

# SEC Proposes New and Enhanced Order Handling Disclosure Requirements

July 29, 2016

On July 13, 2016, the Securities and Exchange Commission (“SEC”) **proposed amendments** (the “**Proposal**”) to Rule 606 of Regulation NMS that would require, for the first time, broker-dealers to disclose standardized information on their handling of large, “institutional-size” orders—both in response to individual, customer requests and on a quarterly, aggregated basis. The Proposal would also enhance current broker-dealer order routing disclosure requirements concerning smaller, “retail” orders. The **two attached charts** compare the current and proposed retail order disclosure requirements with each other and against the proposed institutional order disclosure requirements.

If adopted, the Proposal could fundamentally change how investors choose their broker-dealers and review their broker-dealers’ performance, and have other important implications. For instance, some broker-dealers, faced with the prospect of publicly disclosing statistics and other information concerning their order handling activities and agreements with certain execution venues, may revisit and potentially alter certain practices and arrangements. The new and enhanced disclosures could also become significant components of best execution analyses of broker-dealers and investment advisers, and examiners would likely begin to ask broker-dealers and investment advisers how they use such data in their best execution analyses. Also, more generally, the new publicly available information would provide regulators, academics, vendors and market participants with a trove of information concerning the effects of payment for order flow arrangements, maker-taker pricing systems and changes to exchanges’ fee structures.

## Background

The existing broker-dealer order routing disclosure requirements in Rule 606 apply only in respect of small customer orders. For this purpose, a customer order is any order for an NMS security not for the account of a broker-dealer for a quantity with a market value of less than \$200,000 for NMS stocks and less than \$50,000 for options. Current Rule 606 requires broker-dealers to disclose, upon request, select customer-specific order routing information for customer orders for the prior six months. The rule also requires broker-dealers to disclose publicly, on a quarterly basis, select information concerning their routing of non-directed customer orders on an aggregated basis for all customers.

A variety of market participants—including some broker-dealers—have for years urged the SEC to take action to bring more transparency to broker-dealer order handling, particularly for large orders. The SEC release for the Proposal explains that while some institutional investors have been able to request and receive information from their broker-dealers concerning the handling of their large orders, not all market participants have been able to receive such information, and the data that broker-dealers do provide is not standardized and can be difficult to compare across broker-dealers. The Proposal is intended to help fill this gap by providing market participants with information to help them evaluate broker-dealer execution practices and the impact of certain conflicts of interest and potential information leakage associated with order routing—and ultimately make better informed choices when selecting their broker-dealers.

The Proposal, which appears to reflect many recommendations submitted to the SEC by market participants, is the latest market structure initiative advanced by the SEC following two speeches by SEC Chair Mary Jo White in the summer of 2014, in which she articulated an extensive package of potential market structure reforms, including **enhancements to order handling disclosures**.

## Proposed New Institutional Order Disclosures

The Proposal would require broker-dealers that receive “institutional orders” (any order for a quantity of an NMS stock with a value of \$200,000 or more) to provide individualized reports upon request regarding the venues where such orders are routed for execution or exposed through an actionable indication of interest (“IOI”). The Proposal would treat as an “**actionable IOI**” any IOI that explicitly or implicitly conveys all of the following information with respect to any order available at the venue sending the IOI: (i) symbol; (ii) side (buy or sell), (iii) a price that is equal to or better than the NBBO and (iv) a size that is at least equal to one round lot. The individualized reports would need to address the broker-dealer’s handling of institutional orders (including smaller “child” orders derived from institutional orders) for that customer for the prior six months, and would need to be provided within seven business days of the customer’s request.

As outlined in **Chart A**, the institutional order information that a broker-dealer would be required to disclose upon request would be much more extensive and granular than the individualized information currently required for “customer orders”—and would not cover options. Among other things, a broker-dealer would need to disclose specified order execution quality information, as well as certain data concerning whether executed orders provided or removed liquidity. Information would need to be broken down by month, categorized by trading venue, and also subdivided into “passive,” “neutral” and “aggressive” order routing strategies, as determined and assigned by the broker-dealer based on its own documented methodology.

The Proposal would also require broker-dealers that receive institutional orders to make publicly available on their websites, for three years, quarterly reports that aggregate *all* of their institutional order handling information, broken down by month. As with the existing and proposed quarterly reports, the public disclosure of aggregate information on institutional orders must be made within one month of quarter end.

## Proposed Enhancements to Existing Retail Order Disclosures

The SEC’s proposal to update existing broker-dealer public quarterly reports on the handling of non-directed customer orders (proposed to be renamed “**retail orders**”) is similarly intended to help market participants better assess broker-dealer order routing and execution services. As outlined in **Chart B**, the Proposal would enhance the existing broker-dealer quarterly retail order reports by, among other things, requiring broker-dealers to: (i) break all reporting down by month, (ii) divide limit order information into marketable and non-marketable categories and (iii) disclose the terms of any payment for order flow arrangements and profit-sharing relationships with trading venues that may influence order routing decisions.

The Proposal would not substantively change the existing individualized retail order disclosure requirements of Rule 606(b)(1).

## Other Noteworthy Points

Under the Proposal, the SEC would retain its current authority under Rule 606 to exempt any person, transaction or class of transactions.

In addition, to facilitate better analysis of historical order execution information across market centers, the Proposal would also amend Rule 605 of Regulation NMS to require market centers to make their existing monthly order execution reports under that rule available on their public websites.

## Requests for Comment

The SEC has requested comment on a variety of issues, including for example: (i) whether \$200,000 is the appropriate criteria for defining an institutional order, (ii) the appropriateness of the proposed

definition of actionable IOI and (iii) whether the disclosure of the terms of payment for order flow arrangements and profit-sharing relationships is relevant for retail customers.

Comments are due by September 26, 2016.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Chart A: Comparison of Current and Proposed Requirements for Individualized Reports

|                                                                                                                                             | Requirement                                                                                                                                                                                                                                                                                                                                | Current Retail Rule                                                                                  | Proposed Retail Rule                                                                                 | Proposed Institutional Rule                                                |
|---------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------|
| <b>Scope and Organization of Report</b>                                                                                                     |                                                                                                                                                                                                                                                                                                                                            |                                                                                                      |                                                                                                      |                                                                            |
| 1.                                                                                                                                          | <i>Types of securities covered</i>                                                                                                                                                                                                                                                                                                         | Retail orders in NMS securities over prior six months (NMS stocks and options broken out separately) | Retail orders in NMS securities over prior six months (NMS stocks and options broken out separately) | Institutional orders in NMS stocks (but not options) over prior six months |
| 2.                                                                                                                                          | <i>Information broken down by calendar month</i>                                                                                                                                                                                                                                                                                           | No                                                                                                   | No                                                                                                   | Yes                                                                        |
| <b>Minimum Content Requirements for Each Section of Report</b>                                                                              |                                                                                                                                                                                                                                                                                                                                            |                                                                                                      |                                                                                                      |                                                                            |
| 3.                                                                                                                                          | <i>Whether orders were directed or non-directed</i>                                                                                                                                                                                                                                                                                        | Yes                                                                                                  | Yes                                                                                                  | No                                                                         |
| 4.                                                                                                                                          | <i>Venue(s) where orders routed for execution</i>                                                                                                                                                                                                                                                                                          | Yes                                                                                                  | Yes                                                                                                  | Yes                                                                        |
| 5.                                                                                                                                          | <i>Time of resulting transactions, if any</i>                                                                                                                                                                                                                                                                                              | Yes                                                                                                  | Yes                                                                                                  | No                                                                         |
| 6.                                                                                                                                          | <i>Order Flow Information:</i> (i) Number of shares sent to BD by customer during relevant period; (ii) total number of shares executed by BD as principal for its own account; (iii) number of orders exposed through an actionable IOI; and (iv) venue(s) where orders were exposed through an actionable IOI.                           | No                                                                                                   | No                                                                                                   | Yes                                                                        |
| <b>Venue-by-Venue Information, in the Aggregate and Broken Down by Passive, Neutral and Aggressive Order Routing Strategies<sup>1</sup></b> |                                                                                                                                                                                                                                                                                                                                            |                                                                                                      |                                                                                                      |                                                                            |
| 7.                                                                                                                                          | <i>Order Routing Information:</i> (i) shares routed; (ii) shares marked immediate or cancel; (iii) shares routed that were further routable; and (iv) average order size routed.                                                                                                                                                           | No                                                                                                   | No                                                                                                   | Yes                                                                        |
| 8.                                                                                                                                          | <i>Order Execution Information:</i> (i) shares executed; (ii) fill rate; (iii) average fill size; (iv) average net execution fee or rebate; (v) number and percentage of shares executed at the midpoint; and (vi) number and percentage of shares executed that were priced on each side of the spread.                                   | No                                                                                                   | No                                                                                                   | Yes                                                                        |
| 9.                                                                                                                                          | <i>Information on orders that provided liquidity:</i> (i) number and percentage of shares executed of orders providing liquidity; (ii) for orders providing liquidity, average time in milliseconds between order entry and execution or cancelation; and (iii) average net execution rebate/fee for shares of orders providing liquidity. | No                                                                                                   | No                                                                                                   | Yes                                                                        |
| 10.                                                                                                                                         | <i>Information on orders that removed liquidity:</i> (i) number and percentage of shares executed of orders removing liquidity; and (ii) average net execution fee/rebate for shares of orders removing liquidity.                                                                                                                         | No                                                                                                   | No                                                                                                   | Yes                                                                        |

<sup>1</sup> Under the Proposal, a “passive” order routing strategy would be a strategy that emphasizes price impact minimization over execution speed; a “neutral” order routing strategy would be one that is relatively neutral between price impact minimization and execution speed; and an “aggressive” order routing strategy would be one that emphasizes execution speed over price impact minimization.

Chart B: Comparison of Current and Proposed Requirements for Public Quarterly Reports

|                                                                | Requirement                                                                                                                                                                                                                                                                                                              | Current Retail Rule                                                                        | Proposed Retail Rule                                                                                                | Proposed Institutional Rule                                                                                                                                                                    |
|----------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Scope and Organization of Report</b>                        |                                                                                                                                                                                                                                                                                                                          |                                                                                            |                                                                                                                     |                                                                                                                                                                                                |
| 1.                                                             | <i>Order types</i>                                                                                                                                                                                                                                                                                                       | Non-directed retail orders in NMS securities                                               | Non-directed retail orders in NMS securities                                                                        | Institutional orders in NMS stocks                                                                                                                                                             |
| 2.                                                             | <i>Division of report</i>                                                                                                                                                                                                                                                                                                | Three separate sections for NMS stocks (by listing market); additional section for options | Separate sections for NMS stocks (not divided by listing market) and options                                        | See Chart A: Proposed quarterly report would include aggregate of information in individualized institutional report.                                                                          |
| 3.                                                             | <i>Information broken down by calendar month</i>                                                                                                                                                                                                                                                                         | No                                                                                         | Yes                                                                                                                 | Yes                                                                                                                                                                                            |
| <b>Minimum Content Requirements for Each Section of Report</b> |                                                                                                                                                                                                                                                                                                                          |                                                                                            |                                                                                                                     |                                                                                                                                                                                                |
| 4.                                                             | <i>Order Breakdown:</i> Percentage of total orders that were non-directed orders, and percentages of such orders that were market orders, limit orders, and other orders.                                                                                                                                                | Yes                                                                                        | Yes, but limit orders divided into marketable and non-marketable limit orders.                                      | See Chart A: Proposed quarterly report would include aggregate of information in individualized institutional report, broken down by passive, neutral and aggressive order routing strategies. |
| 5.                                                             | <i>Top Execution Venues:</i> The ten venues to which the most non-directed orders were routed, and any venue to which five percent or more of non-directed orders were routed (any venue described in this row, a “top execution venue”).                                                                                | Yes                                                                                        | Yes                                                                                                                 |                                                                                                                                                                                                |
| 6.                                                             | <i>Distribution:</i> The percentage of total non-directed orders routed to any top execution venue, and the percentages of total non-directed market orders, total non-directed limit orders, total non-directed limit orders, and total other orders routed to each top execution venue.                                | Yes                                                                                        | Yes, but limit orders divided into marketable and non-marketable limit orders.                                      |                                                                                                                                                                                                |
| 7.                                                             | <i>Economic Relationships with Top Execution Venues:</i> Discussion of material aspects of the BD’s relationship with each top execution venue, including a description of any arrangement for payment for order flow and any profit-sharing relationship.                                                               | Yes                                                                                        | Yes, and must include description of any arrangements, written or oral, that may influence a BD’s routing decision. |                                                                                                                                                                                                |
| 8.                                                             | <i>Payments Made and Received:</i> For each top execution venue identified: (i) the net aggregate amount of any payment for order flow received; (ii) any profit-sharing relationship received, (iii) the transaction fees paid; and (iv) transaction rebates received—each of which divided by non-directed order type. | No                                                                                         | Yes                                                                                                                 |                                                                                                                                                                                                |