

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57620)

April 4, 2008

Order Modifying the Exemption for Qualified Contingent Trades from Rule 611(a) of Regulation NMS under the Securities Exchange Act of 1934

I. Introduction

Pursuant to Rule 611(d)¹ of Regulation NMS² under the Securities Exchange Act of 1934 (“Exchange Act”), the Securities and Exchange Commission (“Commission”), by order, may exempt from the provisions of Rule 611 of Regulation NMS (“Rule 611” or “Rule”), either unconditionally or on specified terms and conditions, any person, security, transaction, quotation, or order, or any class or classes of persons, securities, quotations, or orders, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.³ On August 31, 2006, the Commission granted an exemption for qualified contingent trades from Rule 611(a) (“QCT Exemption”).⁴ As discussed below, the Commission is modifying the QCT Exemption to remove the minimum size limitation that was included in the exemption as originally granted.

II. Background

The Commission adopted Regulation NMS in June 2005.⁵ Rule 611 addresses intermarket trade-throughs of quotations in NMS stocks.⁶ The Rule applies only to quotations

¹ 17 CFR 242.611(d).

² 17 CFR 242.600 *et seq.*

³ See also 15 U.S.C. 78mm(a)(1) (providing general authority for Commission to grant exemptions from provisions of Exchange Act and rules thereunder).

⁴ Securities Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006) (“QCT Exemptive Order”).

⁵ Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (“Regulation NMS Adopting Release”).

that are immediately accessible through automatic execution. On August 31, 2006, the Commission granted the QCT Exemption for any trade-throughs caused by the execution of an order involving one or more NMS stocks (each an “Exempted NMS Stock Transaction”) that are components of a qualified contingent trade.⁷ In the QCT Exemptive Order, the Commission defined a “qualified contingent trade” as a transaction consisting of two or more component orders, executed as agent or principal, where:

- (1) at least one component order is in an NMS stock;
- (2) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent;
- (3) the execution of one component is contingent upon the execution of all other components at or near the same time;
- (4) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined at the time the contingent order is placed;
- (5) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since cancelled;⁸

⁶ An “NMS stock” means any security or class of securities, other than an option, for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan. See 17 CFR 242.600(b)(46) and (47).

⁷ QCT Exemptive Order, 71 FR at 52831.

⁸ Transactions involving securities of participants in mergers or with intentions to merge that have been announced would meet this aspect of the exemption. Transactions involving cancelled mergers, however, would constitute qualified contingent trades only

- (6) the Exempted NMS Stock Transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade;⁹ and
- (7) the Exempted NMS Stock Transaction that is part of a contingent trade involves at least 10,000 shares or has a market value of at least \$200,000 (“Size Condition”).¹⁰

The Chicago Board Options Exchange, Inc. (“CBOE”) has requested that the Commission modify the QCT Exemption by removing the Size Condition.¹¹ According to the CBOE Exemption Request, market participants find contingent trades to be an efficient means to effect coupled executions in an option and the underlying stock based on the pricing spread between the two instruments. CBOE notes that a large percentage of these contingent trade orders end up unexecuted due to a variety of factors. CBOE states that one of the factors impeding the execution of contingent trades is the Size Condition. Contingent trades involving a stock size under 10,000 shares (or \$200,000) cannot be executed if the stock leg would trade through an automated trading center’s protected quote.¹² CBOE notes that, due to the need to price the trade based on the spread between the option and stock leg more so than on current

to the extent they involve the unwinding of a pre-existing position in the merger participants’ shares. Statistical arbitrage transactions, absent some other derivative or merger arbitrage relationship between component orders, would not satisfy this element of the definition of a qualified contingent trade.

⁹ A trading center may demonstrate that an Exempted NMS Stock Transaction is fully hedged under the circumstances based on the use of reasonable risk-valuation methodologies.

¹⁰ See 17 CFR 242.600(b)(9) (defining “block size” with respect to an order as at least 10,000 shares or \$200,000 in market value).

¹¹ Letter to Nancy M. Morris, Secretary, Commission, from Edward J. Joyce, President and Chief Operating Officer, CBOE, dated November 28, 2007 (“CBOE Exemption Request”).

¹² See CBOE Exemption Request at 3.

market quotations for the stock, a contingent trade of a modest size may still have the stock leg priced outside of a protected quotation. In CBOE's experience, the Size Condition is a factor that will continue to make it more difficult to complete smaller-sized contingent trades. CBOE believes that this impediment has a greater impact on individual investors who want to effect a buy-write transaction of modest size than on institutional investors, who tend to trade in much larger share amounts.¹³

CBOE states that, if the Size Condition is removed, the other conditions – conditions (1) through (6) above - in the QCT Exemption would continue to ensure that eligible contingent trades are not used in an abusive manner to avoid compliance with Rule 611. CBOE believes that the Commission primarily focused on these conditions when it found that the exemption was narrowly drawn to encompass only those trades most in need of relief to remain part of a viable trading strategy and where execution of the NMS stock component at a trade-through price is reasonably necessary to effect the contingent trade. CBOE notes that the Commission believed that conditions (1) through (6) of the exemption require a close connection between any Exempted NMS Stock Transaction and the other components of a qualified contingent trade, and that this close connection should both significantly limit the number of Exempted NMS Stock Transactions and help assure that the exemption applies only to those trades most in need of flexibility to be executed efficiently. Finally, CBOE believes that a key rationale behind the Qualified Contingent Trade Exemption is that contingent trades are not priced based on current market quotations, but rather the pricing relationship between two related instruments. CBOE believes that the rationale holds as true for a small contingent trade that meets all the requirements of the exemption as it does for a large trade. In this regard, CBOE notes that the

¹³ Id. A buy-write transaction, for example, involves the execution of a stock transaction and a corresponding options transaction.

Commission recently approved a proposed rule change of the options exchanges to amend the definition in the Intermarket Linkage Plan of “complex trade”, which is exempt from trade through liability, to include stock-option trades.¹⁴ CBOE states that the rule change does not set a size minimum for a stock-option trade to be exempt from trade through liability.¹⁵

CBOE therefore believes that the QCT Exemption, even without the Size Condition, would continue to be in the public interest and consistent with the protection of investors. In this regard, CBOE believes that the proposed modification to the exemption would not change the many benefits that contingent trades provide to the market. At the same time, CBOE states that the remaining conditions from the exemption will continue to ensure that the exemption is narrowly drawn to prevent evasion of Rule 611 and that the exemption is limited to a small number of transactions. CBOE believes that removing the Size Condition will not result in a large increase in the number of transactions being exempted from Rule 611 because smaller contingent trades represent a very small portion of the overall amount of stock executions in listed stocks.¹⁶

III. Discussion

After careful consideration and for the reasons discussed in this order, the Commission hereby modifies the QCT Exemption by removing the Size Condition. A “qualified contingent trade” now is defined as a transaction consisting of two or more component orders, executed as agent or principal, where:

- (1) at least one component order is in an NMS stock;

¹⁴ See Securities Exchange Act Release No. 56761 (November 7, 2007), 72 FR 64094 (November 14, 2007).

¹⁵ CBOE Exemption Request at 4.

¹⁶ Id.

- (2) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent;
- (3) the execution of one component is contingent upon the execution of all other components at or near the same time;
- (4) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined at the time the contingent order is placed;
- (5) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since cancelled;¹⁷ and
- (6) the Exempted NMS Stock Transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade.¹⁸

The Commission notes that a trading center must meet all of the foregoing elements of a qualified contingent trade to qualify for the exemption. The exemption is not restricted to dealers or the over-the-counter market. It can be used by any trading center that meets the terms of the exemption.

¹⁷ Transactions involving securities of participants in mergers or with intentions to merge that have been announced would meet this aspect of the exemption. Transactions involving cancelled mergers, however, would constitute qualified contingent trades only to the extent they involve the unwinding of a pre-existing position in the merger participants' shares. Statistical arbitrage transactions, absent some other derivative or merger arbitrage relationship between component orders, would not satisfy this element of the definition of a qualified contingent trade.

¹⁸ A trading center may demonstrate that an Exempted NMS Stock Transaction is fully hedged under the circumstances based on the use of reasonable risk-valuation methodologies.

The Commission recognizes that contingent trades can be useful trading tools for investors and other market participants, particularly those who trade the securities of issuers involved in mergers, different classes of shares of the same issuer, convertible securities, and equity derivatives such as options. Those who engage in contingent trades can benefit the market as a whole by studying the relationships between the prices of such securities and executing contingent trades when they believe such relationships are out of line with what they believe to be fair value. Contingent trades therefore are one example of a wide variety of trades that contribute to the efficient functioning of the securities markets and the price discovery process.

As discussed in the QCT Exemptive Order,¹⁹ the Commission believes that qualified contingent trades potentially could become too risky and costly to be employed successfully if they were required to meet the trade-through provisions of Rule 611. Absent an exemption, participants in contingent trades often would need to use the Rule's intermarket sweep order exception and route orders to execute against protected quotations with better prices than an NMS stock component of the contingent trade. Any executions of these routed orders could throw the participants "out of hedge" and necessitate additional transactions in an attempt to correct the imbalance. As a practical matter, the difficulty of maintaining a hedge, and the risk of falling out of hedge, could dissuade participants from engaging in contingent trades, or at least raise the cost of such trades. The elimination or reduction of this trading strategy potentially could remove liquidity from the market. The Commission therefore determined to exempt qualified exempted trades from Rule 611.²⁰

¹⁹ 71 FR at 52831.

²⁰ Id.

To minimize the effect of the QCT Exemption on the objectives of Rule 611, it was narrowly drawn to encompass only those trades most in need of relief to remain part of a viable trading strategy and where execution of the NMS stock component at a trade-through price is reasonably necessary to effect the contingent trade. In particular, elements (1) through (6) of the exemption, as set forth above, require a close connection between any Exempted NMS Stock Transaction and the other components of a qualified contingent trade. This close connection both significantly limits the number of Exempted NMS Stock Transactions and helps assure that the exemption applies only to those trades most in need of flexibility to be executed efficiently. For example, the execution of one component of the transaction must be contingent upon the execution of all other components at or near the same time, and the Exempted NMS Stock Transaction must be fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade.²¹ In addition, there must be a specified relationship between the instruments involved in the component orders. The component orders must bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since cancelled.²² The QCT Exemption does not apply to contingent trades, such as statistical arbitrage transactions, if their components do not involve instruments with a specified relationship.

²¹ The requirement that an Exempted NMS Stock Transaction be fully hedged should significantly limit the scope of the exemption. For example, a contingent trade would not qualify for the exemption if an NMS stock transaction was the purchase or sale of 50,000 shares, and the only other component was the purchase or sale of a small quantity of options on the NMS stock. A trading center may demonstrate that an Exempted NMS Stock Transaction is fully hedged under the circumstances based on the use of reasonable risk-valuation methodologies.

²² Transactions involving cancelled mergers would be qualified contingent trades only to the extent that they involve the unwinding of a pre-existing position in the merger participants' shares.

In the QCT Exemptive Order,²³ the Commission noted that the Size Condition further limited the QCT Exemption to those transactions where an exemption is likely to be most needed to facilitate the trading strategies of informed customers. As a national securities exchange with extensive experience in executing contingent options and stock transactions, CBOE notes that the Size Condition in practice has served to inhibit retail investors from engaging in buy-write transactions of modest size.²⁴ This type of options strategy can be suitable for a broad range of investors, and the Commission does not wish unnecessarily to inhibit retail investors from engaging in useful investment strategies that are available to those who trade in larger size. In addition, there are existing duties that brokers owe their customers, such as suitability and best execution of contingent stock and options transactions. The Commission therefore has decided to remove the Size Condition from the QCT Exemption to enable the use of a wider range of options strategies for retail investors. In this way, buy-write strategies, as well as other contingent trade strategies, will not be hampered by the terms of the QCT Exemption and will be more readily available to those for whom such strategies are useful and appropriate. In addition, removing the Size Condition, by expanding the range of investors who can take advantage of the QCT Exemption, potentially could promote competition among trading centers.

The Commission does not believe that removing the Size Condition will result in the use of contingent trades to evade the requirements of Rule 611. Elements (1) through (6) of the exemption, as set forth above, are sufficient to encompass only those trades most in need of relief to remain part of a viable trading strategy and where execution of the NMS stock component at a trade-through price is reasonably necessary to effect the contingent trade.

²³ 71 FR at 52831.

²⁴ CBOE Exemption Request at 3.

Accordingly, the QCT Exemption, as modified, should provide appropriate relief in those circumstances where compliance with Rule 611 could be most difficult as a practical matter, but also is limited to a small number of transactions that should not unduly undermine the objectives of Rule 611.²⁵ In this regard, the Commission notes that the exemption, as discussed in the QCT Exemptive Order, is premised on an expectation that qualified contingent trades will continue to be used for essentially the same valid trading purposes as they are currently. A material change in the nature or frequency of such trades could cause the Commission to reconsider the terms of the exemption.

For the foregoing reasons, the Commission finds that removing the Size Condition from the QCT Exemption is necessary and appropriate in the public interest, and is consistent with the protection of investors.

²⁵ See CBOE Exemption Request at 4 (representing that removal of the Size Condition will not result in a large increase in the number of transactions being exempted from Rule 611 because smaller contingent trades represent a very small portion of the overall amount of stock executions in listed stocks).

IV. Conclusion

IT IS HEREBY ORDERED, pursuant to Rule 611(d) of Regulation NMS, that the Size Condition is removed from the QCT Exemption.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁶

Florence E. Harmon
Deputy Secretary

²⁶ 17 CFR 200.30-3(a)(82).