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December 7, 2000

TO: **All PCX Members and Member Organizations**

FROM: **Department of Regulatory Policy**

SUBJECT: **New SEC Rule on Disclosure of Order Execution and Routing Practices (Release No. 34-43590; File No. S7-16-00)**

On November 17, 2000, the SEC adopted two new rules that are intended to improve public disclosure of order execution and routing practices. Under new SEC Rule 11Ac1-5, market centers that trade national market system securities will be required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality. Under new SEC Rule 11Ac1-6, broker-dealers that route customer orders in equity and option securities will be required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. In addition, broker-dealers will be required to disclose to customers, on request, the venues to which their individual orders were routed.

A. SEC Rule 11Ac1-5 – Disclosure of Order Execution Information

1. Introduction

Under this new rule, market centers will be required to prepare and make available to the public monthly reports in electronic form that categorize their order executions and include statistical measures of execution quality. The rule defines the term "market center" as any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association. The SEC anticipates that the reporting entity for the vast majority of orders will be an exchange specialist, OTC market maker, or ATS. Although specialists and market makers frequently operate under the auspices of an SRO (and such an SRO likely will assist its members in meeting the disclosure requirements of the new rule), the responsibility for executing orders generally is handled by the individual firms, and execution quality may vary significantly among them.

To facilitate comparisons across market centers, the Rule adopts basic measures of execution quality (including effective spread, rate of price improvement and disimprovement, fill rates, and speed of execution) and sets forth specific instructions on how the measures are to be calculated.

2. Covered Orders

The new rule applies only to market orders and limit orders that are received and executed by a market center during "regular trading hours" (i.e., between 9:30 a.m. and 4:00 p.m. Eastern Time). Covered orders include only those received during the time that a consolidated BBO is being disseminated. Types of orders that are excluded are those for which the customer has requested special handling, including: orders to be executed at a market opening or closing price, stop orders, short sales, "not held" orders, orders for other than regular settlement, orders to be executed at prices unrelated to the market price at the time of execution, and all-or-none orders. The SEC has determined that immediate-or-cancel orders should be included as covered orders. In addition, the new rule applies only to "national market system" securities; it does not apply to Nasdaq SmallCap securities, Over-the-Counter Bulletin Board securities or exchange-listed options.

3. Required Information

The rule requires market center reports to be categorized by individual security, order type and order size. The five types of orders are: market, marketable limit, inside-the-quote limit, at-the-quote limit and near-the-quote limit. The four "buckets" of order size are: 100-499, 500-1999, 2000-4999 and 5000 or more shares. The rule also requires disclosure of the number of shares cancelled prior to execution and the number of shares executed at both the receiving market center and at any other venue (after being routed elsewhere by the receiving market center). All statistical measures of order execution must include both orders that were executed at the receiving market center and orders that were executed elsewhere.

The reports must also specify the number of shares that were specified within specified periods of time after order receipt (such as "from 0 to 9 seconds" and "from 10 to 29 seconds"). They must also provide information for all order types on the "average realized spread," which is calculated by comparing the execution price of an order with the mid-point of the consolidated BBO as it stands five minutes after the time of order execution. Finally, the reports must provide an additional nine categories of information on market and marketable limit orders. These include the "average effective spread," which is calculated by comparing the execution price of an order with the midpoint of the consolidated BBO at the time of order receipt. In addition, orders are classified based on whether they were "executed with price improvement," "executed at the quote" or "executed outside the quote." For orders that were executed with price improvement or executed outside the quote, market centers must disclose the number of shares, the average amount per share of price improvement (or price disimprovement), and the average speed of execution. For orders executed at the quote, market centers must disclose the number of shares and the average speed of execution.

4. Procedures for Disclosure

The rule directs the SROs to act jointly in establishing procedures for market centers to follow in making their monthly reports available to the public in a readily accessible, uniform, and usable electronic format. Market centers must comply with the rule according to the phase-in schedule set forth below. The SROs must prepare and submit a joint national market system plan to the SEC for approval no later than February 15, 2001.

5. Compliance Dates

The first phase-in of securities subject to the new rule will begin on Monday, April 2, 2001. As of this date, the Rule will apply to the 1000 NYSE securities, 1000 Nasdaq securities, and 200 Amex securities with the highest average daily share volume for the quarter ending December 31, 2000. On this first phase-in date, market centers must begin collecting the necessary data to prepare their monthly reports. In addition, they must make their first report, for April 2001, available by the end of May 2001. The second phase-in date will be July 2, 2001. From this date forward, the Rule will apply to the next 1000 NYSE securities, the next 1000 Nasdaq securities, and the next 200 Amex securities with the highest average daily share volume for the quarter ending March 31, 2001. The third and final phase-in of Rule 11Ac1-5 will begin on October 1, 2001. From this date forward, the Rule will apply to all national market system securities.

B. SEC Rule 11Ac1-6 – Disclosure of Order Routing Information

1. Introduction

Under this new rule, a broker-dealer that routes orders on behalf of customers will be required to prepare quarterly reports that disclose the identity of the venues to which it routed orders for execution. The reports also will disclose the nature of the broker-dealer's relationship with those venues, including the existence of any internalization or payment for order flow arrangements. Finally, broker-dealers will be required to disclose, on customer request, where they routed a customer's individual orders for execution.

2. Scope of Rule

The definition of "covered security" under this new rule includes not only national market system securities (i.e., exchange-listed equities and Nasdaq National Market equities), but also Nasdaq SmallCap equities and listed options. The term "customer order" is defined 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.

The new rule applies to all types of orders (including, for example, pre-opening orders and short sale orders), but broker-dealers must give an overview of their routing practices only for "non-directed orders," which are defined as any customer order other than a directed order. A “directed order” is defined, in turn, as a customer order that the customer specifically instructs the broker-dealer to route to a particular venue for execution.

3. Quarterly Reports

The new rule requires broker-dealers to make publicly available for each calendar quarter a report on its routing of non-directed orders in covered securities. The term "make publicly available" is defined to require broker-dealers to perform three actions -- post on a free Internet web site, furnish a written copy on request, and notify customers at least annually that a written copy will be furnished on request. A quarterly report must be made publicly available within one month after the end of the quarter addressed in the report.

The rule requires that a quarterly report be divided into four separate sections for four different types of covered securities -- one for equity securities listed on the NYSE, one for equity securities qualified for inclusion in Nasdaq, one for equity securities listed on the Amex or any other national securities exchange, and one for options.

A broker-dealer's quantitative description of order routing must include the percentage of total customer orders for a particular section that were non-directed orders, and the percentages of total non-directed orders for a section that were market orders, limit orders, and other orders.

For each of the venues identified in each section of the report, the broker-dealer must disclose the percentage of total non-directed orders for the section routed to the venue, and the percentages of total non-directed market orders, non-directed limit orders, and non-directed other orders for the section that were routed to the venue.

Under the new rule, a broker-dealer also will be required to discuss the material aspects of its relationship with each venue identified in each section of the report, including a description of any payment for order flow arrangement or profit-sharing relationship as it relates to the type of securities for that section. 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.

Although the new rule does not require an estimate of the aggregate dollar amount of payment for order flow, a broker's description of a payment for order flow arrangement must include disclosure of the material aspects of the arrangement. These would include a description of the terms of the arrangement, such as any amounts per share or per order that the broker receives. Similarly, in describing a profit-sharing relationship, a broker will be expected to disclose the extent to which it could share in profits derived from the execution of non-directed orders.

Finally, the new rule requires broker-dealers, on request of a customer, to disclose to the 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. Broker-dealers must notify their customers at least annually of their option to request such information.

4. **Effective Dates and Phase-In of Compliance Dates**

Broker-dealers must comply with the new rule for all covered securities on July 2, 2001. Accordingly, a broker-dealer's first report, for the quarter beginning in July and ending in September, must be made publicly available by the end of October 2001. In addition, broker-dealers will be required to respond to customer requests for information on orders that were routed on July 2, 2001, and after.

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The text of the SEC's order approving the new rules is available on the SEC's website (www.sec.gov) by clicking on "Final Rules" under "Current SEC Rulemaking." Questions regarding this Bulletin may be directed to Michael Pierson at (415) 393-4107.