March 12, 2001

Stuart J. Kaswell
Senior Vice President and
General Counsel
Securities Industry Association
1401 Eye Street, N.W.
Washington, D.C. 20005-2225

Re: Request for Exemptions Under Rule 11Ac1-5

Dear Mr. Kaswell:

In your letter dated February 28, 2001 ("Letter") on behalf of members of the Securities Industry Association ("SIA"), you requested that the Commission issue three exemptions from the provisions of Rule 11Ac1-5 ("Rule") under the Securities Exchange Act of 1934 ("Exchange Act"). The requested exemptions relate to (1) manually-received orders, (2) orders affected by crossed markets, and (3) orders affected by trading halts. The SIA believes that, if granted, the requested exemptions would contribute to the production of fair and meaningful statistics for determining execution quality and be in the best interests of investors and the public. This letter responds to your request.

I. Manually-Received Orders

The SIA requests an exemption for all market centers from the requirement to report under paragraph (b)(1) of the Rule on manually-received orders – orders that are received by a market center otherwise than through automated systems. You state that it would be extremely difficult, if not impossible, for market centers to develop systems to report on these orders prior to the initial compliance date of the Rule. For integrated broker-dealer firms that are market centers, you state that the exemption is needed for orders that are received manually at the firm's trading department and that are not yet covered by the NASD's Order Audit Trail System

On the basis of your representations and the facts presented, the Commission, by the Division pursuant to delegated authority,[1] is using its exemptive authority under paragraph (c) of

---

[1] 17 CFR 200.30-3(a)(69).

the Rule to exempt temporarily all market centers from the requirement to report under paragraph (b)(1) of the Rule on orders that are received by the market center otherwise than through automated systems. The temporary exemption will be withdrawn, after a reasonable period of advance notice to market centers, when the Commission determines that market centers have the ability to capture all orders electronically.

Although market centers receive the overwhelming majority of their orders through automated systems, they also receive orders manually, particularly those for large sizes. Many of these orders may qualify for one of the "special handling" exclusions from the definition of "covered order" under paragraph (a)(8) of the Rule. Nevertheless, unless the necessary information is captured in automated systems, it would be quite difficult to include these orders in the required statistics or to efficiently demonstrate that a particular exclusion applies. The exemption of manually-received orders from the Rule is intended to facilitate timely compliance with the Rule until market centers are able to develop automated systems that will capture all orders.[2]

Integrated broker-dealer firms, however, should be aware that the exemption only covers orders that are routed directly by manual means to the firm's trading desk. Orders received manually from brokerage customers, which are then entered into an automated system for routing and execution would not be eligible for the exemption and would continue to be subject to the Rule. The time of receipt for such orders would be the time that the orders are captured in the automated system.

In addition, this exemption is intended to facilitate compliance with the Rule for orders that currently are not captured in automated systems. Any change in order routing practices from automated to manual means to avoid reporting of orders under the Rule would be the basis for withdrawal of the exemption from that market center, and would raise serious questions with respect to a broker-dealer's obligation to obtain the best execution of its customers' orders.

II. Orders Affected by Crossed Markets

The SIA requests an exemption from the definition of covered order under paragraph (a)(8) of the Rule for any orders whose reporting would be affected by a consolidated best bid and offer that has been "crossed" (the best bid is higher than the best offer) for more than a brief period of time. You note that, for a variety of purposes, the Rule uses the consolidated best bid

---

2 For example, NASD Regulation currently is working on implementing Phase Three of OATS, which would cover orders that are received manually by a firm's trading department. Exchange markets also are developing automated systems to capture manual orders.

and offer as a benchmark for calculating statistics. The Letter asserts that when such quotes have been crossed for a significant period of time, it raises a serious concern that the quotes may not represent a fair and reliable benchmark for a market center's statistics.

On the basis of your representations and the facts presented, the Commission, by the Division pursuant to delegated authority,[3] is using its exemptive authority under paragraph (c) of the Rule to exempt from the definition of covered order under paragraph (a)(8) of the Rule all orders that would require reference to a consolidated best bid and offer ("Consolidated BBO") disseminated by an effective national market system plan that has been crossed for 30 seconds or more.

The Rule requires reference to a Consolidated BBO in four different contexts: (1) classifying limit orders based on the Consolidated BBO at the time of order receipt into one of four categories defined in the Rule (marketable, inside-the-quote, at-the-quote, near-the-quote); (2) calculating the average effective spread for market and marketable limit orders based on the Consolidated BBO at the time of order receipt; (3) classifying executions of market and marketable limit orders as "with price improvement," "at the quote," or "outside the quote" based on the Consolidated BBO at the time of order receipt; and (4) calculating the average realized spread for all five types of orders defined in the Rule (market orders and the four types of limit orders) based on the Consolidated BBO five minutes after the time of order execution (as opposed to the time of order receipt).

In light of the exemption for orders significantly affected by crossed quotes, market centers should follow the following procedure whenever a reference to the Consolidated BBO is necessary, whether at the time of order receipt or the time of order execution:

First, use the Consolidated BBO if the quotes are not crossed, or are locked.

Second, if the Consolidated BBO is crossed, reject the crossed quotes and use the next-in-time uncrossed Consolidated BBO if there has been less than 30 seconds between the last-in-time uncrossed Consolidated BBO and the next-in-time uncrossed Consolidated BBO.

Third, if there has been 30 seconds or more between the last-in-time uncrossed Consolidated BBO and the next-in-time uncrossed Consolidated BBO, the affected order is exempted from the Rule and must be excluded entirely from a market center's report (even if the crossed Consolidated BBO only affects a partial execution of the order).

The following examples illustrate how the foregoing procedure should apply:

[3] 17 CFR 200.30-3(a)(69).

Example II-1: At 11:08:10,[4] a market center receives a limit order to buy 100 shares of Security A with a limit price of $20.75. The Consolidated BBO for Security A at the time of order receipt is $20.75 bid and $20.75 offer.

The locked quotes should be used. The order therefore would be classified as a "marketable limit order" under paragraph (a)(15) of the Rule because the limit price is equal to the consolidated best offer at the time of order receipt.[5] The midpoint of the Consolidated BBO for purposes of calculating an effective spread for the execution is $20.75. If the buy order is executed at a price of $20.75, the execution would classified as "at the quote" under paragraph (a)(10) of the Rule. If the buy order is executed at any price lower than $20.75, the execution would be classified as "with price improvement" under paragraph (a)(12) of the Rule. The calculation of a realized spread for the execution would be based on the midpoint of the Consolidated BBO five minutes after the time of order execution, so that the locked quotes at the time of order receipt would be irrelevant.

Example II-2: At 2:47:20 p.m., a market center receives a market order to sell 500 shares of Security A. The Consolidated BBO for Security A at the time of order receipt is $55.40 bid and $55.30 offer. The time of the last uncrossed Consolidated BBO was 2:47:05 p.m.. The next uncrossed Consolidated BBO is disseminated at 2:47:30 p.m. and is $55.35 bid and $55.35 offer. The market center should reject the crossed quotes at the time of order receipt and instead use the uncrossed quotes at 2:47:30 (even though they were locked) as the Consolidated BBO at the time of order receipt. The midpoint of the Consolidated BBO for purposes of calculating the effective spread for the order execution is $55.35. If the market order to sell is executed at a price higher than, equal to, or lower than $55.35, the execution will be classified, respectively, as "with price improvement, "at the quote," or "outside the quote."

Example II-3: Same facts as Example II-2 except that the next-in-time uncrossed Consolidated BBO after the time of order receipt is disseminated at 2:47:40 p.m. Because the period between the last-in-time uncrossed Consolidated BBO (2:47:05) and the next-in-time uncrossed Consolidated BBO (2:47:40) is 30 seconds or more, the market order to sell 500 shares of Security A is exempted from the Rule and must be excluded from the market center's monthly report.

---

4 The time of order receipt and time of order execution must be recorded "to the second" under paragraphs (a)(20) and (a)(21) of the Rule.

5 Note that the limit order could not be classified as an at-the-quote limit order because the definition of "at-the-quote limit order" in paragraph (a)(13) of the Rule only applies to -marketable limit orders."

III. Orders Affected by Trading Halts

The SIA requests an exemption from the definition of covered order under paragraph (a)(8) of the Rule for orders whose executions are significantly affected by trading that is halted during regular trading hours, either because they were received during the trading halt itself or had not been executed at the time of the trading halt. You note that orders received during a general regulatory trading halt already are excluded from the Rule's definition of covered order (because a Consolidated BBO would not be disseminated during this time). Orders affected by other types of trading halts, however, as well as orders received and unexecuted at the time of a trading halt, currently are covered by the Rule. You state that including these types of orders in monthly reports could result in statistics that are skewed and unrepresentative of a market center's normal trading.

On the basis of your representations and the facts presented, the Commission, by the Division pursuant to delegated authority,[6] is using its exemptive authority under paragraph (c) of the Rule to exempt from the definition of covered order in paragraph (a)(8) of the Rule: (1) all orders that are received during the period of an "announced" trading halt, as described below; and (2) all orders that are received less than five minutes prior to an announced trading halt and that remain outstanding (in whole or in part) at the time of the trading halt.

In light of these two types of exempted orders, the manner of reporting on orders under the Rule will be the same for all "announced" trading halts. To qualify as an "announced" trading halt, the halt must be either a general regulatory halt or a trading halt that is announced by a market center in accordance with all applicable regulatory rules. Orders that are received prior to and during the time of an announced trading halt should be handled in accordance with the following procedures.

First, all orders received during the period that trading is halted must be entirely excluded from a market center's monthly report.[7]

6 17 CFR 200.30-3(a)(69).

7 To be a "covered order" under paragraph (a)(8) of the Rule, an order must be received during "regular trading hours" (defined in paragraph (a)(19) of the Rule) and during a time when a Consolidated BBO is being disseminated pursuant to an effective national market system plan. Consequently, any orders received during a regulatory trading halt (when no Consolidated BBO will be disseminated) are excluded from the definition of covered order. The exemption granted above assures the uniform treatment of orders affected by all trading halts, including non-regulatory trading halts, that are announced in accordance with all applicable regulatory rules.

Second, if an order was received less than five minutes prior to the announced trading halt and remains outstanding (in whole or in part) at the time of the trading halt, the entire order is exempted from the Rule and must be excluded from the market center's monthly report.

Third, for orders that are executed less than five minutes prior to the announced trading halt, the calculation of average realized spread should use the last Consolidated BBO disseminated prior to the time of the trading halt (analogous to the treatment of orders executed less than five minutes prior to the close of regular trading hours that is set forth in paragraph (a)(3) of the Rule).

Fourth, if an order was received five minutes or more prior to the announced trading halt and remains outstanding (in whole or in part) at the time of the trading halt, the order continues to be covered by the Rule; provided, however, that for executions that occur after the end of the trading halt, a market center may deduct the time period during which trading was halted from the calculations using the time of execution of the order.

The following examples illustrate how the foregoing procedures should apply:

Example III-1: At 10:45:30 a.m., Market Center X halts trading in all securities because of a serious systems breakdown. It announces the trading halt in accordance with all applicable regulatory rules. At 11:25:30 a.m., Market Center X resumes trading in all securities. All orders received for execution by Market Center X from 10:45:30 until 11:25:30 are exempted from the Rule and must be excluded from Market Center X's monthly report.

Example III-2: Same facts as Example III-1, except that Market Center X receives a marketable limit order at 10:44:45 that is unexecuted at the time trading is halted 45 seconds later. The order is exempted from the Rule and must be excluded from Market Center X's monthly report.

Example III-3: Same facts as Example III-1, except that Market Center X receives a marketable limit order for 500 shares at 10:42:15 that receives a partial execution of 200 shares at 10:42:20, with the balance of 300 shares still unexecuted and outstanding at the time of the trading halt. The entire order is exempted from the Rule and must be excluded (including the 200-share execution) from Market Center X's monthly report.

Example III-4: Same facts as Example III-1, except that Market Center X receives a near-the-quote limit order at 10:38:15 a.m. that is unexecuted and outstanding at the time of the trading halt. At 11:28:05 a.m., after the end of the trading halt, the order is executed. Because the order was received more than five minutes before the trading halt, the order remains covered by the Rule, except that Market Center X may deduct the 40-minute period of the trading halt from the time of execution. The time of execution for non-marketable limit orders must only be reported in one of the five time buckets set forth in paragraphs (b)(1)(i)(F) through (J) of the Rule. Accordingly, the execution of the order would fall within the time bucket for order executions between 5 and 30 minutes after the time of order receipt (11:28:05 minus 10:38:15 minus 40 minutes).

IV. Conclusion

All of the exemptions granted in this letter are subject to modification or revocation at any time if the Commission determines that such action is necessary or appropriate in the public interest or otherwise in furtherance of the purposes of the Exchange Act.

We will continue to work with the SIA, its members, and the securities industry in general in assisting their efforts to comply with the Rule in a timely manner. If you have questions, please do not hesitate to contact me.

Sincerely,

Annette L. Nazareth
Director