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# Securities Law Developments

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## NEW SEC RULES ON REQUIRED DISCLOSURES FOR EQUITIES AND OPTIONS

On November 15, 2000, the Securities and Exchange Commission (“SEC” or “Commission”) adopted new Rules 11Ac1-5 and 11Ac1-6 under the Securities Exchange Act of 1934 (“Exchange Act”) to improve public disclosure of order execution and routing practices.<sup>1</sup> The Commission also amended Rule 11Ac1-1 under the Exchange Act and adopted new Rule 11Ac1-7 under the Exchange Act in an effort to better facilitate the ability of market participants to obtain the best price for customer orders in exchange-traded options.<sup>2</sup>

### **I. Order Execution and Routing Disclosures**

In its February 2000 “Fragmentation Release,” the SEC described various methods of reducing fragmentation in the equity markets, ranging from increased disclosure of order routing and execution practices to the creation of a single national market linkage requiring price/time priority for all displayed trading interest.<sup>3</sup> After a lengthy study of the fragmentation issue, the Commission concluded that “increased public disclosure of execution quality and order routing practices is a minimum step necessary to address fragmentation.”<sup>4</sup> Therefore, the Commission moved forward in July 2000 by proposing the adoption of two new rules under the Exchange Act.<sup>5</sup>

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<sup>1</sup> *Disclosure of Order Execution and Routing Practices*, Exchange Act Release No. 43590, 65 Fed. Reg. 75414 (Dec. 1, 2000), available at <http://www.sec.gov/rules/final/34-43590.htm> (“Equities Adopting Release”).

<sup>2</sup> *Firm Quote and Trade-Through Disclosure Rules for Options*, Exchange Act Release No. 43591, 65 Fed. Reg. 75439 (Dec. 1, 2000), available at <http://www.sec.gov/rules/final/34-43591.htm> (“Options Adopting Release”).

<sup>3</sup> *Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation*, Exchange Act Release No. 42450, 65 Fed. Reg. 10577 (Feb. 28, 2000) (“Fragmentation Release”).

<sup>4</sup> Equities Adopting Release (see note 1).

<sup>5</sup> *Disclosure of Order Routing and Execution Practices*, Exchange Act Release No. 43084, 65 Fed. Reg. 48406 (Aug. 8, 2000).

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By a 4-0 vote at its November 15th open meeting, the Commission adopted these two new rules, numbered 11Ac1-5 and 11Ac1-6. Together, the rules are designed to increase public investors' opportunities to evaluate the handling of their orders after submission to a broker-dealer for execution. Moreover, by making more visible the execution quality of the securities markets, the rules are intended to spur competition among market centers and broker-dealers to provide investors the best possible price and speed of execution.

Rule 11Ac1-5 will be effective January 30, 2001. Market centers must comply with the rule according to a phase-in schedule, where the first phase-in of securities subject to the rule will begin on April 2, 2001. Rule 11Ac1-6 also is effective on January 30, 2001. Broker-dealers must comply with the 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.

#### **A. Rule 11Ac1-5**

As the Commission noted in the Equities Adopting Release, few market centers today provide detailed public disclosure concerning their execution quality. Therefore, the Commission adopted Rule 11Ac1-5 to assure that all market centers publicly disclose, on a monthly basis, basic standardized information concerning their handling and execution of orders. The Commission believes that the categories of data included in the reports will most likely be useful to the general public only after being distilled by professional market analysts.

The Rule directs the self-regulatory organizations (SROs) to develop and submit to the Commission a joint plan by February 15, 2001 to set procedures for uniform, accessible distribution of reports. In the event that the joint-SRO plan has not been approved by the Commission prior to the compliance date, the market centers must prepare their reports in a consistent, usable, and machine-readable electronic format, and make the reports available on an Internet website that is free and readily accessible to the public.

#### **1. Scope of the Reporting Requirement**

Rule 11Ac1-5 provides that every market center shall make available for each calendar month, in accordance with the procedures established in the rule, an electronic report on the covered orders in national market system securities that it received for execution from any person. By its terms, the rule is limited in scope to market centers, national market system securities, and covered orders.

Rule 11Ac1-5 defines the term "market centers" to include any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association. Moreover, only national market system securities are covered by the rule. Therefore, Nasdaq SmallCap, OTC Bulletin Board securities, and exchange-listed options are excluded.

Relatedly, "covered orders" consist of market orders or limit orders (including immediate-or-cancel orders) that are received by a market center during regular trading hours and, if executed, executed during such time. To be considered a covered order, an order must be received during the

time that a consolidated BBO is being disseminated.<sup>6</sup> The definition of covered order excludes any orders for which the customer requests special handling for execution and that, if not executed, could skew general statistical measures of execution quality. Examples of excluded orders include orders to be executed at a market opening or closing price, stop orders, orders such as short sales that must be executed on a particular tick or bid, orders submitted on a “not held” basis, 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.

## 2. Disclosure of Measures of Execution Quality

The Rule provides that order information for each individual security must be broken down into five order types and four order sizes so that execution quality can be reported for each. The categories of order types are market, marketable limit, inside-the-quote limit, at-the-quote limit, and near-the-quote limit (which is defined as orders that are ten cents below the bid at receipt time for a buy order and ten cents above for a sell order).<sup>7</sup> The order sizes are categories of 100-499 shares, 500-1999 shares, 2000-4999 shares, and 5000 shares and up.

For all covered order types, the following data must be disclosed:

- ?? The number of covered orders.
- ?? The cumulative number of shares.
- ?? The cumulative number of shares of covered orders (1) cancelled before execution; (2) executed at the receiving market center; or (3) executed at another venue. All other categories of data reported by a market center must include both orders that it executes itself and orders that it receives but routes away.
- ?? The cumulative number of shares executed in one of the following five categories of time after order receipt: 0-9 seconds, 10-29 seconds, 30-59 seconds, 60-299 seconds, and 5-30 minutes. Although this information is required for all order types, the SEC has stated that it believes that it will be most useful for evaluating the execution of non-marketable limit orders.<sup>8</sup>
- ?? The average *realized* spread for execution of covered orders, which is defined as “the share-weighted average of realized spreads for order executions calculated . . . as double the amount of difference between the execution price and the midpoint of the consolidated best bid and offer five minutes after the

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<sup>6</sup> The term “consolidated best bid and offer” is defined as the highest firm bid and the lowest firm offer for a security that is calculated and disseminated on a current and continuous basis pursuant to an effective national market system plan.

<sup>7</sup> Disclosure of data for limit orders that are more than 10 cents outside the CBBO when received will not be required because execution of these orders depends more on limit price than handling.

<sup>8</sup> Equities Adopting Release (*see* note 1).

time of order execution.’<sup>9</sup> This measure is designed to measure the flow of uninformed market and marketable limit orders (which are indicated by higher realized spreads), and to show both the costs of stepping ahead of nonmarketable limit orders and the likelihood that they will be executed when the market is moving against them.

Additionally, for market and marketable limit orders *only*, the report also must show:

- ?? The average *effective* spread for execution of covered orders, which is defined as “the share-weighted average of effective spreads for order executions calculated . . . as double the amount of difference between the execution price and the midpoint of the consolidated best bid at the time of order receipt.”<sup>10</sup> This measure of price improvement serves as a single measure of the liquidity premium on market and marketable limit orders.
- ?? For shares executed with price improvement, the cumulative number of shares of covered orders executed with price improvement, the share-weighted average period from the time of order receipt to the time of order execution and the share-weighted average period from order receipt to execution for these shares. These price improvement measures are designed to help weigh liquidity enhancement and the trade-off between speed and price.
- ?? For at-the-quote orders, the cumulative number of shares of covered orders executed at the quote, and the share-weighted average period from order receipt to execution.
- ?? For outside-the-quote orders, the cumulative number of shares of covered orders executed outside the quote, the share-weighted average amount per share that execution prices were outside the quote, and the share-weighted average period from order receipt to execution.

### 3. Meritless Litigation

In an effort to address concerns expressed by a number of commenters the information required to be disclosed under the rule could be misused in support of meritless litigation, a “Preliminary Note” was added to Rule 11Ac1-5, clarifying that the rule is designed merely to require disclosure of general statistics to promote competition, and that the required disclosures do not encompass all of the factors that may be important to investors in evaluating the order routing services of a broker-dealer. Accordingly, the Note states that the statistical information required by the rule does not, by itself, create a reliable basis by which to measure whether a particular broker has failed to meet its legal duty of best execution.

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<sup>9</sup> 17 C.F.R. § 240.11Ac1-5(a)(3). In response to several commenters, the time component of this definition was changed from 30 minutes in the proposed rule to 5 minutes in the final rule.

<sup>10</sup> 17 C.F.R. § 240.11Ac1-5(a)(2).

## **B. Rule 11Ac1-6**

To complement the improved public disclosure of execution quality by market centers, the Commission adopted Rule 11Ac1-6 to improve disclosure of order routing by broker-dealers. Under this Rule, broker-dealers that route orders as agent on behalf of their customers will be required to disclose, on a quarterly basis, the identity of the market centers to which they route a significant percentage of their orders. Broker-dealers also will be required to disclose the nature of their relationships with such market centers, including any internalization or payment for order flow arrangements, that could represent a conflict of interest between the broker-dealer and its customers. In the past, such information has been available, if at all, only by individual customer request on a transaction-by-transaction basis. As a result, there has been little opportunity for the public to evaluate the routing practices of a broker-dealer as a whole.

The final version of Rule 11Ac1-6 differs significantly from the proposed rule. In response to commenters, the Commission substantially cut back the amount of information that broker-dealers are required to disclose concerning their order routing practices.

### **1. Covered Securities and Orders**

Rule 11Ac1-6, which requires every broker or dealer to make publicly available, on a quarterly basis, a report on its routing of non-directed orders in covered securities during that quarter, is broader in scope than Rule 11Ac1-5, as discussed above. Rule 11Ac1-6 applies to covered securities, which includes, not only exchange-listed and Nasdaq National Market equities, but also Nasdaq SmallCap securities and exchange-listed options; it does not include equities quoted on the OTC Bulletin Board. In addition, the rule's disclosure requirements apply to any customer market or limit order, including pre-opening orders, other than non-directed orders. A non-directed order is an order that is not directed to a particular venue at the customer's request. However, large orders involving a market value of at least \$200,000 for stocks or \$50,000 for options are excluded from coverage.

### **2. Required Disclosures**

Rule 11Ac1-6 requires that a quarterly report be divided into four separate sections for each of four different types of covered securities: (1) equity securities listed on the NYSE; (2) equity securities qualified for inclusion on Nasdaq; (3) equity securities listed on the Amex or any other national securities exchange; and (4) options. For each of the four sections, the report must include:

- ?? The percentage of total customer orders that are not directed to a particular market at the customer's request, and of these, the percentage that were market orders, limit orders, and other types.
  
- ?? A listing of the top ten venues to which the most non-directed orders were sent; the percentage of non-directed orders routed to each of these ten venues; and the percentage of non-directed market orders, limit orders, and other orders routed to each of these ten venues. Identical disclosures also must be

made regarding any other venues beyond the top ten most used to which five percent or more of all non-directed orders were routed.<sup>11</sup>

?? A discussion of the material aspects of the broker-dealer's relationship with each venue identified in the report, including a description of any payment for order flow or profit-sharing arrangement (including internalization of orders that the broker-dealer executes as principal).<sup>12</sup> Although Rule 11Ac1-6 does not require an estimate of the aggregate dollar amount of payment for order flow, it does require 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 would be expected to disclose the extent to which it could share in profits derived from the execution of non-directed orders. An example would be the extent of the ownership relation between the broker and execution venue.

Unlike the market center reports described above, the reports required by Rule 11Ac1-6 are designed to be read directly by the public. Therefore, broker-dealers must make their order routing reports publicly available. The three-pronged definition of "make publicly available" requires broker-dealers to (1) post their order routing reports on a free, public and readily accessible Internet website, (2) furnish a copy to a customer upon request, and (3) notify customers at least annually that a written copy will be furnished on request. The report must be publicly available within one month from the end of the quarter addressed in the report.

### ? ? **3. Individualized Customer Disclosure**

To assure that customers have ready access to routing information concerning their own order, at the customer's request, the rule requires the broker-dealer to disclose where that customer's orders were routed over the last six months, whether the orders were directed or non-directed, and the time of execution that resulted. Broker-dealers also have to notify their customers at least once a year that they have the option to request this information.

## **II. Firm Quotes and Trade-Throughs**

In the Options Adopting Release, the Commission expressed concern that recent increases in the multiple listing of options previously listed on a single exchange has "heightened the need to further integrate the options markets into the national market system."<sup>13</sup> As the Commission

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<sup>11</sup> This provision was altered from the proposed version of the rule. The proposal called for disclosure of *all* such venues, but the adopted provision limits the required disclosure to the top ten venues and any other venues receiving five percent or more of non-directed orders.

<sup>12</sup> It also should be noted that the proposed rule required the inclusion in the report of a detailed narrative discussion and analysis of order routing practices. This requirement was not made part of the final version of Rule 11Ac1-6.

<sup>13</sup> Options Adopting Release (*see* note 2).

explained, the absence of effective access for one market to reach a better price displayed on another market, together with the recent expansion of multiply-traded options, has significantly increased the likelihood that a customer order may be executed at a price that is inferior to a price available on another market, known as an “intermarket trade-through.”<sup>14</sup>

In October 1999, in response to the increasing prevalence of trade-throughs in the options markets, the Commission ordered the options exchanges to develop a linkage plan. All five options markets are now participants in the proposed linkage plan (“Linkage Plan”).<sup>15</sup>

The Commission has remained concerned, however, that this Linkage Plan could fail to adapt over time to changes in the market, and could impede the entry of new participants using different business models. Thus, in July 2000, the Commission proposed new Rule 11Ac1-7 (“Trade-Through Disclosure Rule”) and amendments to existing Rule 11Ac1-1 (“Quote Rule”) in order to address certain remaining trade-through and firm quote issues. On November 15, 2000, by a 3-0 vote, with one Commissioner recusing herself, the Commission adopted these changes, mostly as they had been proposed. These changes are “intended to facilitate the ability of market participants to obtain the best price for customer orders without mandating a specific linkage.”<sup>16</sup>

The Trade-Through Disclosure Rule and the amendments to the Quote Rule become effective on February 1, 2001, and have a compliance date of April 1, 2001.

#### **A. Trade-Through Disclosure Rule**

Under the new Trade-Through Disclosure Rule, a broker-dealer must disclose to its customer any occasion on which the customer’s order for listed options is executed at a price inferior to (*i.e.*, trades through) a better published price. The disclosure must be made at or before the completion of the transaction, and disclosure may be provided in conjunction with the confirmation routinely sent to investors. The disclosure must be displayed as prominently as the transaction price.

The Trade-Through Disclosure Rule sets forth a number of trading situations in which disclosure is not required. First, a broker-dealer is not required to disclose a trade-through if the order is executed as part of a block trade. In addition, the requirements of the rule do not apply to any trades effected on an exchange that participates in an approved linkage plan reasonably designed to limit trade-throughs.<sup>17</sup> Because the current Linkage Plan does not meet this standard,

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<sup>14</sup> SEC Fact Sheet, “Market Structure Initiatives in the Options Market” (Nov. 15, 2000) (handout at open meeting; *available at* <http://www.sec.gov/news/extra/faqmstrc.htm>). Intermarket trade-throughs are estimated to occur in as many as five percent of all options trades. *Id.*

<sup>15</sup> Options Adopting Release (*see note 2*).

<sup>16</sup> *Id.*

<sup>17</sup> A linkage plan “reasonably designed to limit trade-throughs” should have provisions which: (1) limit trade-throughs on markets of exchanges that are plan participants, as well as those that are not; (2) require participants to actively surveil their markets for trades-throughs; and (3) emphasize that the failure of a market with a better quote to complain within a specified time period that its quote was traded-through may affect potential liability, but does not negate the occurrence of a trade-through. Options Adopting Release (*see note 2*).

the SEC noted that the Plan must be amended before broker-dealers effecting transactions on the participant exchanges would be excepted from the disclosure requirements of the Trade-Through Disclosure Rule.<sup>18</sup>

Finally, the Trade-Through Disclosure Rule identifies four circumstances in which a trade executed at a price inferior to a published price on another market, nevertheless, would not be considered a trade-through and need not be disclosed under the rule:

- ?? The market on which the order is executed has verified that the market publishing the better price is experiencing a failure, material delay, or malfunction of its systems;
- ?? The Options Price Reporting Authority (OPRA) is experiencing delays in transmitting quotations;
- ?? The better published price was published by an exchange whose members are relieved of their obligations under the Quote Rule because the exchange has determined, for example, that, as a result of unusual market conditions, it is incapable of accurately collecting and disseminating quotes; or
- ?? The quoting market fails to respond to an order routed to it within 30 seconds of the order's receipt by that market.

## **B. Firm Quote Rule for Options**

In the Options Adopting Release, the Commission also extended the application of the Quote Rule to options traded on national securities exchange, subject to certain accommodations for the unique options trading environment.<sup>19</sup> Previously, the Quote Rule -- which generally requires (1) national securities exchanges and associations to establish procedures for collecting and making available to quotation vendors, bids, offers, and quotation sizes for reported securities, and (2) requires quotation information made available to vendors to be firm (with certain exceptions) -- did not apply to the options markets.<sup>20</sup>

### **1. Quotation Size**

The Quote Rule, as currently applied to the equity markets, requires broker-dealer quotes to be firm up to their published size. Because OPRA currently does not have the ability to collect from the exchanges and disseminate to quotation vendors size information, the Commission, under

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<sup>18</sup> Options Adopting Release (*see* note 2).

<sup>19</sup> The Commission extended the Quote Rule to options by amending (1) the definition of "reported security" to include listed options, and (2) the definition of "consolidated system" to include a transaction reporting system pursuant to an effective national market plan.

<sup>20</sup> The five options markets have required their own market makers to have firm quotes for some types of orders, but have not extended their rules to other market participants.



the new rules, has given the options exchanges a choice as to how they comply with the Quote Rule: an exchange will be required to publicize the size for which its quotes will be firm either on a quote-by-quote basis or by publicizing its rule establishing its firm quote sizes.

More specifically, an options exchange may choose to establish by rule and periodically publish the size for which its best bid and offer in each listed options series is firm. If the exchange chooses this option, then responsible brokers or dealers that are members of the exchange will be relieved of their obligations under the Quote Rule to communicate their quotation sizes to that exchange. Instead, each such responsible broker or dealer may satisfy its firm quote obligation by executing any relevant option order in an amount up to the size established by the exchange's rules. Or, the options exchange may choose to establish procedures for collecting from its members, and making available to vendors, the sizes of its members' quotes, just as the equity exchanges do today.

Under the amended rule, options exchanges have the flexibility to establish either the same or different firm quote sizes for broker-dealer orders and for customer orders. Moreover, the SEC believes that each disseminated quote must represent at least one contract because any less would mean that a quote was not actually firm. Therefore, the Commission adopted the requirement that if an exchange allows quotes to be firm in different sizes for broker-dealer orders and for customer orders, its rules must require its responsible brokers or dealers to be firm for a minimum of one contract.

The SEC also amended the Quote Rule to add an additional, options-specific circumstance under which responsible brokers or dealers would be relieved of their obligations under the Quote Rule. Because responsible brokers or dealers may be unable to generate quotes in a timely fashion during trading rotations, they are relieved of their firm quote obligations when an order for listed options is presented during a trading rotation in that listed option.

## **2. Thirty-Second Response**

In the new amendments, the Commission attempted to balance the need for price priority against the need for efficient execution of orders by imposing a thirty-second time limit for a responsible broker-dealer to respond to a listed options order larger than its firm quote size. As a companion to the thirty-second time limit in the Trade-Through Disclosure Rule discussed above, the Commission amended the Quote Rule to require a responsible broker-dealer to respond to any order to buy or sell a listed option in an amount greater than the firm quote size within thirty seconds by either: (1) executing the entire order; or (2) executing at least the portion of the order equal to the applicable firm quote size and revising its bid or offer.

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If you would like copies of either of the SEC releases discussed above, or if you have any questions, please do not hesitate to contact Brandon Becker (202.663.6979 or bbecker@wilmer.com); Soo Yim (202.663.6958 or syim@wilmer.com); Cherie Macauley (202.663.6855 or cmacauley@wilmer.com); Heather Seidel (202.663.6256 or hseidel@wilmer.com); or Russell Clause (202.663.6777 or rclause@wilmer.com).

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