



One Firm Worldwide<sup>SM</sup>



## WHITE PAPER

December 2018

### SEC Expands Order Handling Disclosure Requirements for Broker-Dealers

The Securities and Exchange Commission has amended its rules to require broker-dealers to disclose more information about their order routing practices. The changes are intended to help investors better understand how their broker-dealers route and handle their orders and how that may impact execution quality.

This *White Paper* provides an overview of Rule 606 of Regulation NMS and examines the alterations of the rule, which include the expanded disclosure of payment for order flow and any profit-sharing relationships, new customer-specific reporting requirements (there are two exceptions), and changes to routing practices regarding Actionable IOIs.

## TABLE OF CONTENTS

Expanded Content of the Quarterly Order Routing Report .....	1
Expanded Disclosure of Payment for Order Flow and Profit-Sharing Relationships .....	1
New Customer-Specific Reporting Requirements .....	2
<i>De Minimis</i> Exceptions to Customer-Specific Reporting .....	2
Actionable IOIs .....	3
Timetable for Compliance .....	3
Key Takeaways .....	3
Lawyer Contacts .....	3
Endnotes .....	4

On November 2, 2018, the U.S. Securities and Exchange Commission (“SEC”) adopted amendments to Rule 606 of Regulation NMS to require broker-dealers to disclose more information to investors about the way they handle those customers’ orders in NMS securities.<sup>1</sup> As the SEC noted in its adopting release, and when it originally adopted Rule 606, “in a fragmented market ‘the order routing decision is critically important’ and ‘must be well-informed and fully subject to competitive forces,’ and, further, the public disclosure of order routing practices ‘could provide more vigorous competition on . . . order routing performance.’”<sup>2</sup> For many years, however, industry participants have complained that the routing reports required to be published under Rule 606 (as well as the monthly execution statistics of market centers required by Rule 605 of Regulation NMS) had only limited utility because, among other things, broker-dealer reports differed significantly in format and content, which made comparisons difficult. The expanded public disclosure requirements in Rule 606, and the requirement to make standardized individualized reports to their customers upon request, are intended to help investors better understand how their broker-dealers route and handle their orders and how those activities may impact execution quality, including how their broker-dealers comply with best execution obligations and manage the potential for information leakage and conflicts of interest.

## **EXPANDED CONTENT OF THE QUARTERLY ORDER ROUTING REPORT**

Current Rule 606 requires broker-dealers to publish a quarterly report on their routing of non-directed orders in NMS securities during that quarter, broken down by calendar month.<sup>3</sup> The reported information is currently divided into three sections based on the listing exchange for a NMS stock (i.e., NYSE, Nasdaq, and other national securities exchanges), plus a separate section for options. Amended Rule 606, however, requires the information to be divided between NMS stocks (no matter where listed, and separated into stocks included in the S&P 500 Index as of the first day of that quarter and other NMS stocks) and options that are NMS securities.<sup>4</sup>

Within these two sections, the broker-dealer is required to report on the percentages of total customer orders that were non-directed orders and, of those orders, the broker-dealer must now disclose the percentages that were market orders,

marketable limit orders, non-marketable limit orders, and other orders.<sup>5</sup> (Previously, there was a single category including all limit orders.) As with the current rule requirements, amended Rule 606 requires the firm to identify the 10 venues to which the largest number of total non-directed orders were routed for execution and any venue to which five percent or more of non-directed orders were routed for execution; the percentage of total non-direct orders for the section routed to the venue; and the percentages of total non-directed market orders, total non-directed marketable limit orders, total non-directed non-marketable limit orders, and other total non-directed orders for the section that were routed to the venue.

## **EXPANDED DISCLOSURE OF PAYMENT FOR ORDER FLOW AND PROFIT-SHARING RELATIONSHIPS**

The biggest changes resulting from the amendments, however, are to the reporting requirements for payment for order flow and profit-sharing relationships with venues to which the firm routes orders.<sup>6</sup> These disclosures of fees, rebates, and economic incentives that may affect routing decisions are intended to allow customers to adequately evaluate their broker-dealers’ potential conflict of interest.

Thus, for each identified venue, the broker-dealer must report 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 each of the market orders, marketable limit orders, non-marketable limit orders, and other orders routed to that venue. The SEC also expanded the narrative discussion requirements of Rule 606 reports by specifying the information that must be included in the discussion. Consequently, a firm must now include:

A discussion of the material aspects of the broker’s or dealer’s relationship with each venue identified . . . , including a description of any arrangement for payment for order flow and any profit-sharing relationship and a description of any terms of such arrangements, written or oral, that may influence a broker’s or dealer’s order routing decision including, among other things:

- (i) Incentives for equaling or exceeding an agreed upon order flow volume threshold, such as additional payments or a higher rate of payment;

- (ii) Disincentives for failing to meet an agreed upon minimum order flow threshold, such as lower payments or the requirement to pay a fee;
- (iii) Volume-based tiered payment schedules; and
- (iv) Agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue.<sup>7</sup>

The quarterly reports required under Rule 606(a)(1) must be made publicly available within one month after the end of the quarter addressed in the report.<sup>8</sup> In addition, the reports must be posted and remain available on an Internet web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet web site.<sup>9</sup>

## **NEW CUSTOMER-SPECIFIC REPORTING REQUIREMENTS**

As with the current rule requirements, amended Rule 606 requires that, at the request of its customer, a firm disclose to the customer the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transaction, if any, that resulted from such orders. This information is to be separated for held orders in NMS stocks, not held orders in NMS stocks (if the firm is not required to provide the customer with a separate report, described below), and orders for options that are NMS securities.

The Rule has been amended to require a broker-dealer, upon the request of a customer who places a not held order (i.e., an order in which the customer gives the firm price and time discretion), to provide the customer with a standardized set of individualized disclosures concerning the firm's handling of that customer's order. Among other things, these additional disclosures will include information about rebates received from fees paid to the trading venues to which customer orders were routed.

Specifically, the customer-specific report required by the new Rule 606(b)(3) will include the number of shares sent to the broker-dealer; the number of shares executed by the firm as principal for its own account; not held orders exposed by the broker-dealer through "actionable indications of interest" ("Actionable IOIs"); and the venues to which they were

exposed, provided that the identity of such venue or venues may be anonymized if the venue is a customer of the broker-dealer. The report also will include more specific information than is currently required for each venue to which the broker-dealer routed not held orders for the customer in the aggregate. Thus, the report will include: (i) Total shares routed, whether those orders were marked as immediate or cancel or further routable, and average order size routed; (ii) Information on order execution—including fill rate, average fill size, average net execution fee or rebate, and number of shares and percentage executed at the midpoint of the National Best Bid and Offer ("NBBO") at a price better than the not held order and at a price worse than the not held order; (iii) Information on orders that provided liquidity—including number and percentage of such orders, average time between order entry and receipt or cancellation (in milliseconds), and average net execution rebate or fee for such orders; and (iv) Information on orders that removed liquidity, including number and percentage of such orders and any rebates or fees related to such orders. All rebate and fee information is to be reported in cents per 100 shares, to four decimal places.

Commenters to the SEC's proposed amendments had suggested that the Rule require that additional data points be included in the individual standard reports for customers, but the SEC rejected those suggestions, concluding that the compliance costs and added complexity associated with commenters' suggestions "would not be justified by the marginal utility that these disclosures may add to the report beyond that which is provided by the disclosures."<sup>10</sup>

Although the new rule provisions require standardized customer-specific disclosures, which will allow customers to more easily compare the order-handling practices of their various broker-dealers, there is nothing in the rule, however, that prevents a customer from negotiating with its broker-dealers for additional disclosures regarding the handling of their orders. Broker-dealers certainly can provide more detailed information than is required under Rule 606(b)(3).<sup>11</sup>

## **DE MINIMIS EXCEPTIONS TO CUSTOMER-SPECIFIC REPORTING**

There are two exceptions in Rule 606 to the individualized customer reports for not held orders. The first excepts a

broker-dealer from the report requirement for *any* customer if not held NMS stock orders constitute less than five percent of the total shares of NMS stock orders that the firm receives from its customers over the prior six months (the “five percent threshold”).<sup>12</sup> A broker-dealer that equals or exceeds this five percent threshold (if not excepted under the second exception, described below) must provide reports as requested by customers for at least six calendar months (“Compliance Period”) regardless of the percentage of shares of not held orders in NMS stocks the broker or dealer receives from its customers during the Compliance Period. Once the firm meets or exceeds this firm-level five percent threshold for the first time, however, it has a grace period of three months before it is subject to the customer reporting requirements.

The second excepts a broker-dealer from providing an individualized customer report to a particular customer if that customer traded on average less than \$1 million of notional value of not held orders in NMS stock in each month over the prior six months through the broker-dealer.<sup>13</sup> In addition, the new reporting requirements of Rule 606(b)(3) do not apply to orders received from broker-dealers.

## ACTIONABLE IOIs

As noted, a firm is now required to provide disclosures about its routing practices regarding Actionable IOIs based on customer orders. The SEC has defined Actionable IOIs for purposes of Regulation NMS, and not just for purposes of Rule 606, as any IOI that explicitly or implicitly conveys symbol, side, a price that is equal to or better than the NBBO for buy orders and the NBBO for sell orders, and a size of at least one round lot. This is the same definition of “actionable IOI” that the SEC proposed several years ago in connection with its 2009 so-called “Dark Liquidity” release.<sup>14</sup> Essentially, the SEC considers an Actionable IOI to be the functional equivalent of an order or quotation (i.e., a firm representation of trading interest), such that a recipient of the Actionable IOI may presume that, if it sends a matching contra order, the recipient can get an execution without further agreement of the broker-dealer that routed the IOI. In practice, an Actionable IOI would likely encompass any IOI based on a marketable order, so a firm should be prepared to include all IOIs relating to not held customer orders in their reports.<sup>15</sup>

## TIMETABLE FOR COMPLIANCE

As of May 20, 2019, non-exempt firms will have to provide to customers upon request the customer-specific reports required under new Rule 606(b)(3) covering the customers’ orders routed for execution in the preceding six months. This compliance date is intended to coincide with the six-month look-back period for the new reporting requirements.

## KEY TAKEAWAYS

1. Amended Rule 606 will require more granular reporting of order handling statistics, as well as significantly more disclosure of financial arrangements relating to order routing. Firms should review their systems now to ensure that they are capturing the required information to be included in both the publicly-posted reports and the individualized customer reports under amended Rule 606.
2. Because customer order activity may vary greatly month-to-month, a firm should track its customers’ order flow if it seeks to claim the customer-specific exemption from individualized customer reporting.

## LAWYER CONTACTS

For more information, please contact your principal Jones Day representative or the lawyers below. General email messages may be sent using our “Contact Us” form at [www.jonesday.com/contactus/](http://www.jonesday.com/contactus/).

### Laura S. Pruitt

Washington  
+1.202.879.3625  
[lpruitt@jonesday.com](mailto:lpruitt@jonesday.com)

### Eric A. Love

New York  
+1.212.326.3426  
[elove@jonesday.com](mailto:elove@jonesday.com)

### David P. Bergers

Boston  
+1.617.449.6870  
[dbergers@jonesday.com](mailto:dbergers@jonesday.com)

### Michael R. Butowsky

New York  
+1.212.326.8375  
[mrbutowsky@jonesday.com](mailto:mrbutowsky@jonesday.com)

## ENDNOTES

- 1 See "Disclosure of Order Handling Information," Securities Exchange Act Release No. 84528 ( November 2, 2018), 83 FR 58338 (November 19, 2018) ("Adopting Release").
- 2 Adopting Release, 83 FR at 58339, quoting Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594, 3602 (January 21, 2010) ("Concept Release on Equity Market Structure").
- 3 A "directed order" means an order from a customer that the customer specifically instructed the broker or dealer to route to a particular venue for execution. See 17 CFR 242.600(b)(20). A "non-directed order" means any order from a customer other than a directed order. See 17 CFR 242.600(b)(49).
- 4 See Rule 606(a)(1).
- 5 A "marketable limit order" is any buy order with a limit price equal to or greater than the national best offer at the time of order receipt, or any sell order with a limit price equal to or less than the national best bid at the time of order receipt. 17 CFR 242.600(b)(39). "National best bid and national best offer" is defined in Rule 600 of Regulation NMS. 17 CFR 242.600(b)(42). The SEC has adopted new Rule 600(b)(54) to define "non-marketable limit order" to mean "any limit order other than a marketable limit order."
- 6 "Payment for order flow" has the meaning provided in 17 CFR 240.10b-10. See 17 CFR 242.600(b)(54). A "profit-sharing relationship" is defined in Rule 600 of Regulation NMS. See 17 CFR 242.600(b)(56).
- 7 See Rule 606(a)(1)(iv).
- 8 See Rule 606(a)(2).
- 9 See Rule 606(a)(1). As part of this rulemaking, the SEC also amended Rule 605 to require market centers (i.e., any national securities exchange, national securities association, exchange market maker, OTC market maker, and alternative trading system) to keep their monthly execution reports required by that rule posted on a web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the web site. As part of their "regular and rigorous" best execution reviews, introducing brokers may refer to both Rule 605 reports and Rule 606 reports, and this amendment makes consistent the periods for which such reports will be remain publicly available.
- 10 Adopting Release, 83 FR at 58368.
- 11 In fact, many large institutional customers currently receive detailed statistical reports from their broker-dealers regarding the handling of their orders. The rule changes are intended to make such reports more widely available to customers meeting certain trading activity thresholds.
- 12 See Rule 606(b)(4).
- 13 See Rule 606(b)(5).
- 14 See "Regulation of Non-Public Trading Interest," Securities Exchange Act Release No. 60997 (November 13, 2009), 74 FR 61208 (November 23, 2009). It should be noted, however, that this new definition does not change the definition of "order" for purposes of Regulation ATS, including with respect to the requirements relating to order display and execution access set forth in Rule 301(b)(3) of Regulation ATS, as had been proposed in the Dark Liquidity release.
- 15 This is because, pursuant to the Order Protection Rule (Rule 611 of Regulation NMS), all non-excepted orders are required to be executed at or within the NBBO. Thus, it can generally be implied that the price of the order underlying the Actionable IOI is a price that is equal to or better than the national best bid for buy orders and the national best offer for sell orders. Likewise, many market centers do not accept orders in less than one round lot, so it may be assumed that any IOI routed to such a market center will meet the size threshold to be "actionable."

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form on our website at [www.jonesday.com](http://www.jonesday.com). The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.