

MEMO# 31488

November 19, 2018

SEC Adopts Rules to Improve Transparency of Broker-Dealer Order Handling Practices

[31488]

November 19, 2018 TO: ICI Members

ICI Global Members

Equity Markets Advisory Committee

SEC Rules Committee SUBJECTS: Trading and Markets RE: SEC Adopts Rules to Improve Transparency of Broker-Dealer Order Handling Practices

The Securities and Exchange Commission (SEC or Commission) recently adopted rules that amend Regulation NMS to require broker-dealers to make more detailed disclosures concerning their order handling practices.[\[1\]](#) These order handling transparency rules are the culmination of an ICI-led initiative to improve the ability of institutional investors—especially regulated funds—to evaluate how broker-dealer route their orders, and we welcome the greater transparency these rules will bring to equity markets.[\[2\]](#) Broker-dealers will be required to comply with the order handling transparency rules on May 20, 2019. This memorandum explains the regulatory objectives that the order handling transparency rules are designed to accomplish and summarizes the new rules.

Need for Regulatory Action

Regulation NMS requires disclosure of limited order handling and execution information. Rule 605 of the regulation requires trading venues to publicly report monthly statistical information concerning their order executions, while rule 606 requires broker-dealers to make certain aggregated disclosures about their order handling practices on a quarterly basis. This rule also compels a broker-dealer, upon request, to provide a customer with information about the venues to which that customer's orders were routed. Although rule 605 and 606 reports are available to all investors, these disclosures do not provide institutional investors sufficient information to measure the performance of broker-dealers and execution venues. In addition, those reports are not presented in a uniform manner that allows for easy comparison across different broker-dealers.

In 2014, in response to member interest in enhancing the level of transparency around equity market structure in general and execution quality in particular, ICI organized an industry working group composed of representatives of investment managers, broker-dealers, exchanges, and other trade associations. The working group developed a

standardized disclosure template that each broker-dealer would provide to its institutional clients upon request. This disclosure template would have provided institutional investors with order handling information organized according to the execution venue(s) to which a broker-dealer routed client orders and the algorithm(s) employed by the broker-dealer to execute such orders. ICI and other trade associations recommended that the SEC use this disclosure template as the basis of a rule to provide funds and other institutional investors with a broad range of statistical data regarding a broker-dealer's handling of a specific customer's orders, along with the execution quality achieved by the broker-dealer at each execution venue.[\[3\]](#)

Order Handling Transparency Rules Will Provide Greater Customer-Specific and Aggregate Disclosures in a Consistent, Standardized Format

The order handling transparency rules expand broker-dealers' disclosure responsibilities in several ways, collectively designed to provide more meaningful order handling information. The Commission explains that these new rules should enable customers, particularly institutional customers, to more effectively assess how their broker-dealers are carrying out their best execution obligations and the impact of their broker-dealers' order routing decisions on the quality of their executions, including the risks of information leakage and potential conflicts of interest. To facilitate statistical and comparative analyses across broker-dealers, all reports required by the new rules must be provided using XML and PDF templates that will be published on the Commission's website. The most salient aspects of the new disclosure requirements are described below.

Institutional Investors Will Have the Right to More Granular Information Under Rule 606(b) of Regulation NMS, as Amended

The bulk of the new disclosure requirements pertain to a broker-dealer's handling of "not held"[\[4\]](#) orders, which the Commission believes are commonly used by institutional investors.[\[5\]](#) The order handling transparency rules amend rule 606(b) of Regulation NMS to require a broker-dealer to provide customer-specific disclosures about the broker-dealer's handling of a customer's not held orders within seven business days of receiving a request from that customer. The disclosures apply to not held orders for the prior six months. The order handling transparency rules provide two *de minimis* exceptions that are designed to limit implementation costs but should not materially diminish the effectiveness of the new disclosures for regulated funds.[\[6\]](#)

The disclosures required by the order handling transparency rules must be broken down by calendar month and divided into two sections: one for directed orders and one for non-directed orders.[\[7\]](#) The information that the rule requires to be disclosed generally is consistent with the Commission's 2016 proposal, and with ICI's recommendation to the SEC in 2014. Each section of the report must include: (1) the total number of shares sent to the broker-dealer by the customer during the relevant period; (2) the total number of shares executed by the broker-dealer as principal for its own account; (3) the total number of orders exposed by the broker-dealer through an actionable indication of interest; and (4) the venue(s) to which orders were exposed by the broker-dealer through an actionable indication of interest.[\[8\]](#)

Each section of the report also must include the following columns of aggregated information for each venue to which the broker-dealer routed not held orders for the customer:

- Information on order routing:
 - Total shares routed;
 - Total shares routed immediate or cancel;
 - Total shares routed that were further routable; and
 - Average order size routed.
- Information on order execution:
 - Total shares executed;
 - Fill rate (shares executed divided by the shares routed);
 - Average fill size;
 - Average net execution fee or rebate (cents per 100 shares, specified to four decimal places);
 - Total number of shares executed at the midpoint;
 - Percentage of shares executed at the midpoint;
 - Total number of shares executed that were priced on the side of the spread more favorable to the order;
 - Percentage of total shares executed that were priced at the side of the spread more favorable to the order;
 - Total number of shares executed that were priced on the side of the spread less favorable to the order; and
 - Percentage of total shares executed that were priced on the side of the spread less favorable to the order.
- Information on orders that provided liquidity:
 - Total number of shares executed;
 - Percentage of shares executed;
 - Average time between order entry and execution or cancellation (in milliseconds); and
 - Average net execution rebate or fee (cents per 100 shares, specified to four decimal places).
- Information on orders that removed liquidity:
 - Total number of shares executed;
 - Percentage of shares executed; and
 - Average net execution fee or rebate (cents per 100 shares, specified to four decimal places).

The Commission determined not to adopt two aspects of its proposed changes to rule 606(b). First, the Commission did not adopt the proposed requirement for a broker-dealer to classify its routing strategies as passive, neutral, or aggressive. The Commission explained that commenters, including ICI, believed this aspect of the proposal would be unnecessarily subjective and complex. Second, the Commission did not adopt its proposal to require broker-dealers to make aggregated reports of their institutional order handling activities public. The Commission determined that the proposed public reports would be of limited utility and could generate misleading impressions of broker-dealer practices.

The Quarterly Order Routing Reports that Broker-Dealers Make Under Rule 606(a) of Regulation NMS Will Include More Detailed Information

The order handling transparency rules also make changes to the aggregated order routing disclosures that broker-dealers must make publicly available on a quarterly basis under rule 606(a) of Regulation NMS. Presently, these reports apply to non-directed orders in NMS securities received by broker-dealers during the quarter. As revised, however, the reports would pertain to non-directed orders of any dollar value in NMS stock that are submitted on a held basis, aggregated across all customers.[\[9\]](#) The disclosures must be provided on a

quarterly basis, broken down by calendar month. The report must include a section for NMS stocks—separated by securities that are included in the S&P 500 Index as of the first day of that quarter and other NMS stocks—and a separate section for option contracts. Each section must:

- Differentiate between marketable and non-marketable limit orders;
- Identify the ten 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;
- Disclose the net aggregate amount of any payments received from or paid to the identified trading venues;
- Describe any terms of payment for order flow arrangements and profit-sharing relationships with the identified trading venues.

Broker-dealers must keep the order routing reports posted on a website that is free and readily accessible to the public for a period of three years from the initial date of posting on the website.^[10]

George M. Gilbert
Assistant General Counsel

endnotes

[1] Disclosure of Order Handling Information, Securities Exchange Act Release No. 84528 (November 2, 2018), *available at* <https://www.sec.gov/rules/final/2018/34-84528.pdf> and 83 Fed. Reg. at 58338 (November 19, 2018), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2018-11-19/pdf/2018-24423.pdf> (Release).

[2] The Commission proposed these rules in July of 2016. ICI's comment letter supporting the proposal is *available at* https://www.ici.org/pdf/16_ici_sec_order_routing_ltr.pdf.

[3] See ICI Memorandum No. 28480 (Oct. 23, 2014), *available at* https://www.ici.org/my_ici/memorandum/memo28480; Letter from Dorothy M. Donohue, Deputy General Counsel, ICI, Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, and Randy Snook, Executive Vice President, Securities Industry and Financial Markets Association to Mary Jo White, Chair, SEC, dated October 23, 2014, *available at* <https://www.ici.org/pdf/28480.pdf>.

[4] Typically, a “not held” order provides the broker-dealer with price and time discretion in handling the order, but a broker-dealer must attempt to execute a “held” order immediately.

[5] The use of order classification (*i.e.*, held and not held) to determine the application of the order handling transparency rules differs from the Commission's proposal. The proposed rules would have applied enhanced disclosure requirements only to orders having a market value of at least \$200,000. ICI opposed applying the proposed disclosures on the basis of order size and recommended that the Commission apply the rules instead based on the characteristics of an order or the characteristics of the entity placing the order. The final rules are consistent with ICI's recommendation.

[6] One exception provides relief from the new disclosure requirements for a broker-dealer that rarely handles not held orders. Pursuant to this exception, a broker-dealer does not need to make the new disclosures “if the percentage of shares of not held orders in NMS stocks the broker or dealer received from its customers over the prior six calendar months was less than five percent of the total shares in NMS stocks the broker or dealer received from its customers during that time.” See rule 606(b)(4) of Regulation NMS, as revised by the Release. The second exception is customer specific. A broker-dealer is not required to make rule 606(b) disclosures to any customer “that traded on average each month for the prior six months less than \$1,000,000 of notional value of not held orders in NMS stocks through the broker-dealer.” See rule 606(b)(5), as revised by the Release.

[7] If a customer instructs a broker-dealer to route a particular order to an exchange or other market center, that order is considered a directed order. If the customer does not provide such order handling instructions, the order is a non-directed order.

[8] See rule 606(b)(3) of Regulation NMS, as revised by the Release. An “actionable indication of interest” means “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) Symbol; (ii) Side (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.” See rule 600(b)(1) of Regulation NMS, as revised by the Release.

[9] Rule 606(a) of Regulation NMS also requires certain disclosures for NMS securities that are option contracts, both in its current form and as revised.

[10] The order handling transparency rules also amend rule 605 of Regulation NMS to require market centers to keep execution reports required by the rule posted on a website that is free and readily accessible to the public for a period of three years from the initial date of posting on that website.