

**MEMO# 12472**

August 10, 2000

## **SEC ISSUES PROPOSED RULES ON DISCLOSURE OF ORDER ROUTING AND EXECUTION PRACTICES**

[12472] August 10, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 43-00 SEC RULES COMMITTEE No. 105-00 RE: SEC ISSUES PROPOSED RULES ON DISCLOSURE OF ORDER ROUTING AND EXECUTION PRACTICES The Securities and Exchange Commission has proposed two rules relating to the disclosure of order routing and execution practices.<sup>1</sup> The first proposed rule, Securities Exchange Act Rule 11Ac1-5, would require that market centers that trade national market system securities prepare and make available to the public monthly electronic reports that include information on execution quality on a security-by-security basis. The second proposed rule, Securities Exchange Act Rule 11Ac1-6, would require broker-dealers that route orders in equity and option securities on behalf of customers to make available to the public quarterly reports that describe their order routing practices and disclose the venues to which customer orders are routed for execution. The proposed rules are in response to the concept release on market fragmentation issued by the SEC in February 2000<sup>2</sup> which proposed six potential options to address fragmentation, ranging from increased disclosure of order routing and execution practices to the establishment of a national market linkage system with price/time priority for all displayed trading interest. The Release states that the SEC recognizes the potential operational and technological problems associated with mandating price/time priority across markets and that impending changes in the securities markets, particularly the move to decimal trading, could have a significant impact on market structure. The SEC therefore is not taking action at this time on the price/time priority alternatives described in the fragmentation concept release and is instead proposing rules implementing the first option requiring disclosure of order routing and execution practices. <sup>1</sup> Securities Exchange Act Release No. 43084 (July 28, 2000), 65 FR 48406 (August 8, 2000) ("Release"). <sup>2</sup> Securities Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 (February 28, 2000). <sup>3</sup> Disclosure of Order Execution Information Proposed Rule 11Ac1-5 would require market centers<sup>3</sup> to prepare and make available to the public monthly reports in electronic form that include data on execution quality of "covered orders"<sup>4</sup> in national market system securities.<sup>5</sup> The proposed rule adopts certain basic measures of execution quality and provides specific instructions on how the measures are to be calculated. Specifically, under the proposed rule, statistical information would be categorized by order type, order size, and security. For example, information would include the percentage of shares that were executed within specified periods of time after order receipt, the average realized spread,<sup>6</sup> and, for market orders and marketable limit orders, a comparison of their execution prices with the consolidated best bid and offer at the time of order receipt.<sup>7</sup> The Release specifically requests comment on whether the approach of adopting uniform statistical

measures of execution quality categorized by order type, order size, and security is feasible and implementable without undue burden on market centers and whether there will be sufficient interest by third parties in collecting and summarizing the electronic reports so that the public will have reasonable access to the information. The Release states that the SEC anticipates that independent analysts, consultants, broker-dealers, the financial press, and other market centers will analyze this information and produce summaries that would be provided to investors. In furtherance of this goal, the proposed rule directs the SROs to act jointly in establishing procedures for market centers to follow in making their monthly reports available to the public in a readily accessible, uniform, and usable electronic format within one month after the end of the month addressed in the report. The Release states that the SEC anticipates that the SROs would prepare and submit a joint plan to the SEC for approval under Exchange Act Rule 11Aa3-2 and that public comment would be invited on the proposed plan prior to SEC approval. Disclosure of Order Routing Information Proposed Rule 11Ac1-6 would require broker-dealers to make publicly available a report for each calendar quarter that discusses and analyzes their routing of non-directed orders in covered securities. The term "make publicly available" is defined in the proposed rule as posting on a free Internet web site, furnishing a written copy on request, and notifying customers at least annually that a written copy will be 3 Under the proposed rule, a "market center" is defined as any exchange market maker, OTC market maker, alternative trading system, national securities exchange, and national securities association. 4 The definition of "covered order" applies only to market orders or limit orders that are received by a market center during the time that a consolidated best bid and offer is being disseminated. The definition excludes, among other things, orders to be executed at a market opening or closing price, stop orders, orders that are submitted on a "not held" basis, and orders that are to be executed at prices unrelated to the market price at the time of execution. The Release requested comment on the appropriateness of excluding these orders and specifically whether statistics should be included in the rule to measure the quality of execution of market opening orders. In addition, the Release requested comment on whether there are additional types of orders that should be excluded from the scope of the proposed rule. 5 The definition of "national market system security" would not include Nasdaq SmallCap securities and exchange-listed options. 6 The "average realized spread" would be calculated by comparing the execution price of an order with the midpoint of the consolidated best bid and offer thirty minutes after the time of order execution. The Release requests comment on the usefulness of the average realized spread as a measure of execution quality for both non-marketable limit orders, and market and marketable limit orders, and whether thirty minutes is an appropriate period of time to measure the post-trade value of a security. 7 The Release requests comment on whether any statistics based on time of order execution also should be required. 3furnished on request. The quarterly report must be made publicly available within two months after the end of the quarter addressed in the report. The proposed rule would require broker-dealers to disclose, among other things, the venues to which they routed customer orders,8 the significant objectives that the broker-dealer considered in determining where to route orders, and the results actually achieved compared with the results available at other venues. A broker-dealer also would be required to discuss the material aspects of its relationship with each venue to which non-directed orders were routed, including a description of any payment for order flow arrangement or profit-sharing relationship.9 The Release requests comment on whether any disclosure of the aggregate amount of payment for order flow and shared trading profits should be required. Proposed Rule 11Ac1-6 covers a wider range of securities and types of orders than proposed Rule 11Ac1-5. For example, the definition of "covered security" includes not only exchange-listed equities and Nasdaq National Market equities, but also Nasdaq SmallCap equities and listed options. In addition, the proposed

rule applies to all types of orders, including pre-opening orders. Further Action to Strengthen Competition in the Securities Markets The Release states that in addition to encouraging competition among market centers on execution quality, quote competition and price priority are critical to maintaining the display of the best possible market prices. The SEC therefore is considering ways to preserve the incentives to publish limit orders which contribute to the price setting process and resolving issues impeding including ECN prices in the consolidated quote for listed securities. For example, the Release states that the SEC recognizes that with the introduction of decimal pricing, displayed limit orders may be disadvantaged by market participants trading ahead of limit orders with priority, or "penny jumping." As a result, fewer limit orders may be entered, reducing the benefits limit orders provide for price competition. For these reasons, the SEC states that it will consider whether market makers and similarly-situated market participants should be able to step ahead of limit orders by as little as a penny without previously quoting at that price. In addition, the Release states that the SEC is committed to resolving the remaining issues preventing inclusion of all ECN prices in the public quote for listed equities, the most important of which is the treatment of access fees charged by ECNs to their non-subscribers. One way the SEC is considering to do this is to include the access fee charged by an ECN in a market's public quote. The SEC states that including the access fee in the quote would reflect the economic fact that the net price available is not in fact the quoted price alone, but also includes a fee. Another approach discussed by the SEC would include in the quote those access fees that are large relative to the quoting increment, but to allow access fees that are small in relation to the quoting increment to continue to be charged separately, instead of being reflected in the quote. 8 The term "customer order" is defined as any order to buy or sell a covered security that is not for the account of a broker-dealer, but excludes any order for a quantity of a security having a market value of at least \$50,000 for a covered security that is an option contract and a market value of at least \$200,000 for any other covered security. The Release states that large orders are excluded in recognition of the fact that statistics for where orders are routed and general descriptions of order routing practices are more useful for smaller orders that tend to be homogenous. 9 The term "profit-sharing relationship" is defined in the proposed rule as any ownership or other type of affiliation under which the broker-dealer, directly or indirectly, shares in any profits that may be derived from the execution of non-directed orders. The Release states that it therefore specifically covers internalization of customer orders by a broker-dealer that executes customer orders as principal. 4The Release states that the SEC also is considering ways to strengthen price priority across markets which would assure that other markets will not execute a trade at inferior prices before a better-priced quote is satisfied. The Release states that in order to strengthen price priority, fair access to market centers and efficient linkages to market centers displaying the best quote is essential. The SEC believes, however, that market-based incentives should determine the connections between markets and that having the SEC mandate the specific form of linkage across markets could interfere with the ability of independent market centers to compete by structuring their own manner of trading. The Release therefore states that the SEC is considering whether market participants should now be expected to develop their own efficient linkages to other market centers sufficient to protect price priority for displayed quotes. Finally, the SEC also is considering whether a trade-through disclosure rule should be proposed in the equities markets. A trade-through disclosure requirement would provide that broker-dealers disclose to their customer when the customer's order traded at a worse price than the best quote published in another market center. The SEC believes that a trade-through disclosure requirement could provide an incentive to market centers to develop effective access to all market centers participating in the quote, without the SEC mandating a particular form of linkage, and could help ensure that the best quote interacts

with orders across the markets by discouraging broker-dealers from routinely executing customer orders at inferior price levels. The Release specifically requests comment on whether a trade-through disclosure requirement would strengthen price priority in the equities markets and would give market centers sufficient incentives to develop access arrangements to other equity markets or whether there are impediments to access that should be addressed directly rather than by relying on market-based incentives. Comments on the proposed rules and other proposed actions to strengthen competition in the securities markets are due to the SEC no later than September 22, 2000. If you have any comments you would like the Institute to consider including in a comment 5letter, please provide them to Ari Burstein by phone at (202) 371-5408, by fax at (202) 326-5839, or by e-mail at [aburstein@ici.org](mailto:aburstein@ici.org) or to Amy Lancellotta by phone at (202) 326-5824, by fax at (202) 326-5827, or by e-mail at [amy@ici.org](mailto:amy@ici.org) no later than September 8. Ari Burstein Assistant Counsel Attachment Attachment (in .pdf format)

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