Division of Market Regulation:
Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS

Responses to these frequently asked questions were prepared by and represent the views of the staff of the Division of Market Regulation ("Staff"). They are not rules, regulations, or statements of the Securities and Exchange Commission ("Commission"). Further, the Commission has neither approved nor disapproved of these interpretive answers.

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I. Introduction

On April 6, 2005, the Commission adopted Regulation NMS, a series of initiatives designed to modernize and strengthen the national market system for equity securities. Regulation NMS was published in Securities Exchange Act Release No. 51808 (Jun. 9, 2005), 70 FR 37496 (Jun. 29, 2005) ("NMS Release"). These initiatives include: (1) Rule 610, which addresses access to markets; (2) Rule 611, which provides intermarket price priority for displayed and accessible quotations; (3) Rule 612, which establishes minimum pricing increments; and (4) amendments to the joint-industry plans and rules governing the dissemination of market data. This document jointly addresses Rule 611 and Rule 610 because the price priority and access issues arising under the two rules often are intertwined.[1] The scheduled compliance dates for the phase-in of the two Rules are June 29, 2006 for 250 NMS stocks, and August 31, 2006 for all remaining NMS stocks.

Rule 611, among other things, requires a trading center to establish, maintain, and enforce written policies and procedures reasonably designed to prevent "trade-throughs" – the execution of trades at prices inferior to protected quotations displayed by other trading centers. To be protected, a quotation must be immediately and automatically accessible. Rule 611(b) also sets forth a series of exceptions that are designed to provide efficient and workable intermarket price priority. The exception that is likely to be used most frequently is for intermarket sweep orders ("ISOs"). The ISO exception enables a destination trading center to execute an ISO immediately at its limit price or better, while also requiring that additional ISOs, as necessary, be routed to execute against the full displayed size of any better-priced protected quotations displayed by other trading centers. The ISO exception thereby both furthers the price priority objectives of Rule 611 and facilitates "best-price" routing practices – the automated routing of orders to one or more trading centers displaying the best-priced quotations available for an NMS stock at any particular time (see Questions 9 – 11 below).

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[1] The Staff separately has prepared responses to frequently asked questions concerning Rule 612. See Division of Market Regulation, Responses to Frequently Asked Questions Concerning Rule 612 (Minimum Pricing Increment) of Regulation NMS (available on the Commission's Internet Web site at http://www.sec.gov).

Rule 610, in turn, requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires each national securities exchange and national securities association (collectively, "self-regulatory organizations" or "SROs") to adopt, maintain, and enforce written rules that, among other things, prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross protected quotations.

The following questions and answers have been compiled by the Staff to assist in the application of Rule 611 and Rule 610. They presume that the reader will be familiar with the Rules themselves, as well as the defined terms set forth in Rule 600(b) of Regulation NMS. Some of the more significant of such defined terms include automated quotation, automated trading center, bid or offer, intermarket sweep order, manual quotation, NMS stock, protected bid or protected offer, protected quotation, quotation, regular trading hours, SRO display-only facility, SRO trading facility, trade-through, and trading center. The questions and answers are intended to provide general guidance. Facts and circumstances of a particular transaction may differ, and the Staff notes that even slight variations may require different responses. In addition, the questions and answers reflect current technological and other industry conditions and may require modification in the future if such conditions change materially. The Commission is not bound by the Staff's statements.

The Staff may update these questions and answers periodically. In each update, the questions modified or added after publication of the last version will be marked with ***"MODIFIED!"*** or ***"NEW!"***

The interpretive questions addressed in this document are as follows:

II. Responses to Frequently Asked Questions

Question 1: Will order-routers be able to control the handling of their orders to comply with Rule 611, or must they rely on trading centers themselves to execute and route orders in compliance with the Rule?

Answer: Order-routers will have three basic tools, if they choose to use them, to control the handling of their orders to comply with Rule 611. They are (1) a limit price, (2) an immediate-or-cancel ("IOC") designation, and (3) an ISO designation. Use of a limit price precludes any execution at a price inferior to such price. Use of an IOC designation triggers the requirements for automated quotations set forth in Rule 600(b)(3) of Regulation NMS, particularly the requirement that the trading center provide an immediate response to the order (see Question 4 below). The response must be a fill, in full or in part, or a non-fill, and a cancellation of any unfilled balance of the order, without routing the order away to another trading center. Use of an ISO designation enables the destination trading center to execute the order immediately without regard to better-priced protected quotations at other trading centers. When an order is designated as an ISO, the broker-dealer routing the order must assume the responsibility for transmitting additional orders, as necessary, to execute against any better-priced protected quotations (see Questions 10 and 15 below). Finally, the ISO designation informs the destination trading center that the fees for any order execution should not exceed the limitation of fees set forth in Rule 610(c), unless the order router affirmatively expresses its willingness to accept an order execution beyond the scope of the fee limitation (see Question 9 below).

The coordinated use of a limit price, IOC designation, and ISO designation should be particularly valuable for those who wish to conduct automated best-price routing strategies. For example, when multiple trading centers are displaying the best price for an NMS stock, an investor can route a single IOC/ISO to the most preferred of these trading centers, thereby allowing the preferred trading center to execute the order immediately even if quotations may have changed while the order was in transit (see Question 10 below). If an order-router wishes to execute a large order by sweeping both the protected quotations and depth-of-book quotations at one or more preferred trading centers, it can implement this strategy by routing large-sized IOC/ISOs with aggressive limit prices to the preferred trading centers, while routing additional IOC/ISOs, as necessary, to less preferred trading centers that are priced and sized to execute against only the protected quotations of those trading centers. All of the destination trading centers will be authorized to execute the IOC/ISOs immediately, without regard to the quotations displayed by other trading centers.

Question 2: To be a protected quotation under Rule 611, a quotation must be automated, but the consolidated quotation stream that currently is disseminated to the public does not identify quotations as automated or manual. How will quotations be marked so that the public can readily identify automated and manual quotations?

Answer: The joint-SRO market data networks ("Networks"), which disseminate consolidated quotation data for NMS stocks to the public, have agreed to adopt uniform identifiers for manual and automated quotations. Quotations will have a condition code "B" if manual on the bid, "A" if manual on the offer, and "H" if manual on both the bid and the offer. Quotations without any condition codes will be automated.

In addition, the Networks currently use a number of condition codes for quotations (such as "non-firm" quotations) that render them ineligible for inclusion in the Networks' calculation of a national best bid and offer. None of these quotations are eligible to be automated quotations and, consequently, cannot qualify as protected quotations under Rule 611.

Question 3: To be a protected quotation under Rule 611, a quotation must be displayed by an automated trading center. What types of trading centers can be "automated trading centers" under Regulation NMS?

Answer: The requirements for automated trading centers are set forth in Rule 600(b)(4). They are relevant only for those trading centers that intend to display protected quotations, as defined in Rule 600(b)(57) and (58), in the Network quotation streams. These trading centers are either SRO trading facilities, as defined in Rule 600(b)(72), or trading centers that display quotations in the NASD's Alternative Display Facility ("ADF"). The ADF is the single existing example of an SRO display-only facility, as defined in Rule 600(b)(71). Accordingly, only SRO trading facilities and ADF participants are subject to the requirements for automated trading centers. In addition, the anti-discrimination and other access requirements of Rule 610(a) and (b) apply only to quotations displayed by SRO trading facilities and ADF participants.

Other types of trading centers, such as over-the-counter ("OTC") market makers, which typically provide quotations to SRO trading facilities that are executed through such facilities, are not subject to the requirements for automated trading centers (assuming they do not choose to become ADF participants). Rather, the SRO trading facility itself must meet such requirements for all quotations displayed through such facility, no matter what their source.

Question 4: What are the requirements that govern automated trading centers in identifying their quotations as automated or manual?

Answer: The definition of automated trading center in Rule 600(b)(4) requires, among other things, that a trading center (1) implement such systems, procedures, and rules as are necessary to render it capable of meeting the requirements for automated quotations, as defined in Rule 600(b)(3); and (2) immediately identify its quotations as manual whenever it has reason to believe it is not capable of displaying automated quotations. The definition of automated quotation requires, among other things, that a trading center provide an immediate response to incoming IOC orders and immediately update its quotations.[2]

Consequently, automated trading centers must monitor their systems on a real-time basis to assess whether they are functioning properly. If an automated trading center has reason to believe that it is not capable, because of systems or other problems, of immediately and automatically transmitting responses to IOC orders and immediately and automatically updating quotations, the trading center is required, at a minimum, to identify such quotations as manual. An automated trading center experiencing serious problems also should consider whether it is capable of meeting the "firm quote" requirements of Rule 602(b) and should identify its quotations as non-firm or withdraw its quotations as appropriate.

In addition, an automated trading center should adopt policies and procedures for responding to notices that it receives from other trading centers indicating that they have elected to use the "self-help" exception of Rule 611(b)(1) (see Question 24 below). The self-help exception allows trading centers and order-routers to bypass the protected quotations of an automated trading center that is experiencing systems problems. Immediately upon invoking the exception, the electing entity must notify the bypassed automated trading center. As part of its policies and procedures under Rule 600(b)(4)(i), an automated trading center should, at minimum, provide a mechanism for receiving self-help notifications, as well as assign personnel to monitor the receipt of such notifications on a real-time basis so that potential systems problems can be promptly evaluated and appropriately addressed.

The affirmative duty of automated trading centers to identify their quotations appropriately is a vitally important element of Regulation NMS. It will help promote the smooth and efficient functioning of intermarket price priority and trading in general. Timely and accurate identification of quotations will give investors, broker-dealers, and other trading centers essential information concerning the status of quotations in NMS stocks, thereby minimizing the extent to which the systems problems of a particular trading center can interfere with efficient trading throughout the national market system. For example, when a trading center experiencing systems problems promptly fulfills its duty to cease identifying its quotations as automated and thereby removes them from trade-through protection, it will not be necessary for other trading centers or order–routers to invoke the self-help exception.

Question 5: Under Rule 600(b)(3)(iii), an automated trading center is required to provide an immediate response to an IOC order without routing the order elsewhere. Can an SRO

[2] See NMS Release, 70 FR at 37519. A deliberate delay (i.e., a time period in which a response is not sent or a quotation is not updated for no reasonable purpose) would violate the requirements of Rule 600(b)(3).

trading facility meet this requirement if it displays quotations submitted by an order-delivery ECN?

Answer: An SRO trading facility that displays quotations submitted by an order-delivery ECN can meet the requirement of Rule 600(b)(3)(iii) only if such quotations are closely integrated within the SRO trading facility. An "order-delivery ECN" submits quotations that are displayed within an SRO trading facility, while also simultaneously executing buy and sell orders internally as agent for its subscribers. To preclude the potential for double liability on a single order (e.g., an order executing internally in the ECN immediately before the quotation that reflects such order is executed in the SRO trading facility), the SRO trading facility does not immediately execute orders against the ECN quotation, but delivers the orders to the ECN to assure that the quotation is still available. If so, the order is executed automatically at the ECN and reported back through the SRO execution facility.

Whether the quotations of an order-delivery ECN quotation are closely integrated within the SRO trading facility will be determined from the standpoint of those who route orders to the SRO trading facility. The SRO trading facility must be capable of providing a response to incoming orders that does not significantly vary between orders handled entirely within the SRO trading facility and orders delivered to the ECN. Consequently, the systems that connect the SRO trading facility and ECN must be of very high reliability and speed. In addition, the SRO rules that govern orders delivered to the ECN must assure fast and efficient handling and quotation updates, subject only to addressing the potential for double liability.

Question 6: Is a trading center that displays an automated quotation required to execute an IOC order against the available reserve size for such quotation?

Answer: Yes, the definition of automated quotation in Rule 600(b)(3)(ii) requires that a trading center immediately and automatically execute an IOC order against an automated quotation up to its full size. As discussed in the NMS Release, the term "full size" includes both the displayed size and the reserve size for such automated quotation.[3] The requirement that IOC orders be executed against reserve size is designed to promote efficient intermarket trading by, among other things, minimizing the frequency of unintentional locked or crossed markets.

For example, assume that a trading center's protected bid is $20.05 with a displayed size of 1500 shares and a reserve size of 3000 shares. A market participant routes an IOC order to sell 5000 shares with a limit price of $20.05 to execute against the protected bid. The trading center would

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3 See NMS Release at 37534 n. 313 (an automated quotation "must be immediately and automatically accessible up to its full size, which will include both the displayed and reserve size of the quotation"). In contrast, to qualify for the ISO exception, an ISO need only be routed to execute against the "full displayed size" of a protected quotation under Rule 600(b)(30). Routers of ISOs are not prohibited, however, from oversizing their ISOs in an attempt to sweep both displayed and reserve liquidity at a trading center. The NMS Release notes that, given the requirement that ISOs be routed to execute against protected quotations (even when the displayed size of such protected quotation may be less than the order-router's total trading interest), the trading centers that benefit from this protection for their quotations should be required to provide fair and efficient access to the full size available for the quotation. Id.

be required to execute the order immediately at $20.05 for 4500 shares (the 1500-share displayed size plus the 3000-share reserve size) and immediately cancel the remaining 500-share balance.

Question 7: Can the quotations of two or more ADF participants be consolidated and reflected in a protected bid or a protected offer of the ADF?

Answer: No, the best bid of the ADF must reflect the quotation of a single ADF participant, and the best offer of the ADF must reflect the quotation of a single ADF participant. Under Rule 600(b)(57), the definition of protected bid and protected offer is limited to the best bid and offer ("BBO") of a national securities exchange, Nasdaq, and the ADF. The NMS Release notes that one of the policy objectives of this definition is to treat exchange markets comparably with Nasdaq and the ADF.[4] The Commission therefore specified that a protected bid or protected offer must be accessible by routing an order to a single protected quotation at a single trading center destination (i.e., a single exchange execution system, a single Nasdaq execution system, or a single ADF participant).[5]

Accordingly, when two or more ADF participants are quoting at the best price for an NMS stock, the ADF must identify a single participant quotation for its best bid and size and a single participant quotation for its best offer and size. The identity of such ADF participants will be included in the Network quotation streams that are disseminated to the public.

Question 8: Will there be any public disclosure identifying trades that are executed pursuant to an exception from Rule 611?

Answer: Rule 611(b) sets forth exceptions that are designed primarily to promote intermarket price priority. A trading center's policies and procedures to prevent trade-throughs under Rule 611(a) are not required to prevent transactions that are executed in compliance with these exceptions. In the NMS Release, the Commission noted that increased transparency concerning excepted trades would be beneficial because it would give timely notice to the public that a trade qualified for an exception.[6] The joint-SRO market data plans that operate the Networks currently are working to select uniform identifiers for trades that are executed pursuant to the 611(b) exceptions. The Networks will disseminate these identifiers to the public in the consolidated trade data for NMS stocks.

Question 9: To comply with the ISO exception, Rule 600(b)(30) requires that ISOs be routed to execute against the full displayed size of better-priced protected quotations. What requirements apply to the automated trading center displaying a protected quotation when it receives an ISO?

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[4] 70 FR at 37529.

[5] 70 FR at 37534.

[6] 70 FR at 37535 n. 317.

Answer: At a minimum, an ISO designation indicates the order router's intention to execute against an automated trading center's protected quotation (assuming that the price of the protected quotation on arrival of the order is within the ISO's limit price). An ISO therefore triggers both the firm quote requirements of Rule 602(b) and the limitation on fees of Rule 610(c). The destination trading center is required to execute the ISO at a price at least as favorable as the price of the protected quotation (unless previously executed or withdrawn),[7] and any execution at the price of the protected quotation (regardless whether executed against displayed or reserve size) is subject to the fee limitation of Rule 610(c).[8]

Complications could arise, however, if the destination trading center intends to charge any fees in excess of the limitation in Rule 610(c) ("high fees") for order executions that do not fall within the scope of Rule 610(c) (e.g., for an execution that includes prices other than the price of a protected quotation). One example is if a trading center is holding undisplayed orders at better prices than its protected quotation, against which the ISO would normally execute pursuant to the trading center's priority rules. If the trading center intended to charge a high fee for this execution, the order-router potentially could be charged a fee higher than the limited fee that was expected when the ISO was routed. Another example is if the price of a trading center's protected quotation improved after an ISO was routed. In these circumstances, the limit price of the ISO would be inferior to the improved price of the trading center's protected quotation. Although the trading center would execute the order against the new, better-priced protected quotation to the extent of the quotation's available size (and with a limited fee), any residual portion of the ISO might be executed at the inferior limit price of the ISO. Again, the order-router potentially could be charged a fee higher than the limited fee that was expected when it routed the ISO.

To address the potential problems created by high-fee executions, the NMS Release states that trading centers intending to charge high fees must provide a functionality that enables market participants to assure that they will never inadvertently be charged a fee in excess of the limitation in Rule 610(c).[9] Accordingly, any trading center that intends to charge high fees must provide a separate functionality (such as an order designation) that allows the router of an ISO to indicate affirmatively that it is willing to accept a high-fee execution. In the absence of such an affirmative indication, the trading center cannot charge fees for execution of an ISO that exceed the limitations of Rule 610(c).

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7 The ISO designation allows the trading center to execute the order immediately, regardless of any better-priced protected quotations displayed by other trading centers. In the absence of an ISO designation, the trading center would not be required to execute the order under Rule 602(b) if it would thereby trade through better-priced protected quotations at other trading centers.

8 See NMS Release, 70 FR at 37549 ("When triggered, the fee limitation of Rule 610(c) will apply to any order execution at the displayed price of the protected quotation or the BBO quotation. It therefore would encompass executions against both the displayed size and any reserve size at the price of those quotations.").

9 70 FR at 37546 (section III.A.2).

Moreover, the trading center cannot simply decline to provide any execution of an ISO merely because of the order-router's unwillingness to accept a high-fee execution. For example, the trading center must provide an order execution that meets the firm quote requirements of Rule 602(b). In addition, if the ISO is also marked as IOC (which triggers the requirements for automated quotations in Rule 600(b)(3)), the trading center must provide an order execution up to the full size of its protected quotation at a price that is at least as good as the price of its protected quotation.

Question 10: Is it permissible for an order-router that does not intend to sweep any inferior prices to designate a single limit order as an ISO when it will be routed to only one trading center that is displaying a protected quotation with the best price for an NMS stock (either alone or with other trading centers), without routing an order to another trading center?

Answer: Yes, an order-router that does not intend to sweep any inferior prices can designate a single order as an ISO when it is routed to a trading center displaying the best-priced quotation for a stock. The ISO designation will allow the destination trading center to execute the order immediately, even if another trading center displays a better-priced protected quotation after the ISO is routed and before the ISO is executed by the destination trading center. The definition of an ISO requires that, simultaneously with the routing of an ISO under subparagraph (i) of Rule 600(b)(30), one or more additional ISOs are routed under subparagraph (ii), as necessary, to execute against the full displayed size of any better-priced protected quotations. If there are no protected quotations with better prices than the limit price of the subparagraph (i) ISO at the time of routing, then it is not necessary to route any additional ISOs under subparagraph (ii). In addition, the size of the subparagraph (i) ISO need not equal or exceed the full displayed size of the protected quotation.

For example, if three trading centers are displaying protected bids that equal the national best bid for a stock, it would be appropriate for a best-price order-router to route a sell ISO of any size to any one of them, to any two of them, or to all three. In each case, there would be no better-priced protected bids that necessitated the routing of additional sell orders.

Note, however, that the use of an ISO designation discussed in this question and response is limited to best-price order-routing strategies that will not sweep any inferior prices. In contrast, whenever an order-router intends to sweep one or more inferior prices, an ISO must be routed to execute against every better-priced protected quotation. For example, if a trading center intends to use the exception in Rule 611(b)(6) to enable such trading center to execute a trade at an inferior price, the trading center must route ISOs to execute against the full displayed size of all better-priced protected quotations.

Question 11: As part of a best-price routing strategy, an order-router transmits an ISO to execute against a protected quotation at Trading Center A. Trading Center A responds with a "no-fill" or "partial-fill" cancellation of the ISO. If the price of the protected quotation at Trading Center A does not change, is it permissible for such order-router to continue to route ISOs to other trading centers for one full second, without routing a new ISO to execute against the same-priced protected quotation at Trading Center A?

Answer: Yes, waiting one full second to route a new ISO to an unchanged price at a trading center (after receiving a no-fill or partial fill cancellation of a previous ISO seeking to execute against a protected quotation at such trading center) would qualify as a reasonable policy and procedure under Rule 611(a)(1) to prevent trade-throughs, as well as a reasonable step under Rule 611(c) to establish that orders meet the requirements for ISOs set forth in Rule 600(b)(30).

In the NMS Release, the Commission recognized the practical challenges of implementing intermarket price priority at the level of sub-second time increments.[10] In the national market system, multiple trading centers across the country simultaneously quote and trade in NMS stocks. Particularly for active stocks, many orders can seek to execute against a single displayed quotation, many trades can be executed, and many quotations can be updated, all within a single second.

In recent years, industry participants have acquired substantial practical experience with policies and procedures for automated best-price routing strategies. After the compliance date for Rule 611, the Staff believes that trading centers and broker-dealers should continue to have considerable flexibility in adapting such policies and procedures to address the practical challenges of implementing best-price routing strategies in compliance with the Rule. As long as such policies and procedures are reasonably designed to route orders to execute against the full displayed size of protected quotations prior to the execution of a trade at an inferior price, it will be appropriate to use the ISO designation as a means to implement the best-price routing strategy. Waiting one second before re-routing to a trading center's protected quotation, after receiving a partial-fill or no-fill response to an order seeking to execute against the trading center's quotation at the same price, would be one example of a reasonable policy and procedure.

Question 12: Does Regulation NMS require trading centers to cancel any portion of an ISO that cannot be executed immediately?

Answer: No, Regulation NMS neither requires a trading center to cancel immediately the unexecuted portion of an ISO nor prohibits it from doing so. To assure an immediate cancellation and response, order routers should use the IOC designation. Trading centers, in turn, will have the option of adopting rules requiring that the unexecuted portion of ISOs be immediately canceled. If, however, a trading center chooses not to cancel the portion of ISOs that cannot be executed immediately, its rules will need to address appropriately the subsequent handling of the unexecuted portions. For example, such rules would need to comply with the relevant SRO rule on the display of locking or crossing quotations (see Question 33 below). In addition, any subsequent execution would not qualify for the original ISO exception created by the initial routing of the ISO. The exception will expire after the ISO exhausts the liquidity that is immediately available at the trading center. Consequently, a subsequent execution of the remaining balance of an ISO must independently comply with Rule 611 (e.g., by not trading through a protected quotation or newly qualifying for a Rule 611 exception).

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10 70 FR at 37523.

Question 13: When routing orders to other trading centers to comply with the ISO exception, does Rule 611 permit the routing trading center to bypass a trading center with respect to which the routing trading center is currently exercising the self-help exception? If so, is any broker-dealer responsible for routing ISOs also entitled to bypass a trading center experiencing systems problems that would justify use of the self-help exception?

Answer: When routing orders to meet the requirements for ISOs set forth in Rule 600(b)(30), a trading center can decline to route orders to execute against the protected quotations of a trading center experiencing systems problems for which the routing trading center has triggered the self-help exception of Rule 611(b)(1). This combined use of the self-help and ISO exceptions would be a reasonable policy and procedure under Rule 611(a).

In addition, a broker-dealer responsible for routing ISOs, but which does not fall within the definition of trading center in Rule 600(b)(78) because it does not execute orders internally as agent or principal, would nevertheless be entitled to use the combined ISO/self-help exceptions if it elects to comply with the requirements applicable to trading centers under Rule 611(a). For example, such a broker-dealer would need to adopt the reasonable policies and procedures required by Rule 611(a)(1) to implement the self-help exception (including sending notice to the problem trading center – see Question 24 below), as well as comply with Rule 611(a)(2) by regularly surveiling to ascertain the effectiveness of its policies and procedures.

Question 14: Can a broker-dealer responsible for routing ISOs retain the services of a third-party service provider to meet the requirements of Rule 611?

Answer: Yes, a broker-dealer responsible for routing ISOs is permitted to retain the services of another entity for assistance in meeting the requirements of Rule 611, but such broker-dealer would remain ultimately responsible for compliance with the Rule.[11] For example, Rule 611(c) requires a broker-dealer to take reasonable steps to establish that the ISOs for which it is responsible meet the requirements set forth in the definition of an ISO in Rule 600(b)(30). To meet this requirement when retaining a third-party service provider, the broker-dealer must, at a minimum, adopt reasonable procedures to assure that the service provider is capable of meeting the requirements of Rule 611 and to monitor the service provider's performance on a continuing basis.

Question 15: A broker-dealer intends to utilize the ISO exception to execute a block trade for a customer at a price inferior to one or more protected quotations. How should the block trading desk execute and report the block trade in compliance with the ISO exception?

Answer: Under Rule 611(b)(6), the broker-dealer is required to route, simultaneously with execution of the block trade, an ISO to execute against the full displayed size of any protected quotation with a price superior to the block trade price. To meet this requirement, the broker-dealer will need to utilize an automated system that is capable of ascertaining current protected quotations and simultaneously routing the necessary ISOs. As part of the broker-dealer's

[11] NMS Release, 70 FR at 37522, 37536.

periodic surveillance under Rule 611(a)(2), ISOs should be compared with the protected quotations at the time of execution to affirm that the ISOs were properly routed (see Question 28 below). The Staff does not believe that it would be possible for manual routing of ISOs to comply with the requirement in Rule 611(b)(6).

The extent to which a routed ISO will receive an execution at the destination trading center cannot be known at the time of routing (for example, the protected quotation may already have been executed against or cancelled prior to arrival of the ISO). As a result, a broker-dealer could face practical issues in implementing the block trade for its customer, including (1) transferring to the customer the benefit of any better prices obtained through executed ISOs, (2) handling the residual size of ISOs that did not receive a fill, and (3) reporting the block trade to the relevant SRO.[12] The Staff believes that there are several ways for a broker-dealer reasonably to address these practical issues, depending on the preferences of its customers.

If, for example, a customer consents to not receiving the benefit of any better prices obtained by the ISOs, the broker-dealer could report the block trade immediately on the routing of the ISO orders because the block trade size would not be affected by any fills of the ISOs. By giving its informed consent, the customer would, in effect, recognize that the block price was determined, at least in part, by a judgment of the extent to which the broker-dealer would receive fills of the ISOs at better prices.

If, however, the broker-dealer's customer wished to receive the benefit of any better prices obtained by the ISOs, reporting the block trade is more problematic because its ultimate size will not be known until responses are received to the ISOs (i.e., any fills will reduce the size of the block trade). If the ISOs are also marked as IOC, the Staff believes that the reporting of the block trade could await responses to the IOC/ISOs for a reasonable time (e.g., five seconds or less). At that point, the size of the block trade would be reduced to reflect any fills of the ISOs, and the block trade could be reported to the relevant SRO as an ISO execution. Importantly, however, all material terms of the block trade would need to have been finally agreed upon at the time when the ISOs were routed, subject only to adjusting the block trade size to reflect ISO fills. Under these circumstances, the Staff would consider the broker-dealer to have met the "simultaneous routing" requirement of Rule 611(b)(6). Therefore, the broker-dealer would not be required to route any additional ISOs when the block trade is reported to the relevant SRO.

Further complications could arise if the broker-dealer does not receive a response within a reasonable time to all of the ISOs. To address this situation (which should not occur frequently because of the immediate response requirement for IOC orders), the customer could agree, in advance, to consider the lost IOC/ISO to be unexecuted and to include its size in the block trade at the block price. Alternatively, the block trade could be reported at a reduced size to reflect the lost IOC/ISO, pending its ultimate resolution.

[12] See NMS Release, 70 FR at 37527 n. 250 (noting that the Commission would work with the industry during implementation to achieve an appropriate resolution of these practical issues).

Question 16: NASD rules currently specify a number of modifiers for its members to use when they report trades in certain NMS stocks, including ".PRP" and ".W". Do all trades reported pursuant to these NASD rules qualify for an exception under Rule 611(b)?

Answer: No, the exceptions set forth in Rule 611(b), including the benchmark exception of Rule 611(b)(7) and the stopped order exception of Rule 611(b)(9), are not coextensive with the NASD rules on trade modifiers. Unlike the benchmark and stopped order exceptions, the NASD rules were not formulated to reflect the price priority objectives of Rule 611. Consequently, although many trades currently reported with a trade modifier will qualify for a Rule 611 exception, the terms and conditions of a particular trade must be evaluated in light of the language of Rule 611(b) to determine whether it qualifies for an exception.

Question 17: To fill a customer order for an NMS stock, a broker-dealer effects, as riskless principal, one or more trades and assigns the trades at the same prices to the customer in compliance with the relevant SRO rule on riskless principal reporting. Pursuant to such SRO rule, the "second legs" of the riskless principal transactions are not publicly reported to the Network trade stream. Would the second legs of the riskless principal transactions be considered separate transactions for purposes of compliance with Rule 611?

Answer: No, the second leg of a riskless principal transaction that complies with a relevant SRO riskless principal rule would not constitute a separate transaction for purposes of complying with Rule 611. The second legs therefore would not constitute trade-throughs, regardless of their prices. The relevant SRO rule must provide that the initial trades are assigned to the customer at the same prices and that the second legs are not reported publicly in the Network trade stream. Of course, the first legs of the riskless principal transactions would need to comply with Rule 611.

Question 18: A broker-dealer executes a block trade for a customer at a price that does not trade through a protected quotation at the time of execution. When the trade is reported to the relevant SRO, however, the price is inferior to a protected quotation. How should the broker-dealer demonstrate its compliance with Rule 611?

Answer: The broker-dealer should implement procedures that reliably document the time of execution of the trade. Time of execution for purposes of Rule 611 would be when final agreement is reached on the stock, price, and size of the trade. The identity of the parties to the trade could be added subsequently. To be reliable, the documentation must be generated simultaneously with the time of execution and not be subject to retrospective alteration. For example, the time of execution could be documented manually by machine-stamping the current time on a paper order ticket (with all order tickets numbered and accounted for), or electronically by inputting an order ticket into an automated system (with the system maintaining a record of all inputs). As part of the broker-dealer's periodic surveillance procedures under Rule 611(a)(2), trade prices should be compared with protected quotations at the time of execution, as reliably documented, to affirm that such quotations were not traded through.

Question 19: A broker-dealer buys a block of an NMS stock as principal from a customer. Consistent with the broker-dealer's understanding with its customer, the trade price

reported to the relevant SRO is lowered by two cents per share to compensate the block trading desk for committing its capital. Does this "net price" determine the price of the trade for all purposes under Rule 611?

Answer: Yes, the net price reported to the SRO (and thereafter disseminated in the Network data stream) is the price of the block trade for all purposes under Rule 611, such as determining whether a trade-through occurred and routing the necessary orders to execute against protected quotations to comply with the ISO exception.

Question 20: To fill a large customer order to buy an NMS stock, a broker-dealer effects, as principal, a series of smaller trades to accumulate a position in the stock. The broker-dealer then sells the position to the customer at a price that is the volume-weighted average price of all the smaller trades. If the "second leg" does not meet the requirements of the relevant SRO riskless principal rule, is the second leg of this transaction subject to Rule 611 and, if so, does it meet the terms of the benchmark exception in paragraph (b)(7) of the Rule?

Answer: The second leg of the principal transaction is subject to Rule 611 if it does not fall within the relevant SRO riskless principal rule. The second leg would, however, qualify for the benchmark exception in Rule 611(b)(7) if the customer agreed to the average-price benchmark at that time the order was submitted.

Question 21: Assume the same facts as in Question 20 above, except that the customer agreed to accept a trade price that was two cents per share in excess of whatever turned out to be the volume-weighted average price of the broker-dealer's accumulating trades. Would the second leg of the principal transaction qualify for the benchmark exception?

Answer: No, the agreement to add a specific amount to the trade price would disqualify the transaction for the benchmark exception because this part of the trade price was designed to provide compensation for the trade to the broker-dealer that was reasonably determinable at the time the commitment to execute the order was made. The benchmark exception is intended to facilitate the execution of large orders. It contemplates that broker-dealers generally will attempt to accumulate a position to fill a large order in transactions that are subject to Rule 611 to help them meet the benchmark price.[13] It therefore allows the broker-dealer to fill the order to the customer in a transaction whose price is benchmarked to a price that is not related, directly or indirectly, to the quoted price of the stock at the time of the transaction and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made. In the scenario set forth in the above question, the customer would have agreed to a specific amount, separate from the average price benchmark, that was designed to provide reasonably determinable compensation to the broker-dealer, and this reasonably determinable amount would have been included in the trade price that was reported to the SRO and thereafter disseminated in the Network trade stream. Under these circumstances, the second leg of the principal transaction does not qualify for the benchmark exception.

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[13] See NMS Release, 70 FR at 37536 ("any transactions effected by the broker-dealer during the course of the day to obtain sufficient stock to fill the benchmark order would remain subject to Rule 611").

Question 22: A broker-dealer receives an order outside of regular trading hours. At the time of order receipt, the broker-dealer agrees to execute the order at a market's opening price. Would an execution of the order at such opening price qualify for the benchmark exception, even if the execution was delayed because of a processing back-up in the broker-dealer's systems?

Answer: Yes, an order execution benchmarked to a market's opening price in the future would qualify for the benchmark exception.[14] The delay in processing the order would not disqualify the transaction.

Question 23: Rule 611(b)(9) provides an exception for the execution of certain stopped orders for which a trading center has guaranteed a price to its customer. After the original submission of a non-stopped order, a broker-dealer and its customer agree to modify the order by adding a guaranteed price and making such order a stopped order. Does the subsequent modification of the order to add a guaranteed price allow the order to qualify for the stopped order exception?

Answer: Yes, the subsequent modification of the order to add the new term of a guaranteed price would constitute the time of receipt of the stopped order for purposes of Rule 611(b)(9). Of course, all other terms of the exception must be met, including the requirement that the order be executed at a price that renders it "underwater" from the perspective of the broker-dealer that is giving the guarantee (i.e., the broker-dealer sells to the customer at a price below the national best bid, or buys from the customer at a price above the national best offer).

Question 24: What elements must be included in a trading center's policies and procedures to implement the self-help exception?

Answer: The NMS Release specifies a minimum of three elements that must be included in a trading center's policies and procedures to comply with the self-help exception: (1) notice, (2) systems assessment and response, and (3) objective parameters.[15] On any given trading day, a wide variety of systems problems potentially can arise in the internal systems of a trading center, as well as in the linkages between trading centers and between trading centers and broker-dealers. In addition, the scope of a problem can vary widely (e.g., a systems problem at a trading center can affect only a single stock, a group of stocks, or all stocks). The self-help exception is designed to promote efficient intermarket price priority by providing a flexible tool that generally will allow trading to continue while affected trading centers identify the problem and respond appropriately. Each of the three elements of a trading center's policies and procedures will further this objective.

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[14] See NMS Release, 70 FR at 37536-37537 (benchmark exception encompasses execution of an order that is benchmarked to a market's single-priced opening).

[15] 70 FR at 37519 & n. 174, 37521-37522 & n. 194, 37535 & n. 318.

Notice. A trading center that elects to use the self-help exception must notify the trading center whose quotations are bypassed. The notice can be sent by electronic mail and must be sent immediately upon use of the exception. The self-help notice is intended to give the bypassed trading center an opportunity to assess whether its systems are in fact malfunctioning. For example, if a trading center receives many self-help notices in a short period of time, they provide strong evidence that it is, in fact, the trading center's systems that have a problem. The notice requirement also is generally intended to facilitate communications between the electing trading center and the bypassed trading center that could help identify the source of the problem and promote its resolution. To meet this objective, the notice should, at a minimum, provide a mechanism for communication with someone at the electing trading center who will be able to respond to inquiries concerning the notice. As noted in the response to Question 4 above, automated trading centers that display protected quotations also must provide a mechanism for receiving self-help notifications, as well as assign personnel to monitor the receipt of such notifications on a real-time basis so that potential systems problems can be promptly evaluated and appropriately addressed.

Systems Assessment and Response. When an order-router fails to receive immediate responses to IOC orders from the destination trading center, the precise source of the problem often may not immediately be clear. The problem could be located in the internal systems of the destination trading center, but it also could be located in the internal systems of the order-router or in the connections that the order-router used to access the destination trading center. An order-router that elects to use the self-help exception cannot simply assume that a problem lies elsewhere. The order-router must assess whether the cause of a problem lies with its own systems or connections and, if so, take immediate steps to resolve the problem appropriately.[16]

Objective Parameters. The NMS Release states that a trading center must adopt objective parameters to govern its use of the self-help exception, noting that the repeated failure of a destination trading center to respond within one second to an incoming IOC order (after adjusting for order transmission time) would justify use of the exception.[17] Beyond this basic parameter of a repeated failure to turn around an IOC order within one second, trading centers are free to adopt reasonable policies and procedures that are consistent with the flexible purposes of the self-help exception. Such policies and procedures should address the specific circumstances that will trigger the exception, the stock or stocks that will be affected, and the specific circumstances that will terminate the exception. In recent years, many market participants have developed best-price routing practices and have considerable experience in dealing with trading centers when systems problems occur. The Staff anticipates that many of the policies and procedures already developed to deal with systems problems will qualify as reasonable parameters for use of the self-help exception. To promote clear, consistent, and efficient use of the exception, the Staff is willing to discuss specific parameters with market participants and to offer further guidance on the reasonableness of such parameters.

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16 See NMS Release, 70 FR at 37522.

17 70 FR at 37519, 37535.

Question 25: Aside from the self-help exception, does an order-router have any flexibility in addressing a failure by an automated trading center to provide an immediate response to an IOC order?

Answer: Yes, but only in the limited context of a failure to provide an immediate response to a specific protected quotation. The NMS Release notes that, as part of its policies and procedures to reasonably prevent trade-throughs, a trading center that routed an order to another trading center to access the full displayed size of a protected quotation would be entitled to continue trading without regard to such quotation until a response was received to the order.[18] To the extent, however, that an order router wished to bypass the destination trading center's protected quotations more generally, it would be required to use the self-help exception.

Question 26: In the national market system, trading centers across the U.S. simultaneously display quotations and execute trades in the same NMS stocks. Given the latencies in transmitting data among these trading centers, as well as among broker-dealers that route ISOs to execute against the protected quotations displayed by trading centers, how will regulators assess the compliance of trading centers and broker-dealers with Rule 611?

Answer: In the NMS Release, the Commission stated that, assuming a trading center has implemented reasonable policies and procedures for handling data (see Question 27 below), a trading center's compliance with Rule 611 "will be assessed based on the time that orders and quotations are received, and trades are executed, at that trading center."[19] The same standard will be used to assess the compliance of broker-dealers in routing ISOs under Rule 611(c).

The data that bears on Rule 611 compliance can be divided into three categories: (1) the order and trade data of each trading center or broker-dealer ("Firm"), with internal time stamps reflecting when it was processed by each Firm ("Firm-Specific Order and Trade Data"); (2) the protected quotation data received by each Firm, with internal time stamps reflecting when it was received by the Firm ("Firm-Specific Quotation Data"); and (3) the protected quotation and trade data of the Network processors, with time stamps assigned by such processors ("Network Data"). Assuming reasonable data handling policies and procedures, compliance by individual Firms with Rule 611 will be assessed based on Firm-Specific Order and Trade Data and Firm-Specific Quotation Data, and not on Network Data (the relevance of Network Data to Rule 611 is discussed in Question 29 below).

Question 27: What are examples of matters that need to be addressed in a Firm's data handling policies and procedures?

Answer: As noted in Question 26 above, compliance by individual Firms with Rule 611 will be based on that Firm's own data, assuming that the Firm has implemented reasonable data handling policies and procedures. Such policies and procedures should address latencies in obtaining protected quotation data from the sources of such data. The Firm should implement

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18 70 FR at 37521 n. 194, 37536 n. 321.

19 70 FR at 37523 n. 215.

reasonable steps to monitor such latencies on a continuing basis and take appropriate steps to address a problem immediately should one develop.

In addition, a Firm should adopt reasonable policies and procedures for synchronizing its internal clocks, to the extent that it uses different clocks to assign time-stamps to its order, trade, and quotation data. For example, different trading desks or systems at a Firm potentially could use different clocks to assign time-stamps to trades executed by such desks or systems, and these clocks could be different from the clock that is used to assign time stamps to protected quotations as they are received. The Firm should synchronize these internal clocks to enable the Firm to reasonably determine through its compliance procedures that the trading desks and order handling systems are executing trades and routing orders in compliance with Rule 611.

Question 28: An enormous volume of updates of protected quotations will be disseminated each trading day for the thousands of NMS stocks, particularly for actively traded stocks. Does Rule 611 require that each Firm maintain a comprehensive database of all Firm-Specific Quotation Data so that every trade and every routed ISO can be evaluated?

Answer: No, Rule 611 does not require Firms to maintain a comprehensive database of Firm-Specific Quotation Data if (1) the Firm has implemented reasonable policies and procedures that include periodic review of its compliance with Rule 611, and (2) retains sufficient Firm-Specific Quotation Data to demonstrate the reasonableness of its Rule 611 compliance reviews. The reasonableness of a particular Firm's compliance reviews will be assessed in light of its individual characteristics, including its volume of trading and routing. In general, however, Firms must conduct periodic reviews for specific time periods that are reasonably designed to test the effectiveness of a firm's policies and procedures for preventing trade-throughs and for complying with the Rule's exceptions. For these time periods, the Firm should maintain Firm-Specific Quotation Data so that the effectiveness of its policies and procedures can be adequately evaluated by regulatory authorities. For example, a Firm could randomly select three trading days per month for review (known only to its compliance personnel) and maintain all relevant "snapshots" of the Firm-Specific Quotation Data from those days that are necessary to demonstrate the reasonableness of its policies and procedures to regulators. Under existing regulatory requirements, Firms already are required to maintain their Firm-Specific Order and Trade Data.

Question 29: What is the relevance of Network Data for assessing compliance with Rule 611?

Answer: As noted in the response to Question 26 above, the Network processors disseminate to the public a stream of trade and quotation data, with time-stamps, for each NMS stock. In this respect, Network Data is unlike Firm-Specific Order and Trade Data and Firm-Specific Quotation Data, which will have time stamps that vary to some extent from Firm to Firm. As a result, Network Data constitutes a common reference point for quotations and trades in NMS stocks that will be readily available to the public, Firms, and regulatory authorities.

As discussed in the responses to Questions 26 and 27 above, the compliance of an individual Firm will be assessed based on the data it sees at the time it trades and routes orders, assuming it has implemented reasonable data handling policies and procedures. As a practical matter, however, Firms should be aware that Network Data, as the single available common reference point for quotations and trades in NMS stocks, may be used by regulatory authorities, as an initial matter, to gauge their compliance with Rule 611 generally.

For example, regulatory authorities may examine the Network data for comparable Firms to assess whether any Firm has an exceptionally high trade-through rate. If so, the relevant regulatory authority is likely to contact such Firm and ask for an explanation. At this point, the focus will shift from Network Data to (1) the reasonableness of the Firm's policies and procedures, particularly for handling data and reviewing for compliance with Rule 611, and (2) the Firm-Specific Order and Trade Data and the Firm-Specific Quotation Data that support the results of the Firm's compliance reviews. The Firm will want to be in a position to demonstrate that its policies and procedures are reasonable. For example, it could present Firm-specific data from its periodic compliance reviews showing that trades that might appear to be trade-throughs in the Network data are in fact "false positives" that were not trade-throughs at the Firm.

Firms also should recognize that the widely available Network Data could be a valuable external tool for assessing the effectiveness of their internal policies and procedures. For example, an examination of the Network Data might reveal particular types of stocks, times of day, or types of trading conditions in which the Firm appears to generate a high rate of trade-throughs. The Firm could use this information to fashion its compliance reviews to assess these specific potential problem areas. Such compliance reviews could reveal that the trade-throughs in the Network Data are false positives, as well as the explanation for why they appear to be trade-throughs in the Network Data. Conversely, compliance reviews targeted on the problem areas may reveal weaknesses in the Firm's policies and procedures that the Firm could correct with timely action. In either case, policies and procedures that include the use of Network Data may enable the Firm to provide a more effective response to regulatory inquiries.

Question 30: To what extent do Rule 610 and Rule 611 apply outside of regular trading hours?

Answer: The definition of "trade-through" in Rule 600(b)(77) is limited to trades during "regular trading hours." The term "regular trading hours" is defined in Rule 600(b)(64) as the time between 9:30 a.m. and 4:00 p.m. Eastern Time.[20] Accordingly, a trading center's policies and procedures under Rule 611 are not required to address trades that occur outside of regular trading hours, and the exceptions in Rule 611(b), including the ISO exception, are not needed outside of regular trading hours.

In contrast, the definition of "automated quotation" in Rule 600(b)(3) is not limited to a particular time period. A trading center that chooses to identify its quotations as "automated" outside of regular trading hours must comply with the requirements specified in the Rule 600(b)(3) for automated quotations. In addition, the access requirements of Rule 610(a), (b), and

[20] Rule 600(b)(64) provides that regular trading hours can be changed to other times by the procedures established pursuant to Rule 605(a)(2). To date, these procedures have not been used to alter the 9:30 to 4:00 time period.

(c) are not limited to regular trading hours. Note, however, that the fee limitations of Rule 610(c) apply (either directly or through the definition of "protected quotation" in Rule 600(b)(57)) only to quotations that are the best bids and best offers of an exchange, Nasdaq, or the ADF. Accordingly, the limitations are not operative when these entities are not disseminating a best bid or best offer.

Question 31: Rule 612 of Regulation NMS generally prohibits sub-penny quoting in NMS stocks, except for quotations with a price of less than $1.00 per share. How will protected quotations in increments of less than $0.01 be handled under Rule 611?

Answer: The Staff believes that Rule 611 should reflect the very small minimum pricing increments allowed by Rule 612 for quotations that are priced at less than $1.00 per share. Such quotations can be priced in increments as small as $0.0001. Potentially, intermarket price priority for displayed quotations would be much less workable and efficient if it were fully applicable to sub-penny quotations. The Staff therefore intends to recommend that the Commission adopt an exemption under Rule 611 providing that trade-throughs need not be prevented of protected quotations priced less than $1.00 that are less than one full penny superior to the trade price. In addition, ISOs would not need to not be routed to execute against any protected quotations priced less than $1.00 that are less than one full penny superior to an ISO's limit price.

Question 32: Exchange Act Rule 10a-1, which addresses short sales in exchange-registered securities, permits an exchange to adopt a short-sale rule that uses a tick test based on the last sale effected on that exchange, rather than a tick test based on the consolidated last sale reported pursuant to an effective transaction reporting plan. As a result, it is possible for such an exchange to receive a short sale order at a price that would be executable under Rule 10a-1 on that exchange, but not executable under Rule 10a-1 at another trading center using the consolidated tick test that was displaying a protected bid at a higher price. How should the exchange handle the short sale order?

Answer: Given that the short sale order would be executable at the exchange at a lower price than the protected quotation at the other trading center, the exchange would be allowed to route an ISO to the other trading center that was marked as a "short exempt" order, thereby freeing the other trading center to execute the order at the higher price of its protected bid without regard to the tick restrictions of Rule 10a-1.

Question 33: Rule 610(d) requires each of the SROs to adopt rules addressing locking and crossing quotations. Will the SROs adopt a consistent approach in developing their rules?

Answer: The staff is working with the SROs to achieve reasonable industry-wide standards for their rules addressing locking and crossing quotations. For example, the NMS Release noted that it would be reasonable for the SROs to include exceptions in their rules equivalent to those included in Rule 611(b).[21] The Staff anticipates that the SROs soon will file proposed rule changes that adopt a consistent approach to locking and crossing quotations. The proposed rule

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[21] NMS Release, 70 FR at 37547-37548 & n. 445.

changes will be published for public notice and comment prior to any Commission action on them.

Question 34: The NMS Release specifies two phase-in periods for Rule 610 and Rule 611 – the first for 250 NMS stocks with a compliance date of June 29, 2006 and the second for all remaining NMS stocks with a compliance date of August 31, 2006. Prior to the first compliance date for Rule 611, will market participants have an opportunity to gain experience with the new NMS order types, quotation identifiers, and trade identifiers, as well as the new trading systems currently being developed to comply with Regulation NMS at various trading centers?

Answer: The Staff believes that it would be beneficial for market participants to have an opportunity to gain experience with new NMS order-handling, quoting, and trading procedures, prior to the date on which market participants must begin to comply with the requirements of Rule 611. Accordingly, it intends to recommend to the Commission that, at least one month prior to the initial compliance date for the Rule, a moratorium be placed on the introduction of new quotation and trade identifiers in the Network data streams, as well as on the introduction of new trading systems by SROs or ADF participants that would create new sources of protected quotations. Such a moratorium would provide a useful opportunity for market participants to gain practical experience with the new NMS trading environment, as well as allow market participants to test their policies and procedures for compliance with Rule 611.