

## **SEC's Proposed Amendments to Broker- Dealers' Order Routing Disclosures**

A legal update from Dechert's Financial Services Group

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# SEC's Proposed Amendments to Broker-Dealers' Order Routing Disclosures

The Securities and Exchange Commission (SEC) has published proposed amendments to Rule 606 under Regulation NMS of the Securities Exchange Act of 1934 (Exchange Act), which would require broker-dealers to disclose publicly on their websites, and upon the customer's request, information regarding the handling of institutional orders, and to increase the information required to be disclosed regarding retail orders.<sup>1</sup> "Institutional orders" are proposed to be defined as orders in NMS stocks (*i.e.*, exchange-listed stocks) that are not for the account of a broker-dealer and have a market value of at least \$200,000. Comments are due by September 26, 2016.

The chart beginning on Page 3 summarizes Rule 606 as proposed to be amended. The key changes proposed are set forth below.<sup>2</sup>

- Institutional Order Disclosure
  - In the case of institutional orders, disclosure would be required for customer-directed orders as well as non-directed orders.
  - Upon the request of a customer, a broker-dealer would be required to provide a report of the broker-dealer's handling of the customer's institutional orders, presented on an aggregate basis, in the form of specific monthly data for the prior six months. The determination of whether an order is an institutional order that must be disclosed would be made based on the size of the order received from a customer. If that threshold is met, each smaller (*i.e.* child) order created by the broker-dealer to executed the larger (parent) order would be reflected in the report.
  - The SEC proposes to require that broker-dealers categorize each institutional order by one of three order routing strategies (*i.e.*, passive, neutral and aggressive order) and make and maintain records regarding the particular broker-dealer's methodology for categorizing orders.
  - Similar to current reports for retail orders, broker-dealers would be required to display on their public websites quarterly reports of aggregate information showing the handling of all customers' institutional orders, with information broken down by month.
- Retail Order Disclosure
  - Broker-dealers' Rule 606 retail order routing reports are proposed to be required to include more detailed information regarding remuneration received by the broker-dealer from execution venues and transaction fees paid by the broker-dealer to such venues.

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<sup>1</sup> Release No. 34-78309 (July 13, 2016), 81 Fed. Reg. 49432 (July 27, 2016).

<sup>2</sup> Certain conforming amendments are also proposed to Rules 200 and 204 of Regulation SHO and to Rules 600, 602, 605, 607, and 611 of Regulation NMS to add definitions of new terms and to update cross references. A proposed amendment to Rule 605 would require market centers to display their monthly order execution reports.

- Rule 606 reports would no longer be required to be divided into segments by primary listing market, because the primary listing market may no longer be the dominant market for the security.
- The SEC proposes to require that public quarterly reports be broken down by month.
- As proposed, broker-dealers would be required to provide separate reporting information for marketable and non-marketable limit orders.

Because many broker-dealers already are required to prepare Rule 606 reports on their routing of retail orders, some considerations in reviewing the proposed amendments are:

- The rationale for requiring broker-dealers to disclose information to institutional investors about those customers' directed orders;
- Workability of the proposed categories of order routing strategies and whether the information provided is meaningful to investors;
- The purpose for requiring broker-dealers to identify an order routing strategy for institutional investors' directed orders;
- Whether the proposed definition of actionable indications of interest (IOIs) is over-inclusive because it likely includes IOIs whose terms remain subject to negotiation;<sup>3</sup>
- Benefits to be obtained by requiring quarterly information to be displayed on a month-by-month basis;
- Compliance considerations in capturing the terms of oral arrangements relating to payment for order flow and profit-sharing arrangements;
- Appropriateness of imposing different disclosure requirements for the same type of information (such as payments for order flow and rebates);
- Absence of any materiality standard (e.g., with respect to the venues to which a broker-dealer routes institutional orders);
- Time that would be required to comply with the amended rule, and whether phased-in compliance dates would be practicable; and
- Additional costs for broker-dealers to comply with the extensive new reporting requirements, particularly when weighed against benefits to investors.

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<sup>3</sup> An actionable IOI is proposed to be defined in Rule 600(b)(1) 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: (1) symbol; (2) side (buy or sell); (3) 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 (4) a size that is at least equal to one round lot."

	Retail Orders	Institutional Orders
New Definitions		
Covered orders	<p>“Retail order” is not explicitly defined in Rule 606. However, Rule 606 currently applies to a “customer order,” which means “a [non-directed] order to buy or sell an NMS security that is not for the account of a broker or dealer, but shall not include any order for a quantity of a security having a market value of at least \$50,000 for an NMS security that is an option contract and a market value of at least \$200,000 for any other NMS security.”<sup>4</sup></p>	<p>An institutional order is proposed to be defined as a (directed or non-directed) order to buy or sell an NMS stock that is not for the account of a broker or dealer and is an order for a quantity of NMS stock having a market value of at least \$200,000.</p> <p>For purposes of the proposed institutional order reports, the handling of an institutional order would include the handling of all smaller orders derived from the institutional order.</p>
Actionable IOIs	N/A	Actionable IOIs are proposed to include IOIs that convey to the trading venue, explicitly or implicitly, the symbol, side, price and size
Quarterly Reports		
General requirement for reports	Quarterly, broken down by calendar month, <sup>5</sup> for three years from the initial date of posting on a website that is free and readily accessible to the public.	The same as the proposed amended requirement for retail orders.
Information regarding order routing, order execution, orders providing liquidity and orders taking liquidity	<p>For each section of the report, broker-dealers are proposed to be required to disclose:</p> <p>1. The percentage of total retail orders that were non-directed orders;<sup>6</sup></p>	<p>Broker-dealers are proposed to be required to disclose:</p> <p>1. The total number of shares of institutional orders sent to the broker-dealer by institutional</p>

<sup>4</sup> Rule 600(a)(46) defines “NMS security” as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.”

<sup>5</sup> Currently, Rule 606 reports for retail orders are not required to be broken down by calendar month.

<sup>6</sup> As drafted, the institutional order handling disclosures would not be limited to non-directed orders.

	Retail Orders	Institutional Orders
	<p>2. The percentages of total non-directed orders that were market orders, marketable limit orders, non-marketable limit orders, and other non-directed orders;<sup>7</sup></p> <p>3. The identity of the 10 venues to which the largest number of total non-directed orders for the same section were routed for execution;</p> <p>4. Any venue to which 5% or more of non-directed orders were routed for execution;</p> <p>5. The percentage of total non-directed orders for the section routed to the venue; and</p> <p>6. The percentages of total non-directed market orders, total non-directed marketable limit orders, total non-directed non-marketable limit orders and total non-directed other orders that were routed to the venue.</p>	<p>customers during the relevant period; and</p> <p>2. The total number of shares executed by the broker- dealer as principal for its own account.</p> <p>In addition, for each venue to which the broker-dealer routes institutional orders for a customer, the report would be required to include a column showing in the aggregate:<sup>8</sup></p> <p>1. Order routing information:</p> <ul style="list-style-type: none"> <li>a. Total shares routed;</li> <li>b. Total shares routed marked immediate or cancel;</li> <li>c. Total shares routed that were further routable; and</li> <li>d. Average order size routed.</li> </ul>
		<p>2. Order Execution Information:</p> <ul style="list-style-type: none"> <li>a. Total shares executed;</li> <li>b. Fill rate (shares executed divided by the shares routed);</li> <li>c. Average fill size;</li> <li>d. Average net execution fee or rebate (cents per 100 shares, specified to four decimal places);</li> </ul>

<sup>7</sup> The new category of “non-marketable limit orders” is proposed to be defined as all limit orders other than marketable limit orders.

<sup>8</sup> Unlike retail orders, the SEC did not propose to limit the institutional order reports to the 10 venues to which the largest number of orders were routed.

	Retail Orders	Institutional Orders
		<p>e. Total number of shares executed at the midpoint;</p> <p>f. Percentage of shares executed at the midpoint;</p> <p>g. Total number of shares executed that were priced on the side of the spread more favorable to the institutional order;</p> <p>h. Percentage of total shares executed that were priced at the side of the spread more favorable to the institutional order;</p> <p>i. Total number of shares executed that were priced on the side of the spread less favorable to the institutional order; and</p> <p>j. Percentage of total shares executed that were priced on the side of the spread less favorable to the institutional order.</p>
Assignment of order routing strategies	N/A	<p>Broker-dealers are proposed to be required to assign each institutional order (and reflect in their institutional order handling reports) one of the following order routing strategies:</p> <p>1. "Passive order routing strategy," which is proposed to be defined as one that emphasizes the minimization of price impact over the speed of execution of the entire institutional order;</p>

	Retail Orders	Institutional Orders
		<p>2. "Neutral order routing strategy," which is one that is relatively neutral between minimization of price impact and the speed of execution of the entire institutional order; or</p> <p>3. "Aggressive order routing strategy," which is one that emphasizes the speed of execution of the entire institutional order over minimization of price impact.</p> <p>Broker-dealers would be required to assign order routing strategies consistently in each report, and to promptly update the strategy assignments any time an existing strategy is amended or a new strategy is created that would change such assignment.</p> <p>Broker-dealers also would be required to document the specific methodologies used to assign order routing strategies and to preserve a copy of the methodologies used to assign order routing strategies in a manner consistent with Exchange Act Rule 17a-4(b).</p>
Required information regarding actionable IOIs	N/A	<p>Each report would be required to include:</p> <p>1. The total number of institutional orders exposed by the broker-dealer through an actionable indication of interest; and</p> <p>2. The venue(s) to which institutional orders were exposed by the broker-dealer through an actionable IOI.</p>

	Retail Orders	Institutional Orders
Payments received from, and fees paid to, each of the top 10 venues	<p>Broker-dealers would be required to provide additional information relating to payments received from, and fees paid to, trading venues - specifically, the net aggregate amount of any payments for order flow received, payments received from any profit-sharing relationship, transaction rebates received, and transaction fees paid.</p> <p>Information would be required to be reported as a total dollar amount and per share for each of the following non-directed order types: market orders; marketable limit orders; non-marketable limit orders; and other orders.</p>	The same information described above for institutional orders' quarterly reports.
Narrative regarding relationship with each of the top 10 venues	<p>As proposed to be expanded, a broker-dealer would be required to include a discussion of the material aspects of its relationship with each venue, including:</p> <ol style="list-style-type: none"> <li>1. A description of any payment for order flow arrangement and any profit-sharing relationship; and</li> <li>2. A description of any terms of such arrangements, written or oral, that may influence a broker-dealer's order routing description, including among other things: <ol style="list-style-type: none"> <li>a. Incentives for equaling or exceeding an agreed-upon order flow volume threshold, such as additional payments or a higher rate of payment;</li> <li>b. Disincentives for failing to meet an agreed-upon minimum order flow threshold, such as lower payments or the requirement to pay a fee;</li> <li>c. Volume-based tiered payment schedules; and</li> </ol> </li> </ol>	N/A



	Retail Orders	Institutional Orders
	d. Agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue.	
Deadline for providing information	Broker-dealers are required to post their information on a publicly available website within one month after the end of the quarter addressed in the report.	The same as for retail orders.
Technical format for report	The reports would need be formatted using the most recent version of the XML schema and the associated PDF render as published on the SEC's website.	The same as for retail orders.
*Information upon Requests		
Required information	<p>Broker-dealers are required to provide information relating to retail orders for the six months preceding the customer's request:</p> <ol style="list-style-type: none"> <li>1. The identity of the venue to which the customer's retail orders were routed for execution;</li> <li>2. Whether the orders were directed orders or non-directed orders; and</li> <li>3. The time of any transactions that resulted from such orders.</li> </ol>	<p>Broker-dealers are proposed to be required to provide information relating to institutional orders for the six months preceding the request of a customer that directly or indirectly places an institutional order with the broker-dealer, with the information required to be provided in quarterly reports, but on a non-aggregated, customer-specific basis.</p> <p>Unlike the reports requested by retail customers, broker-dealers are not proposed to be required to advise institutional investors whether orders were directed or non-directed, or the time of execution.</p>
Due date	The broker-dealer must provide the information to the requesting customer within seven business days of receiving the request.	The same as for retail orders.
Notification requirements	At least annually, broker-dealers are required to notify customers in writing of the availability, on the customer's request of information regarding their particular orders.	None proposed.

	Retail Orders	Institutional Orders
Technical format for report	The same as for quarterly reports.	The same as for quarterly reports.
Timeframe for information	The reports must include information for the six months prior to the request.	The same as for retail orders.

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