

SEC Adopts Enhanced Order Handling Disclosure Requirements

By [Annette L. Nazareth](#), [Gregory Rowland](#), [Zachary J. Zweihorn](#) & [Mark A. Sater](#) on November 27, 2018

POSTED IN [BROKER-DEALER](#), [FINAL RULE](#), [SEC](#)

The SEC recently voted to adopt [amendments](#) to Rule 606 of Regulation NMS (the “**Final Rule**”) that expand broker-dealers’ disclosure obligations with regard to how they handle investors’ orders. Specifically, the Final Rule requires broker-dealers, beginning May 20, 2019, (i) to provide, upon request, individualized reports in a standardized format containing information on their handling of customers’ “not held” orders (i.e., those orders for which the broker has price and time discretion) and (ii) to provide enhanced information in their existing quarterly public reports on order routing practices. The Final Rule builds on the July 2016 proposed rule (the “**Proposed Rule**”) described in our prior [memorandum](#)—though with a few noteworthy modifications. Although the Final Rule only directly imposes obligations on broker-dealers, it may also have follow-on impacts on investment advisers, as described below.

Background

Rule 606 of Regulation NMS is intended to provide investors with transparency into broker-dealers’ order handling and routing practices, and to promote competition by allowing investors to evaluate the quality of broker-dealers’ performance, including order handling and conflicts of interest management. Currently, Rule 606(a) requires broker-dealers to provide a publicly available quarterly report regarding routing of non-directed orders, while Rule 606(b) requires broker-dealers to provide customers, upon request, information about the routing of their orders. However, the SEC noted that broker-dealer practices and strategies have become increasingly “automated, dispersed and complex” since the original version of Rule 606 was adopted in 2000. Mindful of these shifts, many have called for readjusting order handling disclosures to keep up with changing market and technological forces.

One area of focus has been how the disclosure rules apply to orders submitted by institutional investors. Prior to these amendments, Rule 606 only applied to “customer orders,” defined to include generally those orders in NMS stocks having a market value of less than \$200,000. Thus, Rule 606 did not apply to many larger institutional orders. Further, on-request customer-specific reports were not prepared in any mandated standardized format, often making it difficult for investors to compare responses from different broker-dealers.

Customer-Specific Reports on Not Held Order Handling

As adopted, new Rule 606(b)(3) will require, subject to two de minimis exceptions described below, broker-dealers to provide customer-specific reports upon request, disclosing the broker-dealer’s handling of the customer’s not held NMS stock orders over the prior six months. Information to be disclosed for each requesting customer includes the number of: (i) shares sent to the broker-dealer, (ii) shares executed by the broker-dealer as principal for its account, and (iii) not held orders exposed by the broker-dealer through actionable indications of interest (“IOIs”), and the venues to which they were exposed, provided that the identity of such venue or venues may be anonymized if the venue is a customer of the broker-dealer. The reports must also contain information regarding the venues to which the broker-dealer routed the customer’s not held order, in the aggregate, such as information on order routing, order execution, orders providing liquidity, and orders removing liquidity.

Two de minimis exceptions limit these requirements. A firm-level exception lifts the broker-dealer’s obligation to provide Rule 606(b)(3) reports to *all* customers if not held NMS stock orders received by the broker-dealer from its customers over the prior six month calendar period constitute less than 5% of the total shares of NMS stock orders received by the broker-dealer. A customer-level exception lifts the broker-dealer’s obligation to provide Rule 606(b)(3) reports to a *particular* customer if that customer traded through the broker-dealer, on average each month for the prior six months, less than \$1,000,000 of notional value of not held orders in NMS stocks.

Notably, the Final Rule departs from the Proposed Rule in the following significant ways. First, the amended Rule 606(b) does not explicitly distinguish between “institutional orders” (any order for a quantity of an NMS stock with a value of \$200,000 or more) and “customer orders” (any order for a quantity of an NMS stock with a value of below \$200,000), which the Proposed Rule would have reclassified

as “retail orders.” The Proposed Rule would have introduced new Rule 606(b)(3) reporting obligations only for “institutional orders.” Instead, the Final Rule opts for using order type (“held” versus “not held”) as the operative distinction. This reformulation ensures that the rule applies to smaller child orders derived from orders that would be subject to Rule 606(b). Though this eliminates the explicit institutional/retail distinction, in practice, most “not held” orders are of larger size submitted by institutional investors, while retail investors typically submit held orders, which require immediate execution without price or time discretion. The SEC noted that it believed that extending the customer-specific reporting obligations to all not held orders advances the rule’s goals of promoting transparency and enabling the customer to better evaluate broker-dealer performance.

Second, the Final Rule also modifies the format of customer-specific order handling reports. The Final Rule abandons the proposed requirement of categorizing disclosures by order routing strategy (passive, neutral, aggressive) for each venue to which the customer’s orders were routed by the broker-dealer, based on the concern that different firms may categorize strategies differently, limiting investors’ ability to compare broker-dealers’ performance.

Third, the Final Rule will require the Rule 606(b)(3) report to segregate the customer’s directed orders and non-directed orders into separate sections. In doing so, the SEC believes reports will enable clients to better evaluate broker-dealer performance for orders where broker-dealers exercise discretion—namely, non-directed not held orders.

Finally, the Final Rule does not adopt the Proposed Rule’s requirement that broker-dealers provide quarterly public reports of aggregated Rule 606(b)(3) order handling information.

Public Reports on Held Order Handling

The Final Rule also enhances the existing disclosure obligations under Rule 606(a). Similar to how Rule 606(b)(3) extends customer-specific reports to orders of *any size* that are *not held*, the modified Rule 606(a) extends the previously required public quarterly reports to NMS stock orders of *any size* that are submitted on a *held* basis (though with respect to NMS securities that are option contracts, Rule 606(a) continues to apply only to those having market value of less than \$50,000, whether held or not held). This redrawing of the rule’s applicability is partly designed

to avoid overlapping coverage between Rule 606(a) and the amended Rules 606(b)(1) and (3) (i.e., those NMS stock orders having less than \$200,000 in market value that are not held).

Additionally, the Final Rule also requires new Rule 606(a) reports to:

- Separate routing information for marketable limit orders and non-marketable limit orders, given the different potential routing incentives;
- Provide the quarterly report showing routing information broken down by calendar month instead of by quarter;
- Categorize routing information by whether the NMS stock is included in the S&P 500 Index as of the quarter's first day, rather than categorizing by listing market;
- Include particular additional information regarding payments received for directing order flow to each of the ten venues ("**Specified Venues**") to which the broker-dealer routed for execution the largest number of total non-directed orders and any venue to which the broker-dealer routed for execution 5% or more of the non-directed orders; and
- Include additional information regarding the terms of the broker-dealer's relationships with each Specified Venue, including information regarding any payment for order flow and profit-sharing arrangements that could affect the order routing decision of the broker-dealer.

Impact on Investment Advisers

Although the Final Rule only explicitly adds new obligations onto broker-dealers, it may also have a significant impact on persons exercising investment discretion on behalf of customers. For example, under the Investment Advisers Act of 1940, investment advisers have a fiduciary duty to seek to achieve the best execution of customer orders. Investment advisers will likely be expected to consider the new enhanced information available regarding their broker-dealers' order routing practices when evaluating their broker-dealers' performance and fulfilling their best execution responsibilities.

Law Clerk Suiwen Liang contributed to this post.