposal has drawn praise from both sides—each emphasizing the part that they like. Regulation NMS, then, may be good politics for the SEC, but it's not good regulatory policy and it's certainly not market structure reform.

More seriously, the 200 page release that accompanied Regulation NMS did not contain any rationale for the proposal. No analysis comparing the benefits to investors of a centralized market with the benefits to be derived from a competitive market. Unfortunately, this follows a pattern at the SEC. Its controversial shareholder access proposal, for example, also has no empirical or analytical support, and seems to be based entirely on placating various constituencies.

The release that accompanied the Regulation NMS proposal noted that “the objective of market center competition can be difficult to reconcile with the objective of investor order interaction.” That's SEC-speak for “it's difficult to choose between a competitive market and a centralized market.” There's no doubt that it's politically difficult, but it's made more difficult if the agency doesn't do any analysis.

One of the purposes of today's conference is to demonstrate the value of analysis in attempting to devise the best structure for the US securities market. The excellent study by Professor Lehn and his colleagues that we will be considering this afternoon does not of course provide a complete answer to the question of which market structure is likely to be best for investors. But it shows that the principal issues are susceptible to analysis, and that the SEC—if it is truly interested in securities market reform—could produce something far more constructive than Regulation NMS.