SIFMA
Securities Industry and
Financial Markets Association

May 1, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Exemptive Application Pursuant to Rule 611(d) of Regulation NMS: Error Correction Transactions

Dear Ms. Morris:

Pursuant to Rule 611(d) of Regulation NMS under the Securities Exchange Act of 1934 ("Exchange Act"), the Trading Committee of the Securities Industry and Financial Markets Association[1] ("SIFMA") requests that the Securities and Exchange Commission ("SEC" or "Commission") exempt bona fide Error Correction Transactions (as defined below) from Rule 611(a) (the Order Protection Rule) of Regulation NMS under the Exchange Act (the "OPR"). We believe that the proposed exemption would supplement the interpretive guidance issued by the Commission Staff on error correction transactions and, like the various exceptions to the OPR adopted by the Commission, is "narrowly drawn to prevent abuse," but would allow broker-dealers to continue to resolve bona fide errors that otherwise would adversely affect customer accounts without violating the OPR.[2] As a result, the proposed exemption is "appropriate in the public interest, is consistent with the protection of investors,"[3] and should be granted by the Commission.

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1 The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

2 Securities Exchange Act Release No. 51808 (June 9, 2005), 70 Fed. Reg. 37496, 37528 (June 29, 2005) ("NMS Release").

3 Rule 611(d) of Regulation NMS under the Exchange Act.

Order Protection Rule and Error Correction Transactions

Error correction transactions are the mechanism through which broker-dealers remedy the execution of customer orders that have been placed in error or mishandled due to an error involving any term of an order including, for example, price, number of shares or other unit of trading, identification of the security, or the execution of a transaction on the wrong side of the market. In addition to operational issues, and given the high level of automation in today's marketplace, errors often involve delays, outages, or other failures of communication systems used in the delivery or execution of an order. Broker-dealers typically remedy such bona fide errors by entering a subsequent trade on behalf of the customer on the correct terms of the original order ("Error Correction Transaction"). However, in the interim, the market for the security may have moved and the subsequent Error Correction Transaction may be effected at a price that no longer is within the national best bid or offer.

The OPR is intended to prevent trade-throughs of protected quotations in NMS stocks,[4] where a trade-through is defined as "the purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer."[5] Under the OPR, broker-dealers seeking to execute Error Correction Transactions would be required to satisfy all better priced protected quotations prior to effecting the Error Correction Transaction, or otherwise engage in a transaction in violation of the OPR. The Commission Staff recently issued interpretive guidance that permits broker-dealers to effect Error Correction Transactions that are "underwater" within the meaning of the stopped order exception of Rule 611(b)(9).[6] We appreciate the Staff's guidance on this issue, as being able to rely on this exception from the OPR will facilitate correcting bona fide errors that are underwater when the OPR becomes effective.

There are, however, many instances in which bona fide errors are in need of remediation, but a broker-dealer is obligated to effect an Error Correction Transaction for a customer at a price that may not meet the technical definition of an underwater trade. As a result, we believe that all obligated Error Correction Transactions, including those that are not underwater, merit a specific exemption from the OPR.

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4 Rule 611(a)(1) of Regulation NMS under the Exchange Act.

5 Rule 600(b)(77) of Regulation NMS under the Exchange Act.

6 See SEC Division of Market Regulation: Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS, FAQ # 3.11 (Oct. 31, 2006). Rule 611(b)(9) excepts from the OPR transactions involving stopped customer orders where the price of the transaction constituting the trade-through was, for a stopped buy order, lower than the national best bid in the NMS stock at the time of execution or, for a stopped sell order, higher than the national best offer in the NMS stock at the time of execution (an "underwater" transaction).

For example, consider the circumstances in which a customer gives a broker-dealer, acting as agent, an order to sell 100,000 shares of Stock A at $90.65. The sales trader at the broker-dealer accidentally types the incorrect price into the system and instead sells Stock A at $90.60. Stock A's bid price in the market subsequently rises to $91.00. The broker-dealer, having entered an erroneous trade, now wants to take the erroneous execution into its proprietary account and execute and print a trade buying from the customer at the customer's $90.65 limit price. Note that, in doing so, the broker-dealer will have lost $0.05 per share on the trade, but because this trade would be "above water," it would not qualify for the stopped order exception of Rule 611(b)(9) as clarified by the Staff's interpretive guidance. Therefore, absent an exemption, the broker-dealer instead would be obligated to buy the customer's stock at $90.65 and sell to any protected bids to prevent a trade-through. We do not believe that such an outcome is in the interests of investors or the market more generally.

Another example would be where a basket order is placed with a broker-dealer at a time when the broker-dealer experiences a system malfunction or a manual processing error. In the case where the orders are accepted by the broker-dealer, but then do not receive the appropriate executions, the price the customer was owed for the basket can normally be determined from the then-current disseminated quotes. Where a broker-dealer is obligated to complete a beneficial commitment to the customer on a basket, the broker-dealer would likely need to fill multiple orders in the basket at prices that are not underwater in order to arrive at the obligated or agreed-upon basket price.

A third instance where such an exemption is necessary involves a broker-dealer that is engaged in a non-basket series of transactions for a customer (for instance, through an open electronic link to the customer), and either a number of those transactions are executed at the incorrect prices due to an error on the part of the broker-dealer, or the series of order tickets are lost. The broker-dealer should be able to correct all of the transactions in the series (or, in the case of a series of lost order tickets, enter the orders for the appropriate executions) so that the customer receives the correct prices, rather than having to sort through the transactions and correct only those for which the broker-dealer is underwater.

As the above examples illustrate, we believe that a distinction between "underwater" and "above water" unnecessarily prevents the correction of those instances where bona fide errors have occurred in trade executions on behalf of customers, whether the broker-dealer is acting as agent or as principal. The inability of broker-dealers to correct all bona fide errors in a manner consistent with a customer's original order without incurring unwarranted excess expense will impede the effective correction of trading errors overall.

Requested Relief

To preserve the ability of broker-dealers to engage in obligated Error Correction Transactions, we recommend that the Commission exempt all such trades from the OPR. Specifically, we request that the Commission exempt from Rule 611(a) any trade-through caused by the execution of an Error Correction Transaction involving one or more NMS stocks effected to correct a bona fide error and thus to meet an execution obligation to the customer. In order to avoid potential abuse of the proposed exemption, we believe that any such relief should be limited to instances in which:

1. For the purposes of this exemption, the Error Correction Transaction is a direct result of a bona fide error [7]:

    a. Resulting from the inaccurate conveyance or execution of any term of an order including, but not limited to, price, number of shares or other unit of trading, identification of the security, identification of the account for which securities are purchased or sold, lost or otherwise misplaced order tickets, short sales that were instead sold long or vice-versa, or the execution of the order on the wrong side of the market;

    b. Involving the unauthorized or unintended purchase, sale, or allocation of securities, or the failure to follow specific client instructions;

    c. Caused by the incorrect entry of data into relevant systems, including reliance on incorrect cash positions, withdrawals, or securities positions reflected in an account; or

    d. Caused by a delay, outage, or failure of a communication system used to transmit market data prices or to facilitate the delivery or execution of an order;

2. The broker-dealer has in place written policies and procedures reasonably designed to address the occurrence of trading errors and the use and terms of Error Correction Transactions in the event of trading errors, and, as part of the broker-dealer's periodic surveillance procedures under Rule 611(a)(2), will monitor to ascertain the effectiveness of such policies and procedures and take prompt action to remedy deficiencies in such policies and procedures;

3. The Error Correction Transaction is effected solely to remedy the bona fide error;

4. The Error Correction Transaction must be recorded in the effecting broker-dealer's error account; and

5. The bona fide error is evidenced by objective facts and circumstances, and the broker-dealer maintains documentation of such facts and circumstances.

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[7] Absent a bona fide error as described below (*e.g.*, a lost or misplaced ticket), this exemption would not apply to a broker-dealer's mere failure to execute a not-held order in accordance with a customer's expectations.

The requested exemption would apply only to the execution of the Error Correction Transaction (*e.g.*, the execution to correct the bona fide error), and would not apply to any subsequent trades effected by a broker-dealer trading out of a proprietary position in connection with the Error Correction Transaction. To avoid confusion in the market, we recommend that all Error Correction Transactions either should *not* be reported to the consolidated tape or, if reported, should be identified as an exempted transaction using the appropriate trade modifier for OPR exceptions. We also are aware that the interaction between Regulation NMS and rules governing short sales is being considered separately, and we believe that, as part of that process, the SEC should clarify that prints of Error Correction Transactions are exempted from any short sale price tests.

We believe that the benefits of the proposed exemption for Error Correction Transactions far outweigh any disadvantages. An exemption for Error Correction Transactions will facilitate the ability of broker-dealers to provide fair remediation to customers and broker-dealers who otherwise would suffer economic consequences as a result of inadvertent mistakes or system failures. Also, the requested relief is narrowly drawn, and we believe that the number of Error Correction Transactions is likely to be small in comparison to the overall number of trades executed in NMS stocks, such that the number of exempted trade-throughs would not "unduly detract from the price protection objectives of the Order Protection Rule."[8]

We recognize that the Commission and the Staff are concerned about the potential abuse of such an exemption. We believe that the general requirement under the OPR that firms maintain policies and procedures reasonably designed to prevent abuse and ensure compliance with the OPR and its exceptions, supplemented by the specific requirements to utilize error accounts for Error Correction Transactions and to have objective written documentation supporting the use of an Error Correction Transaction, as described herein, should alleviate these concerns. In addition, we note that the use of trades to correct bona fide errors is well established in the securities markets and has been subject to effective regulatory oversight by self-regulatory organizations ("SROs") such as the NYSE and NASD.[9] Consequently, both firms and SROs are familiar with the monitoring and recordkeeping necessary for effective surveillance of Error Correction Transactions, as well as with the patterns and practices that might indicate abuse. As a result, we believe that there is not undue opportunity for abuse of the requested Error Correction Transaction exemption.

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[8] NMS Release at 37528.

[9] We note that distinguishing Error Correction Transactions would not be novel from a regulatory standpoint. Corrections of trading errors have been distinguished from other trades in various regulatory contexts in recognition of the unique fairness issues they pose for customers and broker-dealers and in recognition that they result from bona fide errors in trade execution. *See* NYSE Rule 92(c)(4); Exchange Act Rule 11a-1(b)(6).

Conclusion

Error Correction Transactions significantly facilitate the ability of broker-dealers to correct bona fide errors and thereby effect customer transactions in accordance with the original terms of the customer's order. We believe that an exemption for all Error Correction Transactions, subject to the conditions discussed above, is necessary to fully address the issues raised by bona fide errors. Therefore, we urge the Commission to use its authority under Rule 611(d) of Regulation NMS to approve the proposed exemption for Error Correction Transactions.[10]

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If you have any comments or questions, please do not hesitate to contact me at 610.617.2624, or Ann Vlcek, Vice President and Associate General Counsel, SIFMA, at 202.434.8400.

Sincerely,

Jerry O'Connell
Chairman
SIFMA Trading Committee

cc: Chairman Christopher Cox, Securities and Exchange Commission
Commissioner Paul S. Atkins, Securities and Exchange Commission
Commissioner Roel C. Campos, Securities and Exchange Commission
Commissioner Annette L. Nazareth, Securities and Exchange Commission
Commissioner Kathleen L. Casey, Securities and Exchange Commission
Erik R. Sirri, Securities and Exchange Commission
Robert L.D. Colby, Securities and Exchange Commission
David Shillman, Securities and Exchange Commission
Steve Williams, Securities and Exchange Commission
Daniel Gray, Securities and Exchange Commission
Andre Owens, WilmerHale
Cristie March, WilmerHale

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[10] "[T]he Commission has determined that the most appropriate process to handle suggestions that specific types of transactions should be excluded from the coverage of Rule 611 is through its exemptive procedure set forth in paragraph (d) of the Rule. The extended implementation period for Regulation NMS will provide a full opportunity for the public to request specific exemptions that they believe are necessary or appropriate in the public interest and consistent with the protection of investors." NMS Release at 37528.