

INFORMATIONAL

Disclosure Of Order Routing

Member Obligations To Provide Statistical Information About Order Routing Under Rule 11Ac1-6 Of The Securities Exchange Act Of 1934

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Legal & Compliance
- Operations
- Senior Management

KEY TOPICS

- Exchange Act Rule 11Ac1-6
- Disclosure of Order Routing

Executive Summary

Rule 11Ac1-6 under the Securities Exchange Act of 1934 (Exchange Act) requires all broker/dealers that route customer orders in equity and option securities to make publicly available quarterly reports that disclose the venues to which it routes non-directed orders in certain covered securities. The Rule further requires broker/dealers to disclose the nature of any relationship they have with those venues, including any payment for order flow arrangements. Finally, the Rule requires broker/dealers to disclose, upon customer request, the venues to which individual orders were sent for execution. The compliance date for the Rule is July 2, 2001.

Questions/Further Information

Please note that this is a Securities and Exchange Commission (SEC) rule. Accordingly, questions of interpretation or other concerns about the Rule should be directed to the SEC. However, members may direct general questions concerning this *Notice* to Kathleen O'Mara, Assistant General Counsel, or Philip Shaikun, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8071.

Background And Information

In order to improve public disclosure of order execution and routing practices, the SEC on November 17, 2000 adopted Exchange Act Rules 11Ac1-5¹ and 11Ac1-6. Rule 11Ac1-6 requires all broker/dealers that route customer orders in equity and option securities to make publicly available quarterly reports about the routing of customer orders. More specifically, the Rule

requires quarterly disclosure of the percentage of customer orders that were non-directed; the identity of the 10 venues to which the largest number of non-directed orders were routed for execution; the identity of any other venues to which at least five percent of non-directed orders were routed for execution; and disclosure of payment for order flow or other material arrangements between broker/dealers and those venues. The Rule further requires broker/dealers to disclose to customers, upon request, the venue to which the customer's orders were routed for the previous six months and certain other data about those customer orders. Attachment A of this *Notice* contains the text of the Rule.

The scope of Rule 11Ac1-6 differs in some ways from that of Rule 11Ac1-5. For example, Rule 11Ac1-6 covers a wider range of securities. First, whereas Rule 11Ac1-5 applies only to national market system securities, the definition of "covered security" in Rule 11Ac1-6 also includes Nasdaq SmallCap equities and listed options. Second, the Rule applies to all broker/dealers that route orders on behalf of their customers, whereas Rule 11Ac1-5 applies generally to broker/dealers that execute orders. The term "customer order" is defined in Rule 11Ac1-6 as any order to buy or sell a covered security that is not for the account of a broker/dealer. It excludes, however, any order for a quantity of a security having a market value of at least \$50,000 for a covered security that is an option contract and a market value of at least \$200,000 for any other covered security. Third, Rule 11Ac1-6 applies to all types of orders, some of which are specifically excluded from the coverage of Rule 11Ac1-5 (e.g., pre-opening orders and short sale

orders), provided that they are "non-directed orders." All customer orders are considered to be non-directed in the absence of specific customer instructions on where they are to be routed.

The Rule requires that the quarterly reports be divided into four sections, each section to address a different category of covered securities: (1) equity securities listed on the New York Stock Exchange; (2) equity securities qualified for inclusion on Nasdaq; (3) equity securities listed on the American Stock Exchange or another national securities exchange; and (4) options. Each of these sections must contain the quantitative information identified above concerning the percentage of non-directed orders and the venues to which those orders were routed. Additionally, each section must discuss the broker/dealer's relationship, if any, with those venues, including payment for order flow or profit sharing arrangements.²

Broker/dealers must "make publicly available" the quarterly reports within one month after the end of the quarter addressed in the report. The Rule defines "make publicly available" to require broker/dealers to (1) post the report on a free Internet Web site; (2) furnish a written copy of the report on request; and (3) notify customers annually that a copy of the reports will be furnished on request.

Effective Date

Broker/dealers must comply with the Rule for all covered securities beginning on July 2, 2001. Therefore, the first required report must cover transactions during the quarter ending on September 30, 2001. That quarterly report must be made publicly available by October 31, 2001. Broker/dealers must also respond to customer requests for order-routing information for orders routed on July 2, 2001 and after.

Endnotes

- 1 Rule 11Ac1-5 requires "market centers" to provide statistical information concerning order execution. The details of that Rule are contained in *NASD Notice to Members 01-16*. Subsequent interpretive guidance and exemption information related to that Rule can be found on the NASD Regulation Web Site (www.nasdr.com).
- 2 The term "payment for order flow" is defined very broadly in Exchange Act Rule 10b-10(d)(9) to include any payment or benefit that results in compensation to the broker/dealer for routing orders to a particular venue. The term "profit-sharing relationship" is defined in paragraph (a)(7) of Rule 11Ac1-5 to mean any ownership or other type of affiliation under which the broker/dealer, directly or indirectly, shares in any profits that may be derived from the execution of non-directed orders. It, therefore, specifically covers internalization of customer orders by a broker/dealer that executes customer orders as principal.

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ATTACHMENT A**§240.11Ac1-6 Disclosure of order routing information.**

(a) Definitions. For the purposes of this section:

(1) The term covered security shall mean:

(i) Any national market system security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as defined in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)); and

(ii) Any option contract traded on a national securities exchange for which last sale reports and quotation information are made available pursuant to an effective national market system plan.

(2) The term customer order shall mean an order to buy or sell a covered security that is not for the account of a broker or dealer, but shall not include any order for a quantity of a security having a market value of at least \$50,000 for a covered security that is an option contract and a market value of at least \$200,000 for any other covered security.

(3) The term directed order shall mean a customer order that the customer specifically instructed the broker or dealer to route to a particular venue for execution.

(4) The term make publicly available shall mean posting 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.

(5) The term non-directed order shall mean any customer order other than a directed order.

(6) The term effective national market system plan shall have the meaning provided in §240.11Aa3-2(a)(2).

(7) The term national market system security shall have the meaning provided in §240.11Aa2-1.

(8) The term payment for order flow shall have the meaning provided in §240.10b-10(d)(9).

(9) The term profit-sharing relationship shall mean any ownership or other type of affiliation under which the broker or dealer, directly or indirectly, may share in any profits that may be derived from the execution of non-directed orders.

(10) The term time of the transaction shall have the meaning provided in §240.10b-10(d)(3).

(b) Quarterly report on order routing.

(1) Every broker or dealer shall make publicly available for each calendar quarter a report on its routing of non-directed orders in covered securities during that quarter. For covered securities other than option contracts, such report shall be divided into three separate sections for securities that are listed on the New York Stock Exchange, Inc., securities that are qualified for inclusion in the Nasdaq Stock Market, Inc., and securities that are listed on the American Stock Exchange LLC or any other national securities exchange. Such report also shall include a separate section for covered securities that are option contracts. Each of the four sections in a report shall include the following information:

(i) The percentage of total customer orders for the section that were non-directed orders, and the percentages of total non-directed orders for the section that were market orders, limit orders, and other orders;

(ii) The identity of the ten venues to which the largest number of total non-directed orders for the section were routed for execution and of any venue to which five percent or more of non-directed orders were routed for execution, the percentage of total non-directed orders for the section routed to the venue, and the percentages of total non-directed market orders, total non-directed limit orders, and total non-directed other orders for the section that were routed to the venue; and

(iii) A discussion of the material aspects of the broker's or dealer's relationship with each venue identified pursuant to paragraph (b)(1)(ii) of this section, including a description of any arrangement for payment for order flow and any profit-sharing relationship.

(2) A broker or dealer shall make the report required by paragraph (b)(1) of this section publicly available within one month after the end of the quarter addressed in the report.

(c) Customer requests for information on order routing.

(1) Every broker or dealer shall, on request of a customer, disclose to its customer the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders.

(2) A broker or dealer shall notify customers in writing at least annually of the availability on request of the information specified in paragraph (c)(1) of this section.

(d) Exemptions. The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.