MEMO# 6352

November 2, 1994

SEC ADOPTS RULES ON PAYMENT FOR ORDER FLOW AND PROPOSES ADDITIONAL RELATED DISCLOSURE REQUIREMENTS

November 2, 1994 TO: SEC RULES COMMITTEE NO. 117-94 RE: SEC ADOPTS RULES ON PAYMENT FOR ORDER FLOW AND PROPOSES ADDITIONAL RELATED DISCLOSURE REQUIREMENTS ____ As we previously informed you, the Securities and Exchange Commission proposed new Rule 11Ac1-3 and amendments to Rule 10b-10 under the Securities and Exchange Act of 1934, to require enhanced disclosure of payment for order flow practices. (See Memorandum to SEC Rules Committee No. 90-93; Market 2000 Task Force, dated October 12, 1993.) The Commission recently adopted these proposals, which become effective on April 3, 1995. In a companion release, the Commission proposed amendments to these rules to provide investors with more useful information in evaluating the quality of executions. Comments are due on the proposed amendments on December 15, 1994. The Commission's releases are attached and summarized briefly below. Rule 11Ac1-3 and Amended Rule 10b-10 (the "New Rules) The New Rules require broker-dealers to inform customers in writing, when a new account is opened and on an annual basis thereafter, about the dealer's policies regarding the receipt of payment for order flow, including whether payment for order flow is received, and a detailed description of the nature of the compensation received. In addition, broker-dealers are required to indicate on confirmations whether the broker-dealer receives payment for order flow and the availability of further information on request. Rule 10b-10(e)(9) defines "payment for order flow" to include any monetary payment, service, property, or any other benefit that results in remuneration, compensation or consideration to a broker or dealer in return for the routing of customer orders. A non- exhaustive list of specific items of remuneration are included in the definition. In the companion release, the Commission solicited comment on whether to expand this definition. The release for the New Rules notes that several commenters favored a ban on payment for order flow. The Commission concluded, however, that not all payment for order flow arrangements are against the customer's best interests and, therefore, should not be banned per se as compromising a broker's duty to seek best execution of the customer's order. Instead, the Commission took the position that disclosure is the appropriate response to the issues raised by payment for order flow. Proposed Amendments The Commission proposed amendments to the rules discussed above to require broker-dealers receiving payment for order flow to provide customers additional information regarding the value of the compensation received. In addition, broker-dealers would be required to disclose to their customers information regarding their order routing practices generally, regardless of whether they receive payment for order flow or engage in internalized/affiliate practices (i.e., the practice of executing orders as principal or routing orders to an affiliated broker-dealer or exchange specialist). The proposed amendments also would require broker-dealers to inform customers on new account and annual disclosure statements whether they execute orders as principal or route those orders to affiliated firms. Finally, the proposed rule amendments would extend confirmation and account statement disclosure of payment for order flow to transactions in standardized options. Amy B.R. Lancellotta Associate Counsel Attachments