

MEMO# 30797

July 25, 2017

IOSCO Publishes Final Report on Order Routing Incentives: No Further Action Contemplated

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TO: Equity Markets Advisory Committee
ICI Global Trading & Markets Committee
Securities Operations Advisory Committee RE: IOSCO Publishes Final Report on Order Routing Incentives: No Further Action Contemplated

The International Organization of Securities Commissions (IOSCO) has issued a final report concerning incentives for order routing and execution and the effects these incentives may have on brokers' order routing decisions.^[1] The Final Report examines three types of order routing incentives: (1) monetary incentives paid or received by brokers to or from third parties in exchange for routing orders in a particular manner; (2) internalization and the use of broker-affiliated trading venues; and (3) bundling arrangements (e.g., providing research in connection with execution).

The Final Report considers how intermediaries and regulators manage potential conflicts of interest associated with each type of incentive.^[2] The Final Report proposes no next steps, but IOSCO commits to monitor market developments and may consider new work on order routing incentives in the future if conditions warrant.^[3] The main findings of the Final Report are summarized below.

Monetary Incentives, Such As Rebates from Execution Venues and Payments for Order Flow

The Final Report finds that only a handful of jurisdictions prohibit intermediaries from receiving payments from third parties in relation to their order routing or execution activities. It appears that most jurisdictions, however, have adopted rules designed to require intermediaries to manage the potential conflicts of interest that could arise from these payments. A majority of intermediaries that responded to an IOSCO survey stated that they do not receive any third-party payments relating to the routing or execution of client (e.g., regulated fund) orders. Payments that do occur tend to take the form of rebates from trading venues or payments for order flow.

Internalization and Brokers' Use of Affiliated Venues

The Final Report describes the potential benefits and risks to customers that arise when a broker internalizes a customer's order or sends the order to an affiliated trading venue rather than routing that order to an unaffiliated venue. The Final Report states that many intermediaries have taken steps to manage potential conflicts of interest associated with internalization or the use of affiliated venues, including disclosing how their crossing systems work, monitoring execution quality when using internal networks, and adopting information controls and best execution policies. In some cases, these measures have come in response to regulatory reforms.

Provisions of Goods and Services (Such As Research) Bundled with Execution

The Final Report finds that the bundling of goods and services—primarily research and corporate access—linked to execution is prevalent. Two-third of intermediaries that responded to an IOSCO survey stated that they engage in this practice. Some intermediaries report that they may award favorable allocations of shares of initial public offerings to investor clients based on the level of brokerage commissions they pay.

Regulators have concerns that conflicts of interest could arise from bundling arrangements. Regulations addressing bundling arrangements typically focus on the receipt of bundled goods and services, but one jurisdiction regulates the provision of these arrangements.

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endnotes

[1] Board, *Order Routing Incentives, Final Report*, International Organization of Securities Commissions (June 2017), *available at* <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD564.pdf> (Final Report). The Final Report follows the publication of a consultation report on order routing incentives issued in December 2016. ICI Global's comment letter in response to the consultation report explained the importance of order routing decisions to regulated funds and detailed the efforts of ICI and its members to improve transparency into order routing decisions in the United States. The letter expressed the view that IOSCO is the appropriate forum to facilitate a cross-border information exchange on order routing practices. See Letter from Dan Waters, Managing Director, ICI Global, to Alp Eroglu, IOSCO, dated February 21, 2017, *available at* <https://www.ici.org/pdf/30588a.pdf>.

[2] In the European Union, for example, forthcoming legislation under MiFID II includes significant changes that will affect order routing practices.

[3] ICI Global recommended this approach in its comment letter.

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