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SEC Final Rule to Expand Order Execution Disclosures Under Rule 605 of Reg NMS

[35658]

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TO: ICI Members
Closed-End Investment Company Committee
Equity Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee
Security Valuation Operations Committee SUBJECTS: Trading and Markets RE: SEC Final Rule to Expand Order Execution Disclosures Under Rule 605 of Reg NMS

On Wednesday, March 6, the SEC adopted a final rule to update the execution quality disclosures required for market centers under Rule 605 of Regulation NMS ("Reg NMS").[1] The SEC has stated that the amendments are meant to "provide individual investors, institutional customers, and broker-dealers with information that they can use to choose market centers or broker-dealers that align with their investment and execution objectives." Similar to the 2022 proposed rule, the amendments will: (1) expand the scope of entities subject to Rule 605 reporting requirements; (2) update the scope and content of the mandatory standardized monthly reports; and (3) require reporting entities subject to the rule to make a summary report available in a human readable format. The SEC characterized the comments received to the proposal as generally supportive, but also modified the rule in several respects in response to feedback.

Expansion of Entities Subject to Rule 605 Reporting

Similar to the proposal, the final rule amends the scope of Rule 605 reporting entities[2] to include: (1) broker-dealers that introduce or carry 100,000 or more customer accounts[3] ("customer account threshold");[4] and (2) NMS stock ATSs and OTC market makers that operate single-dealer platforms (SDPs).[5] The SEC, however, declined to require market centers that operate "qualified auctions" to submit separate reports for orders received for execution from those auctions. The SEC noted that it is still considering the Order Competition Rule Proposal and, thus, whether to further amend Rule 605 to require such separate reports.

Modifications to Scope of Orders Covered and Required Information

The Commission adopted changes to the scope and content of Rule 605 reports largely as proposed, which include (i) expanding reporting to include additional order types; (ii) modifying the existing order size categories; and (iii) creating a new order type category, as well as replacing three existing order type categories.

Expanded Definition of "Covered Order"

The final rule expands the definition of "covered order"[6]to include information to be reported about certain types of orders received for execution. The expanded definition includes:

- Certain non-marketable limit orders (NMLOs) submitted outside of regular trading hours if they become executable after the opening or reopening of trading during regular trading hours.[7] The SEC modified the proposal to address concerns that certain NMLOs entered outside of normal hours and included in a Rule 605 report could skew reported execution quality statistics.[8]
- Executable orders with stop prices. The SEC modified the proposal to include more granular information that delineates different types of stop orders with similar execution profiles, along with other changes.[9]
- Non-exempt short-sale orders unless a price test restriction is in effect for the security.[10]

Changes to Proposed Order Size Categories

In responses to comments received, the SEC modified its proposal to change Rule 605's reporting format from round-lot order size categories[11] to order size categories reflecting a notional dollar value range, along with an indication that the category reflects a certain order share size, i.e., an odd-lot, at least a round lot, or less than a share. The SEC acknowledged commenters' views that a notional value approach would depict execution quality more clearly and accurately. Accordingly, the adopted notional ranges are:

- less than $250
- $250 to less than $1,000
- $1,000 to less than $5,000
- $5,000 to less than $10,000
- $10,000 to less than $20,000
- $20,000 to less than $50,000
- $50,000 to less than $200,000
- $200,000 or more.

Accordingly, orders will be assigned to 1 of 24 different categories.[12] The SEC explains that the thresholds between these notional ranges are based on its observed variations in order sizes across several factors, including stock prices, market centers, lot type and order share size.

The final rule also includes an execution quality statistic for cumulative notional order size of covered orders, which the SEC believes can be used to determine the average share price for covered orders received when calculated against the number of shares submitted.

Changes in Order Type Categories

The final rule eliminates, as proposed, three existing order type categories related to NMLOs (inside-the-quote limit orders, at-the-quote limit orders, and near-the-quote limit orders) and replaces them with new separate categories of: (1) executable NMLOs[13] (excluding orders submitted with stop prices and beyond-the-midpoint limit orders); (2) "midpoint-or-better limit orders";[14] (3) IOC orders;[15] and (4) executable stop orders.

Changes in Timestamp Conventions

The final rule updates the current seconds-based timestamp conventions for Rule 605 reports to require that the following metrics be expressed in increments of a millisecond or finer: "time of order receipt;" "time of order execution;" the "average time-to-execution" statistics required for marketable order types; and the time an order becomes "executable." The final rule, however, does not adopt, as initially proposed, statistics reflecting the distribution of execution times within each order type (i.e., the share-weighted median and 99th percentile time-to-execution), given the difficulty of aggregation across different stocks or order types.[16] Further, the final rule retains the existing time-to-execution categories and modifies them to provide more granularity and best capture variations in execution times across different order types.[17]

Changes in Execution Quality Statistics

The final rule makes following changes to the information currently required under Rule 605 for covered orders:[18]

- Additional reporting of average realized spread (currently required at 5 minutes after time of execution) to include four additional time intervals: 50 milliseconds, 1 second, 15 seconds, and 1 minute.[19]
- Additional reporting of average effective spreads beyond market and marketable limit order types to include marketable stop order types and midpoint-or-better order types.[20]
- Reporting of average realized spread and average effective spread as percentages, including an average midpoint statistic to be used in the calculation of the percentages.[21]
- Reporting average effective over quoted (E/Q) spread, expressed as a percentage, including an average quoted spread statistic that informs the calculation of the percentage.[22]
- Providing a benchmark metric indicating the level of size improvement by measuring the displayed size at the time of order receipt (or for midpoint-or-better order types, at the time the order becomes executable) ("order size benchmark"),[23] along with, for executions of covered orders, the cumulative number of shares of the order size benchmark.
- Providing a new size improvement metric that indicates the amount of size improvement in instances in which an order could have received size improvement ("size improved outsized shares").[24]
- Reporting of riskless principal orders as executed at another venue, rather than as executed at the market center, broker, or dealer that, to fulfill the customer order, submits a principal order to an away market center.
- Additional reporting of price improvement metrics to show the "best available displayed price" in a way that that accounts for the expansion of NMS core data to include certain odd-lot data,[25] along with additional price improvement statistics relative to the best available displayed price.[26]
- Reporting of the: (1) number of orders that received either a complete or a partial fill; (2) cumulative number of shares executed regular way at prices that could have filled the order while it was in force, as reported pursuant to an effective transaction reporting plan or NMS plan; and (3) cumulative number of shares executed regular way on any national securities exchange at prices that could have filled the order

while it was in force, as reported pursuant to an effective transaction reporting plan or NMS plan.[27]

Summary Execution Quality Reports

Rule 605 reporting entities will be required to make publicly available for each calendar month a report that provides summary execution quality statistics only on covered orders that are market and marketable limit orders, which the SEC notes are the types of order most used by individual investors. The reports will include a section for NMS stocks that are included in the S&P 500 as of the first day of the month and a section for other NMS stocks.

With respect to the categories of statistics to be included, the SEC adopted several categories as proposed,[28] modified certain categories to incorporate additional statistics,[29] and added other new categories.[30] Further, the modified weighting method underlying the summary report statistics—instead of equal weighting by symbol based on share volumes, the summary report statistics will utilize share-based weighting, with certain exceptions.

Rule 605 reporting entities will be required to make the summary reports available in CSV and PDF format. The SEC also notes that the current Rule 605 NMS Plan—which specifies the procedures for making data available to the public and sets forth the file type and structure of the reports—will need to be updated in several aspects to incorporate the changes to Rule 605. Reporting entities are further required to provide the summary reports within one month after the end of the month addressed in the report, and to post the summary reports (along with the detailed Rule 605(a)(1) reports) on an internet website that is free and readily accessible to the public for a period of three years from the initial date of posting.

Compliance Date

The amendments to Rule 605 will become effective 60 days after publication in the Federal Register, and the compliance date will be 18 months after that effective date. The SEC acknowledged, however, that reporting entities may not be able to calculate certain metrics (i.e. price improvement statistics relative to the best available displayed priced) until odd-lot order information is made available pursuant to the SEC's market data infrastructure rule; accordingly, the SEC states that market centers, brokers, and dealers will have six months after sufficient odd-lot order information is available to calculate such metrics.

Nhan Nguyen
Associate General Counsel, Securities Regulation

Notes

[1] Disclosure of Order Execution Information, Exchange Act Rel. No. 34-99679 (Mar. 6, 2024) ("Final Rule"), available at https://www.sec.gov/files/rules/final/2024/34-99679.pdf.

[2] SEC Rule 605 previously required only "market centers" to make publicly available, on a monthly basis, a standardized report concerning the execution quality for covered orders in NMS stocks that they received for execution. Regulation NMS defines a "market center" as any exchange market maker, over-the-counter (OTC) market maker, alternative trading system (ATS), national securities exchange, or national securities association.

[3] Similar as proposed, a broker-dealer that uses an omnibus clearing arrangement for any of its underlying customer accounts would be considered to carry such underlying customer accounts for purposes of calculating the number of customer accounts it introduces or carries. SEC Rule 605(a)(7). The SEC also provides guidance that an introducing broker-dealer should only count the institutional top-level account when it establishes a top-level account for an institutional asset manager. Final Rule at 45-46.

[4] Broker-dealers that meet the threshold would be required to produce Rule 605 reports for at least three calendar months. Further, the rule requires a broker-dealer that meets the customer account threshold and is a market center to produce separate Rule 605 reports for each function. SEC Rule 605(a)(7).

[5] An ATS would be required to report separately from its broker-dealer operator's other activities and an OTC market maker operating an SDP would also be required to devise a separate report pertaining to orders submitted to the SDP. While the SEC modified certain aspects of its proposed description of SDP activity, it nevertheless declined to adopt a commenter's suggestion to amend the rule to focus on reporting of execution quality for non-retail orders, including narrowing the scope of reporting SDPs to those that are used by non-retail investors and that feature certain order types (e.g., immediate-or-cancel, fill-or-kill) with substantially similar trading activities. Final Rule at 60-63.

[6] The Commission suggests that although institutional investors tend to use "not held" orders, which are excluded from definition of "covered order," institutional investors may still find relevant information in Rule 605 reports, as large institutional "parent" orders are often split into multiple smaller "child" orders, which may be handled as held orders and reflected in Rule 605 reports. Final Rule at 293.

[7] Reporting entities would also need to include in Rule 605 reports any covered orders received for execution in a prior calendar month, but which remained open. SEC Rule 605(a)(1).

[8] The SEC notes that the final rule modifies its proposed definition of "executable" to specify that whether an NMLO is executable will be determined based on the order's limit price during regular trading hours and after the primary listing market has disseminated its first firm, uncrossed quotations in the security. The SEC further specifies that this will not include market orders and marketable limit orders received during the interim opening period, which the SEC believes would otherwise skew execution quality statistics. Final Rule at 74-75.

[9] These order type categories consist of: (1) executable market orders submitted with stop prices, (2) executable stop marketable limit orders, and (3) executable stop NMLOs. The category to which a stop order is assigned will be based on the order's status at the time that it is triggered.

[10] The SEC acknowledged its prior staff position that all non-exempt short sale orders were considered "special handling" orders, and thus, excluded from the definition of "covered order" purposes of Rule 605 reporting. In this rule, however, the Commission narrowed this position to only non-exempt short sale orders that are subject to a price test restriction. Under Rule 201 of Regulation SHO, a stock triggers a short sale circuit breaker when it experiences a price decline of at least 10% in one day. A price restriction will then apply to short sale orders in that security for that day and the following day. The SEC states that the prior statements that conflict with its new position will be rescinded.

[11] The categories under the proposal were based on the SEC's amended definition of "round lot" from its 2020 market data infrastructure rule. Market Data Infrastructure, Exchange Act Release No. 34-90610 (Dec. 9, 2020). available at https://www.sec.gov/rules/final/2020/34-90610.pdf.

[12] These categories are: (1) less than $250 and less than a share; (2) less than $250 and odd-lot; (3) less than $250 and at least a round lot; (4) $250 to less than $1,000 and less than a share; (5) $250 to less than $1,000 and odd-lot; (6) $250 to less than $1,000 and at least a round lot; (7) $1,000 to less than $5,000 and less than a share; (8) $1,000 to less than $5,000 and odd-lot; (9) $1,000 to less than $5,000 and at least a round lot; (10) $5,000 to less than $10,000 and less than a share; (11) $5,000 to less than $10,000 and odd-lot; (12) $5,000 to less than $10,000 and at least a round lot; (13) $10,000 to less than $20,000 and less than a share; (14) $10,000 to less than $20,000 and odd-lot; (15) $10,000 to less than $20,000 and at least a round lot; (16) $20,000 to less than $50,000 and less than a share; (17) $20,000 to less than $50,000 and odd-lot; (18) $20,000 to less than $50,000 and at least a round lot; (19) $50,000 to less than $200,000 and less than a share; (20) $50,000 to less than $200,000 and odd-lot; (21) $50,000 to less than $200,000 and at least a round lot; (22) $200,000 or more and less than a share; (23) $200,000 or more and odd-lot; and 24) $200,000 or more and at least a round lot.

[13] See supra note 8 for the SEC's definition of "executable" as adopted. The SEC also provides guidance in the final rule in response to a comment that an order generally should not become executable during a time when the underlying security is in a "Straddle State" under the Limit-Up Limit-Down (LULD) Plan, i.e., the national best bid is below the LULD lower price band or the national best offer is above the LULD upper price band. Final Rule at 116-117.

[14] The SEC expanded the category as proposed—initially entitled "beyond-the-midpoint limit orders" for orders priced aggressively in comparison to the midpoint—to also include limit orders priced at the midpoint. The SEC did so in response to a comment that few NMLOs are priced more aggressively than the mid-point. Final Rule at 120-121. The SEC also adopted, as proposed, requirements that (1) a Rule 605 report include statistics for both marketable order types and non-marketable order types; and (2) time-based statistics be measured from the time such orders become executable. Further, the SEC confirmed that this order type would not fall within the category for executable NMLOs.

[15] The SEC expanded the categories beyond marketable IOC orders to also include two other types: (1) NMLOs that are IOC; and (2) midpoint-or-better limit orders that are IOC. The SEC believes that these additional categories reflect distinct characteristics of IOC orders (i.e., shorter execution times and lower fill rates with respect to orders received by wholesalers). Final Rule at 124.

[16] Final Rule at 134-35.

[17] The SEC adopted this approach, which it had presented as a proposed alternative to requiring share-weighted average time to execution. These revised categories adopted are: (1) less than 100 microseconds; (2) 100 microseconds to less than 1 millisecond; (3) 1 millisecond to less than 10 milliseconds; (4) 10 milliseconds to less than 1 second; (5) 1 second to less than 10 seconds; (6) 10 seconds to less than 30 seconds; (7) 30 seconds to less than 5 minutes; and (8) 5 minutes or more. SEC Rule 605(a)(1)(i)(G)-(N).

[18] SEC Rule 605(a)(1) previously required information on: (1) the number or orders; (2)

cumulative number of shares; (3) cumulative number of shares cancelled prior to execution; (4) cumulative number or shares executed at the receiving market center or at any other venue; (5) and average realized spread.

[19] SEC Rule 605(a)(1)(i)(O)-(X). The SEC asserts that realized spreads statistics allow market participants to identify market centers willing to provide liquidity in stressed market conditions or to otherwise understand a broker-dealers' order execution or routing practices. Final Rule at 145.

[20] For marketable stop order types and midpoint-or-better order types, average effective spread will be measured from the time that the order becomes executable. The SEC also notes that this statistic will not apply to non-marketable order types, which it believes would not provide a useful measure.

[21] "Average percentage effective spread" is defined as the average effective spread for order executions divided by the average midpoint for order executions. This statistic will be required for marketable order types, marketable stop order types, and midpoint-or-better limit order types only. "Average percentage realized spread" is defined as the average realized spread for order executions divided by the average midpoint for order execution. "Average midpoint" is defined as the share-weighted average of the midpoint of NBBO at either the time of order receipt, or for NMLOs or midpoint-or-better limit orders, and orders submitted with stop prices, at the time such orders first become executable. See SEC Rule 600(b).

[22] The SEC modified this statistic from the proposal to utilize spread-based weighting rather than share-based weighting. This statistic would apply to all marketable order types, marketable stop order types, and midpoint-or-better order types. "Average quoted spread" is defined as the share-weighted average of the difference between the national best offer and the national best bid at the time of order receipt, or for order executions of NMLOs, the difference between the national best offer and the national best bid at the time that such orders first become executable. SEC Rule 600(b)(12).

[23] "Order size benchmark" means the number of shares of the (1) full displayed size of all protected bids at the same price as the national best bid at the time of order receipt, in the case of a market or limit order to sell, or (2) the full displayed size of all protected offers at the same price as the national best offer at the time of order receipt, in the case of a market or limit order to buy. SEC Rule 600(b)(72). For marketable stop order types and midpoint-or-better order types, the fully displayed size is measured at the time the order becomes executable. This statistic would be required for marketable order types, marketable stop order types, and midpoint-or-better order types. The SEC modified this metric from the proposal by (1) measuring displayed size at the time of order receipt (except for marketable stop order types or midpoint-or-better limit orders) instead of time of execution; and (2) ensuring that the share count includes all shares at the same price of the NBBO, not just those represented in the NBBO.

[24] This would be the greater of (1) the total number of shares executed with price improvement plus the total number of shares executed at the quote minutes the order size benchmark; or (2) zero.

[25] "Best available displayed price" means (1) with respect to an order to buy, the lower of the national best offer at the time of order receipt or the price of the best odd-lot order to sell at the time of order receipt, as disseminated; and (2) with respect to an order to sell,

the higher of the national best bid at the time of order receipt or the price of the best odd-lot order to buy at the time of order receipt, as disseminated. For midpoint-or-better limit orders, this determination would be based on the time such an order becomes executable. SEC Rule 600(b)(14).

[26] For marketable order types and midpoint-or-better order types, the final rule requires (1) the cumulative number of shares of covered orders (a) executed with price improvement relative to the best available displayed price, (b) executed at the best available displayed price, and (c) executed outside the best available displayed price; (2) the share-weighted average amount per share that prices were improved; and (3) the share-weighted average amount per share that prices were outside the best available displayed price. SEC Rule 605(a)(ii)(M)-(Q).

[27] These reporting requirements would apply to executable NMLOs, executable stop orders, and beyond-the-midpoint limit orders.

[28] These categories include (1) percentage of shares executed at the quote or better; (2) percentage of shares that received price improvement; (3) average percentage effective spread; and (4) average execution speed, in milliseconds.

[29] The SEC modified "average order size" to (1) clarify that the statistic will be reported in number of shares; and (2) add a metric for average notional order size and require categorization of the data by notional order size based on 8 different notional ranges. The SEC also renamed the "average percentage price improvement per order" category to "share-weighted average percentage price improvement" and added "average midpoint" for executions of covered orders. Further, for "average effective spread divided by average quoted spread (E/Q)," the SEC (1) adjusted the weighting methodology to a spread-based approach; and (2) added "average percentage quoted spread" as an additional metric.

[30] These new categories include percentage realized spread as calculated both 15 seconds and 1 minute after time of execution, respectively.