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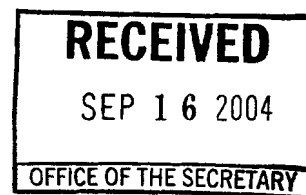
MEMORANDUM

**TO:** File No. S7-10-04

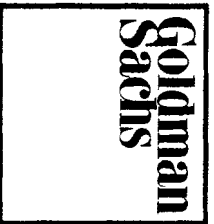
**FROM:** Heather Seidel  
Division of Market Regulation

**DATE:** September 16, 2004

**SUBJECT:** Meeting with Representatives of Goldman, Sachs & Co.



On September 10, 2004, staff of the Division of Market Regulation met with Ann Costello, Annette Kelton, Matthew Lavicka, Duncan Niederauer, Paul Russo and Susan Sidd of Goldman, Sachs & Co. The representatives of Goldman Sachs discussed their views on proposed Regulation NMS as outlined in their July 19, 2004 comment letter on proposed Regulation NMS and the attached handout.



# Reg NMS trade-through rule proposal

## Overview of Goldman Sachs recommendations

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**September 10, 2004**

# Goldman Sachs recommendations summary<sup>1</sup>

- SEC should establish standards for Accessible Quotes (AQs)

- Venues should be free to choose whether to designate all, some or none of their quotes as AQs

- SEC trade-through rule should only protect AQs

- SEC should protect Accessible Quotes throughout the book, not only top-of-book

- SEC should exempt certain narrowly-defined trade types whose prices do not reflect the market

## **AQs must be:**

- Visible – *at a reasonable cost*
- Available for electronic linkage – via “inter-market sweep” orders
- Available for automated execution – *sub-second response*
- Free of separate quote access fees – *price you see, you pay*

**11Ac1-5 statistics should only include the protected AQs**

**Protecting only top-of-book of all venues is problematic<sup>2</sup>**

## **Possible exceptions:**

- VWAP trades
- Derivative-linked trades
- Aggregate-price portfolio trades

**Limited in scope**

**No block-trade exception**

**No opt-out exception**

1. Goldman Sachs comment letter on the SEC Regulation NMS proposal, July 19, 2004.

2. See example on page 6 of Goldman Sachs comment letter.

# Accessible Quotes (AQs) example

Not protected limit orders

- Customer wants to buy 7,000 shares

Buy 7,000 shares

Venue A		
Buy Q	Price	Sell Q
	\$33.04	1,000
	\$33.03	1,000
	\$33.02	1,000
	\$33.01	1,000
1,000	\$32.98	
2,000	\$32.97	

Venue A designates all its quotes AQ

Venue B		
Buy Q	Price	Sell Q
	\$33.04	1,000
	\$33.03	1,000
	\$33.02	1,000
	\$33.01	1,000
	\$33.00	1,000
3,000	\$32.97	

Venue B designates some of its quotes AQ

Venue C		
Buy Q	Price	Sell Q
	\$33.04	100
	\$33.03	1,000
	\$33.02	1,000
	\$33.01	1,000
100	\$32.98	
500	\$32.97	

Venue C designates its top-of-book quotes AQ

1,000 execute at \$33.00 (at Venue B) 1)

3,000 execute at \$33.01 (1000 each at Venues A, B & C) 2) 3) 4)

2,000 execute at \$33.02 (1000 each at Venues A & B) 5) 6)

1,000 execute at \$33.03 (all at Venue A) 7)

Smart routers will virtually consolidate AQs: **auto-sweep of 7 AQs at \$33.014**

Hence, no need for block-trade exception.....

# No block-trade exception

- Customer wants to buy 500,000 shares

## Buy 500,000 shares

- Requests an offer from broker-dealer (BD)
- BD is willing to sell 500,000 at \$33.04
- Displayed best offer: 1,000 at \$33.00

Venue A			Venue B			Venue C		
Buy Q	Price	Sell Q	Buy Q	Price	Sell Q	Buy Q	Price	Sell Q
	\$33.04	1,000		\$33.04	1,000		\$33.04	100
	\$33.03	1,000		\$33.03	1,000		\$33.03	1,000
	\$33.02	1,000		\$33.02	1,000		\$33.02	1,000
	\$33.01	1,000		\$33.01	1,000		\$33.01	1,000
				\$33.00	1,000			
1,000	\$32.98					100	\$32.98	
2,000	\$32.97		3,000	\$32.97		500	\$32.97	

## With block exception

- BD offers to sell 500,000 at \$33.04
- If accepted, customer will buy 500,000 at \$33.04
- BD trades through the 7 better-priced AQs

## No block exception

- BD offers to sell 500,000 at no higher than \$33.04 (because of required sweep of AQs)
- If accepted, customer will buy 7,000 at \$33.014 from AQs and 493,000 at \$33.04 from BD

Accessibility Standards will enable BD to use smart routers for a fast sweep of the 7 better-priced AQs, buying for customer 7,000 at \$33.014

## Advantages of no block exception

- Customer buys at a (slightly) lower price
- Protects better-priced AQs
- Encourages limit orders

## Disadvantages of no block exception

- Order executes in multiple prints
- Broker-dealer is inconvenienced in having to include better-priced AQs – but given the accessibility standards inconvenience is minor and information leakage not an issue

## Quote consolidation and linkages

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- In the Goldman Sachs recommendation, AQs to get price protection must satisfy SEC-defined and mandated Accessibility Standards
- **These Accessibility Standards are designed to ensure AQs are**
  - Visible at a reasonable cost
  - Available for electronic linkage
  - Available for automated execution

**With the Accessibility Standards in place, it will be easy to:**

- **Create the required quote montage**
  - The market will do this – *competing systems already do*
  - Or, an SRO-sponsored utility
- **Create the required linkages**
  - The market will do this - *competing smart-routers already do*
  - Or, an SRO-sponsored linkage – *e.g. the NYSE new proposal to reform ITS*

# The access fees dilemma

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- For some venues access fees are an important revenue source, restricting access fees may alter their revenue model
- The Goldman Sachs proposal only restricts fees on “inter-market sweep” orders against the AQs

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- **Venues have many alternative revenue sources, e.g.**

- Listing fees
- Membership fees
- Regulatory fees
- Fees for value-added services, e.g. different order types, data products, etc.
- Connectivity charges, etc.

Must restrict per share fee/rebate transfers that effectively amount to sub-penny trading

- **Venues have a choice**

- Want price protection? Must agree to fee restriction for protected quotes
- Do not want fee restriction? Can still quote, but without price protection

- **An alternative way to handle AQ access fees**

- Include access fees in the quoted price
- But requires sub-penny quoting