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RegNMS: Rules of Engagement for an Electronic Era

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To commemorate the 20th anniversary of Fidessa's presence in the US, we are proud to present the latest in a series of articles looking at some of the key industry and regulatory events that have helped shape the trading landscape since the opening of Fidessa's first US office in New York some two decades ago.

Perhaps the most sweeping piece of regulation to be imposed upon financial markets in the last 20 years was the SEC's Regulation National Market System (RegNMS for short). A series of reforms designed to strengthen and modernize the US equity market, the new rules marked an unprecedented move towards organization, transparency and fair play. Fidessa was front and center in helping the industry understand and adapt to this new regulation. Here, Chris Kelley, Global Head of Equities Product Management, explains what RegNMS meant for the industry then and why it continues to be a transformative force nearly a decade after it took effect.

The technological advances that swept financial markets in the mid-1990s fundamentally changed the way securities were traded. The vast majority of these changes were positive – electronic trading lowered costs and made it possible to execute trades with unprecedented speed and accuracy, and across a growing number of venues and market centers. The full potential of electronic trading, however, took some time to realize. As the industry grappled with widespread fragmentation and other technological growing pains, the SEC saw the need to intervene with a comprehensive set of reforms intended to address the new realities of a fully electronic marketplace. In doing so, it effectively brought the National Market System into the 21st century.

Although RegNMS was first outlined in 2004, the idea of a single, integrated marketplace came into play as early as 1975, when a series of amendments to the original Securities Exchange Act went into effect. Among other mandates, these amendments called for the establishment of a national market system and unified network for clearing and settlement of securities transactions. Central to this regulation was the revolutionary idea that U.S. markets were sufficiently mature (and underlying structures sufficiently stable) to be considered and managed as a single, integrated entity – a pivotal point in the growth of any financial market. Thirty years later, RegNMS would serve as a guide to the markets' next growth stage: electronification.

The Nuts & Bolts

When RegNMS was initially proposed, it was not without motive. The rapid rise of electronic trading had been accompanied by a relative disparity in its implementation, giving some market participants unfair advantages over others and leaving the system open to a certain degree of manipulation. At the core of RegNMS was a desire to foster greater competition among market participants by ensuring that everyone had access to the same information and were given equal chance to act based on that information. The SEC's rationale seemed to be that a rising tide would lift all boats, and that making markets fairer and more competitive would both benefit the industry as a whole and protect the interests of individual investors. What was ultimately enacted into law consisted of four key rules:

- **Trade-through rule (Rule 611)** – This rule required the industry to protect orders displayed by trading centers by preventing the execution of trades at worse prices and with a publicly-displayed quote on a qualified exchange from being "traded through" by a trade done elsewhere, whether on another exchange or by a broker, at an inferior price

- **Sub-penny rule (Rule 612)** – One of the less contested elements of RegNMS, this guideline dictated that all prices be quoted in penny increments for all shares trading above $1.00. This prevented orders from being leapfrogged by nominal price improvements, something that became easier to do with recent technology advances.

- **Access rule (Rule 610)** – This rule dealt principally with issues related to stock quotations, capping ECN access fees and encouraging market participants to connect using private links. Controls were also put in place to address locked or cross markets

- **Market data rules (Rules 601 & the "Allocation Amendment")** – As exchanges began looking more to market data as a revenue stream, these rules were designed to make the distribution of revenues from market data more equitable, and rescinded the prohibition on SROs and their members from disseminating their trade reports independently with or without fees. Ultimately this helped balance the commercial aspects of market data and its function as public information

Reception

Given the scope of RegNMS, industry reactions were mixed. The sub-penny rule, for example, was generally applauded as it directly addressed some of traders' most common pet peeves. Reception to the trade-through rule, on the other hand, was more contentious, as it was viewed by many as adding unnecessary complexity to workflows and disrupting the business between broker and customer by limiting the ability to seize on internal trading opportunities. Perhaps the most common reaction to RegNMS at the time was confusion – both about the rules themselves and how to implement them in a timely and cost-efficient manner.

Fidessa's Role

From a technology perspective, perhaps the biggest challenge of RegNMS when it was finally implemented in 2005 was not only the sheer magnitude of the rule, but also the fact that it went through multiple versions along the way. In the period between the proposal and enactment, the rule was clarified and re-clarified, requiring us to revise our solution on-the-fly.

On a more symbolic level, RegNMS represented Fidessa's largest new regulatory undertaking in the US up to that time, and it solidified our role as a trusted advisor in helping clients deal with compliance challenges. Years before the term "RegTech" came to signal an irrevocable marriage between regulation and technology, Fidessa recognized the need to help our customers deal with the inevitable overlap between the two disciplines. In the run-up to RegNMS, we implemented a regular series of educational events, calls and webinars for our customers to help them understand the workings – and re-workings – of this unprecedented piece of regulation.

One of the things that really struck me during this time was how much our customers relied on us to help them to come to grips with the rule. In many cases, they viewed us not just as a software provider, but also as a regulatory expert that could help them understand the intricacies of Reg NMS and plan for the rule's impact on their firm's business as well as on its technology. Looking back, RegNMS was a great example of Fidessa's ability to mitigate the impact of new regulatory requirements on our customers by analyzing rulemaking actions carefully – and early – and crafting smart solutions that leave our customers better positioned than their competitors to succeed in this constantly reshaping marketplace.