



## SEC Proposes to Eliminate Flash Orders

On September 18, 2009, the Securities and Exchange Commission (the “SEC”) issued a proposal (the “Proposal”) to eliminate the “flash order” exception from the quotation dissemination requirements of Rule 602 of Regulation NMS under the Securities Exchange Act of 1934, as amended (the “Exchange Act”).<sup>1</sup> The SEC believes that excepting flash orders from those requirements is unnecessary and inappropriate in today’s highly automated trading environment, and could lead to a two-tiered market in which the public does not have access to the same best-price information that is available to those with access to multiple proprietary data feeds.

### Background

Generally, flash orders are orders communicated to a limited universe of market participants with instructions that they be executed immediately and, if they are not, to be withdrawn immediately. Such orders generally are “marketable” (*i.e.*, buy orders that are immediately executable at the national best offer price and sell orders that are immediately executable at the national best bid price). However, unlike an “immediate-or-cancel” order, which only seeks to access liquidity that is currently available in the market when that order arrives, a flash order, if not fully executed against available trading interest in that market at the time it arrives, is transmitted to other participants of that market (but no other market) in an effort to attract additional liquidity. Those market participants that receive the flashed order information have a short period (generally one second or less) in which to respond with an order to execute against the flashed order at a price that matches the flashed price.

Rule 602 of Regulation NMS requires U.S. exchanges to make their best bids and offers available in the consolidated quotation data that is disseminated to the general public. However, under Rule 602(a)(1)(i)(A), bids and offers communicated on an exchange that are executed immediately after communication, or that are cancelled or withdrawn if not executed immediately, are not required to be included in the consolidated quotation data. This exclusion has existed since the adoption of Rule 11Ac1-1, the predecessor of Rule 602, in 1978. At that time, most exchange-listed securities were traded on the physical floors of the listing exchanges. As part of the process of floor trading, non-specialist participants in exchange crowds would engage in on-the-spot discussions that included making bids and offers for securities. The exception was designed to accommodate these “ephemeral quotations,” which could not reasonably be reflected in the market’s published quotation.

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<sup>1</sup> Securities Exchange Act Release No. 60684 (Sept. 18, 2009), 74 Fed. Reg. 48632 (Sept. 23, 2009) (the “Release”).

Trading of equity securities has changed significantly since 1978, and the move to automated electronic markets and trading has enabled markets to disseminate information electronically concerning orders that are intended to be executed immediately or withdrawn. These electronic “immediate execution or withdrawal” orders — flash orders — are in some respects even more “ephemeral” than the manual quotations that existed in 1978, in that their duration may well be even shorter than those traditionally discussed on exchange floors. However, for a number of reasons, the SEC does not believe that they should be excepted from Rule 602.

By its terms, Rule 602 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. Thus, an “alternative trading system” (“ATS”) generally is not subject to Rule 602 directly.<sup>2</sup> However, Rule 301(b) of Regulation ATS, which sets forth the requirements for ATSs, including order display and execution access, requires an ATS that meets a 5 percent volume threshold in an NMS stock<sup>3</sup> 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 for inclusion in the quotation data made available by that exchange or association pursuant to Rule 602. Accordingly, if such an ATS uses a flash order procedure, the same concerns expressed by the SEC with respect to Rule 602 exist.

### The SEC’s Concerns About Flash Orders

According to the Release, an exception from the quotation requirements is antithetical to the goals of the consolidated quotation system, which is intended to provide investors with a single source of information for best prices in listed securities, rather than forcing them to subscribe to independent data feeds from each exchange and ATS that publishes quotations. The SEC is concerned that expanded use of flash orders will lead to a two-tiered market in which the public does not have access to the same best-price information that is available to those with access to multiple proprietary data feeds. The SEC believes that if the use

of flash orders expands, it could detract from the overall fairness and efficiency of the national market system, discouraging the public display of trading interest and harming quote competition among markets.

Because flash orders generally are executed by a market at prices that match the best displayed prices at another market, the SEC is concerned that they may deprive those who publicly display their interests at the best prices from receiving speedy executions. It has long been the SEC’s practice to encourage displayed liquidity because it establishes the current market for a stock and provides a critical reference point for investors. The SEC believes that because the opportunity to obtain the fastest possible execution at a particular price is the primary incentive for displaying trading interest, flash orders could significantly undermine the incentives to display orders and to quote competitively. Indeed, the SEC believes that flash orders may provide incentives for market participants to refrain from displaying their trading interest publicly. Given the importance of displayed quotations for market efficiency, the SEC is concerned that diverting marketable order flow from the public quoting markets could undermine the national market system. An additional concern is that, even though all market participants that receive a particular market’s data feed may receive the flashed order information, only those with sophisticated, pre-programmed trading systems that can respond very rapidly will have any real chance of successfully responding to the flashed order, giving them an unfair advantage.

According to the Release, because the flashing of orders is virtually indistinguishable from the dissemination of automated quotations in today’s trading environment, flash orders also may be inconsistent with the SEC’s policy of giving priority to the first-displayed quotation, which is intended to encourage the posting of quotations and contribute to fair and orderly markets. Also, because a significant part of each market’s revenue is generated through the execution of trades, and markets thus have strong incentives to maximize executed volume by attracting a high volume of order flow and executing as much of it as possible, flash orders provide a market with an additional opportunity to execute marketable orders when they do not have available contra-

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<sup>2</sup> An ATS is an “organization, association, person, group of persons, or system that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange . . . and that does not set rules governing the conduct of subscribers other than the conduct of such subscribers’ trading on such organization, association, person, group of persons, or system; or discipline subscribers other than by exclusion from trading.” It is exempt from registration as a securities exchange, provided that it registers as a broker-dealer and satisfies certain other conditions.

<sup>3</sup> An “NMS stock” is any security or class of securities (other than an option) for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan. See Regulation M, Rules 600(b)(46) & 600(b)(47).

side trading interest at the best prices when the order arrives, and otherwise would be required to route them away.<sup>4</sup>

The SEC does acknowledge that flash orders offer potential benefits to certain types of market participants. For example, some market participants that respond to flash orders represent large institutional investors that are reluctant to display quotations publicly and thereby reveal their full trading interest. Flash orders may attract additional liquidity from such market participants, thus providing opportunities for better executions. In addition, some markets charge fees for accessing their quotations. Flash orders may lead to lower fees by avoiding these charges. In fact, some markets offer rebates on orders that are executed during a flash, so that the order, rather than incurring a fee, can earn a rebate, leading to lower overall transaction costs.

Nevertheless, the SEC believes that, in today's highly automated trading environment, such benefits do not justify the negative aspects of flash orders, including the potential damage to public confidence in the securities markets caused by practices that may appear to give professional, short-term traders an unfair advantage over long-term investors.<sup>5</sup>

## Description of the Proposal

Under the Proposal, Rule 602(a)(1)(i)(A) would be eliminated. As noted, the SEC believes that the Rule, which was originally adopted to accommodate certain quotations on manual exchange trading floors, is no longer necessary or appropriate. The SEC notes, however, that some historical practices still may be necessary for the effective functioning of a physical trading floor. For example, floor brokers representing large discretionary orders must be able to discuss terms of a prospective trade without making those terms public. Otherwise, it could be impossible to effectively represent such orders on a trading floor. Similarly, when a floor broker "requests a market" in a security, the response of the trading crowd may be different than the published quotation, and it would be impractical to require such responses to be published.

Nevertheless, the SEC believes that its concerns about flash orders apply to both electronic and manual flashing of orders, particularly the danger of a two-tiered market in which the public does not

have access to information about the best available prices, and the disincentives to display trading interest publicly. However, the SEC is requesting comments on whether eliminating the flash order exception would seriously detract from the viability of trading floors in the modern, mostly electronic, trading environment, as well as whether manual "flashing" of orders should be permitted to continue on trading floors if electronic "flashing" is prohibited.

In addition, if the SEC eliminates the flash order exception from Rule 602, it would seek to apply Rule 301(b) of Regulation ATS in a consistent manner to ATSs that use flash orders. This would be accomplished by considering orders displayed by an ATS that are immediately executed or withdrawn to be covered by Rule 301(b)(3)(ii), and thus required to be provided to a national securities exchange or national securities association for inclusion in the consolidated quotation data. Such orders would be covered irrespective of any particular term used by the ATS to characterize them, such as "indications of interest."

Finally, if the SEC amends Rule 602 as described above, it would apply the restrictions on locking or crossing quotations found in Rule 610(d) of Regulation NMS in a consistent manner to prohibit the display of marketable flash orders. Rule 610(d) requires each national securities exchange and national securities association to prohibit the display of quotations that lock or cross any protected quotations in NMS stocks. If flash orders are no longer excepted from Rule 602, they would be subject to Rule 610(d) in the same manner as any other quotation, and marketable flash orders (*i.e.*, sell orders flashed at the national best bid or buy orders flashed at the national best offer) would be locking quotations that violate the rule. Flash orders with non-marketable prices (which are far less common than marketable flash orders) would not be locking quotations and would have to be included in the consolidated quotation data.

## Request for Comments

In addition to requesting comments and data generally on all aspects of the Proposal, the SEC has included in the Release a long list of specific questions relating to issues such as the trading strategies that employ flash orders, whether the use of flash orders is in the best interests of such traders and how the elimination of flash orders would affect them, whether there are alternatives to

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<sup>4</sup> The SEC also notes that flashing orders creates a risk that a recipient of the information could act in ways that disadvantage the flashed order; for example, by receiving a flashed order and rapidly transmitting orders to exhaust trading interest at another market before an unfilled flash order can be routed there. However, the SEC notes that those who use flash orders most likely factor the likelihood of such actions into their routing decisions.

<sup>5</sup> According to the Release, the interests of long-term investors and professional short-term traders in fair and efficient markets often coincide, and vigorous competition among short-term traders can lead to important benefits for long-term investors. Nevertheless, if the interests of long-term investors and professional short-term traders conflict, the SEC has emphasized that "its clear responsibility is to uphold the interests of long-term investors."

using flash orders in such trading strategies, the ways in which market participants are likely to change their behavior if unable to use flash orders, and the likely effects of such changes. Comments should be submitted on or before November 23, 2009.

## Conclusion

It is difficult to predict what the impact of the SEC's proposed ban on flash orders will be. The SEC estimates that in July 2009, executed flash orders in listed equities accounted for approximately 3 percent of total trading volume, and executed flash orders in listed equity options accounted for less than 2 percent of total trading volume. Thus, it is unclear what effect they have on overall trading activity. Banning flash orders could address the SEC's concern that we are moving toward a "two-tiered" market structure that provides, at the expense of the investing public (especially retail investors), advantages to those market participants that have the knowledge, expertise, and wherewithal to access multiple data streams and develop systems to use that the information profitably. It also would address concerns that

flash orders discourage the public display of accurate prices and available liquidity. However, as the Release acknowledges, flash orders provide market participants with certain important benefits, including lower costs and opportunities for better execution arising from the fact that flash orders can induce liquidity from market participants that may not be willing to publicly display their interests. These benefits would be lost if flash orders are eliminated.

The proposed ban on flash orders cannot be evaluated in isolation. The SEC is looking at a number of "market structure" issues, including a proposal to increase transparency of trading activity in "dark pools," which are private trading systems that enable participants to effect securities transactions without displaying quotations to the public. The SEC may be considering other measures as well. It is the totality of these measures that will determine the true impact on various market participants and the investing public as a whole.

The Financial Services Practice Group of Winston & Strawn represents a broad range of financial institutions on all regulatory matters. If you have any questions regarding the matters discussed in this briefing, if you need assistance in preparing comments to the SEC regarding the proposed rules, or if you need assistance in developing and/or reviewing systems, controls, and/or procedures relating to the matters covered in this briefing, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact:

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