

ALERTS

SEC Adopts Rules to Enhance Order Handling Information Available to Investors

December 14, 2018

On Nov. 2, 2018, the U.S. Securities and Exchange Commission adopted amendments (“Amendments”) to Rule 606 of the Securities Exchange Act of 1934, as amended (“Exchange Act”), to require new and enhanced disclosures by broker-dealers to customers regarding the handling of their orders.[1] The Amendments are intended to provide customers with greater clarity into broker-dealers’ order routing practices in light of significant changes to equity market structure that have occurred since the routing disclosure rules were originally adopted in 2000.[2] In particular, the Amendments will:

1. Require broker-dealers, upon customer request, to provide customer-specific disclosures regarding the broker-dealer’s handling of a customer’s orders in NMS stocks[3] submitted on a *not held* basis for the prior six months, subject to two de minimis exceptions;[4]
2. Require that broker-dealers’ quarterly order routing reports required by Exchange Act Rule 606(a) cover *all* customer orders in NMS stocks submitted on a *held* basis[5] and provide enhanced disclosures relating to payment for order flow, including both the net aggregate amounts of payment received from identified market centers and amounts received on a per share basis; and
3. Require that broker-dealers maintain the quarterly order routing reports required by Exchange Act Rule 606, as well as the order execution reports currently required by Exchange Act Rule 605, free

and accessible on a website for three years from the initial date of posting on the website.

The Amendments will become effective Jan. 18, 2019 *and* the compliance date will be May 20, 2019.

Background and Current Regulatory Framework

Currently, Exchange Act Rule 606 requires broker-dealers to publicly disclose, on a quarterly basis, certain aggregated order routing information for customer orders^[6] and to disclose separately to any customer, upon request, certain customer-specific order routing information for the six-month period preceding the request.^[7] The SEC adopted the Amendments to address changes in the equity market structure, order routing and handling practices since Exchange Act Rule 606 was originally adopted,^[8] including the increased percentage of orders being handled by trading algorithms and related routing systems. The Amendments are intended to assist market participants in comparing the routing services of broker-dealers and the relative merits of competing trading centers, and to help customers evaluate how broker-dealers handle conflicts of interest and risks of information leakage.

Amendments to Exchange Act Rule 606 of Regulation NMS

Customer-Specific Report on Not Held Order Handling

Newly adopted Exchange Act Rule 606(b)(3) will require broker-dealers to provide a customer, within *seven business days* of the customer's request, a report on the broker-dealer's handling of the customer's NMS stock orders^[9] submitted on a not held basis for the prior six months, including the handling of all child orders derived therefrom. These reports must be separated by calendar month and include separate sections for directed and non-directed orders. Each section must identify the total number of shares sent by the customer, the number of shares executed by the broker-dealer as principal, the number of orders exposed by the broker or dealer through an "actionable indication of interest" and the related

venue(s). Additionally, each report will require the following information for each venue to which the broker-dealer routed the customer's not held orders:

1. Information on Order Routing:

1. Total shares routed;
2. Total shares routed marked immediate or cancel;
3. Total shares routed that were further routable; and
4. Average order size routed.

2. Information on Order Execution:

1. Total shares executed;
2. Fill rate;
3. Average fill size;
4. Average net execution fee or rebate;
5. Total number of shares executed at the midpoint;^[10]
6. Percentage of shares executed at the midpoint;
7. Total number of shares executed that were priced on the side of the spread more favorable to the not held order;
8. Percentage of total shares executed that were priced at the side of the spread more favorable to the not held order;
9. Total number of shares executed that were priced on the side of the spread less favorable to the not held order; and
10. Percentage of total shares executed that were priced on the side of the spread less favorable to the not held order.

3. Information on Orders that Provided Liquidity:

1. Total number of shares executed of orders providing liquidity;
2. Percentage of shares executed of orders providing liquidity;

3. Average time between order entry and execution or cancellation, for orders providing liquidity; and
 4. Average net execution rebate or fee for shares of orders providing liquidity.
4. Information on Orders that Removed Liquidity:
1. Total number of shares executed of orders removing liquidity;
 2. Percentage of shares executed of orders removing liquidity; and
 3. Average net execution fee or rebate for shares of orders removing liquidity.

Definition of Customer

The Adopting Release notes that the term “customer,” when used in Exchange Act Rule 606(b)(3), means the “customer that places the order with the broker-dealer, *even if that customer may be acting on behalf of others and is not the ultimate beneficiary of any resulting transactions*, such as when an investment adviser, as the customer of a broker-dealer, places an order with the broker-dealer that represents the trading interest of clients of the investment adviser.”^[11] This interpretation of the term “customer” for purposes of Exchange Act Rule 606(b)(3) has a number of implications. For instance, an underlying customer of an investment adviser is not the broker-dealer’s “customer” for purposes of Exchange Act Rule 606(b)(3) and may not demand an Exchange Act Rule 606(b)(3) report (such reports, “Rule 606(b)(3) Reports”) unless the underlying customer maintains a separate relationship with the broker-dealer.^[12] Further, an investment adviser, as “customer,” may only demand Rule 606(b)(3) Reports for orders the investment adviser submitted to a broker-dealer *in aggregate* (that is, the investment adviser could not demand a Rule 606(b)(3) Report at the underlying account level). Broker-dealers should note that the SEC’s interpretation of “customer” for purposes of Exchange Act Rule 606(b)(3) may limit the broker-dealer’s ability to rely on the customer-specific de minimis exception.^[13]

Technology Outsourcing Scenarios

The Adopting Release notes that where a “broker-dealer simply forwards its customers’ orders on to another broker-dealer and that second broker-dealer exercises all discretion in determining where and how to

route and execute the orders, [] the first broker-dealer is not required to provide disclosures under Exchange Act Rule 606(b)(3) beyond those relevant to its activity in forwarding orders to the executing broker.”[14] However, the Adopting Release separately notes that where a broker-dealer “license[s] or outsource[s] technology offerings, such as trading algorithms, from third-parties, *including other broker-dealers*, to use for routing and executing orders”,[15] the broker-dealer utilizing these outsourced solutions must ensure it can provide the information required by Exchange Act Rule 606(b)(3). Accordingly, broker-dealers that outsource trading algorithms from other broker-dealers should be aware of the SEC distinction when generating Rule 606(b)(3) Reports. The Adopting Release does not address how such arrangements should be viewed under Exchange Act Rule 606(a).

Newly Defined Terms

The SEC, as part of the amendments, has adopted a number of newly defined terms, including (i) “orders providing liquidity,” (ii) “orders removing liquidity” and (iii) “actionable indication of interest.”

Liquidity Providing and Removing Orders

The term “orders providing liquidity” is defined as any order “executed against after resting at a trading center.”[16] Relatedly, the term “orders removing liquidity” is defined as any order “executed against resting trading interest at a trading center.”[17] Importantly, the Adopting Release does not discuss how broker-dealers should address the use of derivatively priced orders (e.g., “pegged” orders) that may be viewed as both “providing” and “removing” liquidity under the adopted definitions. While participants may choose to rely on liquidity tags provided by destination market centers (such as alternative trading systems) in determining whether an order “provided” or “removed” liquidity, destination venues may have different approaches in determining whether a derivatively priced order “provides” or “removes” liquidity.

Actionable Indications of Interest

The Amendments define the term “actionable indication of interest” as “any indication of interest that explicitly or implicitly conveys all of the following information with respect to any order available at the venue sending the indication of interest: (i) [s]ymbol; (ii) [s]ide (buy or sell); (iii) [a] price that is equal to or better than the national best bid for buy orders

and the national best offer for sell orders; and (iv) [a] size that is at least equal to one round lot.”[18] The Commission affirmed that the definition applies to indications of interest (“IOIs”) that are communicated electronically as well as IOIs that are communicated manually (e.g., via telephone).[19] As such, broker-dealers may need to adopt procedures to track “manual” IOIs and ensure information relating to such manual IOIs is included in Exchange Act Rule 606(b)(3) reports where appropriate.

The Adopting Release notes that where terms (e.g., size or price) are implicitly included in an IOI, the IOI may meet the definition of “actionable indication of interest.”[20] The Adopting Release further notes that past dealings may be relevant in determining whether an IOI is “actionable.” For instance, where past dealings indicate that submission of a marketable order in response to IOI will result in an execution (unless the represented trading interest had already been executed or cancelled), the SEC will likely view the IOI as “actionable.” Notwithstanding the foregoing, the SEC notes that IOIs that require further agreement of the broker-dealer that communicated the IOI (e.g., conditional orders) should *not* be considered actionable IOIs, unless course of conduct suggests that the broker-dealer’s agreement can be assumed.[21]

The Commission believes that the adopted definition of “actionable indication of interest” is “appropriately designed to capture trading interest *that is the functional equivalent to an order or quotation*.”[22] However, the Commission was careful to note that it “is not expanding the scope of existing rules, regulations, or guidance related to orders or quotations, other than Exchange Act Rule 606 and guidance related thereto, with regard to actionable IOIs.”[23]

De Minimis Exceptions

The Commission has also adopted two de minimis exceptions to the Exchange Act Rule 606(b)(3) reporting requirements. Specifically, a broker-dealer is not obligated to provide an Exchange Act Rule 606(b)(3) report: (i) to *any* customer if not held NMS stock orders constitute less than 5 percent of the total shares of NMS stock orders that the broker-dealer receives from its customers over the prior six months,[24] or (ii) to a particular customer if that customer trades through the broker-dealer, on average each month for the prior six months, less than \$1 million of notional value of not held orders in NMS stocks.[25] Importantly, where a broker-dealer relies on a de minimis exception to Exchange Act Rule 606(b)(3)’s reporting requirements, it must nevertheless comply with any

requests for order routing information under Exchange Act Rule 606(b)(1).
[26]

Held Order Disclosures

The Commission, as part of the Amendments, is also enhancing the existing obligation under Exchange Act Rule 606 that broker-dealers provide public quarterly reports on their order routing practices.[27] The Amendments will require the quarterly reports to cover NMS stock orders of *any* size (currently, orders in NMS Stocks with a market value of \$200,000 or higher are excluded) that are submitted on a held basis and continue to cover *any* order, whether held or not held, for an NMS security that is an option contract with a market value less than \$50,000. Broker-dealers will now also be required to:

- Report routing information separately for marketable limit orders and non-marketable limit orders;
- Report routing information by calendar month instead of quarterly and no longer categorize NMS stocks by listing market;
- Report routing information for NMS stock orders separately for securities included in the S&P 500 Index as of the first day of the quarter and other NMS stocks;
- Include the following information for the ten venues to which the largest number of total non-directed orders were routed for execution and for any venue to which five percent or more of non-directed orders were routed for execution:
 - The net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received, both as a total dollar amount and per share for: non-directed market orders, non-directed marketable limit orders, non-directed non-marketable limit orders and other non-directed orders; and
- Include a description of the terms of any payment for order flow and any profit-sharing arrangements that may influence a broker-dealer's order routing decision, including, among other things:
 - Incentives for equaling or exceeding an agreed upon order flow volume threshold;

- Disincentives for failing to meet an agreed upon minimum order flow threshold;
- Volume-based tiered payment schedules; and
- Agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue.

“Other” Order Type

While not discussed in the Adopting Release, the quarterly disclosures currently required by Exchange Act Rule 606(a) must be separated by (i) market, (ii) limit and (iii) “*other*” order types. SEC staff previously issued guidance regarding what orders should be included in the “*other*” order type category, noting that “market opening and closing orders, orders submitted with stop prices, all-or-none orders, orders that must be executed on a particular tick or bid (such as non-exempt short sale orders), *and ‘not held’ orders*”[28] should all be included. While Exchange Act Rule 606(a), as amended, retains the “*other*” order type category,[29] amended Exchange Act Rule 606(a) is expressly limited to orders handled on a “held” basis. Broker-dealers, however, should be aware that the “*other*” order type category will nevertheless remain.

Implications

Broker-dealers will need to assess the order and execution information they record when effecting an order to ensure they are able to comply with the Amendments. As noted above, broker-dealers will have to provide comprehensive disclosures regarding their handling of customers’ not held orders upon customer request. Given the relatively quick seven business day turnaround time to produce such reports, broker-dealers will need to ensure their systems capture all required information at the time of order receipt, routing or execution, as applicable. Further, the Amendments, which will provide regulators and market participants a significant amount of information on the effects of payment for order flow arrangements, maker-taker pricing systems and changes to exchanges’ fee structures, may also lead examiners to begin to ask broker-dealers how they use such data in their *own* best execution analyses.

Investment advisers and other fiduciaries should assess how best to utilize the additional disclosure information provided by the Rule 606(b)(3)

Reports to ensure that the advisers fulfill their best execution obligations. Furthermore, as the Amendments require the disclosure of a significant amount of additional information on the effects of payment for order flow arrangements, maker-taker pricing systems and changes to exchanges' fee structures, investment advisers and other fiduciaries should prepare to be questioned by customers and regulators on the impact of these arrangements and structures on execution quality.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] See Exchange Act Release No. 34-84528 (Nov. 2, 2018), 83 Fed. Reg. 58338 (Nov. 19, 2018) ("Adopting Release").

[2] See Exchange Act Release No. 43590 (Nov. 17, 2000), 65 Fed. Reg. 75414 (Dec. 1, 2000), adopting Exchange Act Rule 11Ac1-6, predecessor to Exchange Act Rule 606.

[3] As that term is defined at Exchange Act Rule 600(b)(47).

[4] As further discussed herein, the requirements of the newly adopted Exchange Act Rule 603(b)(3) are subject to a firm-level de minimis exception and a customer level de minimis exception.

[5] Currently, Exchange Act Rule 606(a) does not cover held orders in NMS stocks with a market value of \$200,000 or more.

[6] See Exchange Act Rule 606(a).

[7] See Exchange Act Rule 606(b).

[8] That is, since Exchange Act Rule 11Ac1-6, the predecessor to Exchange Act Rule 606, was adopted.

[9] While the quarterly reporting requirements of Exchange Act Rule 606(a) apply to all NMS securities (subject to certain exceptions), the customer-specific reports required by Exchange Act Rule 606(b)(3) will only apply to NMS stocks.

[10] This is not limited to customer orders pegged to the midpoint of the NBBO, but rather includes any midpoint execution.

[11] *See* Adopting Release, 83 FR at 58356 (emphasis added).

[12] *Id.*

[13] That is, the broker-dealer will likely be unable to look through an intermediary to the underlying account in determining whether it may rely on the customer-specific de minimis exception.

[14] *See* Adopting Release, 83 FR at 58357.

[15] *See* Adopting Release, 83 FR at 58358 (emphasis added).

[16] *See* Exchange Act Rule 600(b)(54), effective Jan. 18, 2019.

[17] *See* Exchange Act Rule 600(b)(55), effective Jan. 18, 2019.

[18] *See* Exchange Act Rule 600(b)(1), effective Jan. 18, 2019.

[19] *See* Adopting Release, 83 FR at 58354.

[20] Assuming the other factors required by the definition are met.

[21] *See* Adopting Release, 83 FR at 58354.

[22] *See* Adopting Release, 83 FR at 58353 (emphasis added).

[23] *See* Adopting Release, 83 FR at 58355.

[24] *See* Exchange Act Rule 606(b)(4), effective Jan. 18, 2019. Under the rule, the first time a broker-dealer meets or exceeds the 5 percent threshold, it has a grace period of up to three calendar months to provide the Exchange Act Rule 606(b)(3) report. There is no such grace period for compliance after the first time the threshold is met or exceeded.

[25] *See* Exchange Act Rule 606(b)(5), effective Jan. 18, 2019. When either de minimis exception applies, the broker-dealer still must provide, if requested, the Exchange Act Rule 606(b)(1) customer-specific disclosures for not held NMS stock orders that it receives from customers.

[26] That is, the current customer-specific disclosure requirements under Exchange Act Rule 606(b)(1). Exchange Act Rule 606(b)(1) is being amended to clarify its scope in relation to Exchange Act Rule 606(b)(3) and the related de minimis exceptions.

[27] *See* Exchange Act Rule 606(a).

[28] See here (Emphasis added).

[29] That is, disclosures under Exchange Act Rule 606(a)(1) will be separated the following order types: (A) market orders, (B) marketable limit orders, (C) non-marketable limit orders and (D) *other* orders.

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