

INFORMATIONAL

Exchange Act Rules 11Ac1-5 And 11Ac1-6

SEC Issues Interpretive Guidance Concerning Exchange Act Rules 11Ac1-5 And 11Ac1-6

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KEY TOPICS

- Disclosure of Order Execution and Order Routing
- Exchange Act Rules 11Ac1-5 and 11Ac1-6

Executive Summary

NASD Regulation Inc. (NASD RegulationSM) is issuing this *Notice to Members* to inform members about interpretive guidance recently issued by the Division of Market Regulation (Division or SEC Staff) of the Securities and Exchange Commission (SEC or Commission) concerning Rules 11Ac1-5 and 11Ac1-6 under the Securities Exchange Act of 1934 (Exchange Act). On June 22, 2001, SEC staff issued two *Staff Legal Bulletins*. *Staff Legal Bulletin No. 12R (Revised)* addresses frequently asked questions about Rule 11Ac1-5. *Staff Legal Bulletin No. 13* addresses frequently asked questions about Rule 11Ac1-6. The SEC also granted five requests for exemptive relief under these rules.

Rule 11Ac1-5 generally requires market centers that trade national market system securities to prepare and make available to the public monthly electronic reports that include uniform statistical measures of execution quality for covered orders.

Rule 11Ac1-5 also requires self-regulatory organizations (SROs) that trade national market system securities to submit to the SEC a new national market system plan (Joint SRO Plan) establishing procedures for market centers to follow in making their monthly reports available to the public. The Joint SRO Plan was submitted on February 20, 2001, and it was approved by the SEC on April 12, 2001.¹

Rule 11Ac1-6 generally requires broker/dealers that route customer orders in covered securities to make publicly available quarterly reports that disclose venues to which they route non-directed orders. It also requires broker/dealers to disclose the nature of any relationship they have with

those venues, including any payment for order flow arrangements. In addition, broker/dealers must disclose to customers, on request, the venues to which their individual orders were routed.

Questions/Further Information

Please note that Rules 11Ac1-5 and 11Ac1-6 are SEC rules. Accordingly, questions of interpretation or other concerns about the rules should be directed to the SEC staff. Information regarding these rules also can be found on the SEC Web Site at www.sec.gov. In addition, Rules 11Ac1-5 and 11Ac1-6 are discussed in more detail in *Special NASD Notice to Members 01-16* and *NASD Notice to Members 01-30*. Members also may direct general questions concerning this *Notice* to Kathleen O'Mara, Assistant General Counsel, or Philip Shaikun, Assistant General Counsel, NASD Regulation, Inc., at (202) 728-8071.

Background And Information

On November 17, 2000, the SEC adopted Exchange Act Rules 11Ac1-5 and 11Ac1-6.² The SEC's stated goal for adopting Exchange Act Rules 11Ac1-5 and 11Ac1-6 was to make visible the execution quality of the securities markets and order routing performance. Rule 11Ac1-5 generally requires market centers that trade national market system securities to prepare and make available to the public monthly electronic reports that include uniform statistical measures of execution quality for market orders or limit orders received or executed by a market center during regular trading hours.³ Rule 11Ac1-6 generally requires broker/dealers that route

customer orders in national market system securities, Nasdaq SmallCap equities, and listed options to make publicly available quarterly reports that disclose venues to which they route non-directed orders. It also requires broker/dealers to disclose the nature of any relationship they have with those venues, including any payment for order flow arrangements. This rule specifically requires posting of 11Ac1-6 information on an Internet Web site that is free and readily accessible to the public, furnishing a written copy to customers on request without charge, and notifying customers at least annually in writing that a written copy will be furnished on request. In addition, broker/dealers must disclose to customers, on request, the venues to which their individual orders were routed.

Since the adoption of these rules, the SEC and NASD Regulation have received many calls from industry members with a broad range of questions regarding the implementation and operation of these SEC rules. The SEC's staff addresses the most frequently asked questions regarding Rules 11Ac1-5 and 11Ac1-6 in *Staff Legal Bulletin Nos. 12R* and *13*. Also, the SEC Staff has provided as Appendices to *Staff Legal Bulletin No. 12 R* a table with Rule 11Ac1-5 sample statistics for a single security "A" in May 2001 and the text of the Joint SRO Plan adopted pursuant to Rule 11Ac1-5. Similarly, the Staff attached as an exhibit to *Staff Legal Bulletin No. 13* a sample format for Rule 11Ac1-6 quarterly reports. Furthermore, in an effort to address specific requests for exemptive relief, the SEC granted five requests for exemptive relief under Rules 11Ac1-5 and 11Ac1-6. All of this information has been posted

on the SEC Web Site and should be reviewed by members. We are providing a summary of these actions for your convenience.

SEC Staff Legal Bulletins

On June 22, 2001, SEC staff issued two *Staff Legal Bulletins*: *Staff Legal Bulletin No. 12R (Revised)* and *Staff Legal Bulletin No. 13*. These legal bulletins set forth the views of the SEC's Staff and are not binding on the Commission.

Staff Legal Bulletin No. 12R (Revised) addresses frequently asked questions about Rule 11Ac1-5 and incorporates a discussion of all exemption relief issued to date.⁴ The interpretive questions addressed in this bulletin are: (1) format of monthly reports and procedures for making reports publicly available; (2) vendor or SRO assistance in making reports available; (3) the definition of market center in connection with the use of multiple trading venues; (4) integrated broker/dealers acting as market centers and agents solely for purpose of routing to another market center for execution; (5) the definition of covered order and the special handling exclusion; (6) temporary exemption for manually received orders; (7) locked and crossed quotes; (8) trading halts; (9) activity within the Intermarket Trading System; (10) activity within SuperSOES and SelectNet; (11) partial executions and/or partial cancellations; (12) orders left unexecuted and uncancelled at the end of regular trading hours; (13) establishing time of receipt; (14) orders received in same second as a quote change; (15) time of execution for stopped or guaranteed orders; (16) adjusted or voided order executions; (17) calendar month reporting; (18)

phase-in of reporting; (19) exemption for orders received prior to dissemination of quotations by primary listing SRO; (20) filtering potential errors in Consolidated best bid and offer (Consolidated BBO); (21) time of Consolidated BBO; (22) rounding of statistics; (23) modified orders; (24) riskless principal orders; (25) exemption for inactively traded securities; (26) exemption for small market centers; and (27) exemption for block orders.

Staff Legal Bulletin No. 13 addresses frequently asked questions about Rule 11Ac1-6 and incorporates a discussion of all exemption relief issued to date. The interpretive questions addressed in this bulletin are as follows: (1) format of quarterly reports; (2) identification of significant execution venues; (3) materiality of order percentage figures; (4) introducing broker/clearing firm reporting responsibility; (5) multiple reports by a broker/dealer; (6) definition of customer orders and large order exclusion; (7) definition of customer orders and exclusion from the rule of orders received from other broker/dealers or foreign banks acting as broker/dealers; (8) definition of directed orders addressing impact of default routing instructions; (9) classifying market, limit, and other orders; (10) orders executed in multiple venues; (11) execution venue for riskless principal orders; (12) Nasdaq® execution venues; (13) disclosing payment for order flow; (14) disclosing internalized order flow; (15) procedures for making quarterly reports publicly available; (16) responding to requests from customers for individual information; and (17) written notice to customers concerning availability of quarterly reports and individual information.

SEC Staff Issues Five Exemptive Letters

On June 22, 2001 the Commission, by the Division pursuant to delegated authority, also granted five requests for exemptive relief under Rules 11Ac1-5 and 11Ac1-6. The SEC granted four requests for exemptive relief under Rule 11Ac1-5 and one request for exemptive relief under Rule 11Ac1-6. Please note exemptions granted pursuant to the letters discussed in this *Notice* are subject to modification or revocation by the Commission at any time. Below is a summary of each of these exemptive letters.⁵

Exemption Request From 11Ac1-5 By NASD's Small Firm Advisory Board Granted

Many small firms have expressed concerns about the significant compliance costs and the lack of resources available to small firms to comply with these rules and the potential detrimental effects on liquidity. The NASD Small Firm Advisory Board (SFAB) expressed these concerns to the SEC's Staff in a letter dated April 23, 2001, and was instrumental in obtaining two exemptions from Rule 11Ac1-5:⁶ (1) for inactively traded securities;⁷ and (2) for small market centers that do not focus their business on the most actively traded securities.⁸

Exemption Request From 11Ac1-5 By The Nasdaq Stock Market, Inc. Granted

The Nasdaq Stock Market, Inc. (Nasdaq) requested that the Division issue interpretive guidance and exempt certain orders from Rule 11Ac1-5 in a letter dated June 20, 2001. Specifically, given the significant changes to Nasdaq's SelectNet

system that will accompany the phase-in of the SuperSOES rules in July 2001, Nasdaq made certain requests relating to the application of the Rule to SuperSOES and SelectNet in light of these changes. The Division previously found that SOES (which delivers automatic execution) is a market center and that SelectNet (which merely routes orders) is not. Consequently, Nasdaq must report as a market center on SOES orders. In addition, market centers that received preference orders through SelectNet to access displayed quotes must report on these orders. Essentially, the SEC Staff refined its analysis to recognize the significant changes Nasdaq is making to SelectNet and SOES and on behalf of the Commission granted an exemption under certain circumstances from reporting requirements under Rule 11Ac1-5.⁹

Exemption Request From 11Ac1-5 By The New York Stock Exchange, Inc. Granted

The New York Stock Exchange, Inc. (NYSE) requested that the Commission grant two exemptions from Rule 11Ac1-5: (1) that all market centers be exempt from the requirement that the initial monthly reports on trading in May 2001 be made publicly available by the end of June, and (2) that orders with a size of 10,000 shares or greater be exempted from the Rule. The SEC granted a temporary exemption from the requirement that market centers make Rule 11Ac1-5 reports publicly available on an Internet site for trades in exchange-listed national market system securities for the month of May 2001. Market centers, however, are required to prepare a report for transactions occurring during the month of May 2001 and to make the report available for

inspection by SEC staff. Moreover, the SEC determined that reports on trading for the month of June 2001 in listed-securities subject to Rule 11Ac1-5 are to be made publicly available on an Internet site by the end of July in accordance with the Joint SRO Plan.¹⁰ The Commission also exempted from Rule 11Ac1-5 any order with the size of 10,000 shares or greater as requested by the NYSE.

Exemption Request From 11Ac1-5 By Market Systems, Inc. Granted

Market Systems, Inc. requested two exemptions from Rule 11Ac1-5. Specifically, Market Systems requested exemptions related to: (1) orders received prior to dissemination of quotations by the primary market for a security, and (2) orders received during a time when the Consolidated BBO reflects a spread that exceeds \$1 plus 5 percent of the midpoint of the Consolidated BBO. As requested, the Commission exempted from the Rule any order that is received prior to the dissemination of the first firm, uncrossed quotations for the relevant security by the primary market and any order received during a time when the Consolidated BBO reflects a spread that exceeds \$1 plus 5 percent of the midpoint of the Consolidated BBO.¹¹

Exemption Request From 11Ac1-6 By First Union Securities, Inc. Granted

First Union requested that broker/dealers be exempted from reporting under Rule 11Ac1-6 the identity of execution venues that received less than 5 percent of the firm's non-directed order flow. The Commission granted an exemption

from the disclosure requirements of paragraph (b)(1)(ii) of the Rule with execution venues that only receive a small percentage of non-directed orders. Specifically, a broker/dealer is not required to identify execution venues that received less than 5 percent of non-directed orders for a section of the broker/dealer's quarterly report, as long as it has identified the top execution venues that in the aggregate received at least 90 percent of the broker/dealer's total non-directed orders.¹²

Effective Dates

The Adopting Release established a three-stage phase-in of compliance with Rule 11Ac1-5. The initial compliance date for the first phase-in of national market system securities subject to Rule 11Ac1-5 was extended on March 9, 2001 from April 2, 2001 to May 1, 2001. The SEC, subsequently, granted a temporary exemption, until July 31, 2001, from the reporting requirements of Rule 11Ac1-5(b)(1) for all orders in securities that are qualified for inclusion in the National Market tier of Nasdaq. Furthermore, as discussed above, the SEC granted a temporary exemption from the requirement that market centers make Rule 11Ac1-5 reports publicly available on an Internet site for trades in exchange-listed national market system securities for the month of May 2001.

Reports, however, on trading for the month of June 2001 in listed-securities subject to Rule 11Ac1-5 are to be made publicly available on an Internet site by the end of July.

The Adopting Release established July 2, 2001 as the initial compliance date for Rule 11Ac1-6. Therefore, the first report required under Rule 11Ac1-6 must cover transactions during the first quarter ending September 30, 2001. That quarterly report must be made publicly available by October 31, 2001. Broker/dealers also must respond to customer requests for order-routing information for orders routed on July 2, 2001 and after.

Endnotes

- 1 Securities Exchange Act Release No. 44177 (April 12, 2001), 66 FR 19814.
- 2 Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414 (Adopting Release).
- 3 Market orders and limit orders including customer requests for special handling for execution are excluded from the definition of covered orders reportable pursuant to Rule 11Ac1-5. For a complete definition of relevant terms please review Rules 11Ac1-5 and 11Ac1-6.
- 4 *Staff Legal Bulletin No. 12R* revises the prior staff legal bulletin issued on March 12, 2001.
- 5 The SEC previously issued three exemptions under Rule 11Ac1-5. See Letter to Richard G. Ketchum, President, The Nasdaq Stock Market, Inc., from Annette L. Nazareth, Director, Division, SEC, dated March 12, 2001; Letter to Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, from Annette L. Nazareth, Director, Division, SEC, dated March 12, 2001; and Letter to Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, from Annette L. Nazareth, Director, Division, SEC, dated April 12, 2001.
- 6 See Letter to Richard Romano, Chair, and Carl P. Sherr, Co-Chair, NASD Small Firms Advisory Board, from Annette L. Nazareth, Director, Division, SEC, dated June 22, 2001.
- 7 The SEC exempted any national market system security that did not average more than five reported transactions per day, as disseminated pursuant to an effective reporting plan, for each of the preceding six months (or such shorter time that the security has been designated a national market system security). An inactively traded security will lose its exemption only after its average daily reported transactions have exceeded five for each of the preceding six months. Orders in exempted securities need not be included in a market center's monthly

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reports, but a market center is free to include them if it chooses to do so.

8 The SEC exempted any market center that reported fewer than 200 transactions per day on average over the preceding six-month period in securities that are covered by the Rule, but only if more than 90 percent of such transactions were in securities that are not included in the Nasdaq-100 Index or the S&P 500 Composite Stock Price Index. Once a market center's average daily reported transactions for the preceding six-month period reach 200, or the percentage of its reported transactions in Nasdaq-100 and S&P 500 securities reaches 10 percent or greater for the preceding six-month period, the market center will cease to qualify for the exemption.

9 See Letter to Richard G. Ketchum, President, The Nasdaq Stock Market, Inc., from Annette L. Nazareth, Director, Division, SEC, dated June 22, 2001. The Division agreed with Nasdaq's view that SuperSOES is itself a market center for which Nasdaq must issue monthly reports. The Division also found that orders that are all-or-none ("AON") orders or minimum acceptable quantity ("MAQ") orders received by SuperSOES Participants through SelectNet would not be a "covered order" as defined in paragraph (a)(8) of the Rule. Furthermore, the SEC granted an exemption from the Rule's definition of covered order for preferred SelectNet orders received by SuperSOES Participants from UTP Exchanges that are not SuperSOES Participants. Finally, the SEC granted a temporary exemption for SuperSOES participants from reporting on SelectNet preferred orders in the event that SuperSOES is not fully implemented by August 1.

10 See Letter to Darla C. Stuckey, Assistant Secretary, New York Stock Exchange, Inc., from Annette L. Nazareth, Director, Division, SEC, dated June 22, 2001.

11 See Letter to Theodore Karn, President, Market Systems Inc., from Annette L. Nazareth, Director, Division, SEC, dated June 22, 2001.

12 See Letter to Neal E. Sullivan & Gail Marshall-Smith, Bingham Dana LLP (on behalf of First Union Securities, Inc.), from Annette L. Nazareth, Director, Division, SEC, dated June 22, 2001.

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