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Trade-through prohibitions and market quality ☆

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Abstract

On September 4, 2002, the SEC implemented a de minimis exemption to the trade-through rule for three active ETFs, allowing markets to execute trades at prices up to three cents worse than those posted elsewhere. Relaxing the trade-through rule does not worsen ETF market quality. Effective and realized spreads are essentially unchanged or slightly smaller post-event, and prices become slightly more efficient. Part of the explanation is that, in these ETFs, trade-throughs are common, and their frequency changes little following the exemption. Thus, it is difficult to extrapolate from this regulatory experiment to draw broader policy conclusions about trade-through prohibitions.
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1. Introduction

Financial market regulators and researchers are currently wrestling with a fundamental issue: how to facilitate competition between securities markets without destroying the liquidity externalities that arise when traders are able to come together in space and time. This balancing act underlies much of the U.S. regulatory system for multimarket trading. For example, other venues can trade stocks listed on the New York Stock Exchange (NYSE) or American Stock Exchange (AMEX), but most of these venues are linked together (by Congressional mandate). Among other things, the linkages are designed to enable investors to access the best price for a security, no matter where that price may be offered. Alongside these linkages is the so-called trade-through rule that prohibits venues from executing trades at prices worse than those posted elsewhere. This rule is controversial, in part because some market centers do not find the current linkages adequate. Via Regulation NMS, the U.S. Securities and Exchange Commission (SEC) is currently proposing to expand and modify trade-through prohibitions in all U.S. equity markets (SEC, 2004).

On September 4, 2002, the SEC relaxed the trade-through rule in the three most active exchange-traded funds (ETFs). This regulatory change allows us to examine the effect of trade-through prohibitions on market quality. Our results show that relaxing the trade-through rule in this case has little effect on market quality. ETF spreads are little changed, and if anything, there is evidence of a modest reduction in trading costs and a modest improvement in the efficiency of price discovery for these ETFs. When we look at the actual frequency of trade-throughs, we find that the relaxed rule has almost no impact on the incidence of trading through. This is somewhat surprising, but it explains the lack of effect on market quality. For whatever reason, when the trade-through rule is relaxed, trade-throughs change little, and overall market quality also changes little.

With rapid technological improvement and the consequent growth of electronic stock exchanges, competition between and regulation of trading venues are fundamental questions in market microstructure (see O'Hara (2004) for an overview). We know of no other work on the effects of trade-through rules, but research on competition between markets and on order routing and preferencing is related.[1] The Nasdaq order handling rules (Barclay et al., 1999) and the cross-listing of equity options (de Fontnouvelle et al., 2003; Battalio et al., 2004) are excellent examples of how competition between venues benefits investors.[2] Venues compete by posting quotes and also by arranging to receive order flow. Bessembinder (2003) and Chung et al. (2004), among others, examine order flow at venues not posting the best quotes. In studies designed to test causality, Battalio (1997) study NYSE stocks, and

[1]Preferencing is typically defined as execution by a venue not posting the best quotes and is often associated with payment for order flow. See Parlour and Rajan (2003) for a model with competition between venues, order routing, and preferencing/payment for order flow.

[2]Easley et al. (1996), Battalio et al. (1997), Bessembinder and Kaufman (1997), and Barclay et al. (2003) examine competition between venues and whether or not certain venues attract more or less informed traders. In addition, Barclay et al. (2003) and Bessembinder (2003) find that markets offering better prices are more likely to attract orders.

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