

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54389)

August 31, 2006

Order Granting an 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 As discussed below, the Commission is exempting each NMS stock component of certain qualified contingent trades (as defined below) from Rule 611(a) of Regulation NMS.

II. Background

The Commission adopted Regulation NMS in June 2005.⁴ Rule 611 addresses intermarket trade-throughs of quotations in NMS stocks.⁵ 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 See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (“Regulation NMS Adopting Release”).

⁵ 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).

that are immediately accessible through automatic execution.

The Securities Industry Association (“SIA”) has requested that the Commission exempt certain qualified contingent trades from Rule 611(a) of Regulation NMS.⁶ According to the SIA Exemption Request, a contingent trade “is a multi-component trade involving orders for a security and a related derivative, or, in the alternative, orders for related securities, that are executed at or near the same time.”⁷ The SIA notes that the economics of a contingent trade are based on the relationship between the prices of the security and the related derivative or security, and that the execution of one order is contingent upon the execution of the other order. The SIA states that the sought-after spread or ratio between the relevant instruments is known and specified at the time of the order, and this spread or ratio stands regardless of the prevailing price at the time of execution. Therefore, the parties to these transactions are focused on the spread or ratio between the transaction prices for each of the component instruments, rather than on the absolute price of any single component instrument. Because the focus of such trades is on the relative prices of the component instruments, the price of a component of a particular trade may or may not correspond to the prevailing market price of the security. For contingent trades, the parties to the trade will not execute one side of the trade without the other component or components being executed in full (or in ratio) and at the specified spread or ratio.⁸

The SIA states that contingent trades play an important role in the investment and trading strategies of investors. They are the mechanism through which large institutional and broker-dealer proprietary traders enter and exit the market for many securities, including those that are

⁶ Letter to Nancy M. Morris, Secretary, Commission, from Andrew Madoff, SIA Trading Committee, SIA, dated June 21, 2006 (“SIA Exemption Request”).

⁷ SIA Exemption Request at 2.

⁸ See SIA Exemption Request at 2.

involved in a merger, those representing different classes of shares of the same issuer, those with convertible securities that are related to the common stock, and those with actively traded equity derivatives such as options.⁹ The SIA believes that, as a general rule, the market view on what constitutes an appropriate spread or ratio between related securities is less volatile than the quoted prices for the stocks that are part of these contingent trades and, consequently, contingent trades act as a stabilizing factor in the markets.¹⁰

To effectively execute a contingent trade, its component orders must be executed in full or in ratio¹¹ at its predetermined spread or ratio. According to the SIA, parties seeking to effect contingent trades involving NMS stocks in many instances would be able to comply with the Rule, but in other instances – such as trades involving two or more NMS stocks or circumstances in which there was insufficient flexibility to adjust the execution price of the non-NMS stock component of a contingent trade – compliance with Rule 611 would not be possible. In such instances, if the designated price of an NMS stock that was a component order of a proposed contingent trade was inferior to a protected bid or offer, as relevant, the Rule would require the better protected bids or offers to be satisfied prior to the execution of the NMS stock component of the contingent trade, thus preventing the trade from being executed in accordance with the original terms. The SIA believes that, by breaking up one or more components of the contingent trade and requiring that such component(s) be separately executed from the entire trade package and at prices inappropriate for the desired trading strategy, Rule 611 would effectively

⁹ See SIA Exemption Request at 2. In an appendix to its letter, the SIA provided detailed discussions of three types of contingent trades, namely, a risk or merger arbitrage transaction, a convertible security transaction, and a stock option transaction, and how these trades would be affected by Rule 611. See SIA Exemption Request at 8-12.

¹⁰ See SIA Exemption Request at 2-3.

¹¹ “In ratio” clarifies that component orders of a contingent trade do not necessarily have to be executed in full, but any partial executions must be in a predetermined ratio.

undermine the contingent aspect of the trade and leave one or more parties to the trade “out of hedge.”¹²

Without an exemption from Rule 611, the SIA believes that customers might be unable to complete contingent trades. In particular, dealers might be unable to commit capital to those customers who requested it, which could reduce or eliminate this type of trading activity and remove liquidity from the market. The SIA believes that such a result would disadvantage the market as a whole.¹³

In its exemption request, the SIA states that the requested relief is narrowly drawn, noting that the number of qualified contingent trades is small in comparison to the overall number of trades executed in NMS stocks. It therefore believes that the number of possible exempted trade-throughs would similarly be small. The SIA also noted that the requirement that the NMS stock component of a contingent trade be of block size further reduces the risk that the exemption will be used inappropriately for transactions of retail size.¹⁴

III. Discussion

After careful consideration and for the reasons discussed below, the Commission hereby grants an exemption from Rule 611(a) 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. A “qualified contingent trade” is 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;

¹² See SIA Exemption Request at 3.

¹³ See SIA Exemption Request at 4.

¹⁴ See SIA Exemption Request at 6.

- (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;¹⁵
- (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;¹⁶ and
- (7) the Exempted NMS Stock Transaction that is part of a contingent trade involves

¹⁵ Transactions involving securities of participants in mergers or with intentions to merge that have been announced would meet this aspect of the requested 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.

¹⁶ 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.

at least 10,000 shares or has a market value of at least \$200,000.¹⁷

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.

Rule 611 requires trading centers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs, or, if relying on one of the Rule's exceptions, that are reasonably designed to assure compliance with the exception.¹⁸ In addition, a trading center is required to regularly surveil to ascertain the effectiveness of its policies and procedures and to take prompt action to remedy deficiencies.¹⁹ The Rule also includes a number of exceptions, such as intermarket sweep orders²⁰ and orders executed at "benchmark" prices that were not reasonably determinable at the time the commitment to execute the order was made.²¹ Without an exemption, however, qualified contingent trades generally would be subject to the Rule.

As discussed in the Regulation NMS Adopting Release, the Commission previously considered comments favoring a general exception from the Rule for broad categories of transactions, variously described as "contingency" transactions, "arbitrage" transactions, "spread" transactions, and transactions priced with reference to derivatives.²² It noted, however,

¹⁷ 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).

¹⁸ See 17 CFR 242.611(a)(1).

¹⁹ See 17 CFR 242.611(a)(2).

²⁰ See 17 CFR 242.611(b)(5) and (6).

²¹ See 17 CFR 242.611(b)(7).

²² Regulation NMS Adopting Release, 70 FR at 37528.

that any exception for such a broad category of transactions potentially could unduly detract from the objectives of Rule 611. Therefore, when adopting Regulation NMS, the Commission stated that the most appropriate process to handle suggestions that specific types of transactions should be excluded from the coverage of the Rule would be through the exemptive procedure set forth in paragraph (d) of the Rule.

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. 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 has determined to exempt qualified exempted trades from Rule 611.

To minimize the effect of an exemption on the objectives of Rule 611, the exemption is 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 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. 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.²³ 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

²³ 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.

have been announced or since cancelled.²⁴ The exemption does not apply to contingent trades, such as statistical arbitrage transactions, if their components do not involve instruments with a specified relationship. Finally, the Exempted NMS Stock Transaction must be of block-size, involving at least 10,000 shares or having a market value of at least \$200,000. This element further limits the exemption to those transactions where an exemption is likely to be most needed to facilitate the trading strategies of informed customers.

Accordingly, the exemption 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 exception 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 and as described in the SIA Exemption Request. 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 granting an exemption from Rule 611 for qualified contingent trades, as defined above, is necessary and appropriate in the public interest, and is consistent with the protection of investors.

²⁴ 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.

²⁵ See SIA Exemption Request at 5-6 (representing that the number of qualified contingent trades is small in comparison to the overall number of trades executed in NMS stocks and, therefore, the overall number of possible exempted trade-throughs is similarly small).

IV. Conclusion

IT IS HEREBY ORDERED, pursuant to Rule 611(d) of Regulation NMS, that each NMS stock component of qualified contingent trades, as defined above, shall be exempt from Rule 611(a) of Regulation NMS.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁶

Nancy M. Morris
Secretary

²⁶ 17 CFR 200.30-3(a)(82).