

IN THE MARKETS

Finding Route to Best Price

Focus on Exchanges' Order Routing; Top or Depth of Book?

BY DONNA KARDOS YESALAVICH

A pilot program of stock-trading halts designed to avoid a repeat of the "flash crash" has brought to light another issue: Orders don't always get the best price an investor can attain in the market.

In more than a third of the 11 stocks that have hit circuit breakers as part of the pilot program, which pauses trading in a stock for five minutes if its price moves 10% or more in the preceding five minutes, the halts were triggered because of the way orders were routed through the market. A debate is now heating up over whether regulations for order routing should be changed.

According to regulatory guidelines, an exchange operator matches an order against the best bids and offers on its exchange and across the rest of the market, but if the order still hasn't been filled, the originating exchange can finish what remains of the order in its own market.

This type of routing, which focuses on the "top of book," or the best bids and offers across the market, was geared to ensure that investors would get their orders matched against the best prices in the market regardless of which exchange received their orders.

However, there are times when some exchanges may have better prices in their "depth of book," the price levels below their best bids and offers, than what is available at the originating exchange where an order may be completed. When that is the case and an order is routed only to the "top of book," investors may end up buying or selling shares at prices higher or lower than they could have attained if the order was sent to the "depth of book."

Since the circuit-breaker pilot program began in June, trading in companies including Anadarko Petroleum Corp., Cisco Systems Inc. and Nucor Corp.

These incidents have brought attention to an issue that has been under debate for some time. The Securities and Exchange Commission asked market participants in January for comments on whether trade-through protections that guide the way orders are routed should be extended to the "depth of book." Mutual-fund company Vanguard Group is among those that have submitted letters arguing for the extension.

"By protecting only 'top-of-book' prices...market orders interacting with limit orders are disadvantaged in that they pay a price that may not be the best price available in the displayed markets," Vanguard said in its letter.

The SEC declined to comment.

With Anadarko and Nucor, the routing sent stocks to "stub quotes," or placeholder prices that tend to be far from actual market prices. Those trades were canceled. The SEC is examining the use of stub quotes.

But the trades in Cisco stood. In that case, which occurred on NYSE Euronext's Amex exchange, Cisco's stock shot up to \$26 after it had been trading in the \$23 range moments earlier. The NYSE determined that the \$26 trade wasn't erroneous because no legitimate errors had occurred; the jump in price simply was an unfortunate result for the buyer of "top-of-book" routing. The seller, on the other hand, got lucky.

Cisco, with a market capitalization of more than \$122 billion, is a component of many market indexes, including the Dow Jones Industrial Average, the Nasdaq Composite index and the Standard & Poor's 500-stock index. Orders for such a stock typically are easy to come by.

"I'm sure there were a lot of shares on these other exchanges at much better prices than these Amex prints," said John Comerford, global head of trading research at brokerage Instinet. "It clearly exposed some flaws in

market participants is that the Cisco incident isn't considered an isolated event.

"This kind of thing happens all the time, usually only by a couple pennies," said Jamil Nazarali, managing director at trading firm Knight Equity Markets. "What was noteworthy was Cisco is a very liquid stock."

Some stock exchanges do allow orders to be routed to the "depth of book," including Direct Edge and BATS Exchange Inc. Direct Edge said it lets customers choose whether they would like to use "top of book" or "depth of book." BATS said it previously used "top-of-book" routing, but over time it transitioned to "depth of book" after finding the method was more beneficial to customers.

After the NYSE saw Anadarko as well as Washington Post Co. hit circuit breakers on its Amex exchange due to "top-of-book" routing, the exchange operator introduced "depth-of-book" routing on Arca. But on NYSE's primary market and Amex, as well as Nasdaq, routing remains limited to the "top of book."

NYSE spokesman Raymond Pellecchia Jr. said the change to Arca's routing is "better for the customer experience obviously," following the incidents with Anadarko and Washington Post, but because its other exchanges have designated market makers with obligations to keep trading orderly, the NYSE didn't see a need to alter their routing procedures.

A representative of Nasdaq OMX Group Inc. said, "Nasdaq OMX currently offers top-of-book routing and is always looking into new trading features and functionalities."

Some think broader changes should be made across the market.

"Someone's got to improve how the regulations work, otherwise, we're going to have more incidents of this, and it just doesn't instill investor confidence," said Mark Enriquez, managing partner at Pulse Trading, a brokerage firm.



Reuters

at in a field south of Barnaul in Russia last month.

Their Heights

ally weighs on prices during the fall as farmers send more supplies into the pipeline. Ultimate consumers of corn, such as food processors and livestock producers, bought into the dips in the corn market in recent weeks and are content to wait and see how far prices retreat, traders say.

Wheat demand also has slowed recently as fears about tightening global supplies have eased. Wheat prices are down 22% from nearly two-year highs reached when Russia, a major producer, spooked buyers by announcing in early August that it was halting grain exports due to a historic drought.

"In corn and wheat, we have seen some setback in demand," Mr. Zuzolo said. "We have seen some rationing."

Recent rain in Russia has encouraged farmers there to plant wheat that will be harvested in the spring, calming nerves of wheat importers. Buyers have higher hopes for Russia's next crop than they did a month ago, when the Black Sea region was hurting badly from the drought.

The USDA will give market participants an update on the global grain supply and demand situation on Friday. Grain traders expect they have already seen the worst in terms of

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