CLIENT MEMORANDUM

SEC Proposes New Rules to Enhance Order Handling Information Available to Investors

July 28, 2016

AUTHORS

James R. Burns | Justin L. Browder

On July 13, 2016, the Securities and Exchange Commission (the "SEC") proposed amendments to Rules 600, 605, 606, and 607 of Regulation NMS under the Securities Exchange Act of 1934. Among other things, the proposals would require broker-dealers to disclose detailed metrics concerning the routing and execution of orders on behalf of institutional customers and would expand the information included in existing disclosures concerning executions on behalf of retail customers.[1] The proposed rules are intended to provide customers with greater clarity into modern intermediary practices and facilitate a better assessment of broker-dealers' order routing practices in light of significant changes to equity market structure that have occurred since the routing disclosure rules were adopted in 2000.

Currently, Rule 606 requires broker-dealers to disclose publicly, on a quarterly basis, certain aggregated order routing information for "customer orders" and to disclose separately to a customer, upon request, certain customer-specific order routing information for the six-month period preceding the request. The term "customer order" is defined as an order for NMS securities[2] that is not for the account of a broker-dealer and has a market value of less than $200,000 for stocks or

---

[1] *See* Disclosure of Order Handling Information, Exchange Act Release No. 78309 (July 13, 2016), available here.

[2] An "NMS security" is 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. In general, the term refers

less than $50,000 for options. Rule 606 does not currently mandate disclosure of order routing information for large, institutional-sized orders. When Rule 606 was adopted in 2000, the SEC believed that providing standardized order handling statistics for these orders would be of little use because institutional orders were historically executed on a bespoke basis or routed to a few, mostly manual, trading centers. In the intervening years, however, markets have undergone monumental technological changes. Orders of all sizes are now executed – almost exclusively – on an automated basis using complicated order execution algorithms and routing systems. Financial arrangements with trading venues also incentivize broker-dealers to route retail orders to over-the-counter market makers, and large institutional orders can be split up and sent to a variety of venues, including exchanges, dark pools and other alternative trading systems, and internalizing broker-dealers.

As a result of these developments, the SEC now believes that standardized order handling information regarding institutional-sized orders should also be made available to customers upon request. The SEC also believes that public disclosure of institutional order handling information, on an aggregated basis, would assist market participants in comparing the routing services of broker-dealers and the relative merits of competing trading centers and would help customers evaluate how broker-dealers handle conflicts of interest and risks of information leakage. With respect to smaller-sized "customer orders," the SEC believes that existing Rule 606 disclosures should be updated to require that more relevant routing information be provided to customers.

Although broker-dealers are already accustomed to preparing order handling reports, the SEC's proposals, if adopted, would likely yield an increased workload for firms' operational staff as institutional investors are granted access to customer-specific data for the first time. Such investors – many of whom are SEC-registered investment advisers or serve in other fiduciary capacities – would undoubtedly request the reports and scrutinize them closely as part of their best execution oversight, and the result could be downward pressure on commission pricing models.

Comments on the proposals, discussed in detail below, are due on or before September 26, 2016.

Institutional Order Disclosures

The proposed rules would amend Rule 606 to require a broker-dealer to provide to a customer, upon request, a standardized report on the broker-dealer's handling of the customer's "institutional orders." In addition, a broker-dealer would be required to make publicly available a quarterly report containing aggregated information about the broker-dealer's handling of institutional orders for all customers. The term "institutional order" would be defined as an order to buy or sell a quantity of an NMS stock having a market value of at least $200,000, provided that such order is not for the account of a broker-dealer. The term "customer order," currently defined in Rule 600, would be replaced with the term "retail order" to distinguish the varying disclosure requirements for different sized orders.

---

to exchange-listed equity securities and standardized options, but does not include exchange-listed debt securities, securities futures, or open-end mutual funds, which are not currently reported pursuant to an effective transaction reporting plan.

Standardized Customer-Specific Reports under Proposed Rule 603(b)(3)

The customer-specific report under proposed Rule 603(b)(3) would contain routing data for the six months preceding the customer's request. The data would be displayed on an aggregated basis and also categorized into three general strategy categories: (1) a "passive order routing strategy," which emphasizes the minimization of price impact over the speed of execution of the entire institutional order; (2) a "neutral order routing strategy," which is neutral between the minimization of price impact and speed of execution of the entire institutional order; and (3) an "aggressive order routing strategy," which emphasizes speed of execution of the entire institutional order over the minimization of price impact. The report would include (i) total number of shares of institutional orders sent to the broker-dealer by the customer during the reporting period; (ii) total number of shares executed by the broker-dealer as principal for its own account; (iii) total number of institutional orders exposed by the broker-dealer through an actionable "indication of interest"[3] ("IOI"); and (iv) venue or venues to which institutional orders were exposed by the broker-dealer through actionable IOIs. The SEC believes these enhanced, uniform disclosures would assist customers in evaluating the quality of broker-dealer services.

The customer-specific report would also include the following data concerning each venue to which the broker-dealer routed institutional orders for the customer during the six-month period (displayed on an aggregated basis and also categorized into the three general strategy categories, noted above): (i) total shares routed; (ii) total shares routed marked immediate or cancel; (iii) total shares routed that were further routable; (iv) average order size routed; (v) total shares executed; (vi) fill rate; (vii) average fill size; (viii) average net execution fee or rebate; (ix) total number of shares executed at the midpoint; (x) percentage of shares executed at the midpoint; (xi) total number of shares executed that were priced on the side of the spread more favorable to the institutional order; (xii) percentage of total shares executed that were priced at the side of the spread more favorable to the institutional order; (xiii) total number of shares executed that were priced on the side of the spread less favorable to the institutional order; and (xiv) percentage of total shares executed that were priced on the side of the spread less favorable to the institutional order. Current market structures enable sophisticated traders to monitor order and execution activity, looking for patterns that signal the existence of a large institutional order. Each time an order is routed to a particular venue, and each time an actionable IOI is sent, information is revealed about the order. Institutional customers have expressed concern that excessive routing may increase the risk of information leakage with few corresponding benefits. The SEC thus believes that standardized order handling disclosures on a per-venue basis will improve a customer's ability to assess the potential risk of information leakage relative to execution quality.

Finally, the report would contain information about orders that provided and removed liquidity, including the total number and percentage of shares providing and removing liquidity and the average net execution rebate or fee for shares of

---

[3] Under Proposed Rule 600(b)(1), an actionable indication of interest is "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."

orders providing or removing liquidity. The SEC believes that this proposal will permit customers to assess the extent to which broker-dealers base routing decisions on pricing models, including the "maker-taker" model,[4] whereby venues incentivize broker-dealers to route orders by altering the value of access fees charged and/or rebates given.

Quarterly Reports under Proposed Rule 606(c)

Under proposed Rule 606(c) a broker-dealer that receives institutional orders would be required to make publicly available a report that aggregates the information required for customer-specific institutional order handling reports, described above, for all institutional orders it receives. A broker-dealer would be required to make its aggregated report publicly available for each calendar quarter, broken down by calendar month, within one month after the end of the quarter. The report would also be required to be posted on a website for three years. The SEC believes that the aggregated reports would better enable market participants to analyze historical practices of a single broker-dealer or compare practices among multiple firms.

Retail Order Disclosures

Changes to market structure and order routing practices have also prompted the SEC to analyze existing disclosure requirements for "customer" (*i.e.*, "retail") orders under Rule 606. Currently, Rule 606(a)(1)(i) provides that a broker-dealer's quarterly order routing report must include the percentage of total orders that were non-directed orders and the percentage of total non-directed orders that were market orders, limit orders, and other orders. Rule 606(a)(1)(ii) provides that the quarterly order routing report must identity the ten venues to which the largest number of non-directed orders were routed for execution and any venue to which five percent or more of non-directed orders were routed, along with information about the percentage and type of total non-directed orders routed to each. Finally, Rule 606(a)(iii) provides that the quarterly order routing report must describe the material aspects of the broker-dealer's relationship with its key venues, including a description of any arrangement for payment for order flow or profit-sharing relationship. While the SEC believes that Rule 606 currently permits customers to assess order routing and execution services of broker-dealers with respect to retail orders, in light of the technological advances and structural changes noted above, the SEC believes that it is appropriate to update the rule through certain enhanced disclosure requirements.

First, amended Rule 606(a) would require a broker-dealer to distinguish between marketable and non-marketable limit orders in their quarterly reports.[5] Trading venues have historically offered payment for order flow or other financial

---

[4] A trading venue employing a maker-taker fee structure generally pays a per-share rebate to broker-dealers to encourage them to display non-marketable liquidity-providing orders on its limit order book. If an execution occurs, the broker-dealer placing the liquidity-providing order (the "maker") generally receives a rebate while the marketable order that removes liquidity (the "taker") generally is charged a slightly higher fee to fund the rebate to the maker and provide a profit for the trading center.

[5] Marketable limit orders are priced at or above the lowest offer in the market for a buy order and at or below the highest bid in the market for a sell order. Non-marketable limit orders, by contrast, are priced at or below the lowest offer in the market for a buy order and at or above the highest bid in the market for a sell order.

inducements based upon whether retail order flow is marketable or non-marketable and broker-dealers have generally handled marketable and non-marketable retail orders differently as a result. For example, many broker-dealers route marketable retail orders to OTC market makers from whom they receive payment for order flow and route non-marketable retail orders to exchanges with a maker-taker fee schedule. The SEC believes that providing greater public transparency concerning the routing practices of marketable and non-marketable limit orders could increase competition among broker-dealers and highlight potential conflicts of interest.

For the same reason, the SEC has also proposed to amend Rule 606(a) to require more detailed information concerning a broker-dealer's relationships with key trading venues. Specifically, with respect to each of the ten venues to which the largest number of non-directed orders were routed for execution, as well as any venue to which five percent or more of non-directed orders were routed (each a "Specified Venue"), the broker-dealer would be required to report (on a total dollar amount and on a per-share basis) 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 for each of the following: market orders, marketable limit orders, non-marketable limit orders, and other orders.

Separately, amended Rule 606(a) would also require a broker-dealer to disclose any terms, written or oral, of payment for order flow arrangements or profit-sharing relationships that may influence the broker-dealer's order routing decision to a Specified Venue, including, but not limited to: (i) any 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. As noted above, current pay-for-flow compensation models, such as the maker-taker model, may incentivize a broker-dealer to route orders to a venue that offers it the lowest access fee or the highest rebate, and such arrangements may be at odds with a broker-dealer's duty to obtain best execution. The SEC thus believes that enhanced narrative disclosures will better enable customers to evaluate execution quality in light of potential conflicts of interest.

Finally, the SEC proposed to amend Rule 606(a)(1) to eliminate the requirement that a broker-dealer's quarterly report be divided into three separate sections for securities listed on the New York Stock Exchange, securities that "are qualified for inclusion" in NASDAQ, and securities listed on the American Stock Exchange. The SEC noted that the references in the rule are obsolete: NASDAQ is currently a national securities exchange and the American Stock Exchange is now known as NYSE MKT LLC. In addition, the SEC believes that segmenting routing reports by primary listing market is no longer useful because order routing no longer varies significantly based on a security's primary listing market, and the primary listing market may not be the dominant market for the trading of a security.

If you have any questions regarding this memorandum, please contact James Burns (202-303-1241; jburns@willkie.com), Justin Browder (202-303-1264; jbrowder@willkie.com), or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

July 28, 2016

Copyright © 2016 Willkie Farr & Gallagher LLP.

This memorandum is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum may be considered advertising under applicable state laws.