

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54714)

November 6, 2006

Order Granting National Securities Exchanges a Limited Exemption from Rule 612 of Regulation NMS under the Securities Exchange Act of 1934 to Permit Acceptance by Exchanges of Certain Sub-Penny Orders

I. Introduction

The Securities and Exchange Commission ("Commission") is granting national securities exchanges a limited exemption from Rule 612<sup>1</sup> of Regulation NMS under the Securities Exchange Act of 1934 ("Exchange Act") to permit them to accept certain cross orders priced in sub-penny increments, subject to the conditions described below. Rule 612 prohibits a national securities exchange (among other entities) from displaying, ranking, or accepting a bid or offer, an order, or indication of interest in any national market system ("NMS") stock<sup>2</sup> that is priced in an increment smaller than \$0.01 per share, unless the price of the bid or offer, order, or indication of interest is priced less than \$1.00 per share.<sup>3</sup> If the bid or offer, order, or indication of interest is priced less than \$1.00 per share, the minimum allowable increment is \$0.0001 per share.<sup>4</sup>

Recently, the Commission approved a number of SRO rule changes that, subject to the Commission's grant of exemptive relief, envision the acceptance of certain cross orders arranged

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<sup>1</sup> 17 CFR 240.612.

<sup>2</sup> An NMS stock is any non-option security 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 (b)(47).

<sup>3</sup> See 17 CFR 242.612(a).

<sup>4</sup> See 17 CFR 242.612(b).

by members in sub-penny prices.<sup>5</sup> A cross transaction involves a buy order and sell order for the same security at the same price that are pre-matched by an exchange member, whether as principal or agent, and submitted to the exchange for execution.<sup>6</sup> In absence of an exemption from the Rule 612, an exchange is prohibited from accepting cross orders priced above \$1.00 per share in sub-penny increments,<sup>7</sup> even if such orders are immediately executed and printed by the exchange. However, pursuant to Rule 612(c), the Commission, by order, may exempt from the provisions of Rule 612, either unconditionally or on specified terms and conditions, any person, security, 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.

## II. Discussion

After careful consideration, the Commission hereby grants the national securities exchanges a limited exemption from Rule 612 permitting them to accept certain sub-penny cross orders. This exemption is limited to the acceptance by national securities exchanges of cross orders arranged by members that are priced in sub-penny increments and immediately executed

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<sup>5</sup> See, e.g., Securities Exchange Act Release No. 54550 (September 29, 2006), 71 FR 59563 (October 10, 2006) (SR-CHX-2006-05) (approving, among other things, rules permitting cross transactions in increments as small as \$0.000001); Securities Exchange Act Release No. 54538 (September 28, 2006), 71 FR 59184 (October 6, 2006) (SR-Phlx-2006-43) (approving, among other things, benchmark orders that could be priced in increments as small as \$0.0001).

<sup>6</sup> For example, a member could pair together a customer market order to buy and a customer market order to sell at the midpoint between the exchange's best bid and offer ("BBO"), which would result in a sub-penny execution (e.g., \$17.895) if the BBO were an odd number of cents wide (e.g., \$17.89 x \$17.90). In addition, a member could offer sub-penny price improvement when trading as principal with a customer order.

<sup>7</sup> An exchange may, consistent with Rule 612(b) of Regulation NMS, establish rules that permit it to accept orders that are priced less than \$1.00 per share in increments as small as \$0.0001, whether or not as part of a cross transaction.

against each other,<sup>8</sup> and otherwise accepted and handled in accordance with rules approved or established pursuant to Section 19(b) of the Exchange Act.<sup>9</sup>

Among other things, Rule 612 is designed to limit the ability of a market participant to gain execution priority over a competing limit order by an economically insignificant amount. The Commission noted that, “[i]f investors' limit orders lose execution priority for a nominal amount, investors may over time decline to use them, thus depriving the markets of liquidity.”<sup>10</sup> In addition, Rule 612 is intended to reduce the incidence of quote flickering, which makes it more difficult for market participants to identify the best price available in the national market system at a given moment, and to prevent excessive reduction of depth at the best inside quotation.<sup>11</sup> In adopting Rule 612, the Commission explicitly declined to prohibit sub-penny executions, provided such executions do not result from an impermissible sub-penny orders or quotations.<sup>12</sup> The Commission observed that sub-penny trading “does not raise the same concerns as sub-penny quoting. Sub-penny executions do not cause quote flickering and do not decrease depth at the inside quotation. Nor do they require the same systems capacity as would

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<sup>8</sup> Therefore, if an exchange accepts two sub-penny orders that are not immediately executed against each other, the exchange must immediately cancel both orders or be in violation of Rule 612. If the exchange ranked or displayed either sub-penny order, it also would be in violation of Rule 612, as this exemption extends only to the acceptance of such orders. For purposes of this exemption, a cross order is immediately executed if the exchange automatically executes the cross with no delay other than for confirming that the conditions for the cross imposed by the exchange's rules are satisfied.

<sup>9</sup> 15 U.S.C. 78s(b).

<sup>10</sup> See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37551 (June 29, 2005) (“Regulation NMS Adopting Release”).

<sup>11</sup> See id. at 37752.

<sup>12</sup> See id. at 37556. A sub-penny execution could result, for example, from a midpoint or volume-weighted trading algorithm or from price improvement that a broker-dealer provides to a customer order.

sub-penny quoting. In addition, sub-penny executions due to price improvement are generally beneficial to retail investors.”<sup>13</sup>

The Commission believes that this exemption is consistent with the protection of investors because allowing the exchanges to accept sub-penny cross orders for the limited purpose of immediately executing them is akin to a sub-penny execution and should not implicate any of the problems with sub-penny quoting identified by the Commission in adopting Rule 612. Because these sub-penny cross orders are prohibited from being displayed, they will not cause quote flickering, decrease depth at the inside quotation, or degrade systems capacity. Furthermore, because this exemption applies only to pre-arranged cross orders, these sub-penny orders will not gain any execution advantage over resting limit orders on the book.<sup>14</sup>

Furthermore, the Commission believes that this exemption is necessary or appropriate in the public interest to facilitate the execution of pre-arranged cross orders on the exchanges. When the Commission adopted Rule 612, exchange rules did not contemplate sub-penny crosses, which therefore could occur only in the over-the-counter (“OTC”) market. Since that time, some

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Id.

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Nothing in this exemption relieves a national securities exchange of the requirement to establish all rules, including its rules related to cross transactions, in a manner consistent with Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b), and Rule 19b-4 thereunder, 17 CFR 240.19b-4, before accepting sub-penny orders in reliance on this exemption. In reviewing proposed rules relating to cross transactions, the Commission would evaluate, among other things, whether cross orders could gain execution priority over resting limit orders in a manner inconsistent with the Exchange Act. See, e.g., Securities Exchange Act Release No. 54391 (August 31, 2006), 71 FR 52836 (September 7, 2006) (SR-NSX-2006-08) (approving, among other things, NSX Rule 11.12(b), which permits crosses that are priced at least \$0.01 better than any displayed order on the book, and Rule 11.12(c), which permits midpoint crosses); Securities Exchange Act Release No. 54422 (September 11, 2006), 71 FR 54537 (September 15, 2006) (SR-CBOE-2004-21) (approving, among other things, CBOE Rule 52.11, which permits crosses to occur at the same price as displayed orders on the book if the cross transaction: (1) is for at least 5000 shares; (2) is for a principal amount of at least \$100,000; and (3) is greater in size than any single public customer order displayed on the book at the proposed cross price).

exchanges have proposed to offer such execution services.<sup>15</sup> In the OTC market, a broker-dealer could execute a sub-penny cross without the two orders involved having to be accepted by any entity subject to Rule 612. The broker-dealer could simply arrange the trade at the sub-penny price, as principal or agent, and report the execution to the NASD.<sup>16</sup> To execute the same trade on an exchange, however, the exchange's systems might require the broker-dealer to enter matching buy and sell orders that are explicitly priced in a sub-penny increment that, absent an exemption, would not be permitted by Rule 612. The Commission does not believe that Rule 612 should preclude an immediate sub-penny execution on an exchange that results from the submission by a member of a cross order arranged by that member that otherwise is in accordance with exchange rules established consistent with Section 19(b) of the Exchange Act. The Commission believes, therefore, that this exemption is consistent with the public interest because it will level the playing field between the exchanges and the OTC market as venues for sub-penny crossing transactions.<sup>17</sup>

For these reasons, the Commission concludes that this limited exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

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<sup>15</sup> See supra note 5.

<sup>16</sup> While a broker-dealer may execute a cross at a sub-penny price without violating Rule 612, the broker-dealer may not accept a sub-penny order. For example, the broker-dealer could accept a market order to buy, internalize it, and give the customer an execution at \$10.001 (assuming such execution is consistent with all applicable Commission and SRO rules including, for example, rules relating to best execution and order protection). Rule 612 prohibits the broker-dealer from accepting a limit order to buy that the customer has explicitly priced at \$10.001.

<sup>17</sup> However, as with sub-penny crosses arranged in the OTC market, nothing in this exemption permits a broker-dealer itself to accept a limit order that a customer has explicitly priced in an increment not permitted by Rule 612.

III. Conclusion

IT IS HEREBY ORDERED, pursuant to Rule 612(c) of Regulation NMS, that a national securities exchange may accept cross orders priced in sub-penny increments, provided that:

- (1) The orders are immediately executed against each other; and
- (2) The cross transaction is effected in accordance with exchange rules approved or established pursuant to Section 19(b) of the Exchange Act.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

Nancy M. Morris  
Secretary

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<sup>18</sup> 17 CFR 200.30-3(a)(83).