U.S. Securities and Exchange Commission

Division of Market Regulation: Responses to Frequently Asked Questions Concerning Rule 612 (Minimum Pricing Increment) of Regulation NMS

Responses to these frequently asked questions were prepared by and represent the views of the staff of the Division of Market Regulation ("Staff"). They are not rules, regulations, or statements of the Securities and Exchange Commission ("Commission"). Further, the Commission has neither approved nor disapproved these interpretive answers.

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I. Introduction

On April 6, 2005, the Commission adopted Regulation NMS, a series of initiatives designed to modernize and strengthen the national market system for equity securities. Regulation NMS was published in Securities Exchange Act Release No. 51808 (Jun. 9, 2005), 70 FR 37496 (Jun. 29, 2005) ("NMS Release"). One part of Regulation NMS is Rule 612 ("the Rule"), which specifies minimum pricing increments for NMS stocks. In general, the Rule prohibits market participants from displaying, ranking, or accepting quotations, orders, or indications of interest in any NMS stock priced in an increment smaller than $0.01 if the quotation, order, or indication of interest is priced equal to or greater than $1.00 per share. If the quotation, order, or indication of interest is priced less than $1.00 per share, the minimum pricing increment is $0.0001. The Commission has extended the initial compliance date for the Rule from August 29, 2005 until January 31, 2006 in Securities Exchange Act Release No. 52196 (Aug. 2, 2005), 70 FR 45529 (Aug. 8, 2005).

The following questions and answers have been compiled by the Staff to assist in the application of the Rule. These questions and answers are intended to provide general guidance. Facts and circumstances of a particular transaction may differ, and the Staff notes that even slight variations may require different responses. The Commission is not bound by the Staff's statements.

The Staff may update these questions and answers periodically. In each update, the questions modified or added after publication of the last version will be marked with ***"MODIFIED!"*** or ***"NEW!"***

The interpretive questions addressed in this document are as follows:

II. Responses to Frequently Asked Questions

Question 1: May a broker-dealer receive an order in an NMS stock that is explicitly priced in an increment not allowed by the Rule and then round the price to a permissible price before "accepting" it?

Answer: No. The plain language of the Rule prohibits a broker-dealer from accepting such an order. In this case, the order is *explicitly* priced in an impermissible increment, meaning it is provided with a U.S. dollar price per share for representation or display purposes that does not conform to the requirements of the Rule. The broker-dealer must reject the order. However, there are circumstances where a customer may send an order to a broker-dealer that is not explicitly priced in an impermissible increment and for which a permissible price may be derived without violating the Rule. (See next question.)

Question 2: If a customer gives an order in an NMS stock to a broker-dealer that is not explicitly priced in an impermissible sub-penny increment but involves instructions or information intended to permit the broker-dealer to determine an explicit price, may the broker-dealer accept the order and determine the appropriate explicit price, rounding if necessary to a permissible increment?

Answer: Yes. The Rule does not prohibit a broker-dealer from performing calculations to obtain the price of a customer order that is not explicitly priced in an impermissible sub-penny increment when received. For example, if an order is originally priced in a foreign currency, a broker-dealer may convert the price to U.S. dollars, rounding appropriately (*down* in the case of an order to buy, and *up* in the case of an order to sell) to an allowable price increment. Other examples would include an order with a price dependent on the price of another security, an order priced at the previous day's closing price, or an order with a specified percentage variation from the current price of the security (*e.g.*, a "stop price" set at 10% above or below the current price). In each case a broker-dealer would be permitted to determine the actual explicit price for the order, rounding appropriately.

Question 3: If a broker-dealer holds an open order in an NMS stock that must be repriced because of a corporate action (*e.g.*, a stock dividend), may the broker-dealer round the adjusted price to a permissible increment?

Answer: Yes. The Rule does not require a broker-dealer to cancel an order that was permissible when accepted, but for which the price must be adjusted due to a corporate action. However, the broker-dealer would violate the Rule by displaying or ranking the repriced order at an increment not permitted by the Rule. The same principle applies to other types of orders that were permissible when accepted but whose prices must be adjusted. For example, an open order accepted before the Rule's compliance date may be repriced to conform to the requirements of the Rule without canceling the order.

Question 4: May a broker-dealer accept an order with a performance target (*e.g.*, a volume weighted average price ("VWAP")) that is or could be an impermissible sub-penny price?

Answer: Yes. A performance target is not generally a price subject to the Rule as long as it is not used analogously to a limit price for ranking or displaying an order. However, if the performance target were an explicit impermissible sub-penny price and also served as a limit price, then accepting the order would be a violation. Similarly, if the customer specifies a limit price in addition to the performance target, the limit price must meet the requirements of the Rule.

Question 5: If the last sale price of an NMS stock is below $1.00, may a broker-dealer accept an order to sell at $1.001?

Answer: No. The Rule's prohibition on sub-penny orders above $1.00 applies to the price of the order, not the price of the stock. Therefore, an order priced at $0.9999 is permissible at any time and an order priced at $1.001 is impermissible at any time, regardless of where the stock is trading at the moment. However, note that a sub-penny order below $1.00 that is permissible under the Rule may not be permissible under the rules and procedures of every market center. (See next question.)

Question 6: Does every market trading NMS stocks have to accept sub-penny orders priced less than $1.00?

Answer: No. The Rule is permissive rather than mandatory in this respect; any market may accept a sub-penny order priced below $1.00 per share, but is not required to do so. Currently, the NASD and national securities exchanges generally require a minimum pricing variation (MPV) on their markets of $0.01. Therefore, if a market wished to offer the ability to accept orders and quotations in sub-pennies below $1.00, it would first have to amend its MPV rules.

Question 7: Assume that an exchange's rules stipulate an MPV of $0.01 in all cases, including quotations and orders priced below $1.00. May the exchange nevertheless accept orders priced in sub-pennies below $1.00, rounding them appropriately to conform to the exchange's rules?

Answer: Yes. The Rule does not require the exchange to reject an order that is permissible under the Rule. However, if the exchange wants to accept such orders it must have a procedure established by rule. Specifically, the exchange may round order prices away to the nearest penny increment, provided it has an approved rule that specifies the circumstances and manner in which it will do so.

Question 8: May an exchange also accept and round orders in NMS stocks that are explicitly priced in sub-penny increments above $1.00?

Answer: No. In this case the orders are impermissible under the Rule, and must be rejected. (See also Question 1 above.)

Question 9: A broker-dealer receives an order in an NMS stock priced in an allowable sub-penny increment below $1.00. Market A quotes and trades only in increments of $0.01 even below $1.00, but Market B is willing to accept and represent the order at its actual sub-penny price. Is the broker-dealer obligated to send the order to Market B?

Answer: The broker-dealer's obligation is to act in the best interests of the customer. The Rule does not change that. If the order is marketable, the broker-dealer should try to get the best price reasonably available. If the order is not marketable and must be displayed, the broker-dealer should consider whether the customer is best served by displaying the order to buy at a rounded price at Market A, or at its full sub-penny price at Market B. In making the determination, whether on an order-by-order basis or as a broader policy, the broker-dealer should now consider among other things that Market B can represent the actual price of the order in its public quotation, if it is the best price, while Market A cannot. (See also Question 10 below.) If the broker-dealer is a market maker or specialist, it may also be subject to Rule 604 ("Display of customer limit orders"). Consistent with the foregoing, Rule 604 does not require (although it does permit) a market maker or specialist in Market A, which quotes only in $0.01 increments, to send customer sub-penny orders to Market B for display. However, a market maker or specialist in Market B, which displays quotations in sub-penny increments, would not be permitted to send customer sub-penny orders to Market A for display at rounded prices instead of displaying the actual prices in its own quotes.

Question 10: How should sub-penny quotations be incorporated in the best execution analysis of a broker-dealer?

Answer: The possibility that sub-penny quotations may be available in some markets but not in others will be an additional factor in a broker-dealer's best execution analysis. Other relevant factors that a broker-dealer may consider are order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. (See NMS Release, 70 FR at 37538 n.341.) When including the existence of sub-penny quotations in the analysis, a broker-dealer may, in addition to all other relevant factors, consider the extent to which the sub-penny increment represents a materially better price that justifies the cost and difficulty of trying to obtain that price.

Question 11: How will the trade-through provisions of the Intermarket Trading System ("ITS") Plan, which covers trading in exchange-listed stocks, apply to sub-penny quotations that are permitted by the Rule?

Answer: The matter is being considered by the ITS Operating Committee, which has interpretive authority within the scope of the ITS Plan. Currently no ITS Participant permits sub-penny quotations. Implementation of sub-penny quotations by any ITS Participant would require filing of a proposed rule change and approval by the Commission.

Question 12: Will market data vendors be permitted to round sub-penny quotations to whole-penny increments in their data displays in NMS stocks for which the Rule permits sub-penny quotations?

Answer: Market data vendors and other securities information processors are not permitted by Rule 603(c) of Regulation NMS (commonly called the "Vendor Display Rule") to round the national best bid and offer ("NBBO"). The NBBO is the best bid and best offer for a security that is calculated and disseminated pursuant to the CTA Plan for exchange-listed stocks and the Nasdaq/UTP Plan for Nasdaq stocks. Consequently, if these plans disseminate an NBBO that is expressed in a sub-penny increment, and a market data vendor that is covered by Rule 603(c) chooses to display data for these NMS stocks, the vendor is required to display the NBBO without rounding. The requirement applies only to a display in a context in which a trading or order-routing decision can be implemented and does not apply to quotations that are not part of the NBBO.

Question 13: May a market center provide sub-penny price improvement, compared to the NBBO, in an NMS stock for which sub-penny quotations are prohibited by the Rule?

Answer: Yes, provided that the execution does not result from an order, quotation, or indication of interest that was itself priced in an impermissible sub-penny increment. In addition, a broker-dealer must comply with any applicable rules governing trading ahead of customer orders (*e.g.*, NASD IM-2110-2). Also, if the execution resulted from a guarantee of price improvement and if the guarantee were unconditional and detailed as to the amount of price improvement guaranteed, it is possible that such a guarantee would be deemed a prohibited quotation. The Staff does not believe it is practical to consider all the possible variations of price improvement guarantees in this document, but the Staff is available to provide additional guidance to market centers on a case-by-case basis.

Question 14: Are warrants and rights subject to the sub-penny quoting prohibitions of the Rule?

Answer: A warrant or right is subject to the Rule if it is an "NMS stock." Under Regulation NMS, an NMS stock is any security for which transaction reports are collected, processed, and made available pursuant to either the CTA Plan or the Nasdaq/UTP Plan. Thus a warrant or right reported under the CTA or Nasdaq/UTP Plan would be subject to the sub-penny prohibition above $1.00.

Question 15: An exemption from Rule 10a-1's tick test permits registered market makers and exchange specialists publishing two-sided quotes in a security to sell short to facilitate customer market and marketable limit buy orders at the consolidated national best offer (NBO), regardless of the last trade price. (See Letter re: Bernard L. Madoff Investment Securities LLC (February 9, 2001).) Can such a registered market maker or exchange specialist sell short to fill a customer market or marketable limit buy order at a price lower than the NBO by a sub-penny increment in order to provide price improvement? For example, can a registered market maker or exchange specialist execute a short sale at $0.129 (providing price improvement) to facilitate a customer market or marketable limit buy order if the NBO is $0.13?

Answer: The exemption provides relief from Rule 10a-1's tick test to permit registered market makers and exchange specialists publishing two-sided quotes in a security to sell short to facilitate customer market and marketable limit orders at the consolidated national best offer, regardless of the last trade price. If the NBO is $0.13, as in the example above, then the registered market maker or exchange specialist may execute a short sale to fill a customer market or marketable limit buy order at $0.129 or any other increment within a sub-penny below the NBO, regardless of the last sale price reported pursuant to an effective transaction reporting plan, and still be considered within the exemption. This exemption continues to be strictly limited to registered market makers and exchange specialists in instances where they are providing liquidity in response to customer market and marketable limit buy orders. In addition, all short sales effected pursuant to the exemption must be marked as "short exempt" in accordance with Rule 200(g) of Regulation SHO.

Question 16: What minimum price increment, if any, will apply to orders, quotations, and indications of interest in stocks other than NMS stocks?

Answer: No SEC Rule establishes a minimum price increment for orders, quotations, or indications of interest in non-NMS stocks. However, the NASD has filed a proposed rule change (SR-NASD-2005-095) that, if approved, would impose substantially the same requirements as SEC Rule 612 on members trading equity securities other than NMS stocks in the over-the-counter market.

Question 17: If a broker-dealer uses a service bureau or other vendor to provide order handling services on its behalf, does the vendor have to provide the same capabilities to reject or round orders that the broker-dealer would have to provide for itself, or can it rely on the market centers to reject and/or round orders not permitted under the Rule?

Answer: The obligation to comply with the Rule lies with the broker-dealer. If the broker-dealer employs a vendor or facility manager to provide its order handling capabilities, then the vendor or facility manager must follow the requirements of the Rule, or the broker-dealer will not be in compliance.

http://www.sec.gov/divisions/marketreg/subpenny612faq.htm

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