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Investors Win in the "NMS II" Proposal

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Earlier this year, the SEC released a 595-page proposal centered on modifications to RegNMS and improving the SIP, both to its content and introducing competition. We believe the proposed changes will help all investors, but we have submitted a comment letter to the SEC with a few thoughts that we summarize below. The proposal has created some controversy because some market participants will not benefit from the changes, but the good news is that investors are clear winners.

There are three aspects to the proposal. First, the SEC has proposed a change to the definition of "round lots"; lot sizes would now be based on a fixed dollar amount in a target range of $1,000-$1,500, rather than the current 100-shares for stocks of all prices. Second, the SEC is proposing that SIP data can be provided by multiple competing vendors as opposed to the current system in which providers are the largest exchanges themselves. Third, the SEC is proposing that exchanges must include depth-of-book data and auction details to SIP vendors instead of just their Best Bid and Offer (BBO) as is currently required.

Changing the Size of a Round Lot

You may be wondering what the big deal is in changing the definition of lot size since there are no restrictions on using odd lot orders (as was the case with NYSE DOT system until 1990s), but there are two major implications of this change. In the current market structure of 13 exchanges and dozens of off-market venues, brokers, market makers and dark pools track a National Best Bid and Offer (NBBO). The NBBO does not currently contain liquidity at an exchange for orders that (in aggregate) do not constitute a round lot. Therefore, if NYSE has a best bid of 50 shares at $400 and the next best bid is for 60 shares at $395 then the best bid submitted for the calculation of NBBO is 100 shares at $395 (even though the best bid was actually $400). While the bid at $400 does not change the NBBO, a bid at $200 for 100 shares in another stock would change the NBBO—even though it represents the same dollar amount invested. We agree with the SEC's proposal to update the economically meaningless designation of 100 shares and choose lot sizes based on stock price. The higher the price, the lower the shares required for a round lot, making lot sizes roughly equivalent in notional value.

We believe that this will have huge positive impact on the equities market. First, brokers and market makers use NBBO to define best execution. Second, dark pools use reference prices (Peg Passive, Peg Aggressive, Peg Mid) that track the NBBO which will now be at a much tighter spread for higher price stocks. Third, the NBBO will now be available within the SIP so the firms that use SIP will be able to target liquidity that they may miss today.

NBBO and PBBO

The NBBO is currently used for a second particularly important purpose. Rule 611 within RegNMS protects quotes that are at the NBBO; no market participant can trade through the NBBO. That means that NBBO can never lock—bid price cannot be the same as offer price—or cross—bid price cannot be higher than the offer price. Currently, the NBBO is also a Protected Best Bid and Offer (PBBO).

While the SEC recognizes that the existing definition of lot size hurts investors, it seems to stop half-way when it comes to applying the updated definition to Rule 611 for the purposes of protecting the NBBO. That means market participants must track a PBBO for protecting the best price based on the former round-lot definition of 100 shares and the NBBO based on the new price-dependent definition for showing best execution.

We disagree with the SEC on this point. The SEC is hesitant to impact the already controversial Rule 611, even indirectly. The main criticism of Rule 611 is that it creates complexity, but separating the PBBO from the NBBO will only make it worse. Market participants will gravitate toward the definition of round lots that serves them best. Market makers and exchanges will likely stick with the PBBO; it is not clear what ATS operators would do. Execution algorithms providers will use NBBO, but they will have to accommodate frequently crossed quotes and understand what each exchange operator and dark pool is using in relation to pegged order types. The implementation of a separate NBBO and PBBO through each market data vendor may take a long time. While we are strong supporters of the new round lot definition according to stock price, we would like to see the definition applied uniformly to the NBBO and the PBBO alike, reducing complexity overall.

Other Flagship Changes

In addition to the changes described above, the SEC proposal allows for the introduction of new SIP providers. Today the SIP is provided by the same exchange conglomerates that provide direct feeds. While the SIP is quite expensive because of the current single vendor system, direct feeds cost multiples of that. As a result, large exchanges do not have much incentive to innovate the SIP or reduce its cost, cannibalizing their own very profitable direct feed business. Multiple competing SIPs will foster fairness, reduce prices, improve speed, and eliminate the single point of failure that exists today.

The proposal also points to additional content in the SIP feed. Exchanges will be mandated to provide depth-of-book data and auction imbalance data to the SIP. And since lot size definition will be changed, many newly-round odd lot quotes will automatically make their way into SIP as well.

Most institutional brokers, trading firms, technology firms, asset managers, retail brokers, and retail investors depend heavily on the SIP—directly or indirectly—for execution, evaluation, regulatory reporting, and research. While the exchanges compete heavily on transaction pricing, they face zero competition in providing their own market data.

Mandating the exchanges provide additional useful content to SIP providers will help address this important issue and reduce information asymmetry in the marketplace. We have recommended to the SEC that while they should require exchanges to provide the additional content, they should not mandate that each competing SIP provider provide that data to their customers. We believe leaving this decision to individual SIP providers and their customers will attract more vendors, with some focusing on speed and others on rich content, depending on their customers' goals.

Investors Win

Overall, we applaud the SEC's robust proposal. The proposed changes will improve liquidity in all stocks by using a more economically meaningful lot size and lowering information asymmetry among market participants. Competition among SIP providers will likely reduce costs for all market participants, improve quality, and diversify failure risk. While the proposal could have negative effects on the profitability of exchanges and market makers, we believe that investors win with a proper implementation of this proposal. While we agree with the spirit of the proposal wholeheartedly, we hope that our suggestions around implementation of lot sizes and SIP vendor requirements will bolster its positive impacts.