Information Memo

Market Surveillance

NYSE Regulation, Inc. | 11 Wall Street
New York, NY 10005
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Number 07-60
June 29, 2007

ATTENTION: CHIEF EXECUTIVE OFFICER, CHIEF OPERATIONS OFFICER, LEGAL AND COMPLIANCE DEPARTMENTS

TO: MEMBERS AND MEMBER ORGANIZATIONS

SUBJECT: ODD-LOT ORDER REQUIREMENTS

***** Please Show to Your Compliance Officer *****

I. Purpose

The purpose of this Information Memo is to remind all members and member organizations of the NYSE requirements governing use of the odd-lot system remain in effect and that odd-lot order activity must comply with these requirements. Firms are warned that use of the odd-lot system in ways that are inconsistent with traditional odd-lot investment activity is prohibited and violations will be pursued by the relevant regulatory authority, including NYSE Regulation.

II. Background

The NYSE odd-lot system is intended to afford customers of members and member organizations an inexpensive and efficient order execution system compatible with traditional odd-lot investing practices of smaller individual, retail investors. NYSE Rules 124 and 411(b) set forth procedures and requirements for the proper execution and processing of odd-lot orders. From the inception of the NYSE odd-lot system, the NYSE has required that the odd-lot system **not** be used as a professional trading vehicle, except as otherwise provided in this Memo. For purposes of this Memo, a professional trading vehicle includes trading strategies by professionals that would result in more than an incidental use of the odd-lot system.

III. Odd-Lot Order Handling and Prohibited Trading Practices

Use of the odd-lot system in ways that are inconsistent with traditional odd-lot investment activity or order entry practices that are intended to circumvent the round lot market constitute abuses of the odd-lot system and are prohibited. For example, members and member organizations are not permitted to engage in the following conduct:

- Unbundling market or limit round-lots for the purpose of entering odd-lot orders in comparable amounts;

- Failing to aggregate odd-lot orders into round-lots when such orders are for the same account or for various accounts in which there is a common monetary interest/beneficial ownership interest (note that the requirement to aggregate such orders applies to both market and limit orders);

- Entering both buy and sell odd-lot limit orders in the same stock before one of the orders is executed, for the purpose of capturing the "spread" in the stock;

- Effecting prearranged or wash sales in odd-lots, which are trades in which an offer to buy is coupled with an offer to sell back at the same or an advanced price (or the reverse). These trades are violative because they are not actually exposed to the risk of the market. Whether a transaction presents "market risk" is a facts and circumstances determination. As a general matter, however, in order to be considered at the risk of the market, at the time of the first transaction there can be no guarantee or assurance of the price of the second transaction. In addition, the time period between the two transactions would not of itself determine whether the trading had been effected at the risk of the market. Rather, such factors as the liquidity of the security and volume must be considered. Prearranged or wash sales in odd-lots or partial round lots ("PRLs") should not be used to create a false or misleading appearance of more actual or apparent active trading in such security. Such activity would violate SEC and NYSE anti-manipulation and anti-fraud rules, and other NYSE rules including but not limited to just and equitable principals of trade and good business practices.
- Effecting prearranged or wash sales in the round-lot portion of a PRL for the purpose of effecting an execution of the odd-lot portion of the PRL with no market risk and at a more favorable price than market conditions would have otherwise permitted. For example, when the quote in XYZ is .05 - .15, a customer simultaneously bids .06 for 199 shares and offers 100 shares at .06. This would cause 100 shares to execute at .06 (this would be a prohibited wash sale), which would in turn force the specialist to sell to the customer the remaining 99 shares at .06, thereby generating a riskless odd-lot trade at a better price for the odd-lot than the market at the time would have provided.
- Other types of trading activity in odd-lot orders or in PRLs that is not consistent with traditional odd-lot investment activity, including index arbitrage, certain types of program trading, security classes not usually involved in program trading (e.g., REITs, certain narrowly based structure products, etc.), or any pattern of activity that would suggest day trading or is otherwise clearly suspicious because it is inconsistent with traditional odd-lot investment activity.

It is also prohibited to enter a round-lot order to create a favorable execution price for odd-lot market or limit orders pending execution in the odd-lot system.

Odd-lot limit orders <u>may</u> be entered as part of a program trade, provided such orders in the aggregate constitute a relatively small part of the overall program. For example, the NYSE would consider a program consisting primarily of odd-lot orders to be presumptively violative of NYSE Rules and policies since the use of the odd-lot system would not be a "relatively small part" of the overall program.

In determining whether trading involving odd-lots is violative, NYSE Regulation will consider, among other factors, whether a strategy appears to intentionally utilize odd-lots for the purpose of accessing volume that would not be available in the round-lot market. Accordingly, NYSE Regulation will consider whether a strategy appears to be contingent on the use of odd-lots as opposed to round-lots, or seems to be structured in terms of the size or timing of the orders so that an inappropriate large number of odd-lot orders results. The conduct described above, in addition to the above cited rules, constitutes conduct inconsistent with just and equitable principles of trade and possible violations of federal securities laws and will result in disciplinary action by NYSE Regulation.

IV. Supervision

a. Supervision of Sponsored Participants

Members and member organizations must establish and enforce appropriate internal systems and controls to monitor odd-lot activity by customers, whether the order is entered by the firm or whether the order is entered by the customer directly using the firm's electronic order routing systems. Before granting access to its (or a vendor's) electronic order routing system to correspondents or other parties pursuant to carrying, clearing, or other arrangements, the member or member organization must assure that that such correspondents or other sponsored participants has adequate policies and procedures, written controls and supervisory procedures, and surveillances in place that are reasonably designed to detect improper activity and enforce compliance with SEC and NYSE rules. Member firms' supervisory systems must be designed to assure compliance with NYSE and SEC rules, and to monitor for inappropriate and manipulative conduct by their customers. At a very minimum, NYSE Regulation expects member firms to have policies, procedures, systems and controls, and surveillances to contemporaneously detect and deter the violations of NYSE and SEC rules, including but not limited to, the practices outlined above.

In this regard, members and member organizations are reminded that in addition to their regular supervisory duties under NYSE Rule 342, they also have an obligation under NYSE Rule 405 (the so-called "Know Your Customer" rule), to use due diligence to learn the essential facts relative to every customer and every order. The Rule's requirements apply to every customer order routed through electronic trading systems, including the NYSE's odd-lot order service. For further information on requirements for electronic transmission of orders, please refer to Information Memo 02-48.

Members and member organizations are responsible for all order activity effected through the use of their own or their vendors' electronic order routing systems. Firms who fail to adequately monitor for compliance by their customers may be subject to formal disciplinary action, including fines or the suspension or termination of its ability to enter odd lot orders or sponsor customers entering odd lot orders over its electronic order routing systems or other regulatory sanction as appropriate.[1]

b. Books and Records

[1] NYSE Regulation has recently imposed formal disciplinary sanctions and significant fines for odd-lot trading violations, which are described in Hearing Panel Decisions 07-10, 06-160, 06-171, and 06-192 and posted on NYSE.com.

All members and member organizations are reminded of their continuing obligation to accurately record account type information in their audit trail reporting in accordance with NYSE Rule 130(d), and should be aware that their obligation to provide accurate account type information in reporting program trading extends to the incidental odd-lot portions of a program; failure to properly provide account type information may result in disciplinary action against the firm. Therefore, members are advised to be especially diligent in their efforts to ensure the accuracy of program trading-related audit trail information.

V. NYSE Regulation Staff Contacts

Questions concerning this Information Memo should be addressed to:

Clare F. Saperstein, Principal Rule Counsel, Market Surveillance, at (212) 656-2355
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Questions may also be directed to the On-Floor Surveillance Unit via the White Phone or in person at their Booth in the EBR. Questions that are not time sensitive may also be submitted to Ask Market Surveillance. (For information about the Ask Market Surveillance system, refer to Member Education Bulletin 2006-3, which was issued on January 30, 2006, if you or your firm is not already a subscriber.)

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Robert A. Marchman
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Market Surveillance