

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 240 and 242

[Release No. 34-78309; File No. S7-14-16]

RIN 3235-AL67

### Disclosure of Order Handling Information

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission” or “SEC”) is proposing to amend Rules 600 and 606 of Regulation National Market System (“Regulation NMS”) under the Securities Exchange Act of 1934 (“Exchange Act”) to require additional disclosures by broker-dealers to customers about the routing of their orders. Specifically, with respect to institutional orders, the Commission is proposing to amend Rule 606 of Regulation NMS to require a broker-dealer, upon request of its customer, to provide specific disclosures related to the routing and execution of the customer’s institutional orders for the prior six months. The Commission also is proposing to amend Rule 606 of Regulation NMS to require a broker-dealer to make publicly available aggregated information with respect to its handling of customers’ institutional orders for each calendar quarter. With respect to retail orders, the Commission is proposing to make targeted enhancements to current order routing disclosures under Rule 606 by requiring limit order information to be broken down into marketable and non-marketable categories, requiring the disclosure of the net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received by a broker-dealer from certain venues, requiring broker-dealers to describe any terms of payment for order flow arrangements and profit-sharing relationships with certain venues that may influence their order routing decisions, and eliminating the requirement to divide retail order routing information by listing market. In connection with these new requirements, the Commission is proposing to amend Rule 600 of Regulation NMS to include a number of newly defined terms which are used in the proposed amendments to Rule 606. The Commission is also proposing to amend Rules 605 and 606 of Regulation NMS to require that the public order

execution and order routing reports be kept publicly available for a period of three years and to make conforming changes to Rule 607. Finally, the Commission is proposing to amend Rule 3a51-1(a) under the Exchange Act; Rule 13h-1(a)(5) of Regulation 13D-G; Rule 105(b)(1) of Regulation M; Rules 201(a) and 204(g) of Regulation SHO; Rules 600(b), 602(a)(5), 607(a)(1), and 611(c) of Regulation NMS; and Rule 1000 of Regulation SCI, to update cross-references as a result of this proposed rule.

**DATES:** Comments should be received on or before September 26, 2016.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### *Electronic Comments*

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>);
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-14-16 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### *Paper Comments*

• Send paper comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090. All submissions should refer to File Number S7-14-16. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for Web site viewing and printing in the Commission’s Public Reference Room, 100 F Street NE., Washington, DC 20549-1090 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any materials will be made available on the Commission’s Web site. To ensure direct electronic receipt of such notifications, sign up through the “Stay Connected” option at [www.sec.gov](http://www.sec.gov) to receive notifications by email.

#### **FOR FURTHER INFORMATION CONTACT:**

Theodore S. Venuti, Assistant Director, at (202) 551-5658, Arisa Tinaves Kettig, Senior Special Counsel, at (202) 551-5676, Steve Kuan, Special Counsel, at (202) 551-5624, Amir Katz, Special Counsel, at (202) 551-7653, Chris Grobbel, Special Counsel, at (202) 551-5491, or Andrew Sioson, Attorney-Advisor, at (202) 551-7186 Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

#### **SUPPLEMENTARY INFORMATION:**

The Commission is proposing: (1) Amendments to Rules 600 and 606 under the Exchange Act [17 CFR 242.600 and 202.606] to require additional disclosures by broker-dealers to customers about the routing of their orders; (2) amendments to Rule 605 [17 CFR 242.605] to require that the public order execution and order routing reports be kept publicly available for a period of three years; and (3) conforming changes and updating cross-references in Rule 3a51-1(a) under the Exchange Act [17 CFR 240.3a51-1(a)], Rule 13h-1(a)(5) of Regulation 13D-G [17 CFR 240.13h-1(a)(5)], Rule 105(b)(1) of Regulation M [17 CFR 242.105(b)(1)] Rules 201(a) and 204(g) of Regulation SHO [17 CFR 242.201(a) and 242.204(g)], Rules 600(b), 602(a)(5), 605, 607(a)(1), and 611(c) of Regulation NMS [17 CFR 242.600(b), 242.602(a)(5), 242.605, 242.607(a)(1), and 242.611(c)], and Rule 1000 of Regulation SCI [17 CFR 242.1000].

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## I. Introduction

Institutional customers have a compelling interest in the order handling decisions of their executing brokers as they monitor the execution quality of their orders, both from the standpoint of the price received and to evaluate the potential negative effects of information leakage and conflicts of interest.<sup>1</sup> This focus on order handling

<sup>1</sup> An institutional customer includes, for example, pension funds, mutual funds, investment advisers, insurance companies, investment banks, and hedge funds.

has intensified in recent years as routing and execution practices have evolved as markets have become more automated, dispersed, and complex.<sup>2</sup> Historically, there was a substantial manual component involved in the routing and execution of institutional customers' orders. Today, however, institutional orders tend to be routed and executed using sophisticated order execution algorithms developed by broker-dealers or others that break up large institutional orders into smaller "child" orders, and smart order routing systems to route those child orders to the full range of trading centers in the national market system, including exchanges, "dark pool" alternative trading systems ("ATs"), other ATs, and internalizing broker-dealers.<sup>3</sup> These order routing and execution algorithms use a wide variety of methods, ranging from non-time-sensitive passive strategies to aggressive liquidity-taking strategies, to achieve the trading goals of the institutional customer. Although certain advantages flow from technological advancements and the increase in number of venues, the Commission preliminarily believes that the complexity of order execution algorithms and smart order routing systems, and the multiplicity of venues to which broker-dealers may route orders or send actionable indications of interest, have made it increasingly difficult for institutional customers to assess the impact particular order routing strategies may have on the quality of their executions, or the risks presented by any resulting information leakage or broker-dealer conflicts of interest.

Changes to market structure and routing practices have led many institutional customers to demand more specific and detailed institutional order handling information from their broker-dealers. The Commission notes that for

<sup>2</sup> See Securities Exchange Act Release No. 73639 (November 19, 2014), 79 FR 72252, 72397 (December 5, 2014) ("Regulation SCI Adopting Release") (stating that markets have evolved "to become significantly more dependent on sophisticated, complex, and interconnected technology"); see also Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010) ("Concept Release on Equity Market Structure") (stating that "the current market structure can be described as dispersed and complex: (1) Trading volume is dispersed among many highly automated trading centers that compete for order flow in the same stocks; and (2) trading centers offer a wide range of services that are designed to attract different types of market participants with varying trading needs").

<sup>3</sup> A "trading center" means a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent. See 17 CFR 242.600(b)(78).

purposes of this proposing release, the use of “institution” or “institutional” shall refer to an institutional order, as proposed to be defined in proposed Rule 600(b)(31),<sup>4</sup> and the term “institutional customer” shall refer to a sender of an institutional order.

The Commission understands that institutional customer requests range from detailed information about the handling of specific institutional orders to more generic data about the order routing strategies pursued by the broker-dealer for institutional customers and the venues to which their orders are routed and executed. The level of detail of the information provided tends to vary by broker-dealer, as well as the particular institutional customer, some of whom may have the wherewithal and desire to digest and evaluate voluminous order handling information and some of whom may not.

The Commission preliminarily believes that market-based efforts to provide institutional order handling transparency may not be sufficient insofar as smaller institutional customers may lack the bargaining power or the resources to demand relevant order handling information from their broker-dealers. In addition, while many institutional customers regularly conduct, directly or through a third-party vendor, transaction cost analysis (“TCA”) of their orders to assess execution quality against various benchmarks, the Commission preliminarily believes that the comprehensiveness of such analysis could be enhanced with more granular order handling information. The Commission also preliminarily believes that standardizing the baseline information provided by broker-dealers could help ensure the wide availability of meaningful order handling information that may be produced in an efficient and cost-effective manner.<sup>5</sup>

In light of the foregoing, the Commission preliminarily believes that standardized baseline institutional order

handling information should be required to be made available to the institutional customer upon request so that the institutional customer can more effectively assess the impact of order routing decisions on the quality of their executions, including the risks of information leakage and potential conflicts of interest.<sup>6</sup> Further, the Commission preliminarily believes that public disclosure of institutional order handling information, on an aggregated basis, could assist market participants in comparing the routing services of multiple broker-dealers, and the relative merits of competing trading centers, and facilitate institutional customers’ ability to make informed decisions when engaging the services of a broker-dealer. The Commission preliminarily believes that the proposal would further encourage broker-dealers to minimize information leakage when executing an institutional order. The Commission preliminarily believes that the potential benefits of public disclosure of aggregated institutional order handling information should justify any potential negative competitive impact such disclosure may have on broker-dealers.

The changes to market structure have impacted the market for customer order routing and execution services. Currently, a “customer order” means an order to buy or sell an NMS security that is not for the account of a broker-dealer, but shall not include any order for a quantity of a security having a market value of at least \$50,000 for an NMS security that is an option contract and a market value of at least \$200,000 for any other NMS security.<sup>7</sup> As such, the term “customer order,” when used in Regulation NMS, only refers to smaller-sized orders. As discussed in more detail below, the Commission is proposing to rename “customer order” to “retail order” and for purposes of this proposing release, the term “retail customer” shall refer to a sender of a retail order.

As discussed below, the rise in the number of trading centers and the introduction of new fee models for execution services have intensified competition for retail order flow and created new potential conflicts of interest for broker-dealers. The Commission preliminarily believes that simplified and enhanced disclosures for retail orders, particularly with respect to financial inducements from trading centers, should assist retail customers in evaluating better the order routing services of their broker-dealers. Additionally, public transparency of

retail orders should drive competition as broker-dealers seek to compete on the basis of the quality of their order routing and execution services as well as their ability to manage conflicts of interest.

The Commission therefore is proposing amendments to Rules 600<sup>8</sup> and 606<sup>9</sup> of Regulation NMS to require, for the first time, disclosures by broker-dealers about their handling of institutional orders, and enhancements to existing disclosures with respect to retail orders.<sup>10</sup> Specifically, with respect to institutional orders, the Commission is proposing to amend Rule 606 of Regulation NMS to require a broker-dealer, upon request of its customer, to provide specific disclosures, for the prior six months, broken down by calendar month, related to: (1) The handling of the customer’s institutional orders at the broker-dealer; (2) the routing of the customer’s institutional orders to various trading centers; (3) the execution of those orders, and the quality of execution; and (4) the extent to which such orders provided liquidity or removed liquidity, and the average transaction rebates received or fees paid by the broker-dealer. This information would be provided for each venue, and would *further be divided into* passive, neutral, and aggressive order routing strategies. In connection with this new requirement, the Commission is proposing to amend Rule 600 of Regulation NMS to include definitions of the terms “institutional order,” “actionable indication of interest,” “orders providing liquidity,” and “orders removing liquidity,” and to rename the defined term “customer order” to “retail order.” The Commission also is proposing to amend Rule 606 of Regulation NMS to require a broker-dealer to make publicly available the foregoing information, on an aggregated basis, for all of its customers’ institutional orders, for each calendar quarter, broken down by calendar month, and keep such reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

Further, with respect to retail orders, the Commission preliminarily believes that the existing Rule 606 disclosures should be updated to require that more relevant routing information is provided

<sup>8</sup> 17 CFR 242.600.

<sup>9</sup> 17 CFR 242.606.

<sup>10</sup> The Commission notes that the proposed amendments to Rule 606, if adopted, would not limit any other obligations that the broker-dealer may have under applicable federal securities laws, rules, or regulations, including the anti-fraud provisions of the federal securities laws.

<sup>4</sup> See *infra* Section III.A.1.

<sup>5</sup> There have been recent efforts by representatives of broker-dealers and institutional customers to develop a template of baseline order routing disclosure, and these efforts are reflected in a letter from the Investment Company Institute, the Managed Funds Association, and the Securities Industry and Financial Markets Association (collectively, the “Associations”). See Letter to Mary Jo White, Chair, Commission, from Dorothy M. Donohue, Deputy General Counsel, Investment Company Institute, Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, and Randy Snook, Executive Vice President, Securities Industry and Financial Markets Association, dated October 23, 2014 (“Associations Letter”), available at <http://www.sec.gov/comments/s7-02-10/s70210-428.pdf>.

<sup>6</sup> See *infra* Sections II.C.3. and II.C.4.

<sup>7</sup> See 17 CFR 242.600(b)(18).

to retail customers. Specifically, the Commission is proposing to: (1) Require limit order information to be split into marketable<sup>11</sup> and non-marketable<sup>12</sup> categories; (2) require more detailed disclosure of the net aggregate amount of any payments received from or paid to certain trading centers; (3) require broker-dealers to describe any terms of payment for order flow arrangements and profit-sharing relationships with certain venues that may influence its order routing decisions; (4) require that broker-dealers keep retail order routing reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site; and (5) eliminate the requirement to group retail order routing information by listing market.

Finally, consistent with the proposed amendments to Rule 606, the Commission is proposing to amend Rule 605 to require market centers<sup>13</sup> to keep execution reports required by the rule posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site. With respect to Rule 607, the Commission is proposing to amend the rule text to reflect the renaming of the defined term “customer order” to “retail order,” but is making no substantive changes to the defined term. As noted above, the Commission is proposing amendments to other rules to update cross-references as a result of this proposal.<sup>14</sup>

<sup>11</sup> A “marketable limit order” is any buy order with a limit price equal to or greater than the national best offer at the time of order receipt, or any sell order with a limit price equal to or less than the national best bid at the time of order receipt. 17 CFR 242.600(b)(39). “National best bid and national best offer” means, with respect to quotations for an NMS security, the best bid and best offer for such security that are calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan; provided, that in the event two or more market centers transmit to the plan processor pursuant to such plan identical bids or offers for an NMS security, the best bid or best offer (as the case may be) shall be determined by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), and then by time (giving the highest ranking to the bid or offer received first in time). 17 CFR 242.600(b)(42).

<sup>12</sup> The Commission is proposing in new Rule 600(b)(51) to define “non-marketable limit order” to mean “any limit order other than a marketable limit order”, as discussed in more detail below. See *infra* Section III.B.1.

<sup>13</sup> A “market center” means any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association. See 17 CFR 242.600(b)(38).

<sup>14</sup> The Commission is proposing to amend Rule 3a51-1(a) under the Exchange Act; Rule 13h-1(a)(5) of Regulation 13D-G; Rule 105(b)(1) of Regulation M; Rules 201(a) and 204(g) of Regulation SHO;

The release first provides relevant background on Rule 606 and then discusses the technological advances and regulatory changes that have prompted the proposal. The release then discusses, in detail, the proposed amendments to Rules 600, 605, 606, and 607 including the new institutional order handling disclosures that would be required from broker-dealers.

## II. Current Practices and Regulation and the Need for Enhanced Disclosures

### A. Background on Rule 606

The Commission proposed and adopted Rule 11Ac1-6,<sup>15</sup> now known as Rule 606 of Regulation NMS,<sup>16</sup> in 2000, to improve public disclosure of order routing practices. Rule 606 arose out of the Commission’s extended inquiry into market fragmentation, defined at the time as the trading of orders in multiple locations without interaction among those orders.<sup>17</sup> In adopting Rule 606, the Commission stated that “[i]n a fragmented market structure with many different market centers trading the same security, the order routing decision is critically important, both to the individual investor whose order is routed and to the efficiency of the market structure as a whole. The decision must be well-informed and fully subject to competitive forces.”<sup>18</sup> The Commission further stated that public disclosure of order routing practices “could provoke more vigorous competition on . . . order routing performance.”<sup>19</sup>

Rules 600(b), 602(a)(5), 607(a)(1), and 611(c) of Regulation NMS; and Rule 1000 of Regulation SCI.

<sup>15</sup> See Securities Exchange Act Release Nos. 43084 (July 28, 2000), 65 FR 48406 (August 8, 2000) (“Rule 606 Predecessor Proposing Release”) and 43590 (November 17, 2000), 65 FR 75414 (December 1, 2000) (“Rule 606 Predecessor Adopting Release”).

<sup>16</sup> The Commission re-designated Rule 11Ac1-6 as Rule 606 when adopting Regulation NMS in 2005. See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37538 (June 29, 2005) (“Regulation NMS Adopting Release”). For clarity, when this release discusses the proposal of Rule 606 or the adoption of Rule 606, it is referring to the Rule 606 Predecessor Proposing Release and Rule 606 Predecessor Adopting Release, *supra* note 15, respectively.

<sup>17</sup> See Securities Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 (February 28, 2000) (Commission request for comment, included in a notice of a proposed self-regulatory organization (“SRO”) rule change) (“Fragmentation Release”).

<sup>18</sup> See Rule 606 Predecessor Adopting Release, *supra* note 15, at 75415.

<sup>19</sup> *Id.* at 75417. Industry participants commenting in response to the Concept Release on Equity Market Structure, *supra* note 2, have expressed the view that increased order routing transparency has led to increased competition. See, e.g., Letters to Secretary, Commission, from Joan C. Conley, Senior Vice President and Corporate Secretary, The NASDAQ OMX Group, Inc., dated April 30, 2010

In adopting Rule 606, the Commission limited its scope to smaller orders.<sup>20</sup> Larger orders were excluded in recognition of the fact that, at the time, generalized information for order routing practices would be more useful for smaller orders, which tended to be handled in a more homogenous manner.<sup>21</sup> Because institutional orders required more individualized, manual handling, they were excluded from Rule 606 in recognition of the fact that, at that time, providing standardized order handling statistics would be neither practical nor useful in this context.<sup>22</sup>

Thus, in its current form, Rule 606(a) applies only to retail-sized orders, and requires every broker-dealer to publicly provide a quarterly report on its routing of non-directed orders<sup>23</sup> in NMS securities.<sup>24</sup> Currently, the report includes the following information, separated by listing market for NMS stocks,<sup>25</sup> and in the aggregate for NMS securities that are option contracts: (1) The percentage of total retail orders that were non-directed orders, and the percentages of total non-directed orders that were market orders, limit orders, and other orders; (2) the identity of the ten venues to which the largest number of total non-directed orders were routed for execution and of any venue to which

(“NASDAQ Letter”), at 21 (stating that NASDAQ shares the Commission’s belief that transparency promotes competition); from Christopher Nagy, Managing Director Order Strategy, Co-Head of Government Relations, TD Ameritrade and John S. Markle, Deputy General Counsel, Co-Head of Government Relations, TD Ameritrade, dated April 21, 2010 (“TD Ameritrade Letter”), at 3–4 (stating that added transparency has driven brokers to continuously seek better executions for clients).

<sup>20</sup> The Commission limited the scope of Rule 606 to smaller orders by defining a customer order as an order to buy or sell an NMS security that is not for the account of a broker or dealer, but shall not include any order for a quantity of a security having a market value of at least \$50,000 for an NMS security that is an option contract and a market value of at least \$200,000 for any other NMS security. See 17 CFR 242.600(b)(18).

<sup>21</sup> See Rule 606 Predecessor Adopting Release, *supra* note 15, at 75426.

<sup>22</sup> See *id.*

<sup>23</sup> A “non-directed order” means any customer order other than a directed order. See 17 CFR 242.600(b)(48). A “directed order” means a customer order that the customer specifically instructed the broker or dealer to route to a particular venue for execution. See 17 CFR 242.600(b)(19). See also *supra* note 7 and accompanying text. The Commission is proposing to rename “customer order” as “retail order,” which would carry through to these two definitions. See *infra* Section III.B.5.

<sup>24</sup> An “NMS security” is any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options. See 17 CFR 242.600(b)(46).

<sup>25</sup> An “NMS stock” is any NMS security other than an option. See 17 CFR 242.600(b)(47).

five percent or more of such orders were routed (collectively, “Specified Venues”) and the percentage of total non-directed orders routed to each Specified Venue, and the percentages of total non-directed market orders, total non-directed limit orders, and total non-directed other orders that were routed to each Specified Venue; and (3) a discussion of the material aspects of the broker-dealer’s relationship with each Specified Venue, including a description of any payment for order flow<sup>26</sup> or profit-sharing relationship arrangements.<sup>27</sup>

Rule 606(b) currently requires every broker-dealer to provide customers, upon request, specific information about the routing of their orders. Specifically, upon request, every broker-dealer shall: (1) Disclose to its customer the identity of the venue to which the customer’s orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders; and (2) notify customers in writing at least annually of the availability of this information upon request.

### B. Changes in Order Handling Practices

U.S. equity market structure has changed significantly since the adoption of Rule 606. Today it is highly automated, dispersed among myriad trading centers, and more complex than it was in 2000.<sup>28</sup> The primary drivers of this market transformation have been the rapid and ongoing evolution of technologies for generating, routing, and

executing orders, and the impact of regulatory changes.<sup>29</sup> In 2000, a large proportion of order flow in listed equity securities was routed to a few, mostly manual, trading centers, and it was rare that such orders would be re-routed to other venues.<sup>30</sup> In contrast, today, trading in the U.S. equity markets is spread among a number of highly automated trading centers: 12 registered exchanges, more than 40 ATSS,<sup>31</sup> and over 200 over-the-counter (“OTC”) market-makers,<sup>32</sup> and the routing and re-routing of orders to multiple venues is common. These venues offer a wide range of services and pricing structures that are designed to attract different types of market participants with varying trading needs.<sup>33</sup>

According to a staff report published in 1994, prior to the emergence and growth of electronic markets, institutional customers would rely primarily on exchange floor brokers or upstairs block positioners to execute their large orders.<sup>34</sup> Typically, exchange floor brokers or upstairs block positioners would negotiate large trades off the exchange (often referred to as “upstairs”) and subsequently execute or “print” on the exchange—subject to auction market procedures allowing the limit order book or the trading crowd to participate in the trade and exposing the order to the market.<sup>35</sup> The nature of floor trading activity and upstairs block positioning allowed broker-dealers to manually exercise judgment and expertise to achieve best execution, and typically involved strategies that were designed to conceal information about an institutional customer’s trading interest to potential counterparties to minimize price impact.

In today’s electronic markets, however, the manual handling of institutional orders is increasingly rare,

and has been replaced by sophisticated institutional order execution algorithms and smart order routing systems. These sophisticated algorithms and systems decide the timing, pricing, and quantity of orders routed to the various trading centers.<sup>36</sup> Broker-dealers often use order execution algorithms to divide a large “parent” order of an institutional customer into many smaller “child” orders, and route the child orders over time to different trading centers in accordance with a particular strategy.<sup>37</sup> Such algorithms may be “aggressive,” and generally seek to take liquidity quickly at many different trading centers, or they may be “passive,” and generally submit resting orders at one or more trading centers and await executions at favorable prices, or they may be “neutral,” and seek to take liquidity or submit resting orders depending on market conditions.<sup>38</sup> In addition, some broker-dealers utilize indications of interest to notify external liquidity providers of trading interest at that broker-dealer.

### C. Need for Enhanced Disclosures for Institutional Orders

#### 1. Market Complexity

Institutional customers have long focused on the execution quality of their large orders, and the potential impacts from information leakage and conflicts of interest faced by their broker-dealers. While there is some indication that enhancements to electronic order routing systems and processes generally have led to improved execution quality in many cases,<sup>39</sup> the operation of order routing systems and processes often is opaque to customers placing institutional orders, who may not have sufficient information to understand how, where, and why their orders are routed to specific venues, and whether particular order routing and execution strategies, whether or not selected by

<sup>26</sup> “Payment for order flow” has the meaning provided in 17 CFR 240.10b-10. See 17 CFR 242.600(b)(54). “Payment for order flow” means any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker or dealer’s unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation. See 17 CFR 240.10b-10(d)(8).

<sup>27</sup> A “profit-sharing relationship” means any ownership or other type of affiliation under which the broker or dealer, directly or indirectly, may share in any profits that may be derived from the execution of non-directed orders. See 17 CFR 242.600(b)(56).

<sup>28</sup> See Concept Release on Equity Market Structure, *supra* note 2, at 3594. See also Regulation SCI Adopting Release, *supra* note 2, at 72397.

<sup>29</sup> See Concept Release on Equity Market Structure, *supra* note 2, at 3594 (“Changes in market structure also reflect the markets’ response to regulatory actions such as Regulation NMS, adopted in 2005, the Order Handling Rules, adopted in 1996, as well as enforcement actions, such as those addressing anti-competitive behavior by market makers in NASDAQ stocks”).

<sup>30</sup> See Fragmentation Release, *supra* note 17.

<sup>31</sup> Data compiled from Forms ATS-R filed with the Commission as of the end of the fourth quarter of 2014.

<sup>32</sup> More than 200 broker-dealers (excluding ATSS) have identified themselves to the Financial Industry Regulatory Authority (“FINRA”) as market centers that must provide monthly reports on order execution quality under Rule 605 of Regulation NMS (list available at <http://apps.finra.org/datadirectory/1/marketmaker.aspx>).

<sup>33</sup> See Concept Release on Equity Market Structure, *supra* note 2, at 3594.

<sup>34</sup> See Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments, at II-14 (January 1994).

<sup>35</sup> *Id.* at II-14-15.

<sup>36</sup> See, e.g., Terrence Hendershott, Charles Jones, and Albert Menkveld, *Does Algorithmic Trading Improve Liquidity*, 66 *Journal of Finance* 1 (February 2011).

<sup>37</sup> See Concept Release on Equity Market Structure, *supra* note 2, at 3602.

<sup>38</sup> See *id.*

<sup>39</sup> See, e.g., Letter to Secretary, Commission, from Greg O’Connor, Compliance Manager, Wolverine Trading, LLC, dated April 21, 2010 (“Wolverine Trading Letter”), at 5 (stating that technological advancements have led to improved markets and executions as indicated by tighter spreads, lower trading costs, and more liquidity). See also Thierry Foucault and Albert J. Menkveld, *Competition for Order Flow and Order Routing Systems*, 63 *Journal of Finance* 119, 121 (February 2008) (discussing that utilization of smart order routers reduces the incidence of trade-throughs and may encourage provision of liquidity).

the customer, are consistent with the customer's expectations.

As noted above, at the time of adoption of Rule 606, institutional orders generally were handled by an exchange floor broker or upstairs block positioner. The risks of information leakage and broker-dealer conflicts of interest existed with manual order handling, but because the execution alternatives were fewer and simpler, less data was necessary for institutional customers to evaluate those risks and evaluate broker-dealer performance. Now, however, because of the complexity of order execution algorithms and smart order routing systems, and the wide variety of venues to which broker-dealers may route institutional orders or send actionable indications of interest, access to data is important for institutional customers to assess the impact a broker-dealer's order routing strategies may have on the quality of their executions and the risks presented by any resulting information leakage or broker-dealer conflicts of interest.

Institutional customers increasingly have been expressing concerns regarding the difficulty in obtaining and comparing certain information across broker-dealers and venues, and understanding how their institutional orders are handled by broker-dealers, and have called for enhanced order handling disclosures.<sup>40</sup> Institutional customers have cited concerns, among other things, about the extent to which broker-dealer routing decisions are influenced by incentives offered by trading centers to attract order flow, that inefficiencies in order execution algorithms and smart order routing systems may lead to information leakage, and that the complexity and opacity of order routing practices frustrate the ability to monitor execution quality. Importantly, a variety of other market participants, including broker-dealers, also have expressed support for enhanced and consistent disclosure of institutional order handling information.<sup>41</sup>

routing and execution metrics to both retail and institutional investors); from Christopher Nagy, CEO, and Dave Lauer, President, KOR Trading LLC, dated April 4, 2014 ("KOR Trading Letter I"), at 2 (stating Rule 606 has become increasingly outdated as a result of the increasing complexity of order-types as well as the speed of routing and routing practices and Rule 606 should be updated to cover 100% of order flow received, including block transactions); from Kimberly Unger, Esq., Executive Director, Security Traders Association of New York, Inc., dated April 30, 2010 ("STA Letter"), at 8 (stating that since the adoption of Rule 606 in 2000, technological advancements have made some of the measurements in the Rule less meaningful and suggesting that 606 metrics be reviewed, amended, and updated, as needed); NASDAQ Letter, *supra* note 19, at 20 (stating Rule 606 has lagged behind technological advances that enhance market quality, which consequently renders the metrics utilized in Rule 606 less useful to investors, and further suggesting new metrics for inclusion on reports and refinements to current metrics); from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated April 29, 2010 ("SIFMA Letter I"), at 13 (stating that the Commission should direct broker-dealers to provide institutional clients with standardized execution venue statistical analysis reports); from O. Mason Hawkins, Richard W. Hussey, Deborah L. Craddock, Jeffrey D. Engelberg, and W. Douglas Schrank, Southeastern Asset Management, Inc., dated April 28, 2010 ("SAM Letter"), at 7 (stating increased complexity in the marketplace has clouded order handling to the point where even educated customers are not completely confident as to how or why their orders are routed to specific venues in a specific way); from Janet M. Kissane, SVP—Legal & Corporate Secretary, Office of the General Counsel, NYSE Euronext, dated April 23, 2010 ("NYSE Euronext Letter"), at 12, Appendix I at 3–4 (stating that U.S. equity market structure has changed substantially resulting in Rule 606 becoming outdated, and that Rule 606 reports do not capture information concerning block transactions and that the rule should be amended to include such information); Wolverine Trading Letter, *supra* note 39, at 4 (stating that the firm believes information currently required by Rule 606 reports is not as meaningful in the context of today's markets and that Commission staff should determine the types of statistics to add in order to improve usefulness of the reports); from Dan Mathisson, Managing Director, Credit Suisse Securities (USA) LLC, dated April 21, 2010 ("Credit Suisse Letter"), at 9 (stating that equity markets have changed unequivocally since 2000 when Rule 606 was adopted resulting in a need to update the Rule 606 reports); from Karrie McMillan, General Counsel, Investment Company Institute, dated April 21, 2010 ("ICI Letter"), at 8 (stating that currently institutional investors do not have ready access to complete information about their orders and the Commission should consider means to require new disclosures or enhance existing disclosures); from Michael Gitlin, Head of Global Trading, T. Rowe Price Associates, Inc.; David Oestreich, Chief Legal Counsel, T. Rowe Price Associates, Inc.; and Christopher P. Hayes, Sr. Legal Counsel, T. Rowe Price Associates, Inc., dated April 21, 2010 ("T. Rowe Price Letter"), at 3 (supporting interest in revamping Rule 606 reports to provide additional data related to trading volumes and venues to both large and small investors); from Jennifer S. Choi, Assistant General Counsel, Investment Adviser Association, dated April 20, 2010 ("IAA Letter"), at 4 (stating the exclusion of large orders from Rule 606 reports limits the value of such reports to institutional investors); from Seth Merrin, Chief Executive Officer, Liquidnet; Howard Meyerson, General Counsel, Liquidnet; and Vlad Khandros, Corporate Strategy, Liquidnet, dated March 26, 2010 ("Liquidnet Letter"), at 2 (stating that institutional

In the absence of a Commission rule, some institutional customers today have taken steps to acquire more information about the nature and number of venues to which their orders are routed or exposed.<sup>42</sup> For example, some institutional customers, using detailed questionnaires, request and receive information regarding order routing strategies used by their broker-dealers and the venues to which their broker-dealers route orders. In addition, more sophisticated institutional customers often request and receive granular data about the handling of individual orders.<sup>43</sup> The level of detail of the information provided by broker-dealers tends to vary depending on both the broker-dealer and the particular institutional customer, some of which may have the ability and desire to digest and evaluate voluminous individual order handling information and some of which may not. Of concern to the Commission, however, is the risk that some smaller institutional customers may not have the bargaining power to demand relevant order handling information from their broker-dealers. The Commission also understands that while some broker-dealers are willing and able to provide order handling information, the non-standardized and non-transparent nature of the data limits its effectiveness. Moreover, from the standpoint of the broker-dealers, responding to different institutional customers could be time-consuming and costly, as the broker-dealers typically need to prepare custom responses to

and retail investors do not have sufficient information regarding how their orders are handled, and empowering institutional traders with appropriate disclosures regarding the handling of large orders will empower institutions to make the best decisions for their customers). The Commission also received one letter relevant to this proposal in response to requests for comment on Securities Exchange Act Release No. 76474 (November 18, 2015), 80 FR 80997 (December 28, 2015) (File No. S7–23–15) ("NMS Stock ATS Proposing Release") (comment letter available at <http://www.sec.gov/comments/s7-23-15/s72315.shtml>). See Letter to Secretary, Commission, from David M. Weisberger, Managing Director, Markit, dated April 15, 2016 ("Markit Letter"), at 6–7 (stating order routing statistics required under Rule 606 should be enhanced to include basic metrics of execution quality for all categories of executed orders, separately report on routed and executed orders broken down by marketability, report on unexecuted routed orders, quantify net fees paid and rebates received by marketability category, and standardize the interpretation of "directed order"). A discussion of the letters relevant to this proposal is below. See *infra* Section II.F.

<sup>42</sup> See Associations Letter, *supra* note 5, at 2.

<sup>43</sup> See, e.g., Memorandum from the Division of Trading and Markets regarding a March 4, 2011, meeting with representatives of Morgan Stanley with regard to the Concept Release on Equity Market Structure, dated May 7, 2011 ("TM Memo re Morgan Stanley I").

<sup>40</sup> See Associations Letter, *supra* note 5, at 2.

<sup>41</sup> The Commission received letters addressing these issues in response to requests for comment on the Concept Release on Equity Market Structure, *supra* note 2 (comment letters available at <http://www.sec.gov/comments/s7-02-10/s70210.shtml>). See Letters to Secretary, Commission, from Christopher Nagy, CEO, and Dave Lauer, President, KOR Group LLC, dated September 23, 2014 ("KOR Trading Letter II"), at 1–2 (stating Rule 606 is severely outdated, has no coverage of large orders, and should be updated to cover all orders); from Richie Prager, Managing Director, Head of Trading & Liquidity Strategies, et al., BlackRock, Inc., dated September 12, 2014 ("BlackRock Letter"), at 3 (stating broker-dealers should be required to provide periodic standardized reports on order

different questions from each institutional customer who requests order handling information.<sup>44</sup> Accordingly, the Commission preliminarily believes that by requiring standardization of such reports, order handling data could potentially be generated in a more efficient and cost-effective manner, and provided as a matter of course to the benefit of all institutional customers.

## 2. Assessing Best Execution

Broker-dealers have a variety of types of institutional customers that use their order routing services, including pension funds, mutual funds, investment advisers, insurance companies, investment banks, and hedge funds.<sup>45</sup> Due to the large size in which they trade, institutional customers generally are focused on ensuring that their broker-dealers are achieving best execution for their orders. Broker-dealers are legally required to obtain best execution of all customers' orders.<sup>46</sup> FINRA rules specifically require FINRA members to use reasonable diligence to ascertain the best market for the security, and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.<sup>47</sup> Under FINRA's rules, some of the factors a FINRA member must consider in determining whether it has used "reasonable diligence" are: (1) The character of the market for the security, such as the price, volatility, relative liquidity, and pressure on available communications; (2) the size and type of transaction; (3) the number of markets checked; (4) the accessibility of the quotation; and (5)

the terms and conditions of the order which result in the transaction.<sup>48</sup>

Some institutional customers have direct relationships with their broker-dealers, whereas other institutional customers, such as mutual funds and pension funds, often employ investment advisers to buy and sell securities on their behalf. Investment advisers are fiduciaries to their clients (e.g., mutual funds, pension funds) and have an obligation to act in the best interests of their clients.<sup>49</sup> Several obligations flow from an investment adviser's fiduciary duties, including, among other things, the obligation to seek best execution of clients' transactions where the investment adviser has the authority to select broker-dealers to execute client transactions.<sup>50</sup> As discussed above, however, the Commission preliminarily believes it has become more challenging in today's highly automated, complex, and dispersed markets for institutional customers and their advisers, in the absence of additional, standardized disclosure, to monitor the extent to which their broker-dealers are achieving best execution.

Today, broker-dealers are not required by rule to disclose specific order handling information regarding institutional orders. Instead, as noted above, the order handling information obtained by institutional customers is the subject of individualized negotiations with their broker-dealers, with the result that only a subset of institutional customers obtain order handling information and the scope of the information received varies widely. Accordingly, institutional customers and their advisers today monitor broker-dealers for best execution with substantially different levels of

information, and potentially with varying degrees of effectiveness. For example, larger institutional customers may be better able to leverage their market size and position to obtain more detailed and complete disclosures from their broker-dealers, whereas smaller institutional customers may lack sufficient bargaining power to do so.

The Commission preliminarily believes that requiring enhanced order handling disclosures for all institutional orders would not only place small institutional customers on a more level playing field with large institutional customers, but also would create a uniform baseline for all institutional customers to obtain information on how large orders are handled. Widespread institutional access to standardized information could help institutional customers to more effectively assess the performance of their broker-dealers in handling their orders. This, in turn, could help improve the quality of broker-dealer routing practices, by, among other things, introducing more competitive forces so that broker-dealers are actively competing with each other to offer routing services that minimize information leakage and mitigate conflicts of interest.

## 3. Conflicts of Interest

The Commission has recognized that in a market structure with many competing trading centers, broker-dealers play a critical role in deciding where to route a customer's non-directed orders.<sup>51</sup> The Commission also has noted that a competitive environment may spur a trading center to offer economic incentives to broker-dealers to induce the routing of order flow to that trading center.<sup>52</sup> The Commission has recognized that broker-dealer order routing practices can significantly affect the competition among markets, and in adopting Rule 606 noted that the purpose of requiring disclosures concerning the relationships between a broker-dealer and the venues to which it routes orders was to inform customers to potential conflicts of interest that may influence the broker-dealer's order routing practices.<sup>53</sup> The Commission further explained that providing quantitative data to customers would provide them a clearer

<sup>44</sup> The Commission acknowledges that some institutional customers, particularly those that are larger and more sophisticated, may continue to request a customized report, even with the availability of standardized reports. The Commission understands that broker-dealers may respond to such requests for competitive reasons or provide such benefits as a service to its customers. Accordingly, the potential cost and time savings benefits of standardized reports would be reduced for these broker-dealers.

<sup>45</sup> See *supra* note 1.

<sup>46</sup> A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in self-regulatory organization rules and, through judicial and SEC decisions, the antifraud provisions of the federal securities laws. See Regulation NMS Adopting Release, *supra* note 16, at 37538. FINRA has codified a duty of best execution into its rules. See FINRA Rule 5310. Accordingly, violations by a broker of its duty of best execution expose the broker to potential liability under the antifraud provisions of the Exchange Act as well as potential discipline under applicable self-regulatory organization rules.

<sup>47</sup> See FINRA Rule 5310(a)(1) (Best Execution and Interpositioning).

<sup>48</sup> *Id.*

<sup>49</sup> See, e.g., Section 206(2) of the Investment Advisers Act of 1940 that prohibits an investment adviser from engaging in any transaction, practice, or course of business, which operates as a fraud or deceit upon any client or prospective client. As such, investment advisers must act in "utmost good faith," provide full and fair disclosure of all material facts, and employ reasonable care to avoid misleading clients and prospective clients. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 201 (1963).

<sup>50</sup> See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Securities Exchange Act Release No. 23170 (April 23, 1986). An investment adviser must seek to obtain the execution of client transactions in such a manner that the client's total cost or proceeds are the most favorable under the circumstances. In particular, when seeking best execution, an adviser should consider the full range and quality of a broker's services when selecting broker-dealers to execute client trades, including, among other things, the broker's execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided. See *id.* See also *Delaware Mgmt. Co.*, 43 SEC 392, 396 (1967).

<sup>51</sup> See Fragmentation Release, *supra* note 17, at 10582.

<sup>52</sup> *Id.*

<sup>53</sup> See Rule 606 Predecessor Adopting Release, *supra* note 15, at 75427. The Commission has historically taken a disclosure-based approach when addressing conflicts of interest that arise from economic and other incentives provided to broker-dealers to induce the routing of order flow to a trading center, rather than prohibiting such incentives. See, e.g., *id.*

understanding of a broker-dealer's order routing practices.<sup>54</sup> While these previous statements were made in the context of retail order routing, the Commission preliminarily believes they are equally applicable to institutional order routing in today's equity market.

There are a number of potential conflicts of interest that arise for broker-dealers in the handling of institutional orders that may influence their order routing practices. One potential conflict of interest a broker-dealer may face in the handling of institutional orders involves the different pricing structures of trading centers. A prevalent pricing model in the current market structure is the so-called "maker-taker" model, which involves the use of access fees and rebates.<sup>55</sup> To incentivize market participants to provide liquidity, a trading center employing a maker-taker fee structure generally pays a per-share rebate to its members or participants to encourage them to display non-marketable liquidity-providing orders on its limit order book. If an execution occurs, the broker-dealer placing the liquidity-providing order (the "maker") generally receives a rebate. In contrast, the marketable order that removes liquidity (the "taker") generally is charged a slightly higher fee, to fund the rebate to the maker and provide a profit for the trading center.<sup>56</sup>

Broker-dealers that are members of an exchange or participants of an ATS with a maker-taker model pay fees to, and receive rebates from, the venue for each order, including an institutional order, that is executed on it, but generally do not directly pass those fees or rebates back to their institutional customers.<sup>57</sup> In situations where a broker-dealer can earn a rebate or pay a lesser fee for routing its customer's orders to a

particular venue, a conflict of interest may exist between the broker-dealer's duty of best execution and its own direct economic interest.<sup>58</sup> Understanding how a broker-dealer manages this conflict of interest to ensure that its own self-interest does not compromise its best execution obligations is pertinent to institutional customers in evaluating execution quality.<sup>59</sup>

For example, with respect to non-marketable orders, the trading centers that pay the highest rebate for providing liquidity generally charge the highest fee for removing liquidity.<sup>60</sup> These venues are generally lower on the routing table<sup>61</sup> for broker-dealers seeking to remove liquidity due to the high take fee.<sup>62</sup> Thus, if a broker-dealer places an order seeking to provide liquidity at such a venue, the order may not receive an execution (or receive an execution only when the market moves against the order) due to the venue's low position on routing tables for removing liquidity because of the venue's high take fee. High rebate venues also are likely to attract a large number of non-marketable orders, so that the customer queue position, and likelihood of execution, may be lower than on low rebate venues.

<sup>58</sup> See, e.g., *Maker-Taker Memo*, *supra* note 55, at 16. Finance professors Robert Battalio, Shane Corwin, and Robert Jennings' analysis of selected market data has suggested that a significant number of retail firms route non-marketable orders to the venue offering the highest rebate, and do so in a manner that the authors felt might not be consistent with the brokers' duty of best execution. See Battalio, Corwin, and Jennings Paper, *supra* note 57, at 31. Payment for order flow, including payments made to retail brokers from wholesale broker-dealers, presents a similar conflict of interest. The sale of order flow has been described by some industry participants as a revenue center that permits firms to receive payments from market makers for such order flow when they would otherwise have to pay taker fees. See, e.g., Letter to Joseph Dear, Chairman, Investor Advisory Committee, SEC from Joseph Saluzzi and Sal Arluk, Partners and Co-founders, Themis Trading LLC, dated January 27, 2014, available at <https://www.sec.gov/comments/265-28/26528-55.pdf>, at 2.

<sup>59</sup> See, e.g., *Maker-Taker Memo*, *supra* note 55, at 18. This conflict may present itself despite the obligation of FINRA members to conduct a regular and rigorous review of their order routing to evaluate which trading venues offer the most favorable terms of execution, including execution price, execution speed, and the likelihood that the trade will be executed. See, e.g., FINRA Rule 5310, Supplementary Material .09(b).

<sup>60</sup> See, e.g., *Maker-Taker Memo*, *supra* note 55, at 18.

<sup>61</sup> Routing table refers to a broker-dealer's automated process for determining the specific trading venues to which a broker-dealer routes orders and the sequence in which the orders are routed.

<sup>62</sup> See, e.g., Battalio, Corwin, and Jennings Paper, *supra* note 57, at 1; *Maker-Taker Memo*, *supra* note 55, at 18.

A similar conflict of interest may exist for marketable orders.<sup>63</sup> Broker-dealers may seek to minimize trading costs by first routing orders to trading centers with the lowest take fees. However, these venues are likely to offer liquidity providers relatively low rebates so the available liquidity may be less than at a high rebate venue. Accordingly, the liquidity available to a marketable order routed to a low rebate venue may offer less size or fewer opportunities for price improvement than may be available at high rebate venues. Even where the broker-dealer ultimately routes a marketable order to other high take fee venues, prices can move quickly in today's highly automated, electronic markets, and broker-dealers may miss trading opportunities for an institutional customer by prioritizing low take fee venues in their routing tables.

Another potential conflict of interest may arise when a broker-dealer internalizes order flow,<sup>64</sup> routes order flow to affiliated venues, or routes order flow to venues with which it has payment for order flow arrangements. While constrained by its best execution obligation, a broker-dealer still may be incentivized to internalize customer order flow or route to an affiliated venue so that it can benefit from the execution by, among other things, capturing the trading profits or transaction fees. Internalization or execution at affiliated venues, however, may not offer the most favorable terms of execution. Likewise, a broker-dealer may be incentivized to first route customer order flow to venues with which it receives payment for order flow. Again, execution at such venues may not maximize the best execution opportunities of institutional orders. Accordingly, opportunities for internalization, or execution at affiliated venues or those with which the broker-dealers has payment for order flow arrangements, create additional potential conflicts of interest between the broker-dealer's duty of best execution and its own direct economic interest.<sup>65</sup>

As discussed further below, the Commission preliminarily believes

<sup>63</sup> See, e.g., *Maker-Taker Memo*, *supra* note 55, at 19.

<sup>64</sup> Internalization is the process in which a broker-dealer fills an order to buy a security from its own inventory, or fills an order to sell by taking a security into its inventory.

<sup>65</sup> The Commission notes that it recently proposed amendments to the regulatory requirements in Regulation ATS of the Exchange Act applicable to certain ATSs that would require detailed public disclosures about the trading operations of the ATS and the activities of the broker-dealer that operates the ATS and its affiliates. See NMS Stock ATS Proposing Release, *supra* note 41.

<sup>54</sup> See *id.*

<sup>55</sup> See, e.g., Memorandum from the SEC Division of Trading and Markets to the SEC Equity Market Structure Advisory Committee (October 20, 2015) ("Maker-Taker Memo"), available at <https://www.sec.gov/spotlight/emsac/memo-maker-taker-fees-on-equities-exchanges.pdf>. See also Stanislav Dolgoplov, *The Maker-Taker Pricing Model and Its Impact on Securities Market Structure*, 8 Va. L. & Bus. Rev. 231, 232–33 (June 27, 2014) ("Dolgoplov"), available at <http://bit.ly/1mfme9M>.

<sup>56</sup> In contrast to the widespread typical maker-taker model described above, a few trading venues have adopted an inverted taker-maker pricing model, in which market participants are assessed a fee to provide liquidity in securities and provided a rebate to remove liquidity in securities. See, e.g., NASDAQ OMX BX Fee Schedule (as of September 2015).

<sup>57</sup> See, e.g., Robert Battalio, Shane A. Corwin, and Robert Jennings, *Can Brokers Have it All? On the Relation between Make-Take Fees and Limit Order Execution Quality*, at 3 (March 31, 2015) ("Battalio, Corwin, and Jennings Paper"), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2367462](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2367462).

these conflicts of interest could be better evaluated if institutional customers had access to additional information about their broker-dealers' order handling practices.

#### 4. Information Leakage

The Commission has acknowledged "the need of investors executing large size trades to control the information flow concerning their transactions."<sup>66</sup> Executing a large order in today's complex electronic markets poses many of the same issues and risks for institutional customers as existed in the manual markets they replaced, but also poses new challenges because of the variety of ways in which information leakage can occur in today's equity market structure. As a result, it continues to be challenging for institutional customers to trade in large size while minimizing the risks from information leakage. As noted above, institutional customers historically would use exchange floor brokers or upstairs block positioners to execute large orders.<sup>67</sup> In today's electronic markets, however, the manual handling of institutional orders is increasingly rare, and has been replaced by sophisticated institutional order execution algorithms and smart order routing systems. At the same time, sophisticated market participants closely monitor order and execution activity throughout the markets, looking for patterns that signal the existence of a large institutional order, so that they can use that information to their trading advantage.

Each time an order is routed to a venue, and each time an actionable indication of interest is sent to a market participant, information is revealed about that order and the potential existence of a larger institutional order from which it may be derived. Accordingly, broker-dealers must balance the need to sufficiently expose the customer's trading interest to achieve execution, with the risk that such exposure might cause prices to move in a less favorable direction to the detriment of execution quality. Indeed, institutional customers have expressed

concern that excessive routing<sup>68</sup> of their orders may increase the risk of information leakage without a commensurate benefit to execution quality.<sup>69</sup> Because information leakage may lead to higher execution costs for large size orders, the Commission preliminarily believes that additional disclosure would inform investors as to whether a broker-dealer's order routing strategy is potentially resulting in excessive routing and information leakage. As noted above, the Commission preliminarily believes that institutional order handling now has become more susceptible to the type of standard disclosures originally contemplated by Rule 606, and technological developments have made it easier for broker-dealers to produce it. Accordingly, standardized order handling disclosures should improve the ability of institutional customers to assess the potential risk of information leakage of their orders through a more detailed assessment of the number and types of venues to which their broker-dealers are routing their orders or transmitting actionable indications of interest, and the quality of executions that result therefrom.

The Commission preliminarily believes that the amendments to Rule 606 it is proposing today would help institutional customers more efficiently and effectively operate in the current equity market structure. As discussed in more detail below, the required disclosures would provide standardized information for institutional customers so that they can better: (1) Discern where their orders are exposed, routed, and executed; (2) assess their broker-dealers for best execution by examining order execution statistics; (3) monitor conflicts of interest of their broker-dealers with the additional financial incentives disclosures; and (4) assess information leakage with the routing of their orders.

#### D. Need for Public Reporting of Aggregated Institutional Order Information

As discussed above, there are no legal requirements for a broker-dealer to

disclose institutional order handling information to its customers, either privately or publicly. The Commission preliminarily believes that the dearth of public information about each broker-dealer's institutional order handling practices may make efficient and effective comparisons about the nature and quality of services offered by broker-dealers more difficult. Without required public disclosure of aggregated institutional order handling information, institutional customers do not have information that could be used to evaluate, among other things, the venues to which broker-dealers route orders, the execution quality achieved at such venues, and the overall fees paid and rebates received for such executions. Public information on a broker-dealer's institutional order handling practices could both assist institutional customers in selecting one or more broker-dealers for order routing services and foster increased competition among broker-dealers to provide order routing services. Indeed, if institutional order handling information were publicly available to review and analyze, the Commission preliminarily believes that additional competitive forces could be brought to bear on broker-dealer institutional order routing services, thereby potentially enhancing the quality of such services.<sup>70</sup>

#### E. Need for Enhanced Disclosures for Retail Orders

As discussed above, the U.S. equity markets have evolved in recent years to become more automated, dispersed, and complex, and the resulting competition among trading centers has intensified practices to attract order flow, including retail order flow. Historically, trading centers have offered payment for order flow or other financial inducements to broker-dealers based upon whether the retail order flow is marketable or non-marketable. As a result, broker-dealers generally handle marketable and non-marketable retail orders differently. Indeed, whether a retail order is marketable or non-marketable will often determine where the broker-dealer routes the order. Certain broker-dealers route a large portion of marketable retail orders to OTC market makers with whom they have payment for order flow or other arrangements.<sup>71</sup> Non-

<sup>66</sup> See Securities Exchange Act Release No. 60997 (November 13, 2009), 74 FR 61208, 61219 (November 23, 2009) ("Regulation of Non-Public Trading Interest Proposing Release"). For example, Rule 604(b) of Regulation NMS exempts specialists and over-the-counter market makers from displaying customer block size orders. See 17 CFR 242.604(b)(4). A block size order is an order of at least 10,000 shares or for a quantity of stock having a market value of at least \$200,000. 17 CFR 242.600(b)(9).

<sup>67</sup> See *supra* notes 34–35 and accompanying text.

<sup>68</sup> In this context, excessive routing occurs when an order is routed more than may be necessary to obtain full execution of the order. Each additional route of an order reveals information about that order.

<sup>69</sup> See, e.g., Jacob Bunge, *A Suspect Emerges in Stock-Trade Hiccups: Regulation NMS*, Wall Street Journal, January 27, 2014 ("Bunge Article"), available at <http://www.wsj.com/articles/SB10001424052702303281504579219962494432336> (noting that in order to purchase 2.5 million shares of a stock, an institutional investor's brokers had to offer to purchase 750 million shares of the stock).

<sup>70</sup> In adopting Rule 606 in 2000, the Commission stated that public disclosure of order execution and order routing information could provoke more vigorous competition on execution quality and order routing performance. See Rule 606 Predecessor Adopting Release, *supra* note 15, at 75417.

<sup>71</sup> See Concept Release on Equity Market Structure, *supra* note 2, at 3606 (noting that Rule

marketable retail orders, on the other hand, are more frequently routed to exchanges with a “maker-taker” fee schedule, to capture a rebate when the non-marketable order is executed.<sup>72</sup>

Currently, Rule 606(a) does not require broker-dealers to segment their quarterly disclosures for limit orders between marketable and non-marketable orders. By only showing *aggregated* data on retail limit orders, customers have less visibility into the extent to which broker-dealers differentiate between marketable and non-marketable limit orders in their routing practices, and, if so, the potential impact of such practices. Accordingly, the Commission preliminarily believes that customers could better evaluate execution quality and potential conflicts of interest if broker-dealers were required to separately disclose more comprehensive information about how they route marketable and non-marketable limit orders to individual trading centers.

In addition, financial inducements to attract order flow from broker-dealers that handle retail orders have become more prevalent and for some broker-dealers such inducements may be a significant source of revenue.<sup>73</sup> The Commission understands that most broker-dealers that handle a significant amount of retail orders receive payment for order flow in connection with the routing of retail orders or are affiliated with an OTC market maker that

606 statistics reveal that brokers with significant retail customer accounts send the great majority of non-directed marketable orders to OTC market makers that internalize executions, often pursuant to payment for order flow arrangements).

<sup>72</sup> As an example, during a fiscal quarter one large retail broker-dealer routed all non-marketable orders to one of two venues that “offered the highest rebates available in the market.” See *Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets: Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, U.S. Senate, 113th Cong. 48 (2014)* (“Senate PSI Hearing”) (testimony of Steven Quirk, Senior Vice President, TD Ameritrade). In addition to fee incentives that may affect routing decisions, another reason non-marketable retail orders may be routed to exchanges is the requirements of Rule 604 of Regulation NMS. Rule 604 of Regulation NMS requires, among other things, exchange specialists and OTC market makers to immediately display in their bid or offer both the price and the full size of each customer limit order that would improve their quoted price in a particular security. See 17 CFR 242.604.

<sup>73</sup> See, e.g., Bradley Hope and Julie Steinberg, *Payments to Big Brokers Under Fresh Scrutiny*, Wall Street Journal, June 13, 2014, available at <http://blogs.wsj.com/moneybeat/2014/06/13/payments-to-big-brokers-under-fresh-scrutiny/> (stating that TD Ameritrade received \$236 million in payment for order flow in 2013; that a spokesman for Charles Schwab Corporation estimated payment for order flow revenues of \$100 million in 2013; and that E\*Trade Financial Corporation stated in a regulatory filing it received \$72.5 million in such revenues in 2013).

executes the orders.<sup>74</sup> The Commission preliminarily believes that providing market participants with greater disclosure regarding the specific financial inducements received by a broker-dealer from various trading centers would enable market participants to better assess potential conflicts of interest its broker-dealers face when routing retail orders.

Under the quarterly disclosure obligations in current Rule 606(a), broker-dealers are required to discuss the material aspects of their relationship with each Specified Venue, including a description of any arrangement for payment for order flow or profit-sharing relationship. The current disclosure informs the market participants of a potential conflict of interest the broker-dealer may face, but the current rule does not require the broker-dealer to disclose specifics on the conflict, including financial inducements received from each Specified Venue, or transaction rebates received from exchanges and other trading centers.<sup>75</sup> The lack of detailed disclosure on the specifics of the financial inducements received from each Specified Venue make it more difficult for customers to assess a broker-dealer’s management of any conflict of interest and the quality of its broker-dealer’s routing and execution services.

Accordingly, the Commission preliminarily believes that requiring broker-dealers to report more detailed disclosure on the payments received and fees paid for marketable limit orders, non-marketable limit orders, and other order types at each Specified Venue would enable market participants to better assess the extent to which the broker-dealer is effectively managing the potential conflicts of interest, as well as the quality of their broker-dealer’s retail order routing and execution services. The Commission also preliminarily believes that the description of any payment for order flow arrangements and profit-sharing relationships required to be disclosed in the quarterly report should be more comprehensive. As such, the Commission preliminarily believes that it would be appropriate to require broker-dealers to describe in their quarterly disclosure any terms of payment for order flow arrangements and profit-sharing relationships with each Specified Venue that may influence their order routing decisions.

Separately, in adopting Rule 606, the Commission required that retail routing reports be divided into three separate

<sup>74</sup> *Id.*

<sup>75</sup> See Rule 606(a); see also Rule 606 Predecessor Adopting Release, *supra* note 15, at 75427.

sections for NMS stocks listed on: NYSE, NASDAQ, and American Stock Exchange LLC.<sup>76</sup> The listing markets are now dominated by electronic trading and the handling of NMS stocks no longer varies materially based on the primary listing market.<sup>77</sup> As such, the Commission preliminarily believes that the requirement to separate the retail routing reports by primary listing market is outdated and does not provide useful information to customers. Accordingly, the Commission preliminarily believes that requiring retail routing reports to disclose the required information for NMS stocks as a whole would better inform market participants about the manner in which retail orders are routed in today’s markets and should simplify the burdens to comply with the rule.

#### F. Comments on Equity Market Structure

The Commission periodically has examined the regulatory regime for order routing disclosure. The Commission published the Concept Release on Equity Market Structure in 2010, which requested comment on a wide range of issues. Among the issues specifically highlighted for comment were: (1) Whether Rule 606 should be updated and, if so, in what respects; (2) whether Rule 606 reports continue to provide useful information for investors and their broker-dealers in assessing the quality of order execution and routing practices; (3) whether Rule 606 should be updated to address the interests of institutional customers in efficiently executing large orders and, if so, what metrics would be useful; (4) whether institutional customers have sufficient information about the smart order routing services and order execution algorithms offered by their broker-dealers; and (5) whether a regulatory initiative to improve disclosure of these broker-dealer services would be useful

<sup>76</sup> See Rule 606 Predecessor Adopting Release, *supra* note 15. The American Stock Exchange is now known as NYSE MKT LLC. In October 2008, the American Stock Exchange LLC was renamed “NYSE Alternext US LLC.” See Securities Exchange Act Release No. 58673 (September 29, 2008), 73 FR 57707 (October 3, 2008) (SR-Amex-2008-62). In March 2009, NYSE Alternext US LLC was renamed “NYSE Amex LLC.” See Securities Exchange Act Release No. 59575 (March 13, 2009), 74 FR 11803 (March 19, 2009) (SR-NYSEALTR-2009-24). In May 2012, NYSE Amex LLC was renamed “NYSE MKT LLC.” See Securities Exchange Act Release No. 67037 (May 21, 2012), 77 FR 31415 (May 25, 2012) (SR-NYSEAmex-2012-32).

<sup>77</sup> See Letter to Secretary, Commission, from Manisha Kimmel, Managing Director, Financial Information Forum, dated October 22, 2014 (“FIF Letter”), at 3 (noting that with the introduction of automated trading centers and smart order routing as a result of Regulation NMS, order routing practices are no longer based on listing market).

and, if so, what type of initiative the Commission should pursue.<sup>78</sup>

The Commission received twenty-eight comment letters<sup>79</sup> that directly addressed order routing disclosures. The commenters provided a wide range of recommendations and many commenters made multiple recommendations regarding order routing disclosures.

### 1. General Need to Update Rule 606

A few commenters referred generally to existing drawbacks in Rule 606 and

<sup>78</sup> See Concept Release on Equity Market Structure, *supra* note 2.

<sup>79</sup> See Letters to Secretary, Commission, from Michael J. Friedman, General Counsel & Chief Compliance Officer, Trillium, dated November 7, 2014 (“Trillium Letter”); from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA, dated October 24, 2014 (“SIFMA Letter II”); Associations Letter, *supra* note 5; KOR Trading Letter II, *supra* note 41; FIF Letter, *supra* note 77; BlackRock Letter, *supra* note 41; from Micah Hauptman, Financial Services Counsel, Consumer Federation of America, dated September 9, 2014 (“CFA Letter”); KOR Trading Letter I, *supra* note 41; from Senator Edward E. Kaufman, United States Senate, dated August 5, 2010 (“Kaufman Letter”); from Greg Tusar, Managing Director, Goldman Sachs Execution & Clearing, L.P. and Matthew Lavicka, Managing Director, Goldman, Sachs & Co., dated June 25, 2010 (“Goldman Sachs Letter II”); from James J. Angel, Ph.D., CFA, Associate Professor of Finance, Georgetown University, McDonough School of Business, dated April 30, 2010 (“Angel Letter II”); STA Letter, *supra* note 41; NASDAQ Letter, *supra* note 19; SIFMA Letter I, *supra* note 41; SAM Letter, *supra* note 41; from Eric W. Hess, Esq., General Counsel for Direct Edge, dated April 28, 2010 (“Direct Edge Letter”); NYSE Euronext Letter, *supra* note 41; from Jonathan D. Corpina, President, Organization of Independent Floor Brokers; Jennifer Lee, Vice President, Organization of Independent Floor Brokers; and Stephen O’Shaughnessy, Director, Organization of Independent Floor Brokers, dated April 21, 2010 (“IFB Letter”); Wolverine Trading Letter, *supra* note 39; Credit Suisse Letter, *supra* note 41; ICI Letter, *supra* note 41; T. Rowe Price Letter, *supra* note 41; TD Ameritrade Letter, *supra* note 19; IAA Letter, *supra* note 41; from Alan R. Shapiro, President and Chairman, The Transaction Auditing Group, Inc., dated April 19, 2010 (“TAG Letter”); Liquidnet Letter, *supra* note 41; from James J. Angel, Associate Professor, McDonough School of Business, Georgetown University; Lawrence E. Harris, Fred V. Keenan Chair in Finance, Professor of Finance and Business Economics, Marshall School of Business, University of Southern California; Chester S. Spatt, Pamela R. and Kenneth B. Dunn Professor of Finance, Director, Center for Financial Markets, Tepper School of Business, Carnegie Mellon University, dated February 23, 2010 (“Angel Letter I”). See also TM Memo re Morgan Stanley I, *supra* note 43; Memorandum from the Division of Trading and Markets regarding a May 22, 2013, meeting with representatives of Morgan Stanley, dated May 22, 2013 (“TM Memo re Morgan Stanley II”); Memorandum from the Division of Trading and Markets regarding an October 1, 2015, meeting with representatives of Morgan Stanley, dated October 1, 2015 (“TM Memo re Morgan Stanley III”); Memorandum from the Office of Commissioner Walter regarding a June 30, 2010, meeting with representatives of the Managed Funds Association, dated July 19, 2010 (“Walter Memo”). The Commission also received one letter relevant to this proposal in response to requests for comment on the NMS Stock ATS Proposing Release, *supra* note 41. See Markit Letter, *supra* note 41.

the need for improvements to Rule 606 without making specific recommendations. These commenters raised concerns regarding certain conflicts of interest present in order routing practices and the sufficiency of current disclosures under Rule 606, and stated that improvements to Rule 606 would provide more insight to investors and that the utility of Rule 606 was limited by a lack of disclosure.<sup>80</sup> Most commenters focused on specific recommendations to update various aspects of Rule 606.

### 2. Need for Rule 606 to be Modernized to Maintain Pace with Technological Advances

Many commenters cited technological changes in market structure as the basis for updating Rule 606.<sup>81</sup> These

<sup>80</sup> See IFB Letter, *supra* note 79, at 2 (questioning the existing inherent conflicts in the payment for order flow practice and asking whether disclosure requirements under existing Rule 606 are legally sufficient, and also noting that the required disclosures under Rule 606 do not shed light on fiduciary duties); Direct Edge Letter, *supra* note 79, at 2 (stating that “improvements to existing Rules 605 and 606 can be made to provide more detailed insight to investors”); TAG Letter, *supra* note 79, at 3 (stating “utility of the combination of Rules 605 and 606 to the individual investor is limited since the Rule 606 routing percentages coupled with the overall execution quality statistics in Rule 605 only give a general indication as to the results an individual investor can expect,” and “[r]outing information and the associated material aspects of the relationship concerning the broker’s arrangements, if any, with the various trading centers to which they route does not provide sufficient data to assess and compare”).

<sup>81</sup> See, e.g., NASDAQ Letter, *supra* note 19, at 20–21 (noting that Rule 606 has “never been amended despite changes that have revolutionized trading and the national market system, including the advent of decimal trading, the demise of trading floors and other manual trading, proliferation of private linkages, adoption of Regulation NMS, refinement of smart routers, modernization of high frequency trading and automation of dark pools,” stating that 605 and 606 have “lagged behind technological advances that enhance market quality and consequently render the metrics utilized in Rule 605 and 606 less useful to investors,” and questioning whether Rule 606 continues “to provide the level of transparency necessary to exert meaningful pressure on market centers to provide superior execution quality and routing practices.”); NYSE Euronext Letter, *supra* note 41, at 12 (commenting that “as detailed in the Concept Release [on Equity Market Structure], the U.S. equity market structure has changed substantially and, as a result, we believe [Rule 606 has] become outdated”); see also KOR Trading Letter II, *supra* note 41, at 2, 5 (commenting that “[o]ver time and in particular with the adoption of Regulation NMS, [Rules 605 and 606] became increasingly outdated,” and that Rule 606 has “eroded due to the increasing complexity of order-types as well as speed and routing practices in today’s marketplace”); BlackRock Letter, *supra* note 41, at 3 (commenting that “rising complexity in market structure has made the existing reporting inadequate”); CFA Letter, *supra* note 79, at 21 (stating “it is unreasonable to expect that given the changes in speed, technology, complexity, and dark trading in our markets, retail investors would ever utilize them productively”); KOR Trading Letter I, *supra*

commenters touched upon the common theme that the disclosures required by Rule 606 had not kept pace with the technological advances that had taken place since the Rule’s inception.

### 3. Requests for Specific Information and Standardized Disclosures

Most commenters identified specific metrics that broker-dealers should disclose, proposed model templates for disclosure, or called for disclosures to be made in a standardized fashion. Commenters generally requested additional information regarding order type usage and fill rates, marketable and non-marketable limit orders, and the use of indications of interest (“IOI”). Many commenters also requested more detailed disclosure of payment for order flow, including fees paid and rebates received.<sup>82</sup>

note 41, at 1 (noting that while outdated, Rule 606 serves as the only current means to analyze routing behavior); STA Letter, *supra* note 41, at 8 (commenting that “technological advances have made some of the measurements in the rule less meaningful” and suggesting that Rule 606 metrics be reviewed, amended, and updated, as needed); SIFMA Letter I, *supra* note 41, at 16 (commenting that in its current form, Rule 606 does not provide “useful and meaningful comparative information to market participants, particularly individual investors, or regulators, and that the [rule] should be either modified or rescinded in light of market developments”); SAM Letter, *supra* note 41, at 7 (noting that while order handling used to be a transparent and simple process, “transparency has been sacrificed in the name of technological advancement and the evolution of market microstructure,” and stating that the “enormous complexity introduced by this process has clouded order handling to the point where even educated customers are never completely confident how or why their orders are routed to specific venues in a specific way”); Wolverine Trading Letter, *supra* note 39, at 4 (noting that “the information currently required by [Rule 606] reports is not as meaningful in the context of today’s markets” and that Commission staff should determine the types of statistics to add in order to improve usefulness of the reports); Credit Suisse Letter, *supra* note 41, at 9 (stating with regard to Rule 606 that “equity markets have unequivocally changed since 2000 when the rules were adopted, resulting in the need to update the reports,” and providing the example that “the shortest execution report time category in the reports is 0–9 seconds. In today’s trading, where market centers have begun clocking their executions in microseconds (millionths of a second) because milliseconds (thousandths of a second) were too slow, categorizing a 9 second execution in the top speed category renders the reports less meaningful than intended”); ICI Letter, *supra* note 41, at 7 (noting that “complexities in the current market structure and the associated difficulties in assessing market performance for investors”); TM Memo re Morgan Stanley III, *supra* note 79 (noting that “Order Handling and Execution Disclosure Rules have not been updated to address technological advances”).

<sup>82</sup> See, e.g., Markit Letter, *supra* note 41, at 6 (Rule 606 statistics should be enhanced to include basic metrics of execution quality for all categories of executed orders, separately report on routed and executed orders broken down by marketability, and quantify net fees paid and rebates received by marketability category); Associations Letter, *supra* note 5, at Annex A (attaching proposed template for

enumerated, customer-specific institutional order routing disclosure); BlackRock Letter, *supra* note 41, at 3 (stating that revised Rule 605/606 “disclosures should provide greater transparency on marketable and non-marketable limit orders, order fill rates, sub-second execution horizons, pre-/post-trade price movement, alternative order type usage and total fees/rebates paid or received” and that such “metrics should also be available in a standardized template for individual customer activity, not just at an aggregate level by broker-dealer”); KOR Trading Letter I, *supra* note 41, at 5 (proposing a list of updates to Rule 606 including, *et al.*, information on marketable limit orders, total payments or charges to broker-dealers, reporting of the execution venue of all orders, and require average payments to be reported out to one one-hundredth of one penny (*i.e.*, four decimal places)); Goldman Sachs Letter II, *supra* note 79, at 10–11 (proposing disclosure of order routing information for orders that do not receive execution); Angel Letter II, *supra* note 79, at 7–9 (providing sample broker “report card” with eight metrics including percentage of orders executed inside the bid-ask spread); SAM Letter, *supra* note 41, at 7 (proposing eight categories of information that brokers/venues should disclose, including aggregate broker-level detail regarding specific venue market share based on both shares routed and shares executed and “payments, rebates, fees and fee breakpoints (all costs and payment for order flow arrangements) related to execution venues (routing broker or routing venue to venue)”); ICI Letter, *supra* note 41, at 7 (proposing the Commission require improved disclosure regarding order routing, including policies and procedures regarding the dissemination of information about a customer’s order and trade information to facilitate a trade, including the use of IOIs, “external venues to which a broker routes, . . . the percentage of shares executed at each external venue, any ownership and other affiliations between the broker and any venues to which the broker routes orders,” and “payments and other incentives provided or received (such as rebates) to direct order flow to particular trading venues”); TD Ameritrade Letter, *supra* note 19, at 7–8 (recommending, among other things, that Rule 606 disclosures include order type categories for “Opening,” “Marketable Limit,” “Odd-lot,” “Mixed Lot,” “Stop Orders” and “IOC/IOI” and “Spreads” for Options,” and “require brokers that internalize order-flow to include additional disclosure of payments made and overall profitability generated by the internalizing subsidiary internalizing that order-flow”); *see also* Trillium Letter, *supra* note 79, at 3 (suggesting that “Rule 606(b) should be enhanced to simply require brokers to disclose the unabridged order logs of requesting customers”); SIFMA Letter II, *supra* note 79, at 13 (suggesting that the Commission should consider a rule to “require broker-dealers to publish on their Web sites, on a monthly basis, a standardized disclosure report that provides an overview of key macro issues that are of interest to clients, potentially including: (i) Venues accessed, (ii) order types used on exchanges, (iii) order types supported on the broker-dealer’s ATS (if applicable), (iv) fill rates (including internalization numbers, if applicable), (v) location of ATS/co-location footprint, and (vi) market data structure”); FIF Letter, *supra* note 77, at 3 (suggesting that market open, market close, stop orders, and odd lots be removed from the “other” category and listed in their own categories); KOR Trading Letter II, *supra* note 41, at 2 (suggesting Rule 606 should be expanded to mandate uniform disclosure); CFA Letter, *supra* note 79, at 21 (suggesting the reporting metrics in Rule 606 “should be modernized to provide the most relevant information that will allow market participants, regulators, and third-party analysts to assess the quality of order execution practices”); TM Memo re Morgan Stanley II, *supra* note 79, PowerPoint at 6 (suggesting Rule 606 should be modified to require standardized

Some commenters expressed concern regarding information leakage and identified various metrics that could help customers determine whether a broker-dealer’s routing strategy leaves orders vulnerable to information leakage.<sup>83</sup> Additionally, several industry commenters recommended disclosing separately routing statistics for marketable and non-marketable orders.<sup>84</sup>

#### 4. Requests for Specific Disclosures for Institutional Orders

A number of commenters recommended specific order routing disclosures for institutional customers

reports providing an “order life cycle audit trail, not just ultimate execution or first route venue”); Walter Memo, *supra* note 79, at 50–51 (the MFA suggested that Rule 606 could be updated to require a brokerage firm to “provide statistics giving execution times along with the percentages of orders filled at the quote, better than the quote, and worse than the quote, for different size buckets including odd lots”); STA Letter, *supra* note 41, at 8 (suggesting a “standardized set of metrics which might include revised speed of execution data, linkages and access to markets and other measurable data the disclosure of which will provide investors and traders with adequate information upon which to make execution and routing decisions”); NYSE Euronext Letter, *supra* note 41, at Appendix I (suggesting that the “percentage of volume routed and executed internally by a broker-dealer should be indicated, and the criteria used in order routing decisions should be identified”); IAA Letter, *supra* note 41, at 3–4 (noting the format and the presentation of information in 606 reports make the information difficult to analyze); Liquidnet Letter, *supra* note 41, Annex F, at F–1 to F–3 (suggesting the Commission consider modifying Rule 606 reports to “include data on execution quality for orders received and handled by the routing broker, in particular, data regarding execution time and price improvement”); Kaufman Letter, *supra* note 79, at 6 (suggesting generally that “brokers should be required to provide detailed descriptions of their order-routing procedures, including information on payments and rebates received”); TM Memo re Morgan Stanley III, *supra* note 79 (including a proposed venue analysis template with enumerated, specific disclosures to be reported).

<sup>83</sup> *See, e.g.*, ICI Letter, *supra* note 41, at 8–9 (stating that broker-dealers should be required to disclose policies and procedures to control leakage of information regarding a customer’s order and other confidential information and policies and procedures regarding the dissemination of information about a customer’s order and trade information to facilitate a trade, including the use of indications of interest); Liquidnet Letter, *supra* note 41, at 2 (stating that if institutional investors are appropriately informed as to how broker-dealers route their orders, they will make the best decisions as to how their large orders should be handled).

<sup>84</sup> *See* BlackRock Letter, *supra* note 41, at 3 (stating that revised Rule 605/606 disclosures should provide greater transparency on, among other things, marketable and non-marketable limit orders and order fill rates); KOR Trading Letter I, *supra* note 41, at 5 (proposing a list of updates to Rule 606 including requiring disclosure of statistics on marketable limit orders and greater transparency around broker-dealer internal order routing practices and decisions); TD Ameritrade Letter, *supra* note 19, at 6–7 (proposing to change the order classification in Rule 606 disclosures to include, among other things “Marketable Limit”).

or questioned the usefulness of the current disclosure requirements to retail or institutional customers given that large orders are excluded from the rule.<sup>85</sup> Many commenters called specifically for the disclosure of order routing information to institutional customers, noting in various ways that the existing Rule 606 disclosures do not cover large orders and as a result institutional customers may not receive meaningful information about how their orders are routed.

#### 5. Comments on Actionable Indications of Interest

As noted above, some comments on the Concept Release on Equity Market Structure called for the disclosure of information relating to a broker-dealer’s use of IOIs.<sup>86</sup> The Commission has considered these comments, in addition to comments noted above on the Regulation of Non-Public Trading Interest Proposing Release, and is proposing to define actionable IOI.<sup>87</sup>

As discussed below, the Commission proposes to define the term “actionable

<sup>85</sup> *See* Associations Letter, *supra* note 5 (calling for customer-specific order routing disclosures for institutional investors); SIFMA Letter II, *supra* note 79, at 13 (stating that the Commission should require broker-dealers to provide standardized reports to institutional clients); KOR Trading Letter II, *supra* note 41, at 1 (stating that the public would be well served by “expanding Rule 606 to cover all orders and mandating uniform disclosure”); BlackRock Letter, *supra* note 41, at 3 (stating that “[b]roker-dealers should be required to provide periodic standardized reports on order routing and execution metrics to retail and institutional investors”); NYSE Euronext Letter, *supra* note 41, at 12 (noting that “Rule 606 reports do not capture information concerning large block transactions”); ICI Letter, *supra* note 41, at 10 (noting that Rule 606 was drafted primarily with the interests of individual investors in mind and large-sized orders are excluded from the rule); T. Rowe Price Letter, *supra* note 41, at 3 (opining that Rule 606 reports are “rarely used by institutional investors”); IAA Letter, *supra* note 41, at 4 (stating that the “exclusion of large orders in these [Rule 606] reports limits the value of these reports to institutional investors”); Liquidnet Letter, *supra* note 41, at 2 (stating that “[i]nstitutional and retail investors do not have sufficient information regarding how their orders are handled” and suggesting Rule 606 be modified to “[m]andate disclosure of specific order routing practices by institutional brokers”); TM Memo re Morgan Stanley III, *supra* note 79 (suggesting that broker-dealers should be required to “[p]rovide institutional clients with mandated transparency around order handling practices in today’s environment” including an “objective and meaningful standardized venue analysis template”).

<sup>86</sup> *See* TD Ameritrade Letter, *supra* note 19, at 6 (stating that the order classification status should be changed to include IOIs); ICI Letter, *supra* note 41, at 8 (suggesting the Commission consider requiring disclosure of policies and procedures regarding the dissemination of information about a customer’s order and trade information to facilitate a trade, including the use of “indications of interest” or “IOIs”); KOR Trading Letter II, *supra* note 41, at 1 (stating Rule 606 should be expanded to include information on IOIs on dark pools).

<sup>87</sup> *See infra* Section III.A.10.

indication of interest” (“actionable IOI”).<sup>88</sup> In 2009, the Commission proposed rules to regulate non-public trading interest,<sup>89</sup> which described characteristics of actionable IOI.<sup>90</sup> The Commission received a number of comment letters that addressed the characteristics.<sup>91</sup> Most of these commenters either noted in some form that the proposal did not expressly define “actionable IOI” or criticized the guidance.<sup>92</sup> A few of these commenters offered their own definitions or understanding of an actionable IOI.<sup>93</sup>

<sup>88</sup> See proposed Rule 600(b)(1).

<sup>89</sup> See Regulation of Non-Public Trading Interest Proposing Release, *supra* note 66, at 61219. Among other things, the Commission proposed to amend the Exchange Act quoting requirements to apply expressly to actionable IOIs. See *id.*, at 61211.

<sup>90</sup> “[A]n IOI would be actionable if it effectively alerted the recipient that the dark pool currently has trading interest in a particular symbol, side (buy or sell), size (minimum of a round lot of trading interest), and price (equal to or better than the national best bid for buying interest and the national best offer for selling interest).” *Id.*, at 61226.

<sup>91</sup> See Letters to Elizabeth M. Murphy, Secretary, Commission, from Senior Vice President—Legal & Corporate Secretary Office of the General Counsel, NYSE Euronext, dated February 22, 2010 (“NYSE Euronext IOI Letter”); from John A. McCarthy, General Counsel, GETCO, LLC, dated February 22, 2010 (“GETCO Letter”); from P. Mats Goebels, Managing Director and General Counsel, Investment Technology Group, Inc., dated February 22, 2010 (“ITG Letter”); from Vivian A. Maese, Esq., General Counsel and Corporate Secretary, BIDS Trading, LP, New York, New York, dated February 18, 2010 (“BIDS Trading Letter”); from Greg Tusar, Managing Director, Goldman Sachs Execution & Clearing, L.P., and Matthew Lavicka, Managing Director, Goldman Sachs & Co., dated February 17, 2010 (“Goldman Sachs Letter”); from Kimberly Unger, Esq., Executive Director, Security Traders Association of New York, Inc., New York, New York, dated February 17, 2010 (“STA IOI Letter”); from Patrick D. Armstrong, Co-President, Alliance of Floor Brokers, New York, New York, dated January 29, 2010 (“AFB Letter”); from Matthew K. Samelson, Principal, Woodbine Associates, Stamford, Connecticut, dated October 23, 2009 (“Woodbine Letter”).

<sup>92</sup> See NYSE Euronext IOI Letter, *supra* note 91, at 4 (stating that the Commission should provide clear guidance as to what constitutes an actionable IOI, perhaps in the form of a non-exclusive list of examples); ITG Letter, *supra* note 91, at 3 (stating that that the Commission should provide a more precise and predictable definition of “actionable IOI”); BIDS Trading Letter, *supra* note 91, at 2 (noting the uncertainty regarding the definition of an “actionable” IOI); Goldman Sachs Letter, *supra* note 91, at 2 (expressing concern that an explicit definition of actionable IOIs will not be sufficiently broad to encompass the evolving range of messaging and communications that might satisfy the definition of an actionable IOI); STA IOI Letter, *supra* note 91, at 2 (stating that the proposed guidance appears to deem an IOI actionable with specific mention of price, size, or side, and that such a definition is too broad); AFB Letter, *supra* note 91, at 2 (noting that the Commission’s proposal does not specifically define “actionable IOI”); Woodbine Letter, *supra* note 91, at 2–3 (stating that the Commission’s guidance on what constitutes an “actionable IOI” is not clear).

<sup>93</sup> See GETCO Letter, *supra* note 91, at 3 (actionable IOIs explicitly or implicitly convey

The Commission has considered these comments discussed in this Section II.F., and, for the reasons set forth throughout this release, is proposing the amendments to Rules 600, 605, 606, and 607 as described herein. Moreover, as noted earlier, the Commission is proposing amendments to other rules to update cross-references as a result of this proposal.<sup>94</sup>

### III. Proposed Amendments to Rule 600, Rule 605, Rule 606, and Rule 607

#### A. Disclosures for Institutional Orders

The Commission proposes to amend Rule 606 to require a broker-dealer that receives institutional orders in NMS stocks to, upon request, provide customer-specific reports regarding the venues to which the institutional orders are either routed or exposed through an actionable IOI.<sup>95</sup> Such disclosures would provide a broad range of statistical data regarding the broker-dealer’s handling of institutional orders, including order routing and execution information for those orders at each trading center in the aggregate and by order routing strategy. The disclosure of such information would provide customers with standardized information about institutional order routing and order execution quality and serve as a baseline for further analysis and comparison of broker-dealers. In addition, the disclosures would assist customers in reviewing order routing practices, assessing execution quality, managing potential conflicts of interest, and handling information leakage. The Commission preliminarily believes that increased, uniform transparency should assist customers in determining the quality of their broker-dealer’s services.

#### 1. Definition of Institutional Order in Proposed Rule 600(b)(31)

Currently, Rule 606 of Regulation NMS limits the required public disclosure of a broker-dealer’s order routing information to non-directed orders in NMS securities that are in amounts less than (i) \$200,000 for NMS stocks, and (ii) \$50,000 for option contracts.<sup>96</sup> In proposing Rule 606, the Commission discussed the thresholds in

information that there is actionable trading interest in a symbol; AFB Letter, *supra* note 91, at 2 (an actionable IOI is a bid or offer that can be accessed by one set of market participants that is not publicly disseminated).

<sup>94</sup> The Commission is proposing to amend Rule 3a51–1(a) under the Exchange Act; Rule 13h–1(a)(5) of Regulation 13D–G; Rule 105(b)(1) of Regulation M; Rules 201(a) and 204(g) of Regulation SHO; Rules 600(b), 602(a)(5), 607(a)(1), and 611(c) of Regulation NMS; and Rule 1000 of Regulation SCI.

<sup>95</sup> See proposed Rule 606(b)(3).

<sup>96</sup> See 17 CFR 242.606. See also *supra* note 7 and accompanying text.

connection with its proposed definition of “customer order”<sup>97</sup> and noted that “[l]arge 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.”<sup>98</sup> Thus, while customers and market participants have access to publicly-available order execution quality statistics and order routing information for small orders pursuant to Rule 605 and 606 of Regulation NMS,<sup>99</sup> institutional customers have observed that there is a lack of corresponding information for larger orders.

To facilitate enhanced transparency around the handling of larger orders in NMS stocks, the Commission is proposing to amend Rule 600 to include a definition of “institutional order.”<sup>100</sup> Specifically, under proposed Rule 600(b)(31) of Regulation NMS, an institutional order would be defined as an order to buy or sell a quantity of an NMS stock having a market value of at least \$200,000, provided that such order is not for the account of a broker-dealer.<sup>101</sup>

<sup>97</sup> See *supra* note 7 and accompanying text.

<sup>98</sup> See Rule 606 Predecessor Proposing Release, *supra* note 15, at 48417. The Commission cited the heterogeneity of larger orders, and the difficulty in effectively reducing that heterogeneous universe into summary statistics, as the primary reason for excluding those orders from the coverage of the Rule. See *supra* notes 21 and 22 and accompanying text. Today, institutional orders are still not homogenous; however the manner in which they are handled has become increasingly systematized, thus making it more practical to categorize them. The Commission preliminarily believes that the current market structure and advances in routing and execution technology, which automatically and electronically record order routing information, have made statistics for where institutional orders are routed more useful and disclosure of such statistics more practicable.

<sup>99</sup> 17 CFR 242.605–606.

<sup>100</sup> See proposed Rule 600(b)(31).

<sup>101</sup> As proposed, the definition of institutional order would only apply to orders for NMS stocks, and, therefore, would not include orders in NMS securities that are options contracts. Due to differences in the current market structure for NMS securities that are options contracts, in particular the lack of an over-the-counter market in listed options, the Commission preliminarily believes that the same market structure complexities do not exist at this time to warrant the institutional order handling disclosures proposed herein. See Securities Exchange Act Release No. 61902 (April 14, 2010), 75 FR 20738, 20740 (April 20, 2010) (stating that all orders in the listed options market are currently executed on registered national securities exchanges). Specifically, since listed options are limited to trading on the 14 registered options exchanges, the number of venues to which listed options could be routed and executed is significantly less than the over 253 venues for NMS stocks. See *supra* notes 31–32 and accompanying text. In addition, the broker-dealer ownership and affiliation concerns with over-the-counter venues do not exist in the listed options market. The Commission preliminarily believes that at this time

The proposed definition of “institutional order” is intended to complement the current definition of “customer order.”<sup>102</sup> The proposed dollar threshold for an institutional order would dovetail with the definition of “customer order” such that all orders in NMS stocks routed by broker-dealers for their customers, whether retail- or institutional-sized, would be encompassed by order routing disclosure rules.<sup>103</sup> As noted above, institutional orders are generally divided into smaller orders and routed to various trading centers. The Commission notes that, as discussed below, the proposed institutional order handling reports would include the routing of all smaller orders derived from institutional orders.

The Commission preliminarily believes that defining institutional order in relation to the dollar amount of the order is an appropriate means to differentiate between small orders that are typically characterized as orders of \$200,000 or less and larger-sized orders that are generally categorized as orders of \$200,000 or more.<sup>104</sup> Since “customer order” is currently defined using \$200,000 as an upper threshold, the Commission preliminarily believes that market participants are accustomed to considering an order of \$200,000 or more as an institutional order rather than a customer order. In addition, the Commission preliminarily believes that rather than proposing a new monetary value to define large-sized orders generally placed by institutional customers, administration would be more straightforward for broker-dealers using a defined standard that is commonly recognized in the industry. Therefore, the Commission preliminarily believes that the \$200,000 threshold continues to be a reasonable threshold to accommodate such distinction between small orders and large orders, which are generally handled in a different manner by broker-dealers.<sup>105</sup>

The Commission requests comment on the expansion of Rule 606 to include

the current listed options market structure does not present the same concerns regarding fiduciary responsibilities, information leakage, and conflicts of interest as the market structure for NMS stocks.

<sup>102</sup> See *infra* Section III.A.1.

<sup>103</sup> See *id.* The Commission notes that the proposed definition of “institutional order” was referred to as “large orders” in the Rule 606 Predecessor Proposing Release and Rule 606 Predecessor Adopting Release. See *supra* note 15.

<sup>104</sup> See, e.g., 17 CFR 242.606 (defining block size with respect to an order to include an order for a quantity of stock having a market value of at least \$200,000).

<sup>105</sup> As detailed below, the Commission is proposing new disclosures in Rule 606 that would apply to institutional orders.

institutional orders and the definition of “institutional order” in proposed Rule 600(b)(31). In particular, the Commission solicits comment on the following:

1. Do commenters believe Rule 606 should be expanded to include institutional orders? Why or why not? Should the Commission consider an alternative approach? Why or why not?

2. Do commenters believe it is useful or necessary to define an institutional order? Do commenters believe that the proposed definition of institutional order should include securities other than NMS stocks? For example, should NMS securities that are options contracts be included? Why or why not? Should non-NMS securities, such as securities traded only in the OTC market, be included? Why or why not? Would including these types of securities in the definition of institutional order be useful to institutional customers? If so, how? Please explain and provide support for your view.

3. Do commenters believe that dollar value is the proper criterion for defining an institutional order? If so, is \$200,000 the appropriate amount? Why or why not? If not, should it be higher or lower? If so, what amount? Are there other order characteristics the Commission should consider to distinguish between retail and institutional orders, in addition to, or instead of, a dollar threshold? Should the criteria be different for different types of stocks? For example, would \$200,000 capture large-sized orders for liquid or illiquid stocks, high-priced or low-priced stocks, large capitalization or small capitalization stocks? Please explain and provide data to support your argument.

4. Should the Commission define an institutional order based on the number of shares instead of a market value? Why or why not? For example, would 10,000 shares be an appropriate criterion for defining an institutional order, regardless of dollar value? Should it be more or less? Please explain and provide data.

5. Should the Commission require broker-dealers to make the disclosures proposed in Rule 606(b)–(c) for all orders, irrespective of dollar amount? Why or why not? Please explain.

6. Should the definition of institutional order reflect a different threshold, such as order size or market value, for various types of NMS stocks, such as common stock and exchange-traded products? If so, what thresholds are appropriate and for which NMS stocks? If possible, please provide data and analysis to support your view.

7. Should the definition of institutional order incorporate multiple metrics, such as a certain market value of the order plus a certain number of shares for the order? If possible, please provide data and analysis to support your view.

8. Do commenters believe that customers should be able to designate which orders qualify as an institutional order? For example, should a customer be able to designate smaller orders sent to a broker-dealer as an institutional order? If so, how would that be done? Should institutional order be defined as a combination of customers designating institutional orders and a threshold, *i.e.*, if either requirement is satisfied, it would then be defined as an institutional order? Please provide support for your arguments.

9. Do commenters have alternative definitions for an institutional order, or modifications to the proposed definition? Please explain and provide supporting data, if possible.

10. Instead of defining institutional order, do commenters believe that there are alternative approaches that the Commission should consider in structuring order handling disclosures for large orders? If so, please explain the approach in detail, including the benefits and costs of the approach.

## 2. Definition of Actionable Indication of Interest in Proposed Rule 600(b)(1)

To further facilitate the institutional order disclosure regime, the Commission proposes to amend Rule 600 to include a definition of “actionable indication of interest.”<sup>106</sup> As the Commission indicated in 2009, an actionable IOI is a privately transmitted message by certain trading centers, such as an ATS or an internalizing broker-dealer, to selected market participants to attract immediately executable order flow to such trading centers, and functions in some respects similarly to a displayed order or a quotation.<sup>107</sup> As such, actionable IOIs can be used by: (1) A trading center to generate trading volume, which in turn could prompt market participants to send more orders to such venue; (2) market participants that submit orders to a trading center to receive executions through the use of actionable IOIs to attract contra side liquidity; and (3) a trading center to

<sup>106</sup> See proposed Rule 600(b)(1).

<sup>107</sup> See Regulation of Non-Public Trading Interest Proposing Release, *supra* note 66, at 61210 (describing actionable IOIs as privately transmitted messages to selected market participants intended to “attract immediately executable order flow” and comparing their function to “displayed quotations”).

generate transaction fees from the executions.

Under proposed Rule 600(b)(1) of Regulation NMS, an actionable IOI would be defined as “any indication of interest that explicitly or implicitly conveys all of the following information with respect to any order available at the venue sending the indication of interest: (1) Symbol; (2) side (buy or sell); (3) a price that is equal to or better than the national best bid for buy orders and the national best offer for sell orders; and (4) a size that is at least equal to one round lot.”<sup>108</sup> The Commission preliminarily believes that for an IOI to be actionable it must contain information sufficient to attract immediately executable orders to the venue sending the indication of interest. The Commission preliminarily believes that the four elements contained in the proposed definition of actionable IOI (symbol, side, price, and size) are all necessary pieces of information for an external liquidity provider to respond with an order to execute against the order at the venue sending the indication of interest. Indeed, if one of the four elements is not explicitly or implicitly conveyed, an external liquidity provider would not have sufficient information to decide whether to respond to the IOI or to ensure the order it sends in response to the IOI would be immediately executable.<sup>109</sup> Without the symbol, an external liquidity provider would not know the security for which to send an order. Without the side, an external liquidity provider would not know whether to send a buy order or a sell order. Without the price, an external liquidity provider would not know where to price its order to ensure the order is immediately executable. Without the size, an external liquidity provider would not know the number of shares it could expect to receive from responding to the IOI.

A determination of whether an IOI implicitly conveys information—and thus contains each of the four elements to make such IOI actionable—involves a consideration of all of the facts and circumstances, including the course of dealing between the IOI sender and the recipient. For example, a message that alerts the recipient that there is trading interest in a particular symbol and side at the venue sending the IOI generally would be considered “actionable” even though it does not explicitly specify the

price and size if, through the course of dealings, the recipient could expect to respond and receive an execution equal to or better than the applicable national best bid or offer for at least one round lot. The Commission notes that the proposed definition is substantively similar to the Commission’s description of actionable IOIs in the Regulation of Non-Public Trading Release in 2009.<sup>110</sup>

When used in the context of the proposed institutional order handling report, the proposed definition of actionable IOI would require a broker-dealer to disclose its activity that communicates to external liquidity providers to send an order to the broker-dealer in response to a customer’s institutional order. The Commission preliminarily believes information about a broker-dealer’s use of actionable IOIs in executing institutional orders will be useful to customers assessing the broker-dealer’s order handling decisions, particularly in regards to analyzing information leakage because, when “actionable IOIs are intended to attract immediately executable order flow to the trading venue,”<sup>111</sup> actionable IOIs “function quite similarly to displayed quotations”<sup>112</sup> and thus have the capacity to communicate information about the existence of an institutional order. In addition, as discussed in greater detail above,<sup>113</sup> the Commission notes that certain commenters on the Concept Release on Equity Market Structure specifically requested that Rule 606 be expanded to require the disclosure of information related to the use of actionable IOIs.<sup>114</sup> The Commission also notes that some commenters on the Regulation of Non-Public Trading Interest Release raised concerns about the Commission’s description of an actionable IOI, including whether the description of an actionable IOI could be clearer and more precise.<sup>115</sup> A few commenters also differed on whether the Commission’s description of an actionable IOI was too broad or not broad enough to encompass all intended messaging activity that could result in an execution.<sup>116</sup> The Commission has considered these comments. The Commission preliminarily believes on balance that, in the context of the reporting regime

proposed in this release, it remains appropriate to look to the description of actionable IOI contained in the Regulation of Non-Public Trading Interest Release and preliminarily believes that description would capture the necessary information to make an IOI actionable and therefore the functional equivalent of an order. Accordingly, the Commission is using the description of an actionable IOI contained in the Regulation of Non-Public Trading Interest Release as the basis for the proposed definition of actionable IOI in Rule 600(b)(1) of Regulation NMS. In addition, for the reasons stated below, the Commission preliminarily believes that the proposed definition of actionable IOI captures the types of activity that would be pertinent for customers in evaluating how a broker-dealer handles its institutional orders.

One purpose of the proposed amendments to Rule 606 is to reflect how large orders are handled and how information is shared and dispersed among the marketplace. The Commission has previously noted that because actionable IOIs convey similar information as an order, a response to an actionable IOI may result in an execution at the venue of the IOI sender.<sup>117</sup> As such, the Commission preliminarily believes that actionable IOIs, as proposed to be defined, function quite similarly to an order or a displayed quotation.<sup>118</sup> Given this similarity, the Commission preliminarily believes that a rule that did not capture information related to the use of actionable IOIs in this manner would leave customers without information that could help them have a more complete understanding of how broker-dealers handle their institutional orders. If an IOI contains, explicitly or implicitly, the four criteria of the proposed definition of actionable IOI, then it is the functional equivalent to an order or a quotation. Because of this, the Commission preliminarily believes that the proposed definition of actionable IOI will capture information that could be used by customers to better understand how broker-dealers handle their institutional orders, particularly in regards to information leakage, and will be important to customers in evaluating the order handling and execution practices of their broker-dealers.

Separately, the Commission notes that as a result of the Commission proposing both the definitions of institutional order and actionable indications of

<sup>108</sup> See proposed Rule 600(b)(1).

<sup>109</sup> See Regulation of Non-Public Trading Interest Proposing Release, *supra* note 66, at 61210–11 (discussing the four elements of an actionable IOI and the inferences a trader can make to reasonably conclude that the order it sends in response to the indication of interest will result in an execution).

<sup>110</sup> See Regulation of Non-Public Trading Interest Proposing Release, *supra* note 66. See also *supra* Section II.F.5. discussing comments received and discussion relating to actionable IOI.

<sup>111</sup> See Regulation of Non-Public Trading Interest Proposing Release, *supra* note 66, at 61210.

<sup>112</sup> *Id.*

<sup>113</sup> See *supra* Section II.F.5.

<sup>114</sup> See *supra* note 92.

<sup>115</sup> See *id.*

<sup>116</sup> See *id.*

<sup>117</sup> See Regulation of Non-Public Trading Interest Proposing Release, *supra* note 66, at 61210–11.

<sup>118</sup> See *id.*

interest, the Commission is also proposing to renumber the existing definitions in Rule 600(b) accordingly, and update other rules to change cross-references.

The Commission requests comment on the proposed definition of “actionable indication of interest,” as well as the other proposed changes to Rule 600(b) noted above. In particular, the Commission solicits comment on the following:

11. Do commenters believe that a symbol is a necessary element to include in the definition of actionable IOI? Is the side (buy or sell) a necessary element to include in the definition of actionable IOI? Should price be an element in the definition of actionable IOI or is it assumed that it would be equal to or better than the applicable national best bid or offer? Is size a necessary element to define an actionable IOI? Should an actionable IOI be defined to require only a subset of these elements, or should any of the proposed elements be modified? If so, which elements and why? Are there alternative definitions that would capture the activity of a broker-dealer communicating to external liquidity providers that should be included as part of the required disclosure? Are there other elements or factors that the Commission should consider in the definition of actionable IOI? Should any of the proposed elements be omitted? Why or why not?

12. Do commenters believe that an IOI can be “actionable” even if a subset of the elements (symbol, side, price, and size) is conveyed implicitly? Should broker-dealers be required to disclose information about actionable IOIs where one, some, or all of the elements are conveyed implicitly? Why or why not? Would broker-dealers be able to program automated systems to identify as actionable IOIs instances in which information is being conveyed implicitly, such as through a course of dealing between a liquidity provider and the broker-dealer?

13. Do commenters believe there are other types of indications of interest that should be required to be disclosed? If so, what types and how would they be defined?

14. Do commenters believe actionable IOIs are linked to specific orders at the broker-dealer, such that when the external liquidity provider responds to an actionable IOI with a contra-side order, the broker-dealer will be able to match both sides of the trade?

15. Do commenters believe that there are alternative approaches to defining an actionable IOI? If so, please explain

each approach in detail, including the benefits and costs of the approach.

### 3. Scope and Format of Reports

The Commission understands that customers increasingly are requesting institutional order handling information to better understand and assess order routing strategies, best execution, potential conflicts of interest, and the risk of information leakage. The Commission understands that many broker-dealers currently respond to such requests by providing reports on their institutional order handling to customers. However, the Commission understands that these reports often contain non-standardized terms, and often are not presented in a uniform manner to allow for effective comparison across different broker-dealers and trading centers.<sup>119</sup>

The Commission preliminarily believes that requiring broker-dealers to disclose standardized customer-specific institutional order handling information to their customers would facilitate the ability for such customers to assess broker-dealers’ order handling practices and how such practices affect best execution, potential conflicts of interest, the potential for information leakage, and execution quality generally. The proposed disclosures described below effectively would set a baseline for disclosure of customer-specific institutional order handling information that all customers, regardless of size, could receive from their broker-dealers upon request. The Commission preliminarily believes that the proposed disclosures would provide needed transparency into broker-dealer institutional order handling practices, and would promote discussions between broker-dealers and customers regarding the broker-dealer’s institutional order handling practices and the effect such practices have on execution quality. In addition, the Commission preliminarily believes that the proposed disclosures would allow customers to better compare institutional order handling practices across multiple broker-dealers, which should provide a basis for more informed decision making when customers engage the order routing services of broker-dealers.

Specifically, the Commission is proposing to amend Rule 606(b) of Regulation NMS to require that a broker-dealer, on request of a customer that places, directly or indirectly, an institutional order with it, disclose to such customer within seven business days of receiving the request, a report on

its handling of institutional orders for that customer that contains information for the prior six months, broken down by calendar month.<sup>120</sup> The Commission preliminarily believes that requiring broker-dealers to provide the customer-specific reports within seven business days will ensure that all institutional customers, regardless of size, receive their order handling information in a timeframe that would allow them to act in a timely fashion in response to the information contained in the report. The Commission also preliminarily believes that broker-dealers will develop technical processes to produce these reports in an automated manner,<sup>121</sup> and as such, requiring a response to an individual customer request within seven business days would not be unduly burdensome and should provide a sufficient amount of time for broker-dealers to generate the required disclosure and respond to customer requests. Separately, the Commission notes that the proposed requirement to provide customer-specific institutional order handling information for the prior six months is consistent with the reporting period currently required for customer-specific reports on retail order routing.<sup>122</sup> The Commission preliminarily believes that a six-month reporting period is also appropriate for institutional orders, as it would provide individual customers with the most recent months of institutional order handling data and would cover the full period contained in the broker-dealer’s last public aggregated institutional order handling report.<sup>123</sup>

The proposed report would cover instances where an institutional order is handled either directly by the broker-dealer or indirectly through systems provided by the broker-dealer. For example, an institutional order would have been placed with a broker-dealer if a broker-dealer receives an institutional order directly from a customer and works to execute the order itself, as well as if a broker-dealer receives an institutional order indirectly from a customer, where the customer self-directs its institutional order by entering it into a routing system or execution algorithm provided by the broker-dealer.

The Commission notes that the proposal would require a broker-dealer to provide a report “on request of a customer that places, directly or

<sup>120</sup> See proposed Rule 606(b)(3).

<sup>121</sup> See *infra* Section IV.A.1.

<sup>122</sup> See Rule 606(b)(1).

<sup>123</sup> See proposed Rule 606(c). See also Rule 606 Predecessor Adopting Release, *supra* note 15, at 75430 n.81 (discussing the six-month reporting period for reports on customer-specific retail order routing).

<sup>119</sup> See Associations Letter, *supra* note 5, at 2.

indirectly, an institutional order with the broker or dealer . . . .”<sup>124</sup> Accordingly, a broker-dealer must provide a report under the proposed rule to the customer placing the order with the broker-dealer, who may be acting on behalf of others and thus not be the ultimate beneficiary of any resulting transactions.<sup>125</sup> The Commission preliminarily believes that requiring the reports to be provided to the customer that places an institutional order with the broker-dealer is appropriate because it would require the broker-dealer to provide the report to the person that is responsible for making the routing and execution decisions for such institutional order. For example, if an investment adviser, as the customer of a broker-dealer, places institutional orders with a broker-dealer that represents trading interest from multiple underlying clients of the investment adviser, the investment adviser, as the customer of the broker-dealer, would be the sole entity to whom the broker-dealer is required to provide a report under the proposed rule; and not the multiple underlying clients of the investment adviser.

Separately, the Commission notes that while the proposed rule would allow a customer that places, directly or indirectly, an institutional order with a broker-dealer to request and receive its institutional order handling report, it would not limit the number of times a customer could place a request. The proposed rule also would not preclude a customer from making a standing request to its broker-dealer, whereby the customer would automatically receive a recurring report on a periodic basis without the need to make repeated requests for its institutional order handling reports. However, the Commission does not intend for the proposed rule to duplicate information the broker-dealer has previously provided the customer pursuant to a prior request under the proposed rule. For example, if a broker-dealer provides a report to a customer for the prior six months, and that customer requests an additional report the following month, the broker-dealer would only need to

provide a report for the latest month. In addition, the Commission acknowledges that broker-dealers may need to configure their systems to capture the information necessary to produce the proposed institutional order handling reports and, therefore, may not have the ability to produce historical reports about the routing of orders and executions that occurred before such systems are updated. Accordingly, the Commission would not require broker-dealers to produce institutional handling reports containing information to cover months before broker-dealers are required to comply with such rule, if adopted.

For purposes of the report, the handling of an institutional order would include the handling of all smaller orders derived from the institutional orders.<sup>126</sup> As noted above, institutional orders are generally divided into smaller orders and routed to various trading centers. For the disclosure to be meaningful and complete, the Commission preliminarily believes that the routing of each child order derived from an institutional parent order should be required to be included in the report. The Commission understands that current technologies employed by broker-dealers typically are able to track child orders and link such child orders back to the parent order,<sup>127</sup> thus minimizing burdens associated with this component of the proposed rule.

The Commission is further proposing to require that the report be made available using an eXtensible Markup Language (XML) schema and associated PDF renderer to be published on the Commission’s Web site.<sup>128</sup> Requiring the report to be provided in XML should result in the data in the report being provided in a consistent, structured

format. XML is an open standard<sup>129</sup> that defines, or “tags,” data using standard definitions. The tags establish a consistent structure of identity and context. This consistent structure can be automatically recognized and processed by a variety of software applications such as databases, financial reporting systems, and spreadsheets, and then made immediately available to the end-user to search, aggregate, compare, and analyze. In addition, the XML schema could be easily updated to reflect any changes to the open standard. The Commission preliminarily believes that requiring the report be provided in an XML format would provide the customers and the public (in the case of public reports) with data about order handling practices in a format that would facilitate search capabilities, and statistical and comparative analyses across broker-dealers and date ranges. Absent this requirement, any customers or members of the public seeking to use the information would need either to spend time manually collecting the data and manually entering the data into a format that allows for analysis, thus increasing the time needed to analyze the data, or incur the cost of subscribing to a financial service provider that specializes in this data aggregation and comparison process. Further, manual entering of data may lead to errors, thereby potentially reducing data quality and usability. By proposing to require the use of an XML format so that the information would be more readily available, customers might be able to better use the information to compare execution quality of broker-dealers, thereby allowing them to select broker-dealers that are a better match to their preferences. The Commission is also proposing that the report be provided in PDF format using the associated PDF renderer published on the Commission’s Web site so that the report would also be provided in a human-readable format for those customers who prefer only to review individual reports and not necessarily aggregate or conduct large-scale analysis on the data. Like XML, PDF is also an open standard. By using the associated PDF renderer published on the Commission’s Web site, the XML data will be instantly presentable in a PDF format and consistently presented across filings.

The Commission seeks comment generally on the report format proposed in Rule 606(b)(3). In particular, the Commission solicits comment on the following:

<sup>129</sup> The term “open standard” is generally applied to technological specifications that are widely available to the public, royalty-free, at no cost.

<sup>126</sup> See proposed Rule 606(b)(3). The Commission notes that an order would only be required to be included in the proposed report if it met the definition, and thus the size threshold, of an institutional order when received by the broker-dealer.

<sup>127</sup> Broker-dealers have developed their own systems allowing for tracking and linking of child orders to parent orders. Third-party software enables this, as well. See, e.g., *Advanced Orders Panel*, Interactive Brokers, available at [https://www.interactivebrokers.com/en/software/tws/usersguidebook/mosaic/advanced\\_orders\\_panel.htm](https://www.interactivebrokers.com/en/software/tws/usersguidebook/mosaic/advanced_orders_panel.htm); *Viewing Child Orders*, Trading Technologies, available at <https://www.tradingtechnologies.com/help/xtrader/viewing-child-orders/>; *Smart Order Routing*, StreamBase, available at <http://www.streambase.com/industries/capitalmarkets/smart-order-routing/>.

<sup>128</sup> See proposed Rule 606(b)(3). The Commission’s schema is a set of custom XML tags and XML restrictions designed by the Commission to reflect the proposed disclosures in Rule 606.

<sup>124</sup> See *id.*

<sup>125</sup> The Commission notes that “customer” is broadly defined as “any person that is not a broker or dealer” in Rule 600(b)(16). However, for the purposes of the proposed amendments to Rule 606, which are to provide detailed information about order routing and execution quality to the person responsible for assuring the effectiveness of this function, the Commission preliminarily believes that it is appropriate to view the customer placing the order with the broker-dealer, whether the account holder or an investment adviser or other fiduciary, as the “customer.”

16. Do commenters believe the proposed scope of the institutional order handling report is practicable and appropriate? Why or why not? Please explain and provide data, if possible.

17. Do commenters believe that it is appropriate to view the customer placing the order with the broker-dealer, whether the account holder or an investment adviser or other fiduciary, as the "customer" for purposes of the proposed amendments to Rule 606? Should entities other than the customer placing the order with the broker-dealer be entitled to receive the report? For example, if an investment adviser represents multiple underlying clients, should each underlying client be entitled to receive the report? Please explain.

18. Do commenters believe that broker-dealers should be required to provide the customer-specific report on institutional order handling in the proposed format? Why or why not? Do commenters believe broker-dealers should be required to provide the report in a structured XML format? Would such a format facilitate comparison of the data across broker-dealers? If not, why not? Do commenters believe broker-dealers should be required to also provide the report in an instantly readable PDF format? If not, why not? Are there other formats or alternative methods to provide the customer-specific reports that the Commission should consider? If so, please explain and provide data.

19. Do commenters believe that seven business days is a reasonable amount of time for a broker-dealer to respond to a customer request for institutional order handling information? If not, what would be a reasonable amount of time?

20. The Commission notes that Rule 606(b)(2) requires that broker-dealers notify their customers annually, in writing, of the availability of a report on the routing of retail orders. Should the Commission include a similar requirement for a report on the handling of institutional orders?

21. Do commenters believe that the rule should include a de minimis exemption for broker-dealers that receive, in the aggregate, less than a certain threshold number or dollar value of institutional orders? Why or why not? If so, what would be the appropriate threshold number or dollar value of institutional orders a broker-dealer should need to receive from all customers in the aggregate before it would be required to provide customer-specific order handling disclosures to any customer? Please explain and provide data, if possible.

22. Do commenters believe that the rule should be applicable, with respect to disclosures to any particular customer, only if a broker-dealer receives greater than a certain threshold number or dollar value of institutional orders from that customer? Why or why not? What would be the appropriate threshold number or dollar value of institutional orders from a particular customer before a broker-dealer should be required to provide customer-specific order handling disclosures to the particular customer? Please explain and provide data, if possible.

23. Do commenters believe that the required disclosure regarding the handling of an institutional order should include the handling of all smaller (child) orders derived from the institutional order? Why or why not?

24. Do commenters believe that the rule should cover institutional orders placed both directly and indirectly with a broker-dealer? Should the rule only cover orders placed directly with a broker-dealer? Why or why not?

25. Do commenters believe that the rule should specify the number of times a broker-dealer is required by the rule to respond to a customer request for a report on the handling of its institutional orders? Why or why not? If yes, what should the number of times be? Alternatively, do commenters believe that broker-dealers should be required to provide customers with institutional orders ongoing access to order handling reports through a secure portal on their Web sites? Why or why not? How would this impact broker-dealers' compliance costs, or the accessibility to customers of order handling reports? Please explain.

26. As noted above, the proposed rule would not preclude customers from making standing requests for their broker-dealers to provide them order handling reports on a specified regular basis. Do commenters believe broker-dealers should be required to automatically provide reports to customers with respect to their institutional orders, without the customer making a specific request? If so, how frequently should this information be provided (e.g., every month, three months, six months, annually)? Please explain. To what extent would automatically providing reports facilitate the dissemination of order handling information to customers that might not otherwise take the time to request it? On the other hand, to what extent would automatically providing reports require order handling information to be provided to customers that they might not want or use? If order handling reports are required to be

automatically provided, should customers be permitted to opt out from receiving certain information or reports in their entirety? Should a requirement to automatically provide reports exclude customers with only a de minimis number of institutional orders? If so, what would be an appropriate de minimis level? How would a requirement to automatically provide customers with reports rather than provide them upon request change the costs for broker-dealers? Considering that broker-dealers that handle institutional orders would need to be prepared to provide reports to customers on request, and therefore would need to develop the technology to produce such reports in an automated manner, what would be the incremental costs for them to run the reports for all customers on a periodic basis? Would there be any benefits from broker-dealers running the reports for all customers on a periodic basis? Would the broker-dealer experience lower costs from manually providing the reports solely upon request? Would other costs be involved? Please explain and provide data.

As noted above, the Commission is proposing to require that the institutional order handling reports be broken down by calendar month.<sup>130</sup> The Commission understands that trading centers frequently change their fee structures, including the amount of fees and rebates, to attract order flow, and such changes typically occur at the beginning of a calendar month. The Commission preliminarily believes these changes in fee structures at trading centers may affect a broker-dealer's routing decisions. The Commission therefore preliminarily believes that if customer-specific reports on institutional order handling reflected data over a longer period of time, the aggregated information contained in the reports may not be as illustrative or as useful in informing customers as to how fee structures potentially affected the broker-dealer's routing behavior.

For example, if a change in a trading center's pricing structure occurs at the beginning of a calendar month, and the report on a customer's institutional order handling reflected aggregated data for the past six months, then any change in broker-dealer routing behavior as a result of the change in trading center pricing would be harder to detect as the change in data would be diluted and averaged over a period of months. The Commission preliminarily believes that by requiring the reports to be broken down by calendar month would enable

<sup>130</sup> See *id.*

customers to better assess a broker-dealer's institutional order handling practices and any changes in routing behavior in response to internal or external factors. In addition, for those with a fiduciary responsibility to monitor for best execution, monthly detail would help facilitate regular and more precise review to evaluate whether their selected broker-dealers are providing satisfactory execution quality.

As proposed, Rule 606(b)(3) requires that the broker-dealer's report reflect aggregated information regarding the handling of a customer's institutional orders for the prior six months, broken down by calendar month. Additionally, the Commission preliminarily believes that, if a customer places an institutional order that identifies the particular account for which the order was submitted, the broker-dealer would be well-positioned to provide the customer, upon request, a report broken down by account. The Commission preliminarily believes that, because the proposed disclosures will aggregate information to be disclosed to a specific customer across all of the customer's institutional orders, the risk that such disclosures would reveal sensitive, proprietary information about broker-dealers' order handling techniques should be minimal. The Commission is cognizant of the concerns broker-dealers would have if such disclosures revealed proprietary order handling techniques, and preliminarily believes that aggregated customer-specific order handling information would not enable a customer to reverse-engineer proprietary order handling techniques.

The Commission requests comment on this proposed requirement. In particular, the Commission solicits comment on the following:

27. Is six months an appropriate timeframe for the reporting period for customer-specific order handling information? Would a longer or shorter time period (e.g., quarterly) be more appropriate? How soon after month-end should the customer-specific order handling report be provided (e.g., two-weeks after the end of the preceding month)? Please explain.

28. Do commenters believe that aggregated information, broken down by calendar month, is a useful format for the customer? Should the data be required to be provided in a more granular or broader manner? For example, would it be more useful for institutional customers to receive data about the handling of their institutional orders on a stock-by-stock basis rather than aggregated? Please provide support for your arguments and describe any

costs and benefits associated with an alternative format.

29. Does aggregating of all of a customer's institutional orders into a single report adequately prevent sensitive, proprietary information from being revealed? If not, why not? Could aggregated institutional order disclosures allow a customer or competitors to reverse engineer a broker-dealer's order handling techniques?

30. As noted above, the Commission preliminarily believes that, if a customer places an institutional order that identifies the particular account for which the order was submitted, the broker-dealer would be well-positioned to provide the customer, upon request, a report broken down by account. Do commenters believe that the rule should require a broker-dealer to provide, upon request, a report broken down by account, if the customer identifies the particular account for which the order was submitted? Why or why not? Please discuss the benefits and costs with such an account-by-account approach.

Finally, to provide a standardized format for the proposed institutional order handling report, the Commission proposes that the disclosures regarding institutional orders a broker-dealer executes internally or routes to other venues be made in chart form with certain rows and columns of required information.<sup>131</sup> Specifically, the Commission proposes to require that each report contain rows that would be categorized by venue and by order routing strategy category, as described in more detail below, for each venue.<sup>132</sup> In addition, the Commission proposes to require that each report contain certain columns of information, as described below in more detail, for each of the required rows.<sup>133</sup> Thus, each report would be formatted so that a customer would be readily able to observe their order activity at a particular venue, as further subdivided by order routing strategy category for that venue.

The Commission preliminarily believes it is important for customers to understand the venues where their institutional orders are exposed and executed,<sup>134</sup> and that segmenting the institutional order handling report by

venue would be useful for customers to understand where their institutional orders are routed and executed. As proposed, the report would present the order handling information in a manner that would allow customers to readily compare venues. For purposes of the institutional order handling report, a venue would be any trading center<sup>135</sup> to which an order is routed or where an order is executed.

The Commission also proposes to require that the institutional order handling report be categorized by order routing strategy category for institutional orders for each venue.<sup>136</sup> The Commission preliminarily believes that order routing strategies for institutional orders can be categorized into three general strategy categories: (1) A "passive order routing strategy," which emphasizes the minimization of price impact over the speed of execution of the entire institutional order; (2) a "neutral order routing strategy," which is relatively neutral between the minimization of price impact and speed of execution of the entire institutional order; and (3) an "aggressive order routing strategy," which emphasizes speed of execution of the entire institutional order over the minimization of price impact.<sup>137</sup> The Commission is not aware of any generally accepted definitions or metrics to define these order routing strategies, and the proposed rule does not further define these three order routing strategy categories. Rather, by providing a general description, the Commission would afford broker-dealers flexibility to determine how to group their various order routing strategies for institutional orders into the three categories for reporting purposes, according to the general description provided in the proposed rule. A broker-dealer would be required to assign each order routing strategy that it uses for institutional orders to one of the three categories in a consistent manner for each report it prepares pursuant to the proposed rule, and would be required to document the specific methodologies it relies upon for making such assignments.<sup>138</sup> The Commission is proposing to require every broker-dealer to preserve a copy of the methodologies used to assign its order routing strategies and maintain such copy as part of its books and records in a manner consistent with Rule 17a-4(b) under the Exchange

<sup>131</sup> See *supra* note 41. See, e.g., SIFMA Letter II, *supra* note 79, at 13 (stating that the Commission should direct broker-dealers to provide institutional clients with standardized execution venue reports); BlackRock Letter, *supra* note 41, at 3 (stating broker-dealers should be required to provide periodic standardized reports on order routing and execution metrics to both retail and institutional investors).

<sup>132</sup> See proposed Rule 606(b)(3).

<sup>133</sup> See proposed Rule 606(b)(3)(i)-(iv).

<sup>134</sup> See *supra* note 65.

<sup>135</sup> See *supra* note 3.

<sup>136</sup> See proposed Rule 606(b)(3).

<sup>137</sup> See proposed Rule 606(b)(3)(v).

<sup>138</sup> See *id.*

Act.<sup>139</sup> Once a broker-dealer's strategies are assigned a category, the broker-dealer shall promptly update such assignments any time an existing strategy is amended or a new strategy is created that would change such assignment.<sup>140</sup>

The Commission acknowledges that categorization of order routing strategies for institutional orders would be an internal process for a broker-dealer, and, therefore, the methodologies for such process would likely not be entirely consistent *across* broker-dealers, which could result in an order routing strategy being placed in a different category by different broker-dealers. Such inconsistency could make it difficult for institutional customers to effectively compare institutional order handling reports across their broker-dealers. However, the Commission preliminarily believes that the potential inconsistencies of categorization would only occur at the margins among order routing strategies, where characteristics of the strategy could be viewed differently by different broker-dealers. For example, one broker-dealer might reasonably classify a mixed strategy that mostly provides liquidity as being "neutral," whereas another broker-dealer might reasonably categorize the same strategy as "passive." Even if broker-dealers differ at the margins in their categorization of similar order routing strategies, the Commission preliminarily believes that grouping order routing strategies by these three broad categories would still allow for meaningful comparison of order handling practices across broker-dealers.

The Commission recognizes that customers may have different investment strategies and provide specific order handling instructions that will affect how a broker-dealer handles an institutional order and utilizes various venues. The Commission preliminarily believes that if it were to require that the disclosures be categorized only by venue, the disclosures would contain aggregated order routing strategy data that might be less useful in analyzing how a broker-dealer implements the customer's trading decisions. The Commission preliminarily believes that disclosing the proposed institutional order handling information by category of order routing strategy should allow customers to better evaluate a broker-dealer's order handling practices for orders that are handled using similar strategies.

In addition, a customer's order handling instructions may vary at particular points in time depending on a number of different factors. For instance, at certain times a customer may need to quickly liquidate or acquire a position, in which case an aggressive order routing strategy may be appropriate. At other times, speed may not be a primary concern and thus a passive order routing strategy may be appropriate. Because these types of order routing strategies use different methods to liquidate or acquire a position, the order routing strategies may use venues for different purposes. The Commission preliminarily believes that disclosing the required institutional order handling information by passive, neutral, and aggressive strategy for each venue will provide more transparency to customers and a means to understand better which venues are being used as part of a particular strategy. Moreover, the Commission preliminarily believes that the three broad categories should provide a means for customers to ascertain whether a broker-dealer in the aggregate is handling its institutional orders pursuant to its instructions. For example, if a customer instructs its broker-dealer to use mostly passive order routing strategies, the customer could use the institutional order handling report to monitor the use of passive, neutral and aggressive order routing strategies during the reporting period. Finally, the Commission preliminarily believes that, notwithstanding the limitations on comparisons described above, categorizing the proposed institutional order handling information by these three strategies would allow a customer to compare order routing strategies across its broker-dealers.

The Commission acknowledges that broker-dealers may want to prevent other market participants from reverse engineering their proprietary order routing strategies. Thus, the Commission is not proposing to require broker-dealers to disclose detailed methodologies of their order routing strategies. Rather, the Commission is proposing to require broker-dealers to group their various order routing strategies for institutional orders into three categories<sup>141</sup>—passive, neutral, aggressive—which it preliminarily believes should provide valuable transparency to customers while not disclosing proprietary aspects of a broker-dealer's order routing strategies.

The Commission requests comment on its proposal that the customer-specific institutional order handling

report be categorized by venue and order routing strategy category. In particular, the Commission solicits comment on the following:

31. Do commenters believe that disclosure by venues and order routing strategies would be useful to customers placing institutional orders? Are there other ways to categorize the disclosures than by venue and order routing strategies that would be more useful to institutional customers? If so, please explain. Should the Commission consider other methods in providing customer-specific institutional order handling reports? If so, please explain the alternative approach and provide data, if possible.

32. Do commenters believe that disclosure of order routing strategies categorized by passive, neutral, and aggressive would be useful? Should any of these proposed categories be modified or deleted? Are there other categories of strategies that would be more meaningful? Please explain and provide data to support your arguments.

33. Are broker-dealers able to classify their order routing strategies into the three proposed strategy categories? Are there other strategy categories that should be considered?

34. Do commenters believe that customers would have sufficient information to meaningfully compare how their institutional orders were handled by different broker-dealers in light of the fact that each broker-dealer would establish its own categorization of routing strategies?

35. Do commenters agree that potential inconsistencies of categorization will only occur at the margins and grouping order routing strategies by the three broad categories would still allow for meaningful comparison of order handling practices across broker-dealers?

36. Do commenters believe that broker-dealers would be able to produce their order handling statistics in such a manner to favor one strategy over another in an effort to enhance the perception of the services provided? If so, should modifications or additions be made to address this? Further, please explain and provide data, if possible.

37. Should the Commission further define the three order routing strategies, and if so, how? Should routing strategies be defined at all? If not, how should order handling practices be expressed to allow for an effective comparison? Do commenters believe that there is benefit in having the strategies listed if there is no common definition among broker-dealers? Would the report still be useful to customers placing institutional orders in

<sup>139</sup> See *id.*

<sup>140</sup> See *id.*

<sup>141</sup> See *id.*

evaluating their broker-dealers, but not comparing broker-dealers? Please support your arguments.

38. Are there other methodologies that the Commission should consider that would allow institutional customers to meaningfully compare order handling practices across broker-dealers? If so, please explain and provide support, if possible.

39. Would the lack of a more precise definition for the three order routing strategies affect the ability of broker-dealers to produce automated reports?

40. Would the lack of a more precise definition impact the ability of customers to compare order handling practices across broker-dealers?

41. Would disclosing information about the use of the three order routing strategies potentially reveal broker-dealers' sensitive proprietary information? Please be specific about what information and the impact of disclosure.

42. Under the proposal, broker-dealers would be required to document the specific methodologies they rely upon for making assignments of institutional orders to the three order routing strategies. Should these methodologies be made available, in the normal course or upon request, to customers and/or the public? Would disclosure of this information be useful to customers? When a broker-dealer changes its methodology, should it be required to notify its customers or the public of the change, and/or should it be required to restate prior reports "as if" such new methodology had been in place? Would such restatements be useful to customers or potential customers? If so, how? Should such restatements be required for certain material changes in methodology? If so, for which prior reports should restatements be made (e.g., the most recently provided report)? Even if the broker-dealer's methodology is not provided to customers or the public, should they be notified if and when such methodology changes? Why or why not? Please explain. Would transparency regarding the methodologies create risks with respect to sensitive proprietary information of the broker-dealers? If yes, please identify the specific information linked to the risk.

43. Do commenters believe that the Commission should specify how broker-dealers would address a misclassification of a particular order routing strategy? If so, how should broker-dealers be required to address the misclassification? For example, do commenters believe that broker-dealers should be required to promptly provide corrected reports to customers and the

public? Similarly, should the Commission specify how a broker-dealer would address situations in which it determines that any data in a previously provided order handling report is inaccurate? For example, do commenters believe that broker-dealers should be required to promptly furnish corrected reports to customers and/or promptly correct any publicly available reports? Why or why not? Would the dissemination of corrected reports be useful to customers placing institutional orders, and if so for which prior reports would it be useful? Separately, do commenters believe that there should be a materiality threshold for corrections to either the misclassification of order routing strategies or any other inaccuracy in data provided? If so, what would be an appropriate threshold? Please explain and provide data to support your arguments, if possible. As an alternative to a materiality standard, are there other measures that should determine whether a misclassification or other inaccuracy would necessitate a corrected report? For example, if the misclassification or other inaccuracy could impede trend analysis, should that necessitate a corrected report? Please explain.

#### 4. Report Content

##### a. Information on the Customer's Order Flow With the Reporting Broker-Dealer

The Commission also proposes that the report include information on the customer's order flow with the broker-dealer. Specifically, the Commission proposes to require disclosure of: (1) Total number of shares of institutional orders sent to the broker-dealer by the customer during the reporting period; (2) total number of shares executed by the broker-dealer as principal for its own account; (3) total number of institutional orders exposed by the broker-dealer through an actionable IOI; and (4) venue or venues to which institutional orders were exposed by the broker-dealer through an actionable IOI.<sup>142</sup> The Commission preliminarily believes that this information would be useful for customers to evaluate how much order flow the broker-dealer received from the customer during the reporting period, the methods the broker-dealer used to achieve executions for such order flow at the broker-dealer, the management of a broker-dealer's conflicts of interests, and the risk of information leakage associated with such methods.

The Commission preliminarily believes that it is important to require

disclosure of the total number of shares of institutional orders sent to the broker-dealer by the customer during the reporting period to allow the customer to more easily compare the number of shares sent to the broker-dealer versus the number of shares routed by the broker-dealer. As noted above, a broker-dealer often will route orders numerous times, such that the aggregate order total may exceed the total size of the customer's original order flow. Although the information concerning institutional orders sent by the customer to the broker-dealer should be known by the customer, providing the customer with the amount of shares for the customer that the broker-dealer received over the period covered by the report should put in context other data provided in the institutional order handling report. Thus, the Commission preliminarily believes that a broker-dealer should be required to disclose the total number of shares of institutional orders sent by the customer to the broker-dealer. Moreover, because many customers use multiple broker-dealers to execute their institutional orders, requiring each broker-dealer to disclose the total number of shares of institutional orders sent by each customer would allow customers to more readily understand how much of their order flow was handled by a broker-dealer during the reporting period, which should help customers in comparing the order handling reports of their various broker-dealers.

The Commission further proposes that the report disclose the total number of shares executed by the broker-dealer as principal.<sup>143</sup> While customers currently receive disclosure of the number of shares executed by a broker-dealer as principal for each transaction pursuant to Rule 10b-10,<sup>144</sup> the Commission preliminarily believes that including the total number of shares executed by the broker-dealer as principal in the institutional order handling report, which would be an aggregate number of every transaction for the reporting period, would be useful to the customer so that such data would be in the same report as the other data the Commission is proposing to require for institutional orders. Such disclosure would allow customers to understand how often a

<sup>143</sup> See proposed Rule 606(b)(3).

<sup>144</sup> See 17 CFR 240.10b-10. Further, the Commission preliminarily believes that it would be more efficient to require broker-dealers to include this as a line item in the proposed institutional order handling report than for customers to obtain information from the proposed reports, obtain information from Rule 10b-10 required disclosures, and combine the two to perform necessary analysis to evaluate order handling quality.

<sup>142</sup> See proposed Rule 606(b)(3).

broker-dealer trades against its institutional orders, and what order routing strategies lead to this type of activity. The Commission preliminarily believes that this data on the volume of institutional orders interacting with the broker-dealer as principal could be relevant to customers considering potential conflicts of interest their broker-dealers face when trading as principal against their orders, and their broker-dealers' compliance with best execution obligations.

The Commission also proposes to require disclosure of the total number of institutional orders exposed by the broker-dealer through actionable IOIs as well as the venue or venues to which such orders were exposed. The Commission preliminarily believes that transparency into the method of exposing an institutional order through the use of actionable IOIs would provide useful information to customers. As discussed above, the Commission understands that broker-dealers may use actionable IOIs to attract trading interest from external liquidity providers. For example, before a broker-dealer routes an institutional order to another trading center, the broker-dealer may send an actionable IOI to select external liquidity providers to communicate to such liquidity providers to send orders to the broker-dealer to trade with the institutional order that is represented by the actionable IOI at the broker-dealer. While the use of actionable IOIs in this manner by broker-dealers may be beneficial in executing institutional orders, actionable IOIs also may reveal information that could be detrimental to the execution quality of the institutional order. The Commission preliminarily believes that identifying the total number of institutional orders exposed by a broker-dealer through actionable IOIs in the order handling disclosures<sup>145</sup> should give customers a more complete view of how their broker-dealers handle their institutional orders and allow them to better evaluate how their broker-dealer manages information leakage.

The Commission also proposes that broker-dealers disclose the venue or venues that were sent actionable IOIs. Venues that receive the actionable IOIs, such as external liquidity providers that trade proprietarily, could, but are not required to, respond to the actionable IOI by sending an order to the broker-dealer to execute against the trading interest represented by the actionable IOI. The Commission preliminarily believes that disclosure of institutional orders routed to a venue would not,

alone, adequately capture a broker-dealer's order handling practices. As such, the Commission preliminarily believes that disclosure of the specific venue or venues that a broker-dealer exposed an institutional order by an actionable IOI would be useful for the customer to further assess the extent, if any, of information leakage of their orders and potential conflicts of interest facing their broker-dealers. Specifically, the Commission preliminarily believes that such information will enable customers to assess whether their broker-dealers are exposing their institutional orders to select market participants with affiliations, business relationships, or other incentives.

The Commission seeks comment on the disclosure of the reporting broker-dealer's information. In particular, the Commission solicits comment on the following:

44. Do commenters believe that disclosing the total number shares sent to a broker-dealer would be useful to customers placing institutional orders? Why or why not?

45. Do commenters believe that disclosure of the total number of shares executed by the broker-dealer as principal would facilitate understanding the broker-dealer's ability to manage its best execution obligations? Should additional or different information be required regarding institutional orders that are executed by the broker-dealer as principal? Please explain whether and how such additional or different information would be useful.

46. Do commenters believe that disclosure of the total number of shares executed by the broker-dealer as principal would be useful to customers for purposes of evaluating conflicts of interest? Why or why not?

47. Do commenters believe that the institutional order handling report should disclose the total number of institutional orders exposed through an actionable IOI? Is this data useful for customers to evaluate their broker-dealers' institutional order handling practices? Why or why not? Would such disclosure guide customers in better understanding the potential of information leakage of their institutional orders?

48. Do commenters believe that broker-dealers should disclose the venues to which it sends actionable IOIs? Would this information help customers understand how financial incentives or business relationships might impact their orders? Would this information help customers evaluate the risk of information leakage?

49. Do commenters believe there are other data points that would be useful

to customers that should be disclosed on institutional order handling reports? If yes, please explain how such data would be useful to customers.

#### b. Information on Order Routing

Within the venue and order routing strategy segmentations described above, the Commission proposes to require disclosure of information with respect to order routing.<sup>146</sup> The Commission preliminarily believes that information regarding order routing and the size of orders routed, both the aggregate and average order size, would be useful for customers to understand where and how their institutional orders are being routed or exposed to assess the risk of information leakage and any potential conflicts of interest on the part of their broker-dealers. The Commission proposes to require, within each venue and strategy category, disclosure of: (1) Total shares routed; (2) total shares routed marked immediate or cancel ("IOC");<sup>147</sup> (3) total shares routed that were further routable; and (4) average order size routed.<sup>148</sup>

Disclosing total shares routed<sup>149</sup> for each of the required categories would allow customers to readily compare the total shares sent to the broker-dealer, as described above, with the total shares routed by the broker-dealer, which would shed light on the number of shares needed to be routed to fill the institutional orders as well as the potential for information leakage. In addition, disclosing the total shares routed to each venue in total as well as by order routing strategy would provide a customer with information on which venues were used in the process of executing its institutional orders, which strategies were used for each venue, and the extent of such use. The strategies disclosure, coupled with information on fill rates and fee models as further described below, would allow customers to determine whether its broker-dealers are routing orders consistent with the customer's trading objectives. For example, if a broker-dealer routes a significant portion of aggressive orders to a venue that pays a rebate for removing liquidity and the broker-dealer receives a low fill rate from that venue, the customer could ask the broker-dealer why it routes orders seeking liquidity to a venue that rarely

<sup>146</sup> See proposed Rule 606(b)(3).

<sup>147</sup> An order marked IOC will execute immediately at a trading center if liquidity is available at or better than the limit price of the order or otherwise will be immediately canceled. See Concept Release on Equity Market Structure, *supra* note 2, at 3607 n. 69.

<sup>148</sup> See proposed Rule 606(b)(3)(i).

<sup>149</sup> See proposed Rule 606(b)(3)(i)(A).

<sup>145</sup> See proposed Rule 606(b)(3)(i)(B).

executes those orders and whether doing so is consistent with the customer's trading objectives.

The proposed rule would also require disclosure of the total number of shares routed marked IOC,<sup>150</sup> and the total number of shares routed that were further routable.<sup>151</sup> The Commission preliminarily believes that requiring disclosure of these two order characteristics would provide customers a greater understanding of the kind of order flow a broker-dealer sends to each venue and how a broker-dealer uses a venue. For example, orders that are marked IOC are orders that seek to access liquidity at a venue rather than provide liquidity by posting to the venue's book. If no contra side interest is available at the venue at the order's limit price, the order will be canceled back to the broker-dealer. A customer could compare the number of shares routed to a venue marked as IOC with the total shares routed to a venue to understand whether the broker-dealer allows its orders to rest on a venue's book or is primarily seeking to access liquidity at a venue. The Commission is also proposing to require that the broker-dealer disclose the total shares routed that are marked IOC by order routing strategy, which would highlight how the broker-dealer utilizes IOC orders in its various order routing strategies. For example, a customer could assess the rate at which a broker-dealer uses IOC orders by order routing strategy and determine if such rate is consistent with its trading objectives.

In addition, requiring the total shares routed that were further routable would allow the customer to understand whether the broker-dealer allows its orders to be routed by the venue to other venues. Such "re-routing" of orders creates the potential for information leakage every time an order is routed on to another venue. Moreover, customers would be able to determine whether their broker-dealers are in control of the routing of their orders or are relinquishing control of order routing to another entity. In addition, disclosure by order routing strategy would highlight how the broker-dealer utilizes routable orders in its various order routing strategies. For example, a customer could assess the rate at which a broker-dealer uses routable orders by order routing strategy and determine if such rate is consistent with its trading objectives.

Finally, the report would require the disclosure of average order size

routed.<sup>152</sup> The Commission preliminarily believes that requiring disclosure of the average order size routed would provide the customer with information on the nature of a venue, how a venue is being used by a broker-dealer, and possibly what type of participants use a venue.<sup>153</sup> For example, if the average order size routed to a venue is relatively large, a customer may infer that the venue caters to market participants that are willing to trade in larger size. In addition, a customer could compare the average order size routed to a venue to the average fill size at the venue, as described below, to assess the size of orders routed relative to the potential execution. If the average fill size is relatively equivalent to the average order size routed, the customer may infer that the broker-dealer routed the order in a manner that minimized information leakage. If the average order size routed is greater than the average fill size, the customer may infer that the broker-dealer needed to route the order multiple times to receive full execution of the order. As noted in Section II.C.4., each additional route of an order reveals information about that order and such information leakage might cause prices to move in a less favorable direction to the detriment of execution quality. In addition, disclosure of average order size routed by order routing strategy for each venue would allow a customer to better understand the size of orders routed by strategy and determine if such size is consistent with its trading objectives.

The Commission requests comment generally on the order routing information proposed in Rule 606(b)(3)(i). In particular, the Commission solicits comment on the following:

50. Do commenters believe that disclosure of the four data points (total shares routed, total shares routed marked immediate or cancel, total shares routed that were further routable, and average order size routed) as proposed in Rule 606(b)(3)(i)(A)–(D) by both venue and strategy is useful? Should the four data points be defined?

<sup>152</sup> See proposed Rule 606(b)(3)(i)(D).

<sup>153</sup> See Laura Tuttle, Division of Economic and Risk Analysis, SEC, *OTC Trading: Description of Non-ATS OTC Trading in National Market System Stocks*, March 2014, available at [http://www.sec.gov/marketstructure/research/otc\\_trading\\_march\\_2014.pdf](http://www.sec.gov/marketstructure/research/otc_trading_march_2014.pdf) (stating that order and trade sizes can provide information on how a venue is being used by traders, and possibly what type of participants use a venue). The Commission notes that it recently proposed amendments to regulatory requirements in Regulation ATS that would assist in enabling customers to obtain further detail on the nature of certain trading centers. See *supra* note 65.

Are there other factors or order life cycle audit trail information that should be included in order routing information? Should some of the proposed factors be modified or eliminated? If so, which one(s) and why?

51. Do commenters believe it is useful to customers to know the total shares marked IOC and that were routed? Would the cancellation rate of orders be useful to customers placing institutional orders? Are there other order types for which disclosure should be required? If so, which types and why? Should broker-dealers be required to disclose all order types used to execute customer orders? Please explain.

52. Do commenters believe that orders that are not only routable, but are in fact routed on should also be required to be disclosed? Would such re-routing information be useful to customers in determining whether their broker-dealers are in control of the routing of their orders or are relinquishing control of order routing to another entity? Do commenters believe that such re-routing information is retrievable for broker-dealers? Why or why not?

#### c. Information on Order Execution

Within the venue and order routing strategy segmentations described above, the Commission also proposes to require disclosure of information with respect to order execution.<sup>154</sup> The Commission preliminarily believes that information regarding how institutional orders are executed, including fees paid and rebates received for executions, is important for customers to better understand and assess broker-dealer performance. The Commission proposes to require disclosure of: (1) Total shares executed; (2) fill rate;<sup>155</sup> (3) average fill size;<sup>156</sup> (4) average net execution fee or rebate;<sup>157</sup> (5) total number of shares executed at the midpoint; (6) percentage of shares executed at the midpoint; (7) total number of shares executed that were priced on the side of the spread more favorable to the institutional order; (8) percentage of total shares executed that were priced on the side of the spread more favorable to the institutional order; (9) total number of shares executed that were priced on the side of the spread less favorable to the institutional order; and (10) percentage of total shares executed that were priced

<sup>154</sup> See proposed Rule 606(b)(3)(ii).

<sup>155</sup> Fill rate would be calculated by the shares executed divided by the shares routed.

<sup>156</sup> Average fill size would be the average size, by number of shares, of each order executed on the venue.

<sup>157</sup> The fee and rebate would be measured in cents per 100 shares, specified to four decimal places.

<sup>150</sup> See proposed Rule 606(b)(3)(i)(B).

<sup>151</sup> See proposed Rule 606(b)(3)(i)(C).

on the side of the spread less favorable to the institutional order.<sup>158</sup>

Disclosing the total shares executed<sup>159</sup> would provide customers with the means to understand how much of its order flow was executed at a particular venue and readily compare such information across venues. In addition, since the institutional order handling report would also be categorized by order routing strategy, disclosing the total shares executed would provide customers with the means to understand how much of its order flow was executed using passive, neutral, and aggressive order routing strategies at each venue. Requiring broker-dealers to disclose the total shares executed pursuant to order routing strategies could provide customers with more detailed information than they may currently receive from their TCA provider. Typically, third-party TCA providers do not have access to routing information and therefore would not be able to incorporate such information into their TCA offerings.

The Commission preliminarily believes that disclosure of the fill rate<sup>160</sup> would show customers, on a percentage basis, how much of their order flow was executed compared to how much of their order flow was routed. While customers could compute the fill rate by dividing the number of shares executed by the number of shares routed, the Commission preliminarily believes that it is useful for the fill rate to be disclosed in a separate column of information to allow customers to readily compare fill rates without required computations. Such execution information would provide customers the opportunity to assess how effective a venue is in filling its institutional orders as well as how effective particular order routing strategies are at the various venues. The fill rate is an important piece of execution information that helps customers in assessing execution quality received at a trading center, given the customers' strategy. For example, if a broker-dealer's aggressive order routing strategies routinely route to a venue with a low fill rate, it could prompt a discussion between the customer and the broker-dealer to understand the reasons why the broker-dealer favors such a low fill rate venue when using such strategies. While the broker-dealer may be able to explain its order handling practices without the disclosed information, there is currently

very little transparency on the order handling decisions.

The Commission notes that providing customers' fill rate and average fill size<sup>161</sup> at each venue would allow customers to assess whether their broker-dealers are routing its orders to venues that can effectively execute the order. This information could be particularly useful to customers in comparing their fill rate to the average fill size at each venue across its broker-dealers and across a particular broker-dealer. For example, if a broker-dealer routinely routes orders to a venue with low fill rates, the customer could request from its broker-dealer more details regarding such venue, such as the existence of any preexisting business relationship or affiliation. Further, if a broker-dealer regularly routes orders with large average order size to a venue with a high fill rate but a low average fill size, such information may indicate to the customer that the broker-dealer might not be routing the customer's institutional orders in a manner designed to minimize information leakage, because the broker-dealer would need to continue to route additional orders to fill the order. Moreover, requiring the disclosure pursuant to order routing strategies would result in greater transparency into order handling decisions.

As proposed, the report would provide data on the average net execution fee or rebate (cents per 100 shares, specified to four decimal places).<sup>162</sup> The average net execution fee or rebate would disclose to customers potential economic incentives a broker-dealer faces when handling institutional orders. Providing customers with details on the economic incentives of broker-dealers at trading centers would allow customers to more effectively assess any potential conflicts of interest its broker-dealers face when routing its institutional orders. For example, with such information, a customer would be able to compare the average net execution fee or rebate on particular venues in light of other order handling information at the venues like the total shares routed and the fill rate. If a broker-dealer routes a large number of shares to a venue with a low fill rate but that venue provides a significant rebate for orders executed, a customer may seek to inquire about the benefits of routing such a large amount of order flow to that venue.

The Commission acknowledges that, depending on the arrangement between a broker-dealer and its institutional

customer, a broker-dealer may directly pass on execution fees and rebates to its institutional customer. In such instance, any economic incentives to route orders to certain trading centers would not present a potential conflict of interest, as the broker-dealer would not be benefiting from receipt of fees or rebates. The Commission preliminarily believes that a broker-dealer that directly passes on execution fees or rebates to its customers should nonetheless provide the average net execution fee or rebate in the report so that, among other things, the customer has a means to verify that no conflict of interest existed between the broker-dealer and a particular trading center through comparing the execution fees and rebates it received directly through its broker-dealer to the average net execution fee or rebate disclosed in the report.

Moreover, broker-dealers would be required to disclose the average net execution fee or rebate by order routing strategy. Such disclosure would allow customers to assess whether there are conflicts of interest in the broker-dealer's routing decision. For example, if in connection with an aggressive order routing strategy, the broker-dealer routinely routes orders that remove liquidity to venues with rebates for removing liquidity but a low fill rate, it may indicate to the customer that the broker-dealer may not be acting consistent with the customer's trading objectives.

The report would further disclose the total number of shares executed at the midpoint and the percentage of shares executed at the midpoint.<sup>163</sup> Many trading centers offer users the ability to post orders at the midpoint of the NBBO, and incoming marketable orders can execute against such orders.<sup>164</sup> Midpoint execution information would provide a customer with greater information on the execution quality of the venue and the type of liquidity resting at a venue. For example, the midpoint is generally considered to be a higher quality execution than the NBBO because both the buyer and the

<sup>163</sup> See proposed Rule 606(b)(3)(ii)(E)-(F). The midpoint would be the price halfway between the national best bid and national best offer.

<sup>164</sup> See, e.g., Rule 11.9(c)(9) of the Bats BZX Exchange, Inc. ("Bats BZX") (defining Midpoint Peg Order); Rule 4702(d) of The NASDAQ Stock Market LLC (defining Midpoint PEGging); Robert P. Bartlett, III and Justin McCrary, *Dark Trading at the Midpoint: Pricing Rules, Order Flow and Price Discovery* (February 12, 2015) ("Bartlett and McCrary Paper"), available at <http://www.stern.nyu.edu/sites/default/files/assets/documents/2%20Bartlett%20and%20McCrary%20Shall%20We%20Haggle.pdf> (describing midpoint trading on non-exchange venues).

<sup>158</sup> See proposed Rule 606(b)(3)(ii).

<sup>159</sup> See proposed Rule 606(b)(3)(ii)(A).

<sup>160</sup> See proposed Rule 606(b)(3)(ii)(B).

<sup>161</sup> See proposed Rule 606(b)(3)(ii)(C).

<sup>162</sup> See proposed Rule 606(b)(3)(ii)(D).

seller receive price improvement over the best displayed price, and an order at the midpoint generally has less impact on price since the execution does not remove the best displayed price.<sup>165</sup> Customers would be able to examine when they receive midpoint price improvement and at which venues. Coupled with the other required disclosures such as the average net execution fee or rebate and fill rate, customers could further assess the potential for conflicts of interest facing their broker-dealers that may affect the broker-dealer's institutional order routing practices. For example, if a broker-dealer routes a large number of shares to a venue that provides a significant rebate for orders executed but where the customer receives a low fill rate and a low percentage of its shares executed at the midpoint, a customer may seek to question the broker-dealer regarding the benefits of routing such a large amount of order flow to that venue. As proposed, broker-dealers would also be required to disclose the total number of shares executed at the midpoint and the percentage of shares executed at the midpoint by order routing strategy, which should allow customers greater insights into which order routing strategies generate midpoint executions and which venues are providing midpoint executions.

The report would also require disclosure of the total number and percentage of shares executed that were priced on the side of the spread more favorable to the institutional order and the total number and percentage of shares executed that were priced on the side of the spread less favorable to the institutional order.<sup>166</sup> Information with respect to which side of the spread orders executed on would help customers assess the execution quality their institutional orders received, which in connection with the order routing strategy disclosures and the fees and rebates disclosures, would allow customers to better evaluate the performance of its broker-dealers. For example, if the customer's strategy is to be passive, but its broker-dealer is frequently routing orders to a venue or venues that are taking liquidity at the side of the spread less favorable to the institutional order, then the customer could further inquire about the broker-dealer's rationale for routing to such venue. The Commission preliminarily

believes that requiring these granular details of how institutional shares are executed should provide customers with more information to evaluate the quality of their broker-dealers' order handling services.

Comment is generally requested on order execution information as proposed in Rule 606(b)(3)(ii). In particular, the Commission solicits comment on the following:

53. Should any of the terms in proposed Rule 606(b)(3)(ii) be defined? Should the information proposed to be required be modified in any way, should additional information related to order execution be required, or should any proposed requirement be omitted? Please explain.

54. Do commenters believe that the required order execution information would be useful to institutional customers? Please explain with respect to each of the proposed institutional order disclosure categories.

55. Do commenters believe that disclosures regarding fill rates and average fill size would assist institutional customers in understanding how much of their orders are executed at a venue versus routed on to another venue? Are there other data that would be useful in analyzing order execution?

56. Would disclosures related to execution fees and rebates be useful to institutional customers? Would this information support an evaluation of a broker-dealer's potential economic incentives and/or conflicts of interest to route and/or execute orders at a particular venue? Please provide support for your arguments.

57. Do commenters believe that the total number and percentage of shares executed at the midpoint indicate higher quality executions? Would this information be useful to customers interested in examining their institutional order execution quality? Please explain.

58. Do commenters believe that information on the shares executed on the side of the spread favorable or less favorable to the institutional order would be useful to institutional customers in analyzing their broker-dealer's order handling practices? What other order execution data, if any, would be useful to customers? Would information on shares executed against displayed or undisplayed liquidity be useful? Should any of the proposed requirements be modified or eliminated? If so, which ones and why? Please provide support for your arguments.

59. Do commenters believe that the proposed data points outlined above

would provide customers with meaningful information? Would the proposed disclosures allow customers to better assess the execution quality of their broker-dealer? Would the report further permit customers to compare execution quality among multiple broker-dealers across the market? Would the report, as proposed, allow customers to more easily monitor for best execution?

#### d. Information on Orders That Provided Liquidity

In addition to the order routing and execution data detailed above, the Commission proposes to require disclosure of information on institutional orders that provided liquidity within the venue and order routing strategy segmentations described above.<sup>167</sup> In connection with this new requirement, the Commission proposes to define the term "orders providing liquidity" to mean "orders that were executed against after resting at a trading center."<sup>168</sup> Generally, orders providing liquidity are submitted as non-marketable limit orders and are kept in a limit order book awaiting execution. The Commission preliminarily believes that by defining "orders providing liquidity" and "orders removing liquidity" (described in more detail below), broker-dealers would be able to classify orders pursuant to a standardized description for disclosure purposes.

The Commission preliminarily believes that disclosure of information on institutional orders that provided liquidity is important for customers to better understand to which venues the broker-dealer routes liquidity providing orders, how long it takes to execute such orders at each venue, and the fees paid to or rebates received by the broker-dealer at each venue for liquidity providing orders. The Commission proposes to require disclosure of: (1) Total number of shares executed of orders providing liquidity; (2) percentage of shares executed of orders providing liquidity; (3) average time between order entry and execution or cancellation for orders providing liquidity (in milliseconds); and (4) the average net execution rebate or fee for shares of orders providing liquidity (cents per 100 shares, specified to four decimal places).<sup>169</sup>

The information on orders that provided liquidity would include the total number of shares executed of orders providing liquidity and the

<sup>165</sup> See, e.g., Bartlett and McCrary Paper, *supra* note 164 (stating that midpoint of the NBBO is a form of trading that is generally considered to have significant benefits for institutional investors).

<sup>166</sup> See proposed Rule 606(b)(3)(ii)(G)-(J).

<sup>167</sup> See proposed Rule 606(b)(3)(iii).

<sup>168</sup> See proposed Rule 600(b)(55).

<sup>169</sup> See proposed Rule 606(b)(3)(iii).

percentage of shares executed of orders providing liquidity.<sup>170</sup> The Commission preliminarily believes that the total number of shares executed of institutional orders providing liquidity would inform an institutional customer of how much of its order flow provided liquidity at each venue and by order routing strategy. Such information is important for an institutional customer to understand how a broker-dealer is implementing its order execution and routing strategies and at what venues. The Commission also preliminarily believes that the percentage of shares executed of orders providing liquidity would be useful for an institutional customer to readily assess the amount of shares that provided liquidity at a venue in comparison to the total number of shares executed at the venue. Since broker-dealers would also be required to disclose this information by order routing strategy, institutional customers would have further data to better understand and analyze how a broker-dealer routes orders for various strategies and the potential effect on execution quality.

The institutional order handling report also would require data on the average time between order entry and execution or cancellation for orders that provided liquidity prior to execution or cancellation.<sup>171</sup> The average time between order entry and execution or cancellation for orders that provided liquidity would be measured in milliseconds, which, due to the speed of trading in today's equity markets, the Commission preliminarily believes is an appropriate measure. Disclosing the average length of time orders rest at venues before they are either executed or canceled could provide insight into how a broker-dealer utilized venues when seeking to execute institutional orders, specifically how long orders rest on order books before receiving an execution or being canceled and sent back to the broker-dealer for further handling. The Commission preliminarily believes that depending on the order routing strategy, the average length of time that orders are posted to a venue, and thus providing liquidity, could help indicate empirically whether the broker-dealer is appropriately implementing a customer's desired order routing strategy. For example, if a customer wanted its broker-dealer to handle its institutional order using a neutral order routing strategy, such strategy would generally seek to provide liquidity and not aggressively cross the spread, but

speed of execution would still be of relative concern. A venue that pays a significant rebate for shares of orders providing liquidity would most likely have a deep book as many liquidity providing orders would post on that venue's book in order to receive the rebate. Due to the depth of book, the likelihood of receiving an execution for a liquidity providing order on that venue could be low and the average time between order entry and execution or cancellation for orders that provided liquidity could be relatively long. In combination with the average net execution rebate or fee for shares that provided liquidity, described below, customers could use the average time between order entry and execution or cancellation for orders being posted at that venue to assess how their broker-dealers are implementing order routing strategies or whether their broker-dealers may be influenced by the high rebate at such venue, in conflict with the customer's interests.

The report would also contain the average net execution rebate or fee for shares of orders providing liquidity.<sup>172</sup> The Commission proposes that the average net execution rebate or fee would be calculated in cents per 100 shares, specified to four decimal places, to correspond to current industry execution rebate and fee practices<sup>173</sup> and to ensure consistency in reporting among broker-dealers.<sup>174</sup> The Commission preliminarily believes that disclosing the average net execution rebate or fee for shares of orders providing liquidity at each venue and by order routing strategy would allow customers to assess potential conflicts of interest from economic incentives facing their broker-dealers with regard to the venues to which broker-dealers route orders and the order routing strategies that use those venues. For example, if a broker-dealer routes orders that provide liquidity to the venues with the highest rebate, and orders that remove liquidity to the venues with the lowest take fee, a customer could then examine the fill rates at those venues to determine whether there is potential for conflicts of interest with respect to the broker-dealer's own economic interest.<sup>175</sup> The

Commission preliminarily believes that this information will be useful for customers to understand, and assess the potential effect of, economic incentives on execution quality.

The Commission requests comment on the disclosure requirements pertaining to institutional orders that provide liquidity as proposed in Rule 606(b)(3)(iii). In particular, the Commission solicits comment on the following:

60. The Commission proposes to define "orders providing liquidity." Do commenters believe that this term should be defined? Is the proposed definition useful to broker-dealers in categorizing an order for reporting purposes? Should it be modified in any way, including adding additional criteria? Why or why not?

61. Do commenters believe that the total number of shares executed of orders providing liquidity is the appropriate data to inform customers how much of its order flow provided liquidity? Are there other data factors that the Commission should consider?

62. Does the percentage of shares executed of orders providing liquidity provide information customers could use to evaluate how a broker-dealer is implementing its order execution and routing strategies and at what venues? Would this information be useful to customers in analyzing and potentially modifying their trading instructions or choosing a broker-dealer for order routing and execution services?

63. Do commenters believe that the average time between order entry and execution or cancellation (measured in milliseconds) for orders providing liquidity will be an appropriate measure of whether the broker-dealer is implementing a customer's order instructions? If not, why not? Do commenters believe that the "average" is the appropriate measure to gauge the amount of time an order is resting on the book? What are alternative data points or measurements that would achieve the same goal? Separately, is milliseconds an appropriate measure? If not, what would be more appropriate? Are there other time measures and/or data that would be useful to institutional customers in evaluating

customers. For orders from institutional customers, it depends on the arrangement between an institutional customer and a broker-dealer: the broker-dealer may pay fees and receive rebates that result from routing orders of the institutional customer, or the broker-dealer may pass those fees and rebates through to the institutional customer. In the case where a broker-dealer passes the fees and rebates through to the customer, there would not be potential conflicts of interest in the broker-dealer's order routing decisions with respect to fees and rebates.

<sup>172</sup> See proposed Rule 606(b)(3)(iii)(D).

<sup>173</sup> See, e.g., Bats BZX Exchange, Inc. Fee Schedule, available at [http://www.batstrading.com/support/fee\\_schedule/bzx/](http://www.batstrading.com/support/fee_schedule/bzx/); Rule 7018 of the NASDAQ Stock Market LLC, available at <http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F6&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F> (pricing execution fees and rebates to four decimal places).

<sup>174</sup> See proposed Rule 606(b)(3)(iii)(D).

<sup>175</sup> Typically, broker-dealers pay fees and receive rebates that result from routing orders of retail

<sup>170</sup> See proposed Rule 606(b)(3)(iii)(A)-(B).

<sup>171</sup> See proposed Rule 606(b)(3)(iii)(C).

whether the broker-dealer is implementing their order instructions? If so, please explain and provide data to support your argument.

64. Do commenters believe that disclosing the average net execution rebate or fee for shares of orders providing liquidity at each venue and by order routing strategy would be useful in assessing potential conflicts of interest broker-dealers may face with regard to routing venues and the order routing strategies that use those venues?

65. Do commenters believe that specifying the average net execution fee or rebate to four decimal places is appropriate? If not, to what level of precision should the fee or rebate be specified? Please explain and provide data for your argument.

#### e. Information on Orders That Removed Liquidity

Similarly to orders that provided liquidity, the Commission proposes to require the disclosure of information on institutional orders that removed liquidity within the venue and order routing strategy segmentations described above.<sup>176</sup> Related to this new disclosure, the Commission proposes to define the term “orders removing liquidity” to mean “orders that executed against resting trading interest at a trading center.”<sup>177</sup> Generally, orders that remove liquidity are marketable orders that are immediately executable when routed to a venue and execute against and remove orders that are resting on a trading center’s order book. The Commission preliminarily believes that the defined term should reduce any potential broker-dealer confusion when distinguishing orders for reporting purposes and would allow all broker-dealers to more consistently designate certain orders as orders removing liquidity.

The Commission preliminarily believes that disclosure of information on institutional orders that removed liquidity will be useful for customers to understand which venues their broker-dealers route liquidity removing orders to and the fees paid or rebates received at each venue for such orders. The Commission proposes to require disclosure of: (1) Total number of shares executed of orders removing liquidity; (2) percentage of shares executed of orders removing liquidity; and (3) average net execution fee or rebate for shares of orders removing liquidity (cents per 100 shares, specified to four decimal places).<sup>178</sup>

As proposed, the report would require data on the total number of shares executed and the percentage of shares executed of orders removing liquidity.<sup>179</sup> The Commission preliminarily believes the number of shares and the percentage of shares executed that removed liquidity at each venue would allow the customer to understand how much of its total institutional orders removed liquidity at a particular venue, as well as by order routing strategy. Coupled with the information on fill rates, customers could assess the risk of information leakage and the potential effect of the broker-dealer’s routing practices on execution quality. For example, many market participants monitor their and other bids and offers for executions. When an execution occurs on one venue, market participants may adjust their bids or offers on other venues to take into account that there may be more trading interest to follow, which could result in prices moving away from the institutional order and ultimately resulting in the institutional order receiving a worse overall price for the full size of the institutional order. Indeed, the risk of information leakage and its potential negative impact on execution quality may be significant, if a broker-dealer routinely routes orders removing liquidity to a venue with insufficient liquidity to fill the orders. Using the proposed disclosures, customers could assess whether their broker-dealers routed their institutional orders that removed liquidity in the most effective manner to reduce the potential that prices move against the institutional order.

The institutional order handling report also would require disclosure of the average net execution fee or rebate for shares of orders that removed liquidity. Parallel to the information on orders providing liquidity, the average net execution fee or rebate for orders removing liquidity would be calculated in cents per 100 shares, specified to four decimal places, to correspond to current industry practice and to ensure consistency in reporting among broker-dealers.<sup>180</sup> Additionally, similar to the information on orders providing liquidity, this information would allow customers to examine the venues chosen by their broker-dealers, the order routing strategies used, and the economic interests motivating such choices. If a broker-dealer routinely routes orders that remove liquidity to a venue that pays a rebate to the broker-dealer or charges the lowest fee, the

customer could examine whether there is a conflict of interest that affects how the broker-dealer handles its institutional orders, and if so, whether that conflict of interest has a negative impact on execution quality.

The Commission requests comment on disclosures for institutional orders that remove liquidity as proposed in Rule 606(b)(3)(iv). In particular, the Commission solicits comment on the following:

66. The Commission proposes to define “orders removing liquidity.” Do commenters believe that this term should be defined? Is the proposed definition useful to broker-dealers in categorizing an order for reporting purposes? Should it be modified in any way, including adding additional criteria? Why or why not?

67. Do commenters believe that the total number of shares executed of orders removing liquidity is the appropriate data to inform customers how much of its order flow removed liquidity? Are there other data factors that the Commission should consider?

68. Does the percentage of shares executed of orders removing liquidity provide information customers could use to evaluate how a broker-dealer is implementing its order execution and routing strategies and at what venues? Would this information be useful to customers in analyzing and potentially modifying their order instructions and/or choosing a broker-dealer for order routing and execution services?

69. Do commenters believe that the average net execution fee or rebate for shares of orders removing liquidity at each venue and by order routing strategy would be useful in assessing potential conflicts of interest broker-dealers may face with regard to routing venues and the order routing strategies that use those venues?

70. Do commenters believe that specifying the average net execution fee or rebate to four decimal places is appropriate? To what level of precision should the fee or rebate be specified? Please explain and provide data for your argument.

#### 5. Public Report for Institutional Orders

The institutional order handling disclosures, described above, would provide detailed information to a requesting customer with regard to how all of its institutional orders were handled by a broker-dealer, broken down by calendar month. The Commission preliminarily believes that a publicly disclosed aggregated report (aggregating all customer information) could provide additional transparency into the broader institutional order

<sup>176</sup> See proposed Rule 606(b)(3)(iv).

<sup>177</sup> See proposed Rule 600(b)(56).

<sup>178</sup> See proposed Rule 606(b)(3)(iv)(A)–(C).

<sup>179</sup> See proposed Rule 606(b)(3)(iv)(A)–(B).

<sup>180</sup> See proposed Rule 606(b)(3)(iv)(C).

handling practices of broker-dealers, which could, in turn, allow for more efficient and effective comparisons of the quality of services offered by broker-dealers. As noted above, in today's complex equity markets, it may be difficult for customers to assess the order handling services of multiple broker-dealers without standardized order handling disclosures, particularly the services of broker-dealers with which they do not have a relationship.

The Commission preliminarily believes that aggregated public disclosure of the information contained in the customer-specific institutional order handling reports, described above, would be useful to institutional customers and other market participants to determine whether to engage the services of a broker-dealer as well as the ability to gauge the adequacy of the services performed by a broker-dealer. The public disclosure by broker-dealers of aggregated institutional order handling information should promote competition as broker-dealers may seek to differentiate their services and expertise in an effort to retain current customers and attract the business of prospective customers. Indeed, the Commission preliminarily believes that public disclosure of institutional order handling information by each broker-dealer would provide market participants with useful information and could bring competitive forces to bear on broker-dealer institutional order handling services. Accordingly, the Commission preliminarily believes that aggregated public institutional order handling reports would increase the overall transparency of institutional order handling practices to the benefit of customers and the marketplace as a whole.

The Commission proposes to require a broker-dealer that receives institutional orders to make publicly available<sup>181</sup> a report that aggregates the information required for customer-specific institutional order handling reports, described above, for all institutional orders it receives.<sup>182</sup> Broker-dealers would be required to make such report publicly available for each calendar quarter, broken down by calendar month, within one month after the end of the quarter.<sup>183</sup> This public

aggregated institutional order handling report would be mandatory for all of the institutional orders that a broker-dealer handles within a calendar quarter regardless of whether any of its customers request customer-specific institutional order handling reports.

Similar to the customer-specific institutional order handling reports required under proposed Rule 606(b), the public aggregated institutional order handling report would be made available using an XML schema and associated PDF renderer to be published on the Commission's Web site.<sup>184</sup> The Commission preliminarily believes that requiring the public aggregated institutional order handling reports be provided in this format would be useful to customers as it would allow them to more easily analyze and compare the data provided in both types of reports, for the reasons discussed above, and would allow market participants generally to analyze and compare broker-dealer institutional order handling practices.<sup>185</sup>

In addition, the Commission proposes to require that broker-dealers keep such public aggregated institutional order handling reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.<sup>186</sup> The Commission preliminarily believes that making this historical data available to customers and the public generally will be useful to those seeking to analyze past order handling behavior of a broker-dealer or across multiple broker-dealers. To further support customers' usage of the public aggregated institutional order handling reports, the Commission notes that it would be incumbent upon the broker-dealer to maintain accurate order handling data during the three year period.

The Commission recognizes that broker-dealers have proprietary methods for order handling, and is cognizant of the sensitive nature of such business practices and intellectual property. The Commission preliminarily believes that the risk of exposing sensitive proprietary information on the broker-dealers' order handling techniques would be minimal due to the structure of the proposed report and by aggregating the information to be publicly disclosed. Like the proposed customer-specific institutional order

handling reports, the proposed public aggregated institutional order handling report would aggregate a broker-dealer's order handling information for all NMS stocks for the reporting period, and, therefore, the Commission preliminarily believes other market participants would not be able to ascertain which particular securities were routed during the reporting period. Additionally, as routing decisions are generally dependent on the market for the particular security at the time of routing, the Commission preliminarily believes that public aggregated institutional order handling reports for the prior calendar quarter would not provide other market participants, including a broker-dealer's competitors, sensitive information about a broker-dealer's order handling techniques.

Further, while the public aggregated institutional order handling report would provide information on the venues to which a broker-dealer routed its institutional order flow as well as the three categories of order routing strategies used to route those orders, the report would not provide any information about the manner or sequence in which those orders were routed to the venues. For example, the report would not disclose whether the broker-dealer routed orders sequentially or simultaneously to multiple trading centers in order to fully execute an institutional order, or the sequence in which such orders were routed to trading centers. Because such information is essential to effectively reverse engineer an order routing algorithm, the Commission preliminarily believes that the proposed public aggregated institutional order handling information would not provide other market participants with the information to reverse engineer a broker-dealer's proprietary order handling techniques, regardless of the number of orders a broker-dealer routes or the number of institutional customers for which a broker-dealer routes orders during the reporting period. Accordingly, the Commission preliminarily believes that information contained in the proposed public aggregated institutional order handling report should provide appropriate safeguards for broker-dealers' current business practices, while, at the same time, providing meaningful information for customers and others to compare broker-dealers' order routing services.

The Commission also preliminarily believes that the risk of exposing sensitive customer-specific information would be minimal due to the structure of the proposed report and by aggregating the information to be

<sup>181</sup> The Commission notes that "make publicly available" is defined in Rule 600(b)(36) of Regulation NMS to mean "posting on an Internet Web site that is free and readily accessible to the public, furnishing a written copy to customers on request without charge, and notifying customers at least annually in writing that a written copy will be furnished on request." See 17 CFR 242.600(b)(36).

<sup>182</sup> See proposed Rule 606(c).

<sup>183</sup> See *id.*

<sup>184</sup> See *supra* Section II.A.3.

<sup>185</sup> See *id.*

<sup>186</sup> The Commission notes that it is proposing similar reporting format and accessibility requirements for quarterly reports on retail order routing in Rule 606(a)(1), which is discussed in more detail in Section III.B.4. below.

publicly disclosed. As noted above, the proposed public aggregated institutional order handling report would aggregate order handling information for all NMS stocks for the reporting period and would not disclose the customers of the broker-dealer. To the extent a broker-dealer only had one or a few institutional customers to which it provided routing services, market participants could presume a customer's orders were included in the public aggregated institutional order handling report, but only to the extent the market participants knew of the routing relationship. However, even if a market participant is aware of such routing relationship, because the proposed public aggregated institutional order handling report would not disclose the specific securities routed and the historical data would reflect only previous calendar quarters, the Commission preliminarily believes that public disclosure would not expose sensitive information of the institutional customers.

The Commission understands that many customers currently request information about a broker-dealer's order handling practices before engaging its services.<sup>187</sup> Generally, these requests are questionnaires regarding order routing strategies used by the broker-dealer and the venues to which the broker-dealer routes orders.<sup>188</sup> The Commission understands that the information requested in the questionnaires and the responses provided are generally not uniform, and, therefore, not readily comparable across multiple broker-dealers. While customers would continue to be able to use their specific questionnaires, the Commission preliminarily believes that a standardized report reflecting the order handling information for all of a broker-dealer's institutional orders for the past calendar quarter would greatly enhance their ability to understand how the broker-dealer routes and executes institutional orders and would also allow them to compare the execution quality of their orders against the execution quality of all of a broker-dealer's institutional orders. In addition, the standardized structure of the public aggregated institutional order handling report would provide all customers, regardless of size or sophistication, with the means to compare and contrast how broker-dealers implement passive, neutral, and aggressive order routing

strategies, and the quality of executions received with respect to such strategies.

Moreover, the public disclosure of aggregated institutional order handling information would provide academics and others, including third-party vendors offering analytical services, access to order routing and execution information that would not otherwise be available.

Finally, the Commission notes that the proposed public aggregated institutional order handling reports differ from the current reports on retail order routing required pursuant to Rule 606(a).<sup>189</sup> The Commission preliminarily believes that such distinction is appropriate because institutional orders are generally large and may be complex, in contrast to retail orders that are of smaller size, utilize different routing strategies, and which typically have less impact on the market. Specifically, due to the large size of institutional orders, it may be difficult to fully fill the orders by executing against displayed bids or offers resting on a trading center. Instead, institutional orders are often broken up into child orders, routed to multiple trading centers, and filled at multiple price levels which may result in potential information leakage<sup>190</sup> and unfavorable price movement to the institutional order.<sup>191</sup> As such, broker-dealers often employ more complex order routing strategies when handling institutional orders to reduce the potential information leakage and unfavorable price movement.<sup>192</sup> Conversely, marketable retail orders are generally internalized by broker-dealers at prices at or slightly better than the NBBO, with very little risk of information leakage and impact on the market. If not internalized, retail orders, due to their smaller size are typically routed to a single trading center and fully executed. While the potential for information leakage of a retail order is low, even if order information is exposed, there is little influence on the retail order as it would likely already be fully executed. Due to these differences,

<sup>189</sup> Rule 606(a) currently requires the reporting of the percentage of total orders that were non-directed orders, and the percentages of total non-directed orders that were market orders, limit orders, and other orders, the percentages of such orders routed to the Specified Venue, and a discussion of the material aspects of the broker-dealer's relationship with each Specified Venue (including a description of any arrangement for payment for order flow and any profit-sharing relationship). See 17 CFR 242.606(a)(1).

<sup>190</sup> See Bunge Article, *supra* note 69.

<sup>191</sup> See Bartlett and McCrary Paper, *supra* note 164, at 5 (discussing order size and its relation to price impact).

<sup>192</sup> See Concept Release on Equity Market Structure, *supra* note 2, at 3602.

the Commission preliminarily believes that because retail orders are not subjected to similar risks of potential information leakage and disadvantageous price impact as with institutional orders, the use of the proposed aggregated reporting of information for institutional orders—including order routing and execution and orders providing and removing liquidity—to among other things, monitor broker-dealers' management of these risks would not be pertinent for retail orders.

The Commission requests comments on information contained in the public aggregated institutional order handling reports by broker-dealers. In particular, the Commission solicits comment on the following:

71. Do commenters believe that aggregated institutional order handling information being publicly disclosed would be useful to institutional customers and other market participants? Who would it be useful to and in what ways?

72. Do commenters believe that the aggregated institutional order handling information proposed by Rule 606(c) should be disclosed for both retail and institutional orders, rather than only for institutional orders as proposed? Why or why not? Please provide support for your argument.

73. Should the public aggregated institutional order handling report include all the data points enumerated in proposed Rule 606(b)(3)(i)–(iv)? Why or why not? If not, which data points should be excluded or modified? Are there other data points the Commission should consider that would be useful to customers and the public? Please explain and provide data, if possible.

74. Do commenters believe that broker-dealers should be required to provide the public aggregated institutional order handling report in the proposed format? Why or why not? Do commenters believe that providing the report in a structured XML format will facilitate comparison of the data across broker-dealers? If not, why not? Do commenters believe that a structured XML format would be useful to customers and other market participants, and if so how? What incremental costs or savings would broker-dealers incur in providing the report in a structured XML format? Should the Commission consider alternative formats? If so, please explain the alternative formats and associated benefits and costs. Do commenters believe that it would be useful for broker-dealers to also provide the report in an instantly readable PDF format? If not, why not? Are there other formats

<sup>187</sup> See TM Memo re Morgan Stanley I, *supra* note 43.

<sup>188</sup> See *id.*

that would be more appropriate? If so, please explain the alternative formats and benefits and costs.

75. Do commenters believe that the rule should include a de minimis exemption for broker-dealers that receive, in the aggregate, less than a certain threshold number or dollar value of institutional orders? Why or why not? If so, what would be the appropriate threshold number or dollar value of institutional orders a broker-dealer should need to receive from all customers in the aggregate before it would be required to provide the public order handling reports? Please explain. Separately, are there alternative approaches to reduce the compliance costs on broker-dealers with few institutional customers? Please provide data to support your arguments.

76. Regarding broker-dealers with a small number of institutional customers, do commenters believe there is a potential risk of exposing the customer's sensitive, proprietary information in an aggregated report? Should the Commission make any modifications to the proposed disclosures or eliminate any or all of the proposed requirements under certain circumstances? If so, what is the appropriate measure? Please provide support for your argument.

77. Do commenters believe that a broker-dealer that routes less than a certain number of orders should be exempt from the public disclosure requirement? Why or why not? What is an appropriate threshold for this potential exemption? Separately, are there alternative approaches to reduce the compliance costs on broker-dealers who route and execute few institutional orders? Please provide data to support your arguments. What information, if any, should the broker-dealer be required to provide to customers and/or the public if it relies on the potential exemption?

78. Do commenters believe that the public reports would be useful to customers and the public in comparing the quality of services offered by broker-dealers? Do commenters believe that public disclosure of aggregated institutional order handling information will enhance competition among broker-dealers?

79. Do commenters believe that publicly releasing aggregated institutional order handling reports on a quarterly basis is appropriate? Should the report be publicly disclosed at a different interval, such as monthly? Please explain.

80. Do commenters believe that the requirement that the reports be broken down by calendar month is useful?

Should the report be broken down with a different interval(s)? Please explain.

81. Do commenters believe that the aggregated institutional order handling information will be stale if published one month after the end of the quarter? Should the disclosures be available earlier or later? Please explain.

82. Will aggregating the information being publicly disclosed mitigate the risk that the disclosure will reveal sensitive, proprietary information about the broker-dealer's order handling practices? Will it mitigate the risk that the disclosure will reveal sensitive proprietary information about customers' trading strategies? Why or why not? Are there alternative approaches to protecting such information while still requiring the public disclosure of meaningful order handling information? Are there other benefits or risks associated with publicly disclosing aggregated institutional order handling information?

83. Should the Commission require that each quarterly report be publicly available for a designated amount of time? If so, is three years a reasonable amount of time that the reports should be available? Would a shorter or longer period be more appropriate? How, if at all, would a shorter or longer disclosure period impact investors placing orders or broker-dealers? Please explain.

84. Should the Commission require all broker-dealers to make their aggregated institutional order handling reports available on one centralized Web site? For example, should all broker-dealer reports be available on the SEC's Web site? Alternatively, should the SEC's Web site have hyperlinks to the Web sites of broker-dealers where they display their aggregated reports? Why or why not?

85. As proposed, broker-dealers would be required to "make publicly available," as defined in Rule 600(b)(36) of Regulation NMS, their aggregated public institutional order handling reports, which means, among other things, that such reports must be posted on an Internet Web site that is free and readily accessible to the public. Do commenters believe that broker-dealers might place restrictions on or impediments to obtaining the reports from their own Web sites, such as requiring agreement with certain terms, conditions, or provisions prior to being provided access to the reports? If so, what would be the costs and benefits of those restrictions or impediments? Please explain.

86. Should the Commission require that the aggregated institutional order handling reports be filed with or

furnished to the SEC? Should the Commission require that the individual order handling reports provided to customers with institutional orders be filed with or furnished to the SEC? Why or why not?

#### B. Disclosures for Retail Orders

As noted above, changes to market structure and order routing practices have led the Commission to analyze the current requirements for retail orders under Rule 606. Currently, Rule 606 reports allow customers to assess order routing and execution services of broker-dealers with respect to retail orders. Additionally, the Rule 606 reports are used by broker-dealers as a means to compare their order routing and execution services to that of other firms.<sup>193</sup> Some market participants have stated that public disclosure of meaningful data in Rule 606 reports can assist broker-dealers in evaluating their own trade execution performance relative to other firms.<sup>194</sup> The Commission preliminarily believes that Rule 606 reports spur competition among broker-dealers to provide enhanced order routing services and better execution quality, which in turn motivates trading centers to deliver more efficient and innovative execution services as they compete for order flow. The Commission preliminarily believes that investors ultimately benefit from such enhanced competition, as broker-dealers continually seek to enhance their order routing and execution services to achieve better execution quality for their customers and to attract business from prospective customers.

To preserve the benefits of Rule 606 reports and keep pace with market developments, the Commission preliminarily believes that it is appropriate to update Rule 606 to provide customers with enhanced disclosure regarding a broker-dealer's retail order handling practices. As discussed above in detail, currently, Rule 606 requires, among other things, broker-dealers that route "retail" orders to publicly disclose, on a quarterly and

<sup>193</sup> See, e.g., NASDAQ Letter, *supra* note 19, at 20–21 (stating that, despite the fact that retail investors do not review 606 reports, the disclosure rules have positively impacted retail customers since the reports facilitate brokers' rigorous review of execution quality).

<sup>194</sup> See, e.g., TD Ameritrade Letter, *supra* note 19, at 3–4 (stating that Rule 606 reports have performed a vital role in adding transparency to market center execution practices and that retail investors reap the ultimate benefit of the statistics); and Scottrade, Quarterly Order Routing Disclosure, available at <https://www.scottrade.com/online-brokerage/trade-quality-execution.html> (stating that "enhanced, meaningful transparency can serve as a catalyst for driving competition amongst industry participants to the ultimate benefit of the investing public").

aggregated basis, certain information regarding non-directed orders in NMS securities by listing market and material aspects of relationships with Specified Venues.<sup>195</sup>

### 1. Marketable Limit Orders and Non-Marketable Limit Orders

Currently, with respect to what would be defined as “retail” orders by this proposal, Rule 606 distinguishes broadly between “market orders” and “limit orders.” Limit orders, however, fall into two categories: (1) Marketable limit orders, which are priced at or above the lowest offer in the market for a buy order or at or below the highest bid in the market for a sell order; and (2) non-marketable limit orders, which are priced to not execute immediately and seek to provide liquidity.<sup>196</sup> The distinction between a marketable and non-marketable limit order often is a significant factor in a broker-dealer’s order routing practices. Broker-dealers have several options when deciding to route their customers’ limit orders—they may (1) internalize and trade against customer order flow; (2) post the order; or (3) route the order to a third-party trading center.

The Commission preliminarily believes that, under the current rule, customers and other market participants cannot fully evaluate a broker-dealer’s limit order routing practice if both marketable and non-marketable limit orders are combined into a single order category. The Commission preliminarily believes that classifying limit orders into marketable and non-marketable limit orders would allow customers and other market participants to more fully assess a broker-dealer’s routing decisions for both types of orders and the potential impact on execution quality. The Commission also preliminarily believes that greater transparency between the routing practices of marketable and non-marketable limit orders would allow customers and other market participants to better assess whether broker-dealers are effectively managing their potential conflicts of interest. For example, the Commission understands that broker-dealers may be incentivized to route marketable and non-marketable limit orders to certain venues based on their fee or rebate schedule to the benefit of the broker-dealer. Providing greater public transparency between the routing practices of marketable and non-marketable limit orders could increase competition among broker-dealers and minimize the potential conflicts of

interest between maximizing revenue and the duty of best execution.<sup>197</sup>

Currently, Rule 606(a)(1)(i) requires every broker-dealer’s quarterly retail order routing report to include the percentage of total orders that were non-directed orders and the percentages of total non-directed orders that were market orders, limit orders, and other orders. In addition, Rule 606(a)(1)(ii) requires every broker-dealer’s quarterly report on retail order routing to include the identity of the ten venues to which the largest number of non-directed orders were routed for execution, as well as any venue to which five percent or more of non-directed orders were routed (*i.e.*, collectively, Specified Venues). The Commission proposes to amend Rule 606(a)(1)(i) and (ii) to split limit orders and separately disclose them as marketable and non-marketable.<sup>198</sup> In connection with this proposed new requirement, the Commission is proposing to amend Rule 600 of Regulation NMS to include the definition of the term “non-marketable limit order,” which is used in the proposed amendments to Rule 606(a). Specifically, the Commission proposes to define “non-marketable limit order” to mean “any limit order other than a marketable limit order.”<sup>199</sup>

The Commission requests comment on the proposed amendments to Rules 600 and 606(a)(1)(i) and (ii). In particular, the Commission solicits comment on the following:

87. Do commenters believe that broker-dealers use Rule 606 reports as a means to assess how their order routing and execution services compare to other firms? Do commenters believe that the reports encourage competition among broker-dealers? Why or why not? If so, do investors in turn benefit from such increased competition? Please provide data to support your arguments.

88. Do commenters believe that Rule 606 quarterly reports continue to provide useful information for customers placing retail orders in assessing the quality of order execution and the routing practices of their broker-dealers? Why or why not? If not, how could the reports be improved to provide more useful information to retail customers? Please explain.

89. Do commenters believe that the proposed definition of non-marketable limit order is appropriate to distinguish the types of limit orders? Why or why not? Should the proposed definition be

modified in any way? If so, please explain how.

90. Do commenters believe that separately reporting limit orders by marketable and non-marketable will enable customers placing retail orders to better understand broker-dealers’ routing decisions and impact on best execution? Are there other ways in which that information might be useful to customers? Do commenters believe that the separate disclosure of marketable and non-marketable limit orders will be useful to broker-dealers, and if so, how? Do commenters believe it will promote competition among broker-dealers? Please provide data to support your arguments.

91. Do commenters believe that market orders and marketable limit orders should be combined in the quarterly retail order routing report? Would such combination be useful to customers? If so, how? Please explain and provide support, if possible.

92. Should the Commission require the same disclosures for retail orders that it is proposing to require for institutional orders? Why or why not? Would any or all of the disclosures proposed above for institutional orders be appropriate or useful for evaluating order routing of retail orders? If so, would the proposed disclosures need to be modified in any way to be applied to retail orders? Please explain.

93. Are the venues that are required to be included on retail order routing reports appropriate? Should the requirement cover more or fewer venues than are currently included (*i.e.*, the ten to which the largest number of non-directed orders were routed for execution and any to which five percent or more of non-directed orders were routed)?

### 2. Net Payment for Order Flow and Transaction Fees and Rebates by Specified Venue

Currently, Rule 606 requires that a broker-dealer’s quarterly retail order routing report describe the material aspects of the broker-dealer’s relationship with each Specified Venue, including a description of any arrangement for payment for order flow or profit-sharing relationship.<sup>200</sup> The current disclosure requirement is intended to signal to investors the potential conflicts of interest that may influence a broker-dealer’s order routing decisions.<sup>201</sup> Generally, the description

<sup>197</sup> See Battalio, Corwin, and Jennings Paper, *supra* note 57, at 3 (finding that fill rates for displayed limit orders are lower on exchanges with higher take fees).

<sup>198</sup> See proposed Rule 606(a)(1)(i)–(ii).

<sup>199</sup> See proposed Rule 600(b)(51).

<sup>200</sup> See *supra* notes 26 and 27 and accompanying text.

<sup>201</sup> See Rule 606 Predecessor Adopting Release, *supra* note 15, at 75427 (stating that “[t]he purpose of requiring disclosure concerning the relationships between a broker-dealer and the venues to which

<sup>195</sup> See *supra* Section II.A.

<sup>196</sup> See Dolgoplov, *supra* note 55, at 234–235.

of any payment for order flow arrangement includes the material terms of the relationship, a description of the amounts per share or per order that the broker-dealer receives, and any transaction rebates.<sup>202</sup> Similarly, a broker-dealer that has entered into a profit-sharing relationship arrangement with a Specified Venue must disclose the extent to which it would share in profits derived from the execution of non-directed orders.<sup>203</sup>

As noted above, financial inducements to attract order flow have become more varied and may be a substantial source of revenue.<sup>204</sup> A significant percentage of retail orders are routed to OTC market makers and most broker-dealers that handle retail orders either receive payment for order flow in connection with the routing of orders or are affiliated with an OTC market maker that executes the orders.<sup>205</sup> The Commission understands that financial inducements to attract order flow may create conflicts of interest between maximizing revenue and broker-dealers' duty of best execution to their customers.

While Rule 606 currently requires public reports on order routing percentages to Specified Venues and a discussion of the broker-dealer's relationship with each Specified Venue, it does not require detailed disclosure of payment for order flow received, payment from any profit-sharing relationship received, or access fees or transaction rebates. As a result, the Commission preliminarily believes that customers have not received as complete a picture of a broker-dealer's

it routes orders is to alert customers to potential conflicts of interest that may influence the broker-dealer's order routing practices").

<sup>202</sup> See *id.*

<sup>203</sup> *Id.*

<sup>204</sup> See *supra* notes 71–74 and accompanying text. See also Battalio, Corwin, and Jennings Paper, *supra* note 57, at 15–16 ("Nine of the brokers route at least a portion of their orders to market makers that offer payment for marketable orders . . . Charles Schwab, Morgan Stanley, Edward Jones, Just2Trade, and LowTrade route all non-directed market and limit orders to market makers that purchase order flow (although LowTrade and Just2Trade indicate that they do not accept payment for order flow, Edward Jones reports 'no material economic relationship' with the market makers, and Morgan Stanley reveals no payment for order flow)").

<sup>205</sup> See *id.* In a typical payment for order flow arrangement, a broker-dealer is paid for sending retail orders to another broker-dealer, which will in turn trade with the retail orders out of its own inventory or route the order to another venue for execution. The internalizing broker-dealer is able to capture small profits on these trades, and is thus able to pay for the order flow which generates this profit. Moreover, retail order flow is considered to be less informed about near-term price movements and therefore particularly attractive to internalizing broker-dealers. See Concept Release on Equity Market Structure, *supra* note 2, at 3612.

activities to fully evaluate its broker-dealer's management of any potential conflicts of interest and the quality of their broker-dealers' retail order routing practices. The Commission further preliminarily believes that providing such data for specific order types would further enhance a customer's ability to assess their broker-dealers' retail order routing practices.

As such, the Commission proposes to amend Rule 606(a)(1) to include new subparagraph (iii) to require that, for each Specified Venue, the broker-dealer must report the net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received, both as a total dollar amount and on a per share basis, for each of the following non-directed order types: (1) Market orders; (2) marketable limit orders; (3) non-marketable limit orders; and (4) other orders.<sup>206</sup>

The Commission preliminarily believes identifying specific payment information received for each category of order type by Specified Venue would provide customers with useful information to more completely evaluate their broker-dealers' services. Specifically, the Commission preliminarily believes that providing the aggregate amount of payments and fees received is important to give investors and others a comprehensive overview of their broker-dealer. Additionally, the Commission preliminarily believes that payments and fees received in total dollar amounts per share for each order type would allow customers to have a stronger grasp on a broker-dealer's motivation to route to a particular Specified Venue, the management of any potential conflicts of interest, and provide more insight into their retail order routing practices. The Commission preliminarily believes that the greater transparency achieved by such detailed information would be useful to retail customers when selecting or re-evaluating a broker-dealer.

The Commission requests comment on the proposed detailed disclosure of payments received and fees paid for market, marketable limit, non-marketable limit, and other order types at each Specified Venue. In particular, the Commission solicits comment on the following:

94. Do commenters believe that requiring broker-dealers to disclose, for each Specified Venue, payment for order flow received, payment from any profit-sharing relationship received,

transaction fees paid, and transaction rebates received would enable customers placing retail orders to better assess their broker-dealers' management of potential conflicts of interest and quality of routing and execution services? Should the Commission require such information to be disclosed? Is there additional information that a customer could use to better assess their broker-dealer's conflicts of interest and quality of routing and execution services? Would requiring such disclosure affect broker-dealers' routing decisions? Please explain and provide support for your argument.

95. Do commenters believe that the proposal will permit customers placing retail orders to be able to better assess whether financial inducements impact their broker-dealer's order routing decisions for different types of orders and the execution quality of those orders? Why or why not?

96. Do commenters believe there are other specific categories of orders in addition to market orders, marketable limit orders, and non-marketable limit orders that should be included in the disclosure that would aid investors placing retail orders in assessing the quality of their order routing? Please provide support for your arguments.

97. Do commenters believe that broker-dealers should disclose the information required by proposed Rule 606(a)(1)(iii) for all orders, not just retail orders?

### 3. Discussion of Arrangement Terms With a Specified Venue

As noted above, Rule 606(a)(1)(iv) currently requires that a broker-dealer, in its quarterly Rule 606 report, provide a discussion of the material aspects of its relationship with a Specified Venue, including a description of any arrangement for payment for order flow and any profit-sharing relationship. In adopting the rule, the Commission stated that the description of a payment for order flow arrangement must include disclosure of the material aspects of the arrangement.<sup>207</sup> The Commission noted that material aspects of the arrangement should include a description of the terms of the arrangement, such as any amounts per share or per order that the broker-dealer receives.<sup>208</sup> While the Commission understands that certain terms, such as amounts per share or per order received, are important to a reasonable investor in evaluating a broker-dealer's routing practices, based

<sup>207</sup> See Rule 606 Predecessor Adopting Release, *supra* note 15, at 75427.

<sup>208</sup> See *id.*

<sup>206</sup> See proposed Rule 606(a)(1)(iii).

on market structure changes since the Rule 606 Predecessor Adopting Release, among other things, the Commission preliminarily believes that disclosure of any terms, written or oral, that may influence a broker-dealer's order routing decision would be useful for customers to assess the potential conflicts of interest facing broker-dealers when implementing their retail order routing decisions. Accordingly, the Commission preliminarily believes it should require broker-dealers to describe any terms, written or oral, of payment for order flow arrangements or profit-sharing relationships that may influence a broker-dealer's order routing decision in the discussion of a broker-dealer's relationship with a Specified Venue.

The Commission acknowledges that payment for order flow arrangements are intensively fact-based in nature and may vary across broker-dealers, nevertheless, the Commission preliminarily believes that disclosing the terms of such arrangements will provide more complete information for customers to better understand and evaluate a broker-dealer's retail order routing decision. In this regard, the Commission preliminarily believes that requiring broker-dealers to describe the terms of such arrangements with a Specified Venue that may influence their decision of where to route a retail order should serve to provide additional clarity to customers in evaluating a broker-dealer's retail order routing practices. The Commission preliminarily believes that the following are a non-exclusive list of terms of a payment for order flow arrangement or profit-sharing relationships that may influence a broker-dealer's order routing decision and would be required to be disclosed under the proposal: (1) Incentives for equaling or exceeding an agreed upon order flow volume threshold, such as additional payments or a higher rate of payment; (2) disincentives for failing to meet an agreed upon minimum order flow threshold, such as lower payments or the requirement to pay a fee; (3) volume-based tiered payment schedules; and (4) agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue.<sup>209</sup> The Commission preliminarily believes that these four types of terms reflect existing types of arrangements.

The Commission is proposing to require broker-dealers to disclose when a Specified Venue provides incentives for equaling or exceeding a volume threshold by offering additional payments or a higher rate of payment,

or conversely, disincentives for failing to meet an agreed upon minimum retail order flow threshold, such as a lower payment or charging a fee. The Commission understands that such arrangements may vary among venues, as well as for each broker-dealer sending orders to those venues, and some venues provide higher rebates for meeting or exceeding order flow quotas or charge financial penalties for failing to meet order flow quotas. The Commission preliminarily believes that such incentives and disincentives influence a broker-dealer's decision to either meet or route additional retail order flow to exceed the threshold, and should be disclosed to inform customers of their broker-dealer's conflicts of interest.

Further, the Commission is proposing to require broker-dealers to disclose any volume-based tiered payment schedules with a Specified Venue. Venues that offer these payment schedules typically offer incrementally higher rebates or lower fees to broker-dealers for additional retail order flow volume. The Commission preliminarily believes that these payment schedules can encourage a broker-dealer to route additional retail order flow to such venue in an effort to reap a financial benefit and should be disclosed. Additionally, the Commission is proposing to require broker-dealers to disclose agreements regarding the minimum amount of retail order flow that a broker-dealer would be required to send to a Specified Venue. These types of agreements typically specify that a broker-dealer must send a minimum number of orders or shares to a venue during a particular time period. The Commission preliminarily believes that such commitments for retail order flow may present conflicts of interest and should be disclosed. Finally, the Commission acknowledges that as market structure evolves, new types of arrangements not specifically listed may come about. The four arrangements referenced in Rule 606(a)(1)(iv) are not an exhaustive list of terms of payment for order flow arrangements or profit-sharing relationships that may influence a broker-dealer's retail order routing decision that would be required to be disclosed under the proposed rule. The proposed rule would require disclosure of *any* term of such arrangements that may influence a broker-dealer's retail order routing decision.

As described above, because certain terms of payment for order flow arrangements or profit-sharing relationships may encourage broker-dealers to direct their orders to a specific venue in order to achieve an economic benefit or avoid an economic

loss, potential conflicts of interest may arise. The Commission preliminarily believes that disclosure of such information would be useful for customers to assess the extent to which a broker-dealer's payment for order flow arrangements and profit-sharing relationships may potentially affect or distort the way in which retail orders are routed. The Commission further preliminarily believes that providing customers a comprehensive description of such quantifiable terms of a broker-dealer's relationship with a Specified Venue would allow them to fully appreciate the nature and extent of potential conflicts of interest facing their broker-dealers and assist them in evaluating the broker-dealers' management of such potential conflicts of interest.

The Commission requests comment on requiring broker-dealers to describe any terms of payment for order flow arrangements and profit-sharing relationships with a Specified Venue that may influence their retail order routing decisions. In particular, the Commission solicits comment on the following:

98. Do commenters believe that disclosure of any terms of payment for order flow arrangements and profit-sharing relationships that may influence order routing decisions is relevant for retail customers to understand and evaluate a broker-dealer's routing practices and handling of potential conflicts of interest? If so, do commenters believe that the Commission should require a description of these terms to be disclosed in the retail order routing reports? Why or why not? Please explain. Would requiring such disclosure affect broker-dealers' routing decisions?

99. Do commenters believe that broker-dealers should disclose the information required by proposed Rule 606(a)(1)(iv) for all orders, not just retail orders?

100. Do commenters believe that the four enumerated examples in proposed Rule 606(a)(1)(iv) reflect the types of payment for order flow arrangements and other profit-sharing relationships currently in practice? If not, how should their descriptions be modified and what other types of arrangements, if any, should be specified in the rule text?

101. Do commenters believe that there are other identifiable factors, beyond the four included in the proposed rule, that may influence a broker-dealer's order routing decisions for retail orders? If yes, what are the factors and should the rule specify those factors?

<sup>209</sup> See proposed Rule 606(a)(1)(iv).

102. Do commenters believe that incentives for equaling or exceeding an agreed upon order flow volume threshold influence a broker-dealer's order routing decision for retail orders? Why or why not? Please explain.

103. Do commenters believe that disincentives for failing to meet an agreed upon minimum order flow threshold influence a broker-dealer's order routing decision for retail orders? Why or why not? Please explain.

104. Do commenters believe that volume-based tiered payment schedules influence a broker-dealer's order routing decision for retail orders? Why or why not? Please explain.

105. Do commenters believe that agreements regarding the minimum amount of order flow that a broker-dealer would send to a venue influence a broker-dealer's order routing decision for retail orders? Why or why not? Please explain.

106. Do comments believe that both written and oral terms that may influence a broker-dealer's order routing decision should be required to be disclosed? Why or why not? Please explain.

#### 4. Additional Amendments to Retail Disclosures

The Commission is further proposing amendments to remove the requirement that Rule 606(a)(1) report be divided into three separate sections for securities listed on the NYSE, securities that are qualified for inclusion in NASDAQ, and securities listed on the American Stock Exchange.<sup>210</sup> First, the Commission notes that the language is stale, as NASDAQ is currently a national securities exchange and the American Stock Exchange is now known as NYSE MKT LLC.<sup>211</sup> Second, the Commission preliminarily believes that segmenting retail order routing reports by primary listing market is no longer necessary or particularly useful to customers placing retail orders because the handling of NMS stocks no longer varies materially based on the primary listing market and the primary listing market often is not the dominant market for the trading of its listed securities.<sup>212</sup> As noted earlier, in 2000, when Rule 606 was adopted, the primary listing markets looked and

operated very differently than they do today. For example, NYSE and the American Stock Exchange were primarily manual markets with limited electronic trading, while NASDAQ, not yet a national securities exchange, was a quote-driven dealer market. Today, with the adoption of Regulation NMS and the advances in technology, the primary listing markets are all dominated by electronic trading and the trading characteristics of securities listed on those markets may no longer warrant separating the routing report by primary listing market.<sup>213</sup> Accordingly, the Commission preliminarily believes that the division of reports by listing market is not particularly useful to retail customers interested in analyzing their broker-dealers' routing practices. While the Commission recognizes that eliminating the division of reports by the three distinct listing markets may potentially cause some reduction in informational content (as further discussed below), the Commission preliminarily believes that any diminution in granular listing market data is appropriate in light of the proposed new requirement to provide customers with pertinent retail order routing data that reflects today's multiple trading centers and practices.

The Commission is proposing that the public retail order routing reports required by Rule 606(a)(1) be broken down by calendar month.<sup>214</sup> Currently, Rule 606(a)(1) requires broker-dealers to make retail order routing reports publicly available for each calendar quarter, and such reports contain aggregate quarterly information on the routing of retail orders. As noted above, the Commission understands that trading centers frequently change their fee structures, including the amount of fees and rebates, in order to attract order flow, and such changes typically occur at the beginning of a calendar month. The changes in fee structures at trading centers may affect a broker-dealer's routing decisions. Disclosing retail order routing information on an aggregated quarterly basis can mask changes in routing behavior in response to changes in a trading center's fee structure. The Commission preliminarily believes that disclosing the information contained in the public retail order routing reports by calendar month would allow customers to better assess whether their broker-dealers' routing decisions are affected by changes in fee structures and the extent such changes affect execution

quality. Accordingly, similar to the proposed rule to require institutional order handling reports to be broken down by calendar month,<sup>215</sup> the Commission is proposing to amend Rule 606(a)(1) to require that public retail order routing reports also be broken down by calendar month.<sup>216</sup>

In addition, the Commission is proposing that the public retail order routing reports required by Rule 606(a)(1) and customer-specific retail order routing report required by Rule 606(b)(1) be made available using an XML schema and associated PDF renderer to be published on the Commission's Web site.<sup>217</sup> The Commission preliminarily believes that retail customers would have a similar interest as institutional customers in receiving the reports in a format that would allow them to use software applications to automatically recognize and process the information rather than having to manually enter the data to perform a comparison across broker-dealers. The Commission preliminarily believes that requiring both the public and customer-specific retail order routing reports to be provided in the proposed format should be useful to customers as it would allow them to more easily analyze and compare the data provided in both types of reports across broker-dealers, for the reasons discussed above.<sup>218</sup>

The Commission is also proposing to amend Rule 606(a)(1) to require every broker-dealer to keep the reports required pursuant to Rule 606(a)(1) posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site. Similar to the identical requirement proposed for the public aggregated institutional order handling report under proposed Rule 606(c), the Commission preliminarily believes that making this historical data available to customers and the public generally will be useful to those seeking to analyze past routing behavior of broker-dealers. Should the proposal be adopted, the requirement to post and maintain reports on an Internet Web site that is free and readily accessible to the public would begin at that time and apply going forward. Affected entities would not be required to post past reports created prior to the proposed Rule's effectiveness, but such entities would be neither prevented nor discouraged from posting such reports.

<sup>210</sup> See proposed Rule 606(a)(1).

<sup>211</sup> See *supra* note 76.

<sup>212</sup> For example, from February 2005 to February 2014, NYSE's market share in its listed securities declined from 78.9% to 20.1%. See Memorandum from the SEC Division of Trading and Markets to the SEC Market Structure Advisory Committee (April 30, 2015) ("Rule 611 Memo"), available at <http://www.sec.gov/spotlight/emsac/memo-rule-611-regulation-nms.pdf>.

<sup>213</sup> See FIF Letter, *supra* note 77, at 3 (stating that order routing practices are no longer based on listing market).

<sup>214</sup> See proposed Rule 606(a)(1).

<sup>215</sup> See *supra* Sections III.A.3. and III.A.4.

<sup>216</sup> See *id.*

<sup>217</sup> See proposed Rule 606(a)(1).

<sup>218</sup> See *supra* Section III.A.3.

Finally, the Commission proposes to insert the term “retail” in the heading of Rule 606(a),<sup>219</sup> to state “Quarterly report on *retail* order routing.” The Commission preliminarily believes that such distinction between retail order routing information referred to in Rule 606(a) and institutional order handling information proposed in Rule 606(b) will help clarify the requirements of broker-dealers’ reporting obligations under the Rules.

The Commission seeks comment on the proposed amendments to retail order routing disclosures. In particular, the Commission solicits comment on the following:

107. Do commenters believe that it continues to be useful for options to be included in disclosures for retail orders pursuant to Rule 606, in light of the fact that the proposal with respect to institutional orders would exclude options?

108. Should the Commission require retail order routing reports, both customer-specific and public, to be made available using an XML schema and associated PDF renderer? Why or why not?

109. Do commenters believe that broker-dealers should be required to provide the customer-specific and aggregated reports on retail order routing in the proposed format? Why or why not? Do commenters believe that it is useful to customers for broker-dealers to provide the reports in a structured XML format that would facilitate comparison of the data across broker-dealers? If not, why not? Should only the customer-specific report be provided in a structured XML format? Should only the aggregated report be provided in a structured XML format? Do commenters believe that it is useful to customers for broker-dealers to also provide the reports in an instantly readable PDF format? If not, why not? Are there other formats that would be more appropriate?

110. Do commenters believe that it is appropriate to remove the requirement to report retail order routing information by listing market (NYSE, NASDAQ, and the American Stock Exchange (n/k/a NYSE MKT LLC))? Why or why not?

111. Do commenters believe that the retail order routing report divided by the three listing markets continues to be relevant and useful to customers placing retail orders and/or analyzing their broker-dealer’s routing practices? Why or why not?

112. Do commenters believe that alternative or additional criterion should be required in reports regarding

retail order routing such as market capitalization or security type (e.g., exchange-traded products or NMS stocks)? If so, please explain why should such criterion be used to report retail order routing information? Please provide data to support your arguments.

113. Do commenters believe that retail order routing information organized by stocks included in the S&P 500 Index and stocks not included in the S&P 500 Index versus by listing market or by NMS stocks would be useful to customers? Why or why not? Please explain.

114. Do commenters believe that it is reasonable and appropriate to require that the retail order routing reports be broken down by calendar month? Should the Commission require the retail order routing reports be produced on a different frequency than quarterly (e.g., monthly)? Why or why not? What are the incremental burdens or benefits of providing reports at a different frequency? Please explain.

115. Do commenters believe that the Commission should require each retail order routing report be publicly available for a designated amount of time, as proposed? If so, is three years a reasonable amount of time that the reports should be available? Would a shorter or longer disclosure period be useful to investors and/or onerous to broker-dealers? Please explain.

116. Broker-dealers currently are required to make publicly available for each calendar quarter their quarterly reports on retail order routing and retain such reports for a period of not less than three years. Generally, broker-dealers will remove the previous quarterly report from their Web site and replace it with their most recent quarterly report. Since past quarterly reports are already required to be retained by broker-dealers, should the Commission require broker-dealers to make publicly available the prior three years’ worth of quarterly reports from the effective date of the rule? Why or why not?

117. Should the Commission require all broker-dealers to make their public retail order routing reports available on one centralized Web site? For example, should all broker-dealer reports be available on the SEC’s or an SRO’s Web site? Why or why not?

5. Amendment to Rule 600(b)(18) To Rename “Customer Order” to “Retail Order”

Finally, the Commission proposes to amend Rule 600(b)(18) to rename the defined term “customer order” to “retail order,” and to amend Rules 600(b)(19), 600(b)(23), 600(b)(48), 605, 606, and 607 to reflect such change. “Customer

order” is currently defined in Rule 600(b)(18) to include smaller-sized orders in NMS securities.<sup>220</sup> As discussed above, the Commission is proposing to define institutional order to include larger-sized orders in NMS stocks.<sup>221</sup> Since “retail” generally connotes orders of a smaller size and “institutional” generally connotes orders of a larger size, the Commission preliminarily believes it is appropriate to rename “customer order” to “retail order” in connection with this proposed rulemaking. The Commission preliminarily believes that such change would clarify to market participants that the defined terms are based on the size of the order.

The Commission requests comment on the proposal to rename the defined term “customer order” to “retail order.” In particular, the Commission solicits comment on the following:

118. Do commenters believe that the proposed change is appropriate? Do commenters believe that such change would provide clarity to market participants? Are there alternative ways to distinguish small and large-sized orders? Please provide support for your arguments.

### C. Amendment to Disclosure of Order Execution Information

The Commission is proposing to amend Rule 605(a)(2) to require market centers to keep reports required pursuant to Rule 605(a)(1) posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site. Similar to the analogous requirements proposed in Rules 606(a) and 606(c) described above, the Commission preliminarily believes that making past order execution information available to customers and the public generally for a specified period of time will be beneficial to those seeking to analyze historical order execution information at various market centers. Should the proposal be adopted, the requirement to post and maintain reports on an Internet Web site that is free of charge and readily accessible to the public would begin at that time and apply going forward. Affected entities would not be required to post reports covering periods prior to the proposed Rule’s effectiveness.

The Commission requests comment on the proposed amendments to the disclosure of order execution

<sup>220</sup> See 17 CFR 242.600(b)(18) and *supra* note 7 and accompanying text.

<sup>221</sup> See proposed Rule 600(b)(31) and *supra* Section III.A.1.

<sup>219</sup> See proposed Rule 606(a).

information. In particular, the Commission solicits comment on the following:

119. Do commenters believe that the monthly electronic reports required by Rule 605(a) should be publicly available for a designated amount of time? If so, is three years a reasonable amount of time that the reports should be available? Would a shorter or longer disclosure period be useful to investors placing institutional orders and/or onerous to broker-dealers? Please explain.

#### IV. Paperwork Reduction Act

Certain provisions of these proposed amendments contain “collection of information requirements” within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>222</sup> The Commission is submitting these collections of information to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The current collection of information for Rule 606 entitled “Disclosure of order routing information” is being modified in a way that creates new collection of information burden estimates and modifies existing collection of information burden estimates. The existing collection of information for Rule 605 entitled “Disclosure of order execution information” is being modified in manner that does not alter the collection of information burden estimate. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the agency displays a currently valid control number.

##### A. Summary of Collection of Information

The proposed amendments to Rule 606 would include a collection of information within the meaning of the PRA for broker-dealers who receive and route retail and institutional orders.

##### 1. Customer Requests for Information on Institutional Orders

As detailed above, proposed Rule 606(b)(3) of Regulation NMS would require a broker-dealer, on request of a customer that places, directly or indirectly, an institutional order with the broker-dealer, to electronically disclose to such customer within seven business days of receiving the request, a report on the broker-dealer’s handling of institutional orders for that customer for the prior six months, broken down by calendar month. Specifically, the report would contain certain

information on the customer’s order flow with the reporting broker-dealer as well as certain columns of information on institutional orders handled by the broker-dealer, as described below, categorized by venue and by order routing strategy category—passive, neutral, and aggressive—for each venue. The required columns of information include four groups of information: (1) Information on institutional order routing; (2) information on institutional order execution; (3) information on institutional orders that provided liquidity; and (4) information on institutional orders that removed liquidity.<sup>223</sup>

With regard to information about the customer’s order flow with the reporting broker-dealer, the Commission is proposing to require disclosure of: (1) Total number of shares of institutional orders sent to the broker-dealer by the customer during the reporting period; (2) total number of shares executed by the broker-dealer as principal for its own account; (3) total number of institutional orders exposed by the broker-dealer through an actionable indication of interest; and (4) venue or venues to which institutional orders were exposed by the broker-dealer through an actionable indication of interest.<sup>224</sup>

With regard to information on institutional order routing, the Commission is proposing to require disclosure of: (1) Total shares routed; (2) total shares routed marked immediate or cancel; (3) total shares routed that were further routable; (4) average order size routed.<sup>225</sup>

With regard to information on institutional order execution, the Commission is proposing to require disclosure of: (1) Total shares executed; (2) fill rate;<sup>226</sup> (3) average fill size;<sup>227</sup> (4) average net execution fee or rebate;<sup>228</sup> (5) total number of shares executed at the midpoint; (6) percentage of shares executed at the midpoint; (7) total number of shares executed that were priced on the side of the spread more favorable to the institutional order; (8) percentage of total shares executed that were priced on the side of the spread more favorable to the institutional order; (9) total number of shares executed that were priced on the side of the spread

less favorable to the institutional order; and (10) percentage of total shares executed that were priced on the side of the spread less favorable to the institutional order.<sup>229</sup>

With regard to information on institutional orders that provided liquidity, the Commission is proposing to require disclosure of: (1) Total number of shares executed of orders providing liquidity; (2) percentage of shares executed of orders providing liquidity; (3) average time between order entry and execution or cancellation for orders providing liquidity (in milliseconds); and (4) average net execution rebate or fee for shares of orders providing liquidity (cents per 100 shares, specified to four decimal places).<sup>230</sup>

Finally, with regard to information on institutional orders that removed liquidity, the Commission is proposing to require disclosure of: (1) Total number of shares executed of orders removing liquidity; (2) percentage of shares executed of orders removing liquidity; and (3) average net execution fee or rebate for shares of orders removing liquidity (cents per 100 shares, specified to four decimal places).<sup>231</sup>

##### 2. Public Aggregated Report on Institutional Orders

Proposed Rule 606(c) of Regulation NMS would require a broker-dealer that receives institutional orders to make publicly available a report that aggregates the information required for customer-specific reports pursuant to proposed Rule 606(b)(3) for all institutional orders the broker-dealer receives, regardless of whether the information was requested by a customer and that such report would be broken down by calendar month. A broker-dealer would be required to make such report publicly available for each calendar quarter within one month after the end of the quarter. Broker-dealers would also be required to keep such reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

##### 3. Requirement To Document Methodologies for Categorizing Institutional Order Routing Strategies

Proposed Rule 606(b)(3)(v) would require broker-dealers to provide the required information for each venue broken down and classified by the

<sup>223</sup> See *supra* Section III.A.4.

<sup>224</sup> See proposed Rule 606(b)(3).

<sup>225</sup> See proposed Rule 606(b)(3)(i)(A)–(D).

<sup>226</sup> Fill rate would be calculated by the shares executed divided by the shares routed.

<sup>227</sup> Average fill size would be the average size, by number of shares, of each order executed on the venue.

<sup>228</sup> The fee and rebate would be measured in cents per 100 shares.

<sup>229</sup> See proposed Rule 606(b)(3)(ii)(A)–(I).

<sup>230</sup> See proposed Rule 606(b)(3)(iii)(A)–(D).

<sup>231</sup> See proposed Rule 606(b)(3)(i)(A)–(C).

<sup>222</sup> 44 U.S.C. 3501 *et seq.*

following order routing strategy category: (1) "Passive order routing strategy," which emphasize the minimization of price impact over the speed of execution of the entire institutional order; (2) "neutral order routing strategy," which are relatively neutral between the minimization of price impact and the speed of execution of the entire institutional order; and (3) "aggressive order routing strategy," which emphasize the speed of execution of the entire institutional order over the minimization of price impact. The proposed rule would require the broker-dealer to assign each order routing strategy that it uses for institutional orders to one of these three categories in a consistent manner for each report it prepares, promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments, and to document the specific methodologies it relies upon for making such assignments. The Commission is proposing to require every broker-dealer to preserve a copy of the methodologies used to assign its order routing strategies and maintain such copy as part of its books and records in a manner consistent with Rule 17a-4(b) under the Exchange Act.

#### 4. Amendment to Current Disclosures With Respect to Retail Orders

The proposed amendments to Rule 606(a) of Regulation NMS would: (1) Break down the existing limit order disclosure into separate categories of marketable limit orders and non-marketable limit orders; (2) require that for each Specified Venue, the broker-dealer must report the net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received, both as a total dollar amount and on a per share basis, for each of the following order types: (i) Market orders; (ii) marketable limit orders; (iii) non-marketable limit orders; and (iv) other orders; (3) require broker-dealers to describe specific aspects of any terms of payment for order flow arrangements and profit-sharing relationships, whether written or oral, with a Specified Venue that may influence their order routing decisions, including: (i) Incentives for equaling or exceeding an agreed upon order flow volume threshold, such as additional payments or a higher rate of payment; (ii) disincentives for failing to meet an agreed upon minimum order flow threshold, such as lower payments or the requirement to pay a fee; (iii) volume-based tiered payment

schedules; and (iv) agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue; (4) require that such reports be broken down by calendar month; (5) require that such reports be kept posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site; and (6) remove the requirement that the Rule 606(a)(1) report be divided into three separate categories by listing market. Instead, the information required under Rule 606(a)(1) would be aggregated for all NMS stocks. The proposed amendments would require reports produced pursuant to Rules 606(a) and 606(b)(1) to be formatted in the most recent versions of the XML schema and the associated PDF renderer as published on the Commission's Web site.

#### 5. Amendment to Current Disclosures Under Rule 605

The Commission is proposing to amend Rule 605(a)(2) to require market centers to keep reports required pursuant to the Rule 605(a)(1) posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

#### B. Proposed Use of Information

Generally, the order routing disclosures required under the proposed amendments to Rule 606 would provide detailed information to both institutional and retail customers that would enable them to evaluate how their orders were routed by their broker-dealers, assess conflicts of interest facing their broker-dealers in providing order routing services, and have the ability to engage in informed discussions with their broker-dealers about the broker-dealer's order routing practices. The proposed order routing disclosures could inform future decisions on whether to retain a broker-dealer's order routing services or engage the order routing services of a new broker-dealer. In addition, broker-dealers may use the public disclosures to compete on the basis of order routing services, and academics and others may use the public disclosures pursuant to Rules 605 and 606 to review and analyze broker-dealer routing practices and trading center order executions.

#### 1. Customer Requests for Information on Institutional Orders

The order handling disclosures proposed under Rule 606(b)(3) would provide detailed order routing and

execution information to a customer regarding its specific institutional orders during the reporting period. Generally, the five groups of information contained in the institutional order handling report would enable customers to understand where and how their institutional orders were routed or exposed as well as where their orders were executed during the reporting period. Customers could use the information contained in an institutional order handling report to assess any considerations a broker-dealer may have faced when routing its orders to various venues, whether those considerations may have affected how a broker-dealer routed its orders, and whether those considerations may have affected its execution equality.

Specifically, customers would be able to review each venue to which their institutional orders were routed and identify potential conflicts of interest, affiliations, or business arrangements between their broker-dealer and the venue and assess whether large volumes of orders or certain order types were directed to venues from which the broker-dealer may receive significant economic benefit. The information provided in the institutional order handling report could further be used by customers to assess whether a broker-dealer's order routing practices may have led to risks of information leakage. In addition, the information contained in the institutional order handling report would enable investors to assess, monitor, and generally determine the overall execution quality received from a broker-dealer. As noted above, customers could use the proposed order handling disclosures to inform future decisions on whether to retain a broker-dealer's order routing services or engage the order routing services of a new broker-dealer.

#### 2. Public Aggregated Report on Institutional Orders

Proposed Rule 606(c) would require a broker-dealer that receives institutional orders to make publicly available a report that aggregates the information enumerated in proposed Rule 606(b)(3), even if not requested by a customer. The proposed public aggregated institutional order handling reports would enable customers to use a standardized set of information to compare how broker-dealers handle institutional orders and use such information in determining whether to retain the services of a broker-dealer or engage the services of a new broker-dealer. Broker-dealers could use the aggregated information to compare its order handling services against other broker-dealers, which

could improve competition among broker-dealers on the basis of order routing and execution quality. In addition, academic researchers and others could use the public aggregated institutional order handling information for research and analysis. Further, third-party vendors offering analytical services may use the information in the public reports in an attempt to sell customized reporting tools and services.

### 3. Requirement to Document Methodologies for Categorizing Institutional Order Routing Strategies

Broker-dealers would assign order routing strategies into passive, neutral, and aggressive categories, applying consistent classification of their order routing strategies for purposes of producing customer-specific and public aggregated institutional order handling reports, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments. Regulators, including the Commission, could use the documented methodologies as a reference in determining whether a broker-dealer is consistently classifying and applying its order routing strategies for reporting purposes.

### 4. Amendment to Current Disclosures With Respect to Retail Orders

The proposed amendment to Rule 606(a) to break down the existing limit order disclosure in the retail order routing reports into separate categories of marketable limit orders and non-marketable limit orders could be used by customers to assess the differences in the ways broker-dealers route these specific order types. Customers could use the information contained in the retail order routing reports to assess potential conflicts of interest its broker-dealers face with respect to routing these distinct order types, particularly with respect to the economic incentives received from trading centers. Customers could use this information to determine whether to retain a broker-dealer's services or engage the services of a new broker-dealer, which could foster competition among broker-dealers on the basis of quality of order routing and execution. In addition, academic researchers and others could use this information for research and analysis.

The proposed requirement that a broker-dealer disclose the net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received, both as a total dollar amount and on a per share basis, for

specified non-directed order types for each Specified Venue could allow customers to determine how broker-dealers route different types of orders relative to any economic benefit or consequence to the broker-dealer. Customers could use this information to further assess whether their broker-dealers' routing decisions may be influenced by conflicts of interest. The requirement in proposed Rule 606(a)(1) that the quarterly reports be broken down by calendar month could allow customers to determine whether and how their broker-dealer's routing decisions changed in response to changing fee and rebate structures in the marketplace, which often change at the beginning of a calendar month. The proposed requirement that such reports be kept posted on an Internet Web site for three years could allow customers and others, such as researchers, to analyze historical routing behavior of particular broker-dealers. In addition, the proposed requirement for broker-dealers to describe any terms of payment for order flow arrangements and profit-sharing relationships with a Specified Venue that may influence their order routing decisions, including information relating to specific incentives or volume minimums, could allow customers to understand how their broker-dealers route retail orders and whether and how such routing is influenced by payment for order flow and/or a profit-sharing relationship.

### 5. Amendment to Current Disclosures Under Rule 605

The requirement that reports required under Rule 605 be kept posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site could allow customers and others, such as researchers, to analyze historical order execution quality at various market centers. The three years of data could be useful to those seeking to analyze how execution quality has changed over time, in addition to changes in response to regulatory or other developments.

### C. Respondents

The respondents to these proposed amendments would be broker-dealers that route retail or institutional orders and market centers that create reports pursuant to Rule 605. As of December 2015, the Commission estimates that there were approximately 4,156 total registered broker-dealers.<sup>232</sup> Of these,

<sup>232</sup> The Commission is basing its estimate off data compiled from responses to Form BD.

the Commission estimates 266 are broker-dealers that route retail orders.<sup>233</sup> The Commission estimates that 200 broker-dealers are involved in the practice of routing institutional orders, all of whom also route retail orders.<sup>234</sup> The Commission estimates that there are 380 market centers to which Rule 605 applies.<sup>235</sup> The Commission requests comment on the accuracy of these estimated figures.

### D. Total Initial and Annual Reporting and Recordkeeping Burdens

#### 1. Customer Requests for Information on Institutional Orders

##### a. Initial Reporting and Recordkeeping Burden

The Commission preliminarily believes that many broker-dealers that route institutional orders already create and retain the order handling information required by the proposed changes to Rule 606(b)(3). In such cases, the initial burden to comply with the requirement would be significantly lower than for a broker-dealer whose systems do not already create and retain the required information. In addition, the Commission preliminarily believes that many broker-dealers who do not have proprietary systems which create and retain order handling information use third-party service providers to allow them to create and retain the information required by the proposed changes to Rule 606(b)(3). For this reason, the Commission is providing two estimates below, one for broker-dealers that route institutional orders whose systems do not currently support creating and retaining the information required by Rule 606(b)(3) who will upgrade their systems either in-house or via a third-party service provider, and another for broker-dealers that route institutional orders whose systems currently do create and retain such information, including those that use a third-party service provider whose systems currently obtain such information.

The Commission preliminarily believes that most broker-dealers either have systems that currently obtain the

<sup>233</sup> See *id.* The Commission estimates that both clearing brokers and introducing brokers route retail orders. The Commission notes that the term "retail order" refers to "customer order" defined in Rule 600 (b)(18) of Regulation NMS. See *supra* note 7 and accompanying text.

<sup>234</sup> See *id.* Using Form BD data, the Commission estimates that clearing brokers and some introducing brokers route institutional orders.

<sup>235</sup> The Commission derived this estimate based on the following: 236 OTC market makers (not including market makers claiming an exemption from the reporting requirements of the Rule), plus 12 exchanges, 1 securities association, 86 exchange market makers, and 45 ATSS.

information required by the proposed rule, or use third-party service providers who have systems that obtain such information. The Commission further preliminarily believes that all broker-dealers have systems in place that at least capture some of the information required by the proposed rule. Of the 200 broker-dealers involved in routing institutional orders, the Commission estimates that 25 broker-dealers that route institutional orders do not currently have systems that obtain all of the information required by the proposed amendments.<sup>236</sup> The Commission estimates that these 25 broker-dealers would be able to perform the required enhancements in-house, but could also use a third-party service provider. As discussed further below, the Commission further estimates that, after required systems enhancements were performed, all broker-dealers would capture the necessary information in-house, but some broker-dealers would create the required reports in-house, while other broker-dealers would engage third parties to create the reports.

Based on discussions with industry sources, the Commission estimates that the average one-time, initial burden for broker-dealers that route institutional orders that do not currently create and retain the proposed order handling information to program systems in-house to implement the requirements of the proposed amendments to Rule 606(b)(3) in-house would be 200 hours<sup>237</sup> per broker-dealer. The Commission estimates the average one-time, initial burden for broker-dealers that route institutional orders that do not currently create and retain the proposed order handling information to engage a third-party to program the broker-dealers' systems to implement the requirements of the proposed amendments to Rule 606(b)(3) to be 50

hours<sup>238</sup> and \$35,000.<sup>239</sup> The Commission estimates that of the 25 broker-dealers that route institutional orders who do not currently have systems in place to capture the information required by the rule, 10 such broker-dealers will perform the necessary programming upgrades in-house, and 15 will engage a third-party to perform the programming upgrades. Additionally, of the 25 broker-dealers that route institutional orders who do not currently have systems in place to capture the information required by the proposed rule, the Commission estimates that 10 such broker-dealers will need to purchase hardware and software upgrades to fulfill the requirements of the proposed rule at an average cost of \$15,000 per broker-dealer, and that the remaining 15 broker-dealers have adequate hardware and software to capture the information proposed by the rule. Therefore, the total initial burden for broker-dealers that route institutional orders who do not currently capture order handling information required by the proposed rule to program their systems to produce a report to comply with the proposed rule change is 2,750 hours<sup>240</sup> and \$675,000.<sup>241</sup>

A broker-dealer that routes institutional orders whose systems already capture the data required by the proposed rule would need to format its systems to produce a report that complies with the proposed rule. The Commission estimates the average burden for a broker-dealer who already captures information required by the proposed rule to format its systems to

<sup>236</sup> The Commission estimates the monetized burden for this requirement to be \$15,125. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: (Compliance Manager at \$283 per hour for 20 hours) + (Sr. Business Analyst at \$251 per hour for 15 hours) + (Attorney at \$380 per hour for 15 hours) = 200 hours and \$15,125. This burden hour estimate was based on discussions with various industry participants.

<sup>237</sup> The Commission estimates that, on average, a third-party service provider would charge \$35,000 to perform the necessary work.

<sup>240</sup> 200 hours per broker-dealer who routes institutional orders who does not currently obtain data required by the proposed rule who will upgrade its own systems × 10 such broker-dealers + 50 hours per broker-dealer who will engage a third-party to perform the necessary systems upgrades × 15 such broker-dealers = 2,750 hours. The Commission estimates the total monetized burden for this requirement to be \$831,075 (10 routing broker-dealers who will perform upgrades in-house × \$60,420 = \$604,200) + (15 broker-dealers who will engage a third-party × \$15,125 = \$226,875) = \$831,075. See *supra* notes 237 and 238.

<sup>241</sup> (\$35,000 per broker-dealer who will engage a third-party × 15 such broker-dealers) + (\$15,000 per broker-dealer who will need to purchase hardware and software upgrades × 10 such broker-dealers) = \$675,000. See *supra* note 239.

produce a report to comply with the proposed rule would be 40 hours.<sup>242</sup> The Commission estimates that 125 broker-dealers would format systems to produce the reports in-house. A broker-dealer that routes institutional orders who uses a third-party service provider to produce reports using such order handling information would need to need to work with the vendor to ensure the proper data is captured in the reports. The Commission estimates 50 broker-dealers that route institutional orders would use a third-party vendor to ensure data required by the rule is captured in the reports. The Commission estimates the average burden for a broker-dealer who uses a third-party service provider to work with such service provider to ensure proper reports are produced would be 20 hours<sup>243</sup> and \$5,000.<sup>244</sup> The Commission preliminarily believes that broker-dealers whose systems currently capture and retain information required by the rule would not need to purchase hardware or software upgrades. Thus, the total burden for broker-dealers who currently obtain the required data but need to format their systems, or work with their data provider, to prepare a report to comply with the proposed rule is 6,000 hours<sup>245</sup> and \$250,000.<sup>246</sup>

<sup>242</sup> The Commission estimates the monetized burden for this requirement to be \$12,084. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: (Sr. Programmer at \$303 per hour for 20 hours) + (Sr. Database Administrator at \$312 per hour for 8 hours) + (Sr. Business Analyst at \$251 per hour for 8 hours) + (Attorney at \$380 per hour for 4 hours) = 40 hours and \$12,084.

<sup>243</sup> The Commission estimates the monetized burden for this requirement to be \$5,726. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: (Compliance Manager at \$283 per hour for 14 hours) + (Sr. Business Analyst at \$251 per hour for 4 hours) + (Attorney at \$380 per hour for 2 hours) = 20 hours and \$5,726.

<sup>244</sup> The Commission estimates a third-party service provider working with a broker-dealer whose systems currently capture and retain information required by the rule would, on average, charge \$5,000 to program the systems to create a report that complies with the rule.

<sup>245</sup> 40 hours per broker-dealer who needs to format its systems to prepare a report × 125 broker-dealers who need to format their systems to prepare a report + 20 hours per broker-dealer who needs to work with a third-party vendor to ensure a proper report is produced × 50 broker-dealers who need to work with third-party vendors = 6,000 hours. The Commission estimates the monetized burden for this requirement to be \$1,796,800 (\$12,084 per broker-dealer who needs to format its systems to prepare a report × 125 such broker-dealers + \$5,726 per broker-dealer who needs to work with a third-party vendor to ensure a proper report is produced × 50 such broker-dealers = \$1,796,800). See *supra* notes 242 and 243.

<sup>246</sup> \$5,000 per broker-dealer who works with a third-party vendor to ensure proper reports are

<sup>236</sup> This estimate was based on discussions with various industry participants.

<sup>237</sup> The Commission estimates the monetized burden for this requirement to be \$60,420. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: (Sr. Programmer at \$303 per hour for 100 hours) + (Sr. Database Administrator at \$312 per hour for 40 hours) + (Sr. Business Analyst at \$251 per hour for 40 hours) + (Attorney at \$380 per hour for 20 hours) = 200 hours and \$60,420. This burden hour estimate was based on discussions with various industry participants.

Therefore, the estimated total initial burden to comply with proposed Rule 606(b)(3) is 8,750 hours<sup>247</sup> and \$925,000.<sup>248</sup>

The Commission requests comment regarding the accuracy of its estimate as to how many broker-dealers that route institutional orders are currently able to obtain the information required by the proposed rules and the estimated burden hours necessary to comply with the proposal.

#### b. Annual Reporting and Recordkeeping Burden

Proposed Rule 606(b)(3) requires broker-dealers to respond to individual customer requests for information on institutional orders. The Commission estimates that 135 of the 200 broker-dealers that route institutional orders would respond to proposed Rule 606(b)(3) requests in-house.<sup>249</sup> The Commission estimates that an average response to a Rule 606(b)(3) request for a broker-dealer who responds to such requests in-house will take approximately 2 hours per response.<sup>250</sup> The Commission estimates that an average broker-dealer will receive

produced  $\times$  50 such broker-dealers = \$250,000. See *supra* note 244.

<sup>247</sup> 2,750 hours for broker-dealers who need to format their systems to obtain the information required by the proposed rule and prepare reports + 6,000 hours for broker-dealers who currently obtain such information and need to format their systems or work with their third-party vendor to prepare a report to comply with the rule = 8,750 hours. The Commission estimates the total monetized burden for this requirement to be \$2,627,875 (\$831,075 for broker-dealers who need to format their systems either on their own or by using a third-party to obtain the information required by the proposed rule + \$1,796,800 for broker-dealers who currently obtain such information and need to format their systems or work with their third-party vendor to prepare a report to comply with the rule = \$2,627,875). See *supra* notes 240 and 245.

<sup>248</sup> (\$35,000 per broker-dealer who will engage a third-party  $\times$  15 such broker-dealers) + (\$15,000 per broker-dealer who will need to purchase hardware and software upgrades  $\times$  10 such broker-dealers) + (\$5,000 per broker-dealer who works with a third-party vendor to work with such vendor to ensure proper reports are produced  $\times$  50 such broker-dealers) = \$975,000. See *supra* notes 241 and 246.

<sup>249</sup> The Commission estimates that the 125 broker-dealers estimated already to capture the information that would be required plus the 10 broker-dealers that would do systems work in-house who do not currently capture the information that would be required would respond to Rule 606(b)(3) requests in-house.

<sup>250</sup> Based on discussions with industry participants, the Commission estimates that each response will require a Jr. Business Analyst for 1 hour and a Programmer Analyst for 1 hour. Thus, the burden estimate is calculated as follows: Jr. Business Analyst at \$160 per hour for 1 hour, and a Programmer Analyst at \$220 per hour for 1 hour, for a total burden of 2 hours and \$380 per report. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*.

approximately 200 requests annually.<sup>251</sup> Therefore, on average, a broker-dealer who responds to 606(b)(3) requests in-house will incur an estimated annual burden of 400 hours to prepare, disseminate, and retain responses to customers required by Rule 606(b)(3).<sup>252</sup> With an estimated 135 broker-dealers who route institutional orders who will respond to 606(b)(3) requests in-house, the estimated total annual burden for such 135 broker-dealers to comply with the customer response requirement in proposed Rule 606(b)(3) is 54,000 hours.<sup>253</sup>

For the 65 broker-dealers that route institutional orders who are anticipated to use a third-party service provider to respond to requests pursuant to Rule 606(b)(3), the Commission estimates the burden to be 1 hour<sup>254</sup> and \$100 per response.<sup>255</sup> With an estimated 200 requests pursuant to Rule 606(b)(3) per year, the Commission estimates that on average, the annual burden for a broker-dealer who uses a third-party service provider to respond to requests pursuant to Rule 606(b)(3) will be 200 hours<sup>256</sup> and \$20,000. With an estimated 65 broker-dealers that route institutional orders who will respond to Rule 606(b)(3) requests using a third-party-service provider, the Commission estimates the total annual burden for

<sup>251</sup> This estimate was based on discussions with various industry participants.

<sup>252</sup> 2 hours per request  $\times$  200 annual requests = 400 hours. The Commission estimates the total monetized burden for this requirement to be \$76,000 annually (200 annual requests  $\times$  \$380 per request = \$76,000). See *supra* note 250.

<sup>253</sup> 400 hours annually per broker-dealer that routes institutional orders who will respond to requests in-house  $\times$  135 such broker-dealers = 54,000 hours. The Commission estimates the total monetized burden for this requirement to be \$10,260,000 (\$76,000 per broker-dealer that routes institutional orders that will respond to requests in-house  $\times$  135 such broker-dealers = \$10,260,000). See *id.*

<sup>254</sup> The Commission estimates the monetized burden for this requirement to be \$283. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Compliance Manager at \$283 per hour for 1 hour = \$283.

<sup>255</sup> The Commission estimates a third-party service provider would charge on average \$100 to respond to requests pursuant to the rule.

<sup>256</sup> 1 hour per broker-dealer who will use a third-party service provider per request  $\times$  200 requests annually = 200 hours. The Commission estimates the monetized burden for this requirement to be \$56,600 (200 annual requests  $\times$  \$283 per request = \$56,600). See *supra* note 254.

such 65 broker-dealers will be 13,000 hours<sup>257</sup> and \$1,300,000.<sup>258</sup>

Therefore, the total annual burden for all 200 broker-dealers that route institutional orders to comply with the customer response requirement in proposed Rule 606(b)(3) is estimated to be 67,000 hours<sup>259</sup> and \$1,300,000.<sup>260</sup>

#### 2. Public Aggregated Report on Institutional Orders

##### c. Initial Reporting and Recordkeeping Burden

Once a broker-dealer that routes institutional orders has systems in place to record and report the information required by proposed Rule 606(b)(3) to individual customers, the broker-dealer creating the quarterly public aggregated institutional order handling reports in-house will need to configure its systems to aggregate the information required by proposed Rule 606(c) or use a third-party service provider to create such reports. Once the systems to obtain such information are in place, the Commission estimates that broker-dealers or their third-party service providers would incur a modest additional burden or cost to format such data into an aggregated report. The Commission estimates that some broker-dealers will format these reports themselves in-house while others will use a third-party service provider to format the reports. The Commission estimates that a broker-dealer who routes institutional orders which formats and creates the required reports itself would incur an initial burden of 20 hours to comply with the quarterly reporting requirement of proposed Rule 606(c).<sup>261</sup> The Commission estimates

<sup>257</sup> 200 hours annual per broker-dealer who will use a third-party service provider  $\times$  65 such broker-dealers = 13,000 hours. The Commission estimates the monetized burden for this requirement to be \$3,679,000 (\$56,600 annually per broker-dealer who will use a third-party service provider  $\times$  65 such broker-dealers = \$3,679,000). See *id.*

<sup>258</sup> \$100 per request  $\times$  200 requests annually  $\times$  65 broker-dealers who will use a third-party service provider = \$1,300,000. See *supra* note 255.

<sup>259</sup> 400 hours annually per broker-dealer that routes institutional orders who will respond to requests in-house  $\times$  135 such broker-dealers + 200 hours annually per broker-dealer who routes institutional orders who will use a third-party to respond to requests  $\times$  65 such broker-dealers = 67,000 hours. The Commission estimates the total monetized burden for this requirement to be \$13,939,000 (\$10,260,000 for broker-dealers that route institutional orders who will respond to requests in-house + \$3,679,000 for broker-dealers that route institutional orders who will use a third-party service provider to respond to requests = \$13,939,000). See *supra* notes 253 and 257.

<sup>260</sup> See *supra* note 258.

<sup>261</sup> The Commission estimates the monetized burden for this requirement to be \$4,990. The Commission derived this estimate based on per hour figures from SIFMA's *Management &*

Continued

that a broker-dealer who uses a third-party service provide to create the necessary reports would incur an initial burden of 5 hours<sup>262</sup> and \$2,500.<sup>263</sup> The Commission estimates that consistent with the estimates above about reports pursuant to proposed Rule 606(b)(3), 135 broker-dealers who route institutional orders will create the required reports themselves while 65 broker-dealers will use a third-party service provider to create the required reports. Therefore, the estimated total initial burden for broker-dealers that route institutional orders to produce the quarterly report is 3,025 hours<sup>264</sup> and \$162,500.<sup>265</sup>

#### d. Annual Reporting and Recordkeeping Burden

The Commission estimates that each broker-dealer that routes institutional orders who prepares its reports in-house will incur an average burden of 10 hours<sup>266</sup> to prepare and make publicly available a quarterly report in the format required by proposed Rule 606(c), or a burden of 40 hours per year.<sup>267</sup> Once a report is posted on an internet Web site,

*Professional Earnings in the Securities Industry 2013*: Programmer at \$248 per hour for 10 hours + Sr. Business Analyst at \$251 per hour for 10 hours = 20 hours and \$4,990.

<sup>262</sup> The Commission estimates the monetized burden for this requirement to be \$1,415. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Compliance Manager at \$283 per hour for 5 hours = \$1,415.

<sup>263</sup> The Commission estimates a third-party service provider would charge on average \$2,500 to format a broker-dealer's data to produce a report to comply with the rule.

<sup>264</sup> 20 hours per broker-dealer that routes institutional orders who will create the required reports itself × 135 such broker-dealers + 5 hours per broker-dealer that routes institutional orders who uses a third-party service provider to create the required reports itself × 65 such broker-dealers = 3,025 hours. The Commission estimates the total monetized burden for this requirement to be \$765,625 (\$4,990 per broker-dealer that routes institutional orders × 135 such broker-dealers + \$1,415 per broker-dealer who uses a third-party service provider to create the required reports × 65 such broker-dealers = \$765,625). See *supra* notes 261 and 262.

<sup>265</sup> \$2,500 per broker-dealer who uses a third-party service provider to create the required reports × 65 such broker-dealers = \$162,500. See *supra* note 263.

<sup>266</sup> The monetized cost for this burden requirement was derived as follows: (Jr. Business Analyst at \$160 per hour for 10 hours = \$1,600). The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*.

<sup>267</sup> 10 hours per broker-dealer that routes institutional orders per quarter × 4 quarters = 40 hours per broker-dealer that routes institutional orders. The Commission estimates the total monetized burden for this requirement to be \$6,400 (\$1,600 per broker-dealer that routes institutional orders per quarter × 4 quarters = \$6,400). See *id.*

the Commission does not estimate that there would be an additional burden to allow the report to remain posted for the period of time specified in the rule. With an estimated 135 broker-dealers that route institutional orders that will prepare their own reports, the total burden per year to comply with the quarterly reporting requirement in proposed Rule 606(c) is estimated to be 5,400 hours.<sup>268</sup>

The Commission estimates that each broker-dealer that routes institutional orders that uses a third-party service provider to prepare the report will incur an average burden of 2 hours<sup>269</sup> and \$500<sup>270</sup> to prepare and make publicly available a quarterly report in the format required by proposed Rule 606(c), or a burden of 8 hours<sup>271</sup> and \$2,000 per year.<sup>272</sup> Once a report is posted on an internet Web site, the Commission does not estimate that there would be an additional burden to allow the report to remain posted for the period of time specified in the rule. With an estimated 65 broker-dealers that route institutional orders that will use a third-party service provider to prepare their reports, the total burden per year to comply with the quarterly reporting requirement in proposed Rule 606(c) is estimated to be 520 hours<sup>273</sup> and \$130,000.<sup>274</sup>

<sup>268</sup> 40 hours annually per broker-dealer that routes institutional orders × 135 broker-dealers that route institutional orders = 5,400 hours. The Commission estimates the total monetized burden for this requirement to be \$864,000 (\$6,400 annually per broker-dealer that routes institutional orders × 135 such broker-dealers = \$864,000). See *id.*

<sup>269</sup> The Commission estimates the monetized burden for this requirement to be \$443. The monetized cost for this burden requirement was derived as follows: (Jr. Business Analyst at \$160 per hour for 1 hour + Compliance Manager at \$283 per hour for 1 hour = \$443). The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*.

<sup>270</sup> The Commission estimates a third-party service provider would charge on average \$500 to prepare a report required by the rule.

<sup>271</sup> 2 hours per broker-dealer that routes institutional orders per quarter who uses a third-party service provider × 4 quarters = 8 hours per such broker-dealer. The Commission estimates the total monetized burden for this requirement to be \$1,772 (\$443 per broker-dealer that routes institutional orders who uses a third-party service provider per quarter × 4 quarters = \$1,772). See *supra* note 269.

<sup>272</sup> \$500 per report × 4 reports per year = \$2,000. See *supra* note 270.

<sup>273</sup> 8 hours annually per broker-dealer that routes institutional orders who will use a third-party service provider to prepare its reports × 65 such broker-dealers = 520 hours. The Commission estimates the total monetized burden for this requirement to be \$115,180 (\$1,772 annually per broker-dealer that routes institutional orders × 65 such broker-dealers = \$115,180).

<sup>274</sup> \$2000 per broker-dealer who will use a third-party service provider to prepare its reports × 65 such broker-dealers = \$130,000.

Therefore, the total annual burden for all 200 broker-dealers who route institutional orders to comply with the quarterly reporting requirement in proposed Rule 606(c) is estimated to be 5,920 hours<sup>275</sup> and \$130,000.<sup>276</sup>

### 3. Requirement To Document Methodologies for Categorizing Institutional Order Routing Strategies

#### a. Initial Reporting and Recordkeeping Burden

The Commission estimates that broker-dealers that route institutional orders already have descriptions for their order routing strategies (or employ third-party vendors who have descriptions for such strategies) and will need to assign each order routing strategy for institutional orders to comply with the passive, neutral, and aggressive categories. Thus, the Commission estimates that the one-time, initial burden for a broker-dealer that routes institutional orders to assign its own current strategies and establish and document its specific methodologies for assigning order routing strategies as required by Rule 606(b)(3)(v) to be 40 hours.<sup>277</sup> The Commission estimates that, consistent with its estimates above, 135 broker-dealers that route institutional orders would do this in-house. With an estimated 135 broker-dealers who will assign their strategies and establish and document its specific methodologies for assigning institutional order routing strategies as passive, neutral, and aggressive in-house, the total initial burden for such broker-dealers is estimated to be 5,400 hours.<sup>278</sup>

<sup>275</sup> 40 hours per broker-dealer that routes institutional orders who will create the required reports × 135 such broker-dealers + 8 hours per broker-dealer that routes institutional orders who will use a third-party service provider to create the required reports itself × 65 such broker-dealers = 5,920 hours. The Commission estimates the total monetized burden for this requirement to be \$979,180 (\$6,400 per broker-dealer that will create the reports itself × 135 such broker-dealers + \$1,772 per broker-dealer who uses a third-party service provider to create the required reports × 65 such broker-dealers = \$979,180). See *supra* notes 267 and 271.

<sup>276</sup> See *supra* notes 274.

<sup>277</sup> The Commission estimates the monetized burden for this requirement to be \$12,620. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Sr. Business Analyst at \$251 per hour for 20 hours + Attorney at \$380 per hour for 20 hours = 40 hours and \$12,620. This burden hour estimate was based on discussions with various industry participants.

<sup>278</sup> 40 hours per broker-dealer that routes institutional orders × 135 such broker-dealers = 5,400 hours. The Commission estimates the total monetized burden for this requirement to be \$1,703,700 (\$12,620 per broker-dealer that routes institutional orders × 135 such broker-dealers = \$1,703,700). See *id.*

The Commission estimates that the one-time, initial burden for the 65 broker-dealers that route institutional orders who will work with a third-party service provider to assign each order routing strategy for institutional orders into passive, neutral, and aggressive categories and establish and document its specific methodologies for assigning order routing strategies as required by Rule 606(b)(3)(v) to be 10 hours<sup>279</sup> and \$5,000.<sup>280</sup> With an estimated 65 broker-dealers that route institutional orders who will work with a third-party service provider, the total initial burden for such broker-dealers to assign their current routing strategies for institutional orders into passive, neutral, and aggressive strategies is estimated to be 650 hours<sup>281</sup> and \$325,000.<sup>282</sup>

Therefore, the total initial burden for all 200 broker-dealers who route institutional orders to comply with the requirement to document the methodologies for categorizing order routing strategies in proposed Rule

606(b)(3)(v) is estimated to be 6,050 hours<sup>283</sup> and \$325,000.<sup>284</sup>

#### b. Annual Reporting and Recordkeeping Burden

Once established, broker-dealers that route institutional orders would be required to maintain the documentation of their order routing strategies. After a broker-dealer's strategies are initially assigned to one of the three categories in a consistent manner, the broker-dealer would be required to promptly update such assignments any time an existing strategy is amended or a new strategy is created that would change such assignment. The Commission estimates that the annual burden for a broker-dealer who will perform the work in-house to assign the descriptions of order routing strategies and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments to comply with Rule 606(b)(3)(v) will be 15 hours.<sup>285</sup> With an estimated 135 broker-dealers who route institutional orders who will maintain and assign their own descriptions, the total annual burden for such broker-dealers to assign the routing strategies for their institutional orders into passive, neutral, and aggressive strategies is estimated to be 2,025 hours.<sup>286</sup>

<sup>283</sup> 5,400 hours for broker-dealers who will assign each order routing strategy into one of the three categories and document methodologies for assigning such order routing strategies in-house plus 650 hours for broker-dealers who will use a third-party service provider to assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments = 6,050 hours. The Commission estimates the monetized burden for this requirement to be \$1,891,940 (\$1,703,700 for broker-dealers who will assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments in-house plus \$188,240 for broker-dealers who will use a third-party service provider to assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments = \$1,891,940). See *supra* notes 278 and 281.

<sup>284</sup> See *supra* note 282.

<sup>285</sup> The Commission estimates the monetized burden for this requirement to be \$3,500. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Jr. Business Analyst at \$160 per hour for 10 hours + Attorney at \$380 per hour for 5 hours = 15 hours and \$3,500. This burden hour estimate was based on discussions with various industry participants.

<sup>286</sup> 15 hours per broker-dealer that routes institutional orders who will assign and maintain

The Commission estimates that the annual burden for a broker-dealer who routes institutional orders who engages a third-party service provider to comply with Rule 606(b)(3)(v) will be 5 hours<sup>287</sup> and \$1,000.<sup>288</sup> With an estimated 65 broker-dealers who route institutional orders who will engage a third-party to assign each order routing strategy for institutional orders into one of these three categories, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments, the total annual burden for such broker-dealers to work with a third-party service provider to assign the routing strategies for their institutional orders into passive, neutral, and aggressive strategies is estimated to be 325 hours<sup>289</sup> and \$65,000.<sup>290</sup>

Therefore, the total annual burden for all 200 broker-dealers who route institutional orders to comply with the requirement to document the

their own descriptions × 135 such broker-dealers = 2,025 hours. The Commission estimates the total monetized burden for this requirement to be \$472,500 (\$3,500 per broker-dealer that routes institutional orders × 135 such broker-dealers = \$472,500). See *id.*

<sup>287</sup> The Commission estimates the monetized burden for this requirement to be \$1,609. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Compliance Manager at \$283 per hour for 4 hours + Sr. Business Analyst at \$251 per hour for 4 hours + Attorney at \$380 per hour for 2 hours = 5 hours and \$1,609. This burden hour estimate was based on discussions with various industry participants.

<sup>288</sup> The Commission estimates a third-party service provider would charge \$1,000 annually to maintain and keep current strategy categorizations strategies documentation of specific methodologies for assigning order routing strategies as required by Rule 606(b)(3)(v).

<sup>289</sup> 5 hours per broker-dealer that routes institutional orders who will engage a third-party to assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments × 65 such broker-dealers = 325 hours. The Commission estimates the total monetized burden for this requirement to be \$104,585 (\$1,609 per broker-dealer that routes institutional orders who will engage a third-party to assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments × 65 such broker-dealers = \$104,585). See *supra* note 287.

<sup>290</sup> \$1,000 per broker-dealer who will use a third-party service provider to assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments × 65 such broker-dealers = \$65,000.

<sup>279</sup> The Commission estimates the monetized burden for this requirement to be \$2,896. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Compliance Manager at \$283 per hour for 4 hours + Sr. Business Analyst at \$251 per hour for 4 hours + Attorney at \$380 per hour for 2 hours = 10 hours and \$2,896. This burden hour estimate was based on discussions with various industry participants.

<sup>280</sup> The Commission estimates a third-party service provider would charge on average \$5,000 to assign into one of the three categories the current strategies a broker-dealer uses and establish and document the specific methodologies for assigning order routing strategies as required by Rule 606(b)(3)(v).

<sup>281</sup> 10 hours per broker-dealer that routes institutional orders who will engage a third-party service provider to assign into one of the three categories its routing strategies and document such categorizations × 65 such broker-dealers = 650 hours. The Commission estimates the total monetized burden for this requirement to be \$188,240 (\$2,896 per broker-dealer that routes institutional orders × 65 such broker-dealers = \$188,240). See *supra* note 279.

<sup>282</sup> \$5,000 per broker-dealer who will use a third-party service provider to assign into one of the three categories its routing strategies and document the methodologies for making such assignments × 65 such broker-dealers = \$325,000. See *supra* note 280.

methodologies for categorizing order routing strategies and maintain the documentation of such methodologies in proposed Rule 606(b)(3)(v) is estimated to be 2,350 hours<sup>291</sup> and \$65,000.<sup>292</sup>

#### 4. Amendment to Current Disclosures With Respect to Retail Orders

##### a. Initial Reporting and Recordkeeping Burden

Any broker-dealer that routes retail orders is subject to the collection of information in Rule 606(a) and the proposed amendments thereto. The Commission notes that there are differences among the estimated 266 broker-dealers that are subject to retail order routing disclosure requirements.<sup>293</sup> Introducing firms typically rely primarily on clearing brokers to handle their customer accounts, and the collection of information burden would not apply to introducing brokers unless they are directly involved in determining where their customer orders are routed.<sup>294</sup> The Commission estimates that there are currently 185 clearing brokers that route retail orders. In addition to the 185 clearing brokers, there are approximately 81 introducing brokers that receive (but do not hold) funds or securities from their customers.<sup>295</sup> Generally, introducing brokers rely on

<sup>291</sup> 2,025 hours for broker-dealers who will assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments in-house plus 325 hours for broker-dealers who will use a third-party service provider to assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments = 2,350 hours. The Commission estimates the monetized burden for this requirement to be \$577,085 (\$472,500 for broker-dealers who will assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments in-house plus \$104,585 for broker-dealers who will use a third-party service provider to assign into one of the three categories its routing strategies, document the methodologies for making such assignments, and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments = \$577,085). See *supra* notes 286 and 291.

<sup>292</sup> See *supra* note 290.

<sup>293</sup> The Commission has previously noted the differences between these types of broker-dealers. See, e.g., Rule 606 Predecessor Proposing Release *supra* note 15, at 48427.

<sup>294</sup> See Securities Exchange Act Release No. 40122 (June 24, 1998), 63 FR 35508 (June 30, 1998).

<sup>295</sup> This estimate is based on December 2015 Form Custody data received by the Commission.

clearing brokers to clear and execute trades and handle customer funds and securities.<sup>296</sup> However, the Commission preliminarily believes that some introducing brokers which receive funds or securities for customers may be involved in initiating orders or initially routing orders on behalf of their customers and may therefore have involvement in determining where retail orders are routed for execution. Because such introducing brokers may have involvement in determining where orders are routed, they have been included, along with clearing brokers, in estimating the total burden of the proposed amendments for institutional routing disclosure. The Commission preliminarily believes that the estimates should be the same for a clearing broker or an introducing broker that routes retail orders. Therefore, the Commission estimates that there are 266 broker-dealers to which the proposed requirements would apply.<sup>297</sup>

Rule 606(a)(1) currently requires that broker-dealers make publicly available quarterly reports on retail order routing. While the proposed rule does not alter this requirement; it does modify the content of the report. As noted above, broker-dealers will be required to account for the proportion of non-directed marketable limit and non-marketable limit orders as a percentage of total retail orders as well as the percentage of such orders broken down by Specified Venue. In addition, for each Specified Venue, broker-dealers would be required to provide information about net payment for order flow received per share, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received per share and in the aggregate broken down by order type. The proposed rule would require that such reports be broken down by calendar month. The proposed rule also eliminates a requirement that the order routing information contained in the customer reports be broken down by listing market, which simplifies presentation of information required under the rule.

To comply with the proposed requirements, broker-dealers who do not have systems that currently obtain information required by the rule will have to alter their current systems to obtain, record, and retain the information required by the proposed changes. The Commission preliminarily

<sup>296</sup> See Rule 606 Predecessor Proposing Release, *supra* note 15 at 48427.

<sup>297</sup> 185 clearing brokers + 81 introducing brokers that receive funds or securities from customers = 266 broker-dealers that route retail orders.

believes that broker-dealers would not encounter capital expenditures to comply with this requirement. The Commission estimates that most broker-dealers that route retail orders already obtain the information required by the proposed rule and that 50 broker-dealers do not currently obtain such information.<sup>298</sup> The Commission estimates that 25 of these 50 broker-dealers would update their systems in-house, while 25 would use third-party service providers.

The Commission estimates that the initial burden for a broker-dealer that routes retail orders whose systems do not currently capture all of the information required by the rule to update its systems to capture the information required by proposed Rule 606(a) and format that information into a report to comply with the rule will be 80 hours.<sup>299</sup> Therefore, the Commission estimates the total initial burden for the 25 broker-dealers who the Commission estimates do not currently capture information required by the proposed rule that perform the necessary system updates in-house will be 2,000 hours.<sup>300</sup>

The Commission estimates that the initial burden for a broker-dealer that routes retail orders to engage a third-party to program the necessary system updates to comply with proposed Rule 606(a) will be 20 hours<sup>301</sup> and \$10,000.<sup>302</sup> Therefore, the Commission

<sup>298</sup> The Commission estimates that most broker-dealers currently obtain such information. At the time of routing, for instance, a broker-dealer should know what type an order is, (i.e., market or limit), whether the order is directed or not, and, if the order is a limit order, whether the limit order is marketable or not. Additionally, a broker-dealer should know after execution what types of fees or rebates were received, both on a per share basis and in the aggregate.

<sup>299</sup> The Commission estimates the monetized burden for this requirement to be \$22,648. The Commission derived this cost estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Sr. Programmer at \$303 per hour for 40 hours) + (Sr. Database Administrator at \$312 per hour for 16 hours) + (Sr. Business Analyst at \$251 per hour for 16 hours) + (Attorney at \$380 per hour for 4 hours) = 80 hours and \$22,648.

<sup>300</sup> 80 hours per broker-dealer that routes retail orders who will perform necessary system updates in-house × 25 such-broker-dealers = 2,000 hours. The Commission estimates the total monetized burden for this requirement to be \$566,200 (\$22,648 per broker-dealer that routes institutional orders × 25 such broker-dealers = \$566,200). See *id.*

<sup>301</sup> The Commission estimates the monetized burden for this requirement to be \$5,985. The Commission derived this cost estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Compliance Manager at \$283 per hour for 10 hours + Sr. Business Analyst at \$251 per hour for 5 hours + Attorney at \$380 per hour for 5 hours = 20 hours and \$5,985.

<sup>302</sup> The Commission estimates that a third-party service provider would charge an average of \$10,000 to upgrade a broker-dealer's systems to comply with proposed Rule 606(a).

estimates the total initial burden for the 25 broker-dealers who the Commission estimates do not currently capture information required by the proposed rule who will engage a third-party service provider to perform the necessary system updates will be 500 hours<sup>303</sup> and \$250,000. The Commission notes that this estimate contemplates the impact of making the reports available using the most recent versions of the XML schema and the associated PDF renderer, as published on the Commission's Web site, as required by both proposed Rule 606(a) and 606(b)(1). Therefore, the total initial burden estimate for all 50 broker-dealers who the Commission estimates will need to update their systems and create a new report is 2,500 hours<sup>304</sup> and \$250,000.<sup>305</sup>

For the remaining 216 broker-dealers whom the Commission estimates currently capture the data required by the proposed modifications to Rule 606(a), such broker-dealers would need to only format their reports to incorporate such data. The Commission estimates that 108 of such broker-dealers currently engage a third-party service provider to provide reports pursuant to existing Rule 606(a) and such broker-dealers would continue to use third-party service providers to format reports to comply with proposed Rule 606(a), as described further below. The Commission estimates that the remaining 108 broker-dealers who already capture information required by the proposed rule would prepare and format a report to comply with the proposed rule in-house. The Commission estimates for a broker-dealer who already captures such data,

<sup>303</sup> 20 hours per broker-dealer that routes retail orders who will engage a third-party service provider to perform necessary system updates × 25 such-broker-dealers = 500 hours. The Commission estimates the total monetized burden for this requirement to be \$149,625 (\$5,985 per broker-dealer that routes institutional orders × 25 such broker-dealers = \$149,625). See *supra* note 301.

<sup>304</sup> 2,000 hours for a broker-dealer that routes retail orders whose systems do not currently capture the required information who will perform upgrades + 500 hours for a broker-dealer who routes retail orders whose systems do not currently capture the required information who will engage a third-party to perform the necessary upgrades = 2,500 hours. The Commission estimates the total monetized burden for this requirement to be \$715,825 (\$566,200 for broker-dealers that route retail orders whose systems do not currently capture the required information who will perform necessary upgrades in-house + \$149,625 for broker-dealers that route retail orders whose systems do not currently capture the required information who will engage a third-party service provider to perform the system updates × 25 such broker-dealers) = \$715,825. See *supra* notes 300 and 303.

<sup>305</sup> \$10,000 per broker-dealer who will engage a third-party to perform necessary updates × 25 such broker-dealers = \$250,000.

the burden to format that data into its existing reports on its own would be 20 hours.<sup>306</sup> Therefore, the total initial burden for broker-dealers to format already captured data into a report in-house to comply with proposed Rule 606(a) is estimated to be 2,160 hours.<sup>307</sup>

The Commission estimates the initial burden for the 108 broker-dealers who engage a third-party service provider to format reports to comply with proposed Rule 606(a) would be 8 hours<sup>308</sup> and \$2,000.<sup>309</sup> Therefore, for the 108 broker-dealers the Commission estimates route retail orders who will engage a third-party to format and prepare a report that would comply with the proposed rule, the estimated total initial burden to comply with proposed Rule 606(a) is 864 hours<sup>310</sup> and \$216,000.<sup>311</sup> Thus, the total estimate for the 216 broker-dealers for whom the Commission estimates currently capture the data required by proposed Rule 606(a) to format their reports to incorporate such data is 3,024

<sup>306</sup> The Commission estimates the monetized burden for this requirement to be \$4,975. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Programmer at \$248 per hour for 15 hours + Sr. Business Analyst at \$251 per hour for 5 hours = 20 hours and \$4,975.

<sup>307</sup> 20 hours per broker-dealer who will format reports in-house × 108 such broker-dealers = 2,160 hours. The Commission estimates the monetized burden for this requirement to be \$537,300 (\$4,975 per broker-dealer who will format reports in-house × 108 such broker-dealers). See *id.*

<sup>308</sup> The Commission estimates the monetized burden for this requirement to be \$2,555. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: Compliance Manager at \$283 per hour for 5 hours + Attorney at \$380 per hour for 3 hours = 8 hours and \$2,555. This burden hour estimate was based on discussions with various industry participants.

<sup>309</sup> The Commission estimates a third-party service provider would charge on average \$2,000 to format already captured data into a report that would comply with proposed Rule 606(a).

<sup>310</sup> 8 hours per broker-dealer who will perform the necessary system updates in-house × 108 such broker-dealers = 864 hours. The Commission estimates the monetized burden for this requirement to be \$275,940 (\$2,555 per broker-dealer who will perform the system updates in-house 108 such broker-dealers). See *supra* note 308.

<sup>311</sup> \$2,000 per broker-dealer who will use a third-party service provider to format data and prepare a report × 108 such broker-dealers = \$216,000. See *supra* note 309.

hours<sup>312</sup> and \$216,000.<sup>313</sup> The Commission notes that these estimate include the impact of making the reports available using the most recent versions of the XML schema and the associated PDF renderer as published on the Commission's Web site, as required by both proposed Rule 606(a) and 606(b)(1).

Therefore, the Commission estimates that the total initial burden to comply with the proposed modifications to Rule 606(a) for all 266 broker-dealers which the Commission estimates route retail orders is 5,524 hours<sup>314</sup> and \$466,000.<sup>315</sup>

Finally, the Commission proposes to amend Rule 606(a)(1)(iv)<sup>316</sup> to require broker-dealers to describe specific aspects of any terms of payment for order flow arrangements and profit-sharing relationships, whether written or oral, with a Specified Venue that may influence their order routing decisions, including information relating to specific incentives or volume minimums.<sup>317</sup> The Commission estimates that the initial burden for a broker-dealer that routes retail orders to review, assess, and disclose its payment for order flow arrangements and profit-sharing relationships would be 10

<sup>312</sup> 2,160 hours for broker-dealers who currently capture the information required by proposed Rule 606(a) and will format their systems to create reports to comply with the proposed rule in-house + 864 hours for broker-dealers who currently capture such information who will hire a third-party service provider to format their systems to comply with the proposed rule = 3,024 hours. The Commission estimates the total monetized burden for this requirement to be \$813,240 (\$537,500 for broker-dealers who currently capture the information required by proposed Rule 606(a) and will format their systems to create reports to comply with the proposed rule in-house + \$275,940 for broker-dealers who currently capture such information who will hire a third-party service provider to format their systems to comply with the proposed rule = \$813,240). See *supra* notes 307 and 310.

<sup>313</sup> See *supra* note 311.

<sup>314</sup> 2,500 hours for broker-dealers who need to update their systems and prepare a report + 3,124 hours for broker-dealers who currently capture the information required by proposed Rule 606(a) and need to format their systems to create reports to comply with the proposed rule = 5,524 hours. The Commission estimates the total monetized burden for this requirement to be \$1,529,065 (\$715,850 for broker-dealers who need to update their systems and prepare a report + \$813,240 for broker-dealers who currently capture the information required by proposed Rule 606(a) and need to format their systems to create reports to comply with the proposed rule = \$1,529,065). See *supra* notes 304 and 312.

<sup>315</sup> \$250,000 for broker-dealers who will engage a third-party to perform necessary upgrades + \$216,000 for broker-dealers who will engage a third-party to format reports to comply with the proposed rule = \$466,000. See *supra* notes 305 and 311.

<sup>316</sup> Renumbered from Rule 606(a)(1)(iii).

<sup>317</sup> See proposed Rule 606(a)(1)(iv).

hours<sup>318</sup> and that all 266 broker-dealers who route retail orders would describe such agreements and arrangements themselves. Therefore, the total initial burden for all broker-dealers who route retail orders to review, assess, and disclose its payment for order flow arrangements and profit-sharing relationships is estimated to be 2,660 hours.<sup>319</sup>

#### b. Annual Reporting and Recordkeeping Burden

Rule 606(a) currently requires brokers-dealers that route retail orders to make available reports on the routing of all non-directed orders. The proposed changes to Rule 606(a)(1) will: (1) Eliminate the requirement that such reports be divided based on primary listing market and instead aggregate all NMS stocks into a single section; (2) add requirements that the reports contain information relating to the routing of marketable and non-marketable orders, as well as average payment for order flow for different types of orders; (3) require broker-dealers to describe any terms of payment for order flow arrangements and profit-sharing relationships with a Specified Venue that may influence their order routing decisions; and (4) require that such reports be made available using the most recent versions of the XML schema and the associated PDF renderer as published on the Commission's Web site.<sup>320</sup> The proposed amendments do alter the information currently collected under an existing collection of information requirement. The Commission preliminarily believes that once the initial burdens, described above, have been incurred to allow the broker-dealer to obtain the required information, the ongoing burden to produce a quarterly report would remain the same. However, broker-dealers would need to monitor payment for order flow and profit-sharing relationships and potential SRO rule changes that could impact their order routing decisions and incorporate any new information into their reports. Thus, the Commission estimates the

<sup>318</sup> The Commission estimates the monetized burden for this requirement to be \$3,155. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: (Sr. Business Analyst at \$251 per hour for 5 hours) + (Attorney at \$380 per hour for 5 hours) = 10 hours and \$3,155.

<sup>319</sup> 10 hours per broker-dealer that routes retail orders x 266 such broker-dealers = 2,660 hours. The Commission estimates the total monetized burden for this requirement to be \$839,230 (\$3,155 per broker-dealer that routes retail orders x 266 such broker-dealers = \$839,230). *See id.*

<sup>320</sup> *See supra* Section III.B.

average annual burden for a broker-dealer to comply with the proposed amendments to Rule 606(a)(1)(i)–(iii) would be 10 hours.<sup>321</sup> Thus, the total annual burden for all broker-dealers to comply with the proposed amendments is estimated to be 2,660 hours.<sup>322</sup>

Proposed Rule 606(a)(1)(iv) would require broker-dealers to describe any terms of payment for order flow arrangements and profit-sharing relationships with a Specified Venue that may influence their order routing decisions. Current Rule 606(a)(1)(iii), being renumbered as proposed Rule 606(a)(iv), requires broker-dealers to provide a discussion of the material aspects of the broker-dealer's relationship with each Specified Venue, including a description of any arrangement for payment for order flow and any profit-sharing relationship. Therefore, the proposed changes would require broker-dealers to describe any terms of payment for order flow arrangements and profit-sharing relationships with a Specified Venue that may influence their order routing decisions, in addition to the material aspects of the broker-dealer's relationship with each Specified Venue. Additionally, the costs noted in this section include the impact of posting the required reports in the specified format to an internet Web site. Once a report is posted on an internet Web site, the Commission estimates that there would not be an additional burden to allow the report to remain posted for the period of time specified in the rule. The Commission estimates that the average annual burden for a broker-dealer that handles retail orders to describe and update any terms of payment for order flow arrangements and profit-sharing relationships with a Specified Venue that may influence their order routing decisions to be 15 hours.<sup>323</sup> With 266 broker-dealers involved in retail order routing practices that would be required

<sup>321</sup> The Commission estimates the monetized burden for this requirement to be \$3,155. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: (Sr. Business Analyst at \$251 per hour for 5 hours) + (Attorney at \$380 per hour for 5 hours) = 10 hours and \$3,155.

<sup>322</sup> 10 hours per broker-dealer that routes retail orders x 266 such broker-dealers = 2,660 hours. The Commission estimates the total monetized burden for this requirement to be \$839,230 (\$3,155 per broker-dealer that routes retail orders x 266 such broker-dealers = \$839,230). *See id.*

<sup>323</sup> The Commission estimates the monetized burden for this requirement to be \$3,500. The Commission derived this estimate based on per hour figures from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*: (Jr. Business Analyst at \$160 per hour for 10 hours) + (Attorney at \$380 per hour for 5 hours) = 15 hours and \$3,500.

to comply with the rule, the Commission estimates the total annual burden for complying with proposed Rule 606(a)(1)(iv) to be 3,990 hours.<sup>324</sup>

#### 5. Amendment to Current Disclosures Under Rule 605

Currently, Rule 605 requires market centers make available standardized, monthly reports of statistical information concerning their order executions. Further, the Rule requires that such reports be in electronic form and be made available for downloading from an Internet Web site that is free and readily accessible to the public. The proposed amendment to Rule 605 would require that such reports be kept posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site. Because reports are already posted to an internet Web site pursuant to current Rule 605, the Commission estimates the proposed amendment to Rule 605 would not impose an additional burden. The proposed amendment prescribes a minimum period of time for which such reports that are already required to be posted on an Internet Web site shall remain posted.

#### E. Collection of Information Is Mandatory

All of the collection of information would be mandatory.

#### F. Confidentiality of Responses to Collection of Information

To the extent that the Commission receives confidential information pursuant to the collection of information, such information will be kept confidential, subject to the provisions of applicable law.<sup>325</sup> Any information required to be disclosed publicly by the proposed Rules would not be confidential.

The quarterly order routing reports prepared and disseminated by broker-dealers pursuant to Rules 606(a) and 606(c), as proposed, would be available to the public. The individual responses by broker-dealers to customer requests for order routing information required by Rules 606(b)(1) and (b)(3), as proposed, would be made available the customer. The Commission, SROs, and

<sup>324</sup> 15 hours annually per broker-dealer that routes retail orders x 266 such broker-dealers = 3,990 hours. The Commission estimates the total monetized burden for this requirement to be \$931,000 (\$3,500 annually per broker-dealer that routes retail orders x 266 such broker-dealers = \$931,000). *See id.*

<sup>325</sup> *See, e.g.*, 5 U.S.C. 552 *et seq.*; 15 U.S.C. 78x (governing the public availability of information obtained by the Commission).

other regulatory authorities could obtain copies of these reports as appropriate.

#### *G. Retention Period for Recordkeeping Requirements*

Pursuant to proposed Rule 606(a), broker-dealers shall be required to keep quarterly retail order routing reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

For Rule 606(b), broker-dealers shall be required to preserve all communications required under these proposed amendments pursuant to Rule 17a-4, as applicable.<sup>326</sup> For the categorization of order routing strategies pursuant to proposed Rule 606(b)(3)(v), broker-dealers shall be required to preserve such records in a manner consistent with Rule 17a-4(b), specifically for a period of not less than three years, the first two years in an easily accessible place.

Pursuant to proposed Rule 606(c), broker-dealers shall be required to keep public aggregated institutional order handling reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

Pursuant to the proposed amendments to Rule 605, market centers shall be required to keep order execution reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

#### *H. Request for Comments*

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

120. Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility;

121. Evaluate the accuracy of our estimates of the burden of the proposed collection of information;

122. Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and

123. Evaluate whether there are ways to minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

<sup>326</sup> 17 CFR 240.17a-4. Registered brokers and dealers are already subject to existing recordkeeping and retention requirements under Rule 17a-4.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090, with reference to File Number S7-14-16. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File Number S7-14-16 and be submitted to the Securities and Exchange Commission, Office of FOIA/PA Services, 100 F Street NE., Washington, DC 20549-2736. As OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

#### **V. Economic Analysis**

The Commission is sensitive to the economic consequences and effects, including costs and benefits, of its rules. The following economic analysis identifies and considers the costs and benefits—including the effects on efficiency, competition, and capital formation—that may result from the proposed amendments to Rules 600, 605, and 606.<sup>327</sup> These costs and benefits are discussed below and have informed the policy choices described throughout this release.

##### *A. Introduction*

Among the primary economic considerations for the proposed amendments to Rule 600, Rule 605, and Rule 606 are transparency for customers placing institutional orders, enhanced transparency for customers placing retail orders, and enhanced access to order handling reports.

<sup>327</sup> The Commission also considered the proposed amendments to Rule 607 and preliminarily believes that there are no costs and benefits associated with those proposed amendments. The proposed amendments to Rule 607 replace “customer order” with “retail order” to be consistent with the proposed amendments to Rule 600(b)(19). However, since the definition in proposed Rule 600(b)(19) remains unchanged, there are no cost and benefits to the proposed amendments to Rule 607. The Commission is also proposing to amend Rule 3a51-1(a) under the Exchange Act; Rule 13h-1(a)(5) of Regulation 13D-G; Rule 105(b)(1) of Regulation M; Rules 201(a) and 204(g) of Regulation SHO; Rules 600(b), 602(a)(5), 607(a)(1), and 611(c) of Regulation NMS; and Rule 1000 of Regulation SCI, to update cross-references as a result of today’s proposal, which would not result in costs or benefits.

The Commission proposes to amend Rule 600 to include a definition of “institutional order” and to amend Rule 606 to require broker-dealers to (1) disclose standardized customer-specific institutional order handling information to their customers, including the use of actionable IOIs in executing institutional orders and (2) make publicly available for each calendar quarter a report that aggregates the information required for customer-specific institutional order handling reports for all institutional orders they receive.

In short, and as discussed earlier, the Commission preliminarily believes that standardizing customer-specific institutional order handling disclosures, as would be required by proposed Rule 606(b)(3), would provide information to customers to enable them to: (1) Assess the potential for information leakage with the routing of their orders; (2) assess the conflicts of interest that may influence the broker-dealer’s order handling practices; and (3) compare institutional order handling practices across multiple broker-dealers. The Commission also preliminarily believes that requiring broker-dealers to disclose their use of actionable IOIs in executing institutional orders will be useful to customers assessing broker-dealers’ order handling decisions, particularly in regards to analyzing information leakage.

In addition, the Commission preliminarily believes that public disclosure by each broker-dealer of aggregated information about its institutional order handling, as would be required by proposed Rule 606(c), would, among other things, (1) assist market participants, including customers, in comparing the order handling services of all broker-dealers; (2) facilitate customers’ ability to make informed decisions when engaging a broker-dealer’s services; (3) provide academics and other members of the public with access to additional data for conducting research on institutional order routing and market execution quality; (4) allow broker-dealers to better compare their own services against other broker-dealers; and (5) permit trading centers to better compare their execution statistics against other trading centers.

The Commission preliminarily believes that the customer-specific as well as the public aggregated institutional order handling reports may further incentivize broker-dealers to provide customers with higher-quality routing services when executing their institutional orders, thereby mitigating the potential for information leakage,

and better manage any potential conflicts of interest the broker-dealers may face. The Commission also preliminarily believes that the reports will promote competition among broker-dealers to capture customers' order flow, and among trading centers for order execution.

With respect to retail orders, the Commission proposes to amend Rule 606(a)(1) to include new subparagraph (iii) to require that, for each Specified Venue, the broker-dealer must report the net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received, both as a total dollar amount and on a per share basis, for each of the following non-directed order types: (1) Market orders; (2) marketable limit orders; (3) non-marketable limit orders; and (4) other orders.<sup>328</sup> In addition, proposed amendments to Rule 606(a)(1)(iv) would require disclosure of a description of any terms of payment for order flow arrangements and profit-sharing relationships, whether written or oral, with a Specified Venue that may influence a broker-dealer's order routing decisions, including, but not limited to: (1) Incentives for equaling or exceeding an agreed upon order flow volume threshold, such as additional payments or a higher rate of payment; (2) disincentives for failing to meet an agreed upon minimum order flow threshold, such as lower payments or the requirement to pay a fee; (3) volume-based tiered payment schedules; and (4) agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue. The Commission preliminarily believes that these amendments will enhance transparency on the routing of retail orders and enhance competition among broker-dealers that route retail orders, to the benefit of investors.

In addition, the Commission preliminarily believes that the proposed amendments would allow customers to better assess the retail order routing and execution quality offered by their broker-dealers. As a result, the Commission preliminarily believes that these additional disclosures may provide broker-dealers further incentives to improve execution quality for their customers and better manage any potential for conflicts of interest the broker-dealers may face. In addition, the ability of customers to better assess routing and execution quality could also lead to increased competition among broker-dealers with respect to execution quality, which could, in turn, result in

broker-dealers providing even higher-quality retail order routing and execution services.

The Commission is further proposing to require that all reports on institutional order handling and retail order routing be provided in a consistent, structured format. The Commission preliminarily believes that requiring the reports be provided in this format would be useful to customers as it would allow them to more easily analyze and compare data across broker-dealers.

Finally, the Commission is proposing to amend Rules 605 and 606 of Regulation NMS to require that the public order execution and order routing reports be kept publicly available for a period of three years. The Commission preliminarily believes that this would allow the public to more efficiently evaluate the services of broker-dealers because it would be easier for the public to access historic reports and analyze the data over an extended time period. For example, at a minimum, the public would have access to three years of historic data and may choose to download the reports periodically to analyze data over a time period of more than three years.

The discussion below presents an overview of the current practices with regards to the reporting and disclosure of order routing and execution quality for institutional as well as retail orders, a consideration of the costs and benefits of the proposed new reporting requirements for institutional orders and of the proposed amendments to the reporting requirements for retail orders, and a discussion of the potential effects of the proposed amendments to Rule 606 on efficiency, competition, and capital formation. This discussion will also describe the Commission's proposal to amend Rule 605 by requiring market centers to keep public execution reports posted on an Internet Web site that is accessible to the public for a period of three years.

#### B. Baseline

The baseline for considering the economic impact of amending Rule 606 to require reporting for institutional orders consists of: (1) Information that customers currently receive from their broker-dealers regarding how their institutional orders are handled; (2) the format in which such information is currently provided to customers; (3) conflicts of interest broker-dealers currently face; (4) the current use of actionable IOIs; and (5) the ability to assess order routing and execution quality currently provided by different broker-dealers and execution quality

currently provided by different trading centers.

The baseline for considering the economic impact of amending Rule 606 for retail orders and of amending Rule 605 consists of: (1) Information that customers currently receive under current Rules 605 and 606 or information that customers currently receive from their broker-dealers that is not required by current Rules 605 and 606; (2) the format in which information required by current Rule 606 for retail orders is provided to customers; (3) conflicts of interest broker-dealers currently face; (4) how long reports required by current Rules 605 and 606 are available to the public; and (5) the ability to assess order routing and execution quality currently provided by different broker-dealers and execution quality currently provided by different trading centers.

Further, the baseline for considering the economic impact of amending Rule 606 for institutional and retail orders and Rule 605 comprises the current competitive landscape in the markets for brokerage services and for execution services and any current limitations on efficiency or capital formation relevant to the proposed amendments. These various baseline factors are discussed in further detail below.

#### 1. Ad Hoc Reports for Institutional Orders

Currently, broker-dealers may voluntarily provide some information on routing and execution quality of institutional orders to individual customers in response to requests by these customers. Customers may also use third-party vendors for TCA (*e.g.*, to analyze the execution prices of orders compared to various benchmarks). However, the Commission understands that TCA provided by third-party vendors generally does not encompass an analysis of routing decisions because the third-party vendors, similar to customers, do not have access to the order handling information necessary to do so. Therefore, the completeness of any analysis of institutional orders, including TCA, is affected by a lack of specific order handling information with regard to the various venues to which institutional orders are routed. In addition, while TCA provided by third-party vendors may focus on measuring and comparing execution quality of orders, TCA does so typically at the parent order or broker-dealer level, and generally not at the trading center level, because the third-party vendors, again, do not have access to the information about institutional order handling that would be necessary to do so.

<sup>328</sup> See proposed Rule 606(a)(1)(iii).

The Commission further understands that reports that institutional customers currently receive upon request from their broker-dealers may not provide the consistent and standardized information needed to fully assess the performance of their broker-dealers. In particular, the Commission understands that these reports are not prepared or presented in a uniform manner that allows for easy comparison of institutional order handling across different broker-dealers, and there is no uniformity in the current disclosure of execution fees charged or rebates paid by the trading centers to the broker-dealers. The reports contain what the broker-dealers provide upon the requests of customers or what the customers specifically request from the broker-dealers. As a result, a broker-dealer will often supply reports containing different information to different customers, and more importantly, a customer may receive reports containing different information from different broker-dealers. Further, even if the reports contain the same data elements, those data elements may not be computed in the same way or use the same terminology across different broker-dealers or over time for the same broker-dealer. These differences make it more difficult for institutional customers to compare broker-dealers or to examine one broker-dealer's performance over time. In addition, as these reports are not standardized and vary by broker-dealer or by customer, the Commission understands that some of these reports group order routing strategies by their aggressiveness,<sup>329</sup> while other reports do not.

Even if a broker-dealer voluntarily provides information about institutional orders upon request, it may not do so with respect to all customers. Whether a given customer receives a report and how responsive the report is to the request likely depends on the customer's current or potential business relationship with the broker-dealer. A broker-dealer may be more accommodating towards customers that send, or may send in the near future, substantial order flow. To the extent that some customers receive reports from broker-dealers while other customers do not or that some customers receive higher-quality reports than other customers, the playing field may not be level with respect to institutional order handling information.

Moreover, the public currently does not have access to information on the

<sup>329</sup> This grouping could be similar to the grouping into aggressive, neutral, and passive as proposed in Rule 606(b)(3).

performance of broker-dealers relating to institutional orders. Under current Rule 606, a broker-dealer is not required to provide public reports for orders having a market value of \$200,000 or more. While an institutional customer can request ad-hoc reports from broker-dealers about the handling of its orders, the lack of public reports relating to institutional orders makes it infeasible for an institutional customer to compare handling of institutional orders by broker-dealers that the customer does not have a business relationship with. For the broker-dealers that the customer does send orders to, the customer is not able to compare these broker-dealers more generally based on all orders those broker-dealers handle rather than only the orders the customer sends to the broker-dealers.<sup>330</sup> Institutional customers and the public may use public reports for retail orders required under current Rule 606 to evaluate broker-dealers, with the effectiveness of that approach being dependent upon how good a proxy the order routing for retail orders is for the order routing for institutional orders. The Commission understands that some customers use the reports for retail orders required by current Rule 606 to predict, among other things, the execution quality of institutional orders.

## 2. Publication Period for Reports on Retail Orders Required by Current Rules 605 and 606

Currently, Rule 605 does not specify the minimum length of time that market centers need to post publicly the order execution reports and Rule 606 does not specify a minimum length of time that broker-dealers need to post publicly the order routing reports. The Commission understands that generally, when reports are posted, market centers and broker-dealers will remove the previous report from their Web site and replace it with their most recent report,<sup>331</sup>

<sup>330</sup> Currently, a customer placing institutional orders can only compare broker-dealers based on the orders it had sent to the broker-dealers because only those are contained in the ad-hoc reports the broker-dealers provide upon request, but cannot compare how the broker-dealers handle the orders it had sent compared to all of the institutional orders the broker-dealers had received. In addition, the ad-hoc reports provided by the broker-dealers upon request by a customer placing institutional orders may be provided in different formats and contain different and potentially inconsistent information, which makes the comparison of the order routing decisions and execution quality of broker-dealers more difficult and less useful.

<sup>331</sup> See, e.g., Morgan Stanley Rules 605 and 606 Disclosures, available at [http://www.morganstanley.com/institutional-sales/sec\\_rules\\_605\\_606](http://www.morganstanley.com/institutional-sales/sec_rules_605_606); Wells Fargo Legal Disclosures, available at <https://www.wellsfargoadvisors.com/disclosures/legal-disclosures.htm>; Charles Schwab Order Routing, available at <http://>

though some may make reports available for a longer period of time that varies.<sup>332</sup> The Commission understands that this may make it difficult for the public to analyze historical data. For example, the public must download the data regularly to have access to historical data. Alternatively, the public may rely on third-party vendors who retrieve and aggregate Rule 605 and 606 reports from market centers and broker-dealers, respectively, to get access to historical data.

## 3. Available Information on Conflicts of Interest

Current Rule 606 requires for retail orders, among other things, a description of any arrangement for payment for order flow<sup>333</sup> and any profit-sharing relationships. The current required disclosure is designed to set forth arrangements, including financial relationships, that could lead to conflicts of interest for a broker-dealer when routing retail orders.<sup>334</sup> Broker-dealers have a variety of choices for order routing and execution, and the venue that a broker-dealer chooses may have a tangible effect on the execution quality of an order. Broker-dealers face conflicts of interest when routing orders, such as affiliations with trading centers, receipt of payment for order flow or receipt of payment from any profit-sharing relationship, and liquidity rebates. For example, recent research analyzed the relation between maker-taker fee schedules and order routing. According to this study, four out of ten national brokerage firms appear to consistently route limit orders to the

[www.schwab.com/public/schwab/nn/legal\\_compliance/important\\_notices/order\\_routing.html](http://www.schwab.com/public/schwab/nn/legal_compliance/important_notices/order_routing.html); TD Ameritrade Disclosures, available at <https://www.tdameritrade.com/disclosure.page>; Fidelity Quarterly Reports, available at [https://capitalmarkets.fidelity.com/app/item/RD\\_13569\\_21696.html](https://capitalmarkets.fidelity.com/app/item/RD_13569_21696.html).

<sup>332</sup> See, e.g., UBS Order Routing Disclosure, available at <https://www.ubs.com/us/en/wealth/misc/orderroutingdisclosure.html>.

<sup>333</sup> In addition, Rule 10b-10 under the Exchange Act requires broker-dealers, when acting as agent for the customer, to disclose on the confirmation of a transaction whether payment for order flow was received and, upon written request of the customer, to furnish the source and nature of the compensation received. See 17 CFR 240.10b-10(a)(2)(i)(C). Accordingly, Rule 10b-10 provides disclosure to a specific customer of whether payment for order flow was received on a particular transaction while Rule 606 provides public disclosure of any arrangement for payment for order flow and any profit-sharing relationship by requiring a description of such arrangements.

<sup>334</sup> 17 CFR 242.606(a)(1)(iii). See Rule 606 Predecessor Adopting Release, *supra* note 15, at 48417 (stating that "[t]he purpose of requiring disclosure of any relationships between a broker-dealer and the venues to which it routes orders is to alert customers to potential conflicts of interest that may influence the broker-dealer's order-routing practices.").

exchange(s) paying the highest rebate for those limit orders. In this research, an analysis of proprietary limit order data and trades from NYSE's trade and quote ("TAQ") data showed strong empirical evidence of a negative relation between take fees and limit order execution quality.<sup>335</sup> The Commission preliminarily believes that such financial incentives have the potential to affect how broker-dealers route retail orders; however, these conflicts of interest might not only affect retail orders.

Under the quarterly disclosure obligations in current Rule 606(a), a broker-dealer is required to discuss the material aspects of the broker-dealer's relationship with each Specified Venue (which is determined based on retail order routing), including a description of any arrangement for payment for order flow, but broker-dealers are not required to provide information on the net amount of payment for order flow per share or by order type nor payment received for any profit-sharing relationship. Further, current Rule 606(a) does not require broker-dealers to disclose rebates received and access fees paid per share or by order type nor does it require a description of the terms of a payment for order flow arrangement or profit-sharing relationship that may influence a broker-dealer's order routing decision. The current information required by Rule 606(a) can be used by customers to assess order routing and execution services of broker-dealers as well as the potential conflicts of interest faced by broker-dealers in providing such services and determine whether to retain the services of broker-dealers or to discontinue the use of such services. In addition, broker-dealers could use the current information required by Rule 606(a) as a means to evaluate and enhance their order routing and execution services, compare their order routing and execution services to that of other firms, and use such comparisons in selling their services to customers.

Moreover, current Rule 606(a) does not specify a minimum length of time that reports must be made available from broker-dealers. As a result, customers placing retail orders may not be able to compare the order routing decisions of a broker-dealer through time, if past quarterly reports are not

available. Instead, customers may need to rely on third-party vendors to provide and/or analyze past quarterly reports.

As noted above, conflicts of interest may affect institutional orders in ways similar to effects on retail orders. The ad hoc nature of the current order handling disclosures of institutional orders is not conducive to providing institutions with information they can use efficiently to assess conflicts of interest. In particular, a broker-dealer for which conflicts of interest influence routing decisions may have the incentive to obscure the conflicts of interest in the ad hoc reports.

#### 4. Available Information on Execution Quality for Institutional and Retail Orders

The Commission preliminarily believes that broker-dealers are incentivized to provide their customers with information about the quality of services they offer as they may lose business if their competitors provide reports and they do not. However, as described above, under current rules, broker-dealers are not required to provide customers standardized reports about the handling of their institutional orders and instead customers may receive ad-hoc reports from broker-dealers upon request. Additionally, a broker-dealer may have an incentive to structure its reports and provide data in a way that is advantageous to the broker-dealer. Specifically, broker-dealers may want to design the ad hoc reports to highlight areas where the broker-dealer believes it compares well to others and obscure areas where the broker-dealer may not compare well or where customers are likely to have concerns. Separately, there are no public reports about the handling of institutional orders for independent research and analysis, by academic researchers, the public at large, or third-party vendors. Due to the limitations noted above, the Commission preliminarily believes that customers may not be able to compare the institutional order handling performance of broker-dealers reliably and as a result, broker-dealers may have less incentive to compete on the quality of their institutional order handling, which may result in broker-dealer routing practices that are suboptimal for customers, e.g., practices that do not avoid excessive information leakage or that may not provide the execution quality desired by the customer.

For customers placing retail orders, current Rule 606 requires quarterly public reports on retail order routing and disclosure of retail order routing information upon request, but the

reports do not require information on payment for order flow received, payment from any profit-sharing relationship received, or transaction rebates and access fees, and they are not required to separate limit orders into marketable and non-marketable limit orders. As a result, it may be difficult for customers to use the information provided in the reports to evaluate the quality of their broker-dealers' retail order routing. Customers may therefore not be well informed as to how their broker-dealers manage any potential conflicts of interest they may face. The Commission preliminarily believes providing payment for order flow data in the quarterly public reports, broken down by calendar month, separately for marketable and non-marketable limit orders would create an opportunity for more detailed analysis.<sup>336</sup>

As noted above, the current information on retail order routing required by Rule 606(a) may spur competition between broker-dealers on the basis of order routing services and execution quality.<sup>337</sup> Customers may use the information required by Rule 606(a) to evaluate and retain the services of a broker-dealer or to discontinue the use of such services. In addition, broker-dealers may use the current information required by Rule 606(a) as a means to: (1) Evaluate and enhance their order routing and execution services; (2) compare their order routing and execution services to that of other firms; and (3) use such comparison in selling their services to customers.

#### 5. Format of Current Reports for Institutional and Retail Orders

As discussed above, broker-dealers currently may provide some information on routing and execution quality of institutional orders to individual customers in response to requests by these customers. The Commission understands that broker-dealers provide these reports in a variety of formats and a given broker-dealer may use different formats for different customers and/or may modify their formats over time. The formats of these reports vary from unstructured to structured formats, such as unstructured text and PDF files to structured XML files. The Commission is soliciting comment on whether broker-dealers currently provide their reports in a structured or unstructured format, and which format the broker-dealers use for these reports. For those broker-dealers that provide their reports

<sup>335</sup> See Battalio, Corwin, and Jennings Paper, *supra* note 57. The authors "document a strong negative relation between take fees and several measures of limit order execution quality. Based on this evidence, [they] conclude that the decision of some national brokerages to route all nonmarketable limit orders to a single exchange paying the highest rebate is not consistent with the broker's responsibility to obtain best execution for customers." *See id.*

<sup>336</sup> See Battalio, Corwin, and Jennings Paper, *supra* note 57.

<sup>337</sup> See *supra* Section III.B.

in a structured format, the Commission is further soliciting comment on how prevalent or useful the selected structured format is.

Under current Rule 606(a), broker-dealers are required to provide public quarterly reports on retail order routing. The current Rule 606(a) does not specify a format for these reports. The Commission understands that broker-dealers currently provide these reports on a Web site or downloadable as a PDF file. The reports typically are presented as tables with one line for each listing exchange for NMS stocks and exchange-listed options, where each row represents metrics for a particular routing venue, but they are not in a structured format.

#### 6. Quality of Broker-Dealer Routing Practices for Institutional Orders

The Commission does not have data to gauge the current level of quality of broker-dealer routing practices for institutional orders, as current Rule 606 only covers retail orders and not institutional orders.<sup>338</sup> As noted, customers of broker-dealers can and do request ad-hoc reports about the handling of their orders and broker-dealers may voluntarily provide such reports. Customers can use those reports to evaluate their broker-dealers' routing practices. This, in turn, may give broker-dealers additional incentives to provide high execution quality to their customers. However, as discussed, there are limitations to the current situation, namely, the ad-hoc reports are not standardized across broker-dealers and there are no public reports that would allow customers to evaluate all broker-dealers, independent of whether they place orders with them or not.

#### 7. Use of Actionable IOIs in Institutional Orders

Some broker-dealers use actionable IOIs to communicate to external liquidity providers to send an order to the broker-dealer in response to liquidity at the broker-dealer, generally a customer's institutional order. As noted above, because actionable IOIs convey similar information as an order, a response to an actionable IOI may result in an execution at the venue of the IOI sender. Accordingly, a broker-dealer's use of actionable IOIs creates potential information leakage similar to the routing of orders. The Commission does not have data to gauge the current level of use of actionable IOIs by broker-dealers to attract orders to execute

<sup>338</sup> As noted above, including in Section V.B.3., current Rule 606 provides information on the quality of broker-dealer routing practices for retail orders.

against institutional orders represented by such actionable IOIs. In addition, current Rule 606 for retail orders does not require the inclusion of actionable IOIs in the reports.

#### 8. Competition, Efficiency, and Capital Formation

The proposed amendments are likely to affect competition among broker-dealers that route institutional and retail orders. These broker-dealers compete in a segment of the market for broker-dealer services. The market for broker-dealer services is highly competitive, with most business concentrated among a small set of large broker-dealers and thousands of small broker-dealers competing for niche or regional segments of the market.<sup>339</sup> To limit costs and make business more viable, small broker-dealers often contract with larger broker-dealers or service bureaus to handle certain functions, such as clearing and execution, or to update their technology.<sup>340</sup> Larger broker-dealers typically enjoy economies of scale over small broker-dealers and compete with each other to service the smaller broker-dealers, who are both their competitors and their customers.<sup>341</sup> Among other services, broker-dealers provide execution and strategy services, distribute shares from initial public offerings, and provide analyst research on securities. Brokerage commissions typically are charged for a broker-dealer's premium services, and represent an average, not marginal, cost of trading.<sup>342</sup>

As discussed in Section IV.C., as of December 2015, there were approximately 4,156 registered broker-dealers.<sup>343</sup> Of these, the Commission preliminarily estimates that 266 route retail orders.<sup>344</sup> The Commission preliminarily estimates that 200 broker-dealers route institutional orders, all of whom also route retail orders, and that each broker-dealer who routes

<sup>339</sup> See Securities Exchange Act Release No. 63241 (November 3, 2010), 75 FR 69791, 69822 (November 15, 2010) (Risk Management Controls for Brokers or Dealers with Market Access).

<sup>340</sup> *Id.*

<sup>341</sup> *Id.*

<sup>342</sup> Brokerage commissions are fixed according to a client agreement and pay for expected services, such as research, advice, and execution. However, while the commissions may pay for a variety of services, broker-dealers charge them only on a per-share basis at the time of an order's execution. Therefore, the commissions reflect broker-dealers' expectations of customers' average use of services and not the cost of servicing each order execution on a per-share basis. See Michael Goldstein, Paul Irvine, Eugene Kandel, and Zwi Wiener, *Brokerage Commissions and Institutional Trading Patterns*, 22 Review of Financial Studies 5175 (December 2009).

<sup>343</sup> See *supra* note 232.

<sup>344</sup> See *supra* note 233.

institutional orders will receive an average of 200 requests for reports pursuant to proposed Rule 606(b)(3) annually.<sup>345</sup> All of these broker-dealers compete for business from retail and institutional customers. The Commission also preliminarily estimates that there are approximately 5,594 customers that may place institutional orders.<sup>346</sup>

Among other factors, broker-dealers may compete for retail and institutional customers by trying to offer them better terms for trading, such as better execution quality. The emergence of discount brokerages has encouraged full-service brokers to compete on price and led to the unbundling of research from execution services.<sup>347</sup> In addition, the fragmentation of NMS stock trading into 12 registered exchanges, more than 40 ATSs, and over 200 OTC market makers<sup>348</sup> has contributed to the need for broker-dealers to focus on venue selection in executing orders. Broker-dealers may also innovate to attract new customers by, for example, offering access to algorithms designed to match trading or investment objectives. However, as noted above, the information on which broker-dealers offer better terms of trade may be non-standardized, presented inconsistently over time, or may employ complex calculations using undisclosed methods.<sup>349</sup> Further, the format of the reports may limit the comparison of reports across broker-dealers.<sup>350</sup> As a result, customers may not be able to efficiently identify which broker-dealers provide better execution quality. This may reduce the incentives for broker-dealers to compete by offering better execution quality or to innovate on execution quality. Without the incentive

<sup>345</sup> See *supra* notes 234 and 251.

<sup>346</sup> The Commission preliminarily estimates the number of customers that may place institutional orders as the number of 13F institutions as of December 31, 2015. The Commission recognizes that not all of these institutions necessarily trade NMS Stocks and not all necessarily submit orders that would qualify for the definition of institutional order. Further, some customers that submit institutional orders may not be 13F institutions. While this preliminary estimate may not be precise, the Commission preliminarily believes that it approximates the number of customers that may be affected by the proposed amendments.

<sup>347</sup> See *supra* note 342.

<sup>348</sup> See *supra* Section II.B.

<sup>349</sup> See generally *supra* Sections V.B.1., V.B.4., and V.B.5.

<sup>350</sup> See *supra* Section V.B.5. for a discussion of current formats. Broker-dealers provide reports in a variety of formats and a given broker-dealer may use different structures and formats for different customers. This makes it difficult to electronically read reports into a system to compare multiple broker-dealers and conduct statistical analysis across broker-dealers. Differing formats also make it difficult to electronically search across broker-dealers for various data points in the reports.

to compete by offering better execution quality, broker-dealers may route customer orders in ways that do not necessarily promote better execution quality.<sup>351</sup> Such inefficient routing could have effects on the market for trading services.

The market for trading services, which is served by trading centers, relies on competition among these market centers to supply investors with execution services at efficient prices. These market centers, which compete to, among other things, match traders with counterparties, provide a framework for price negotiation, and provide liquidity to those seeking to trade. As discussed in Section IV.C., the Commission preliminarily estimates that there are 380 market centers to which Rule 605 applies.<sup>352</sup>

These market centers compete with each other for order flow on a number of dimensions, including execution quality. Their primary clients are the broker-dealers who route their own or their customers' orders for execution at the trading center. One way to attract order flow is to offer payment for order flow. The Commission understands that a large portion of retail order flow is sent to internalizers who pay for retail order flow. Trading centers also may innovate to differentiate themselves from other trading centers to attract more order flow. For example, several exchanges recently started pilots intended to provide better execution quality for retail orders to attract more retail order flow.<sup>353</sup> Trading centers also may adjust fees and rebates to incent broker-dealers to route more order flow to them. To the extent that broker-dealers route orders for reasons other than execution quality, trading centers may have less of an incentive to compete and innovate on execution quality. This may limit overall execution quality and result in higher transaction costs for customers than

would exist with greater competition on execution quality.

Transaction costs reflect the level of efficiency in the trading process, with higher transaction costs reflecting less efficiency.<sup>354</sup> Inefficiency in the trading process creates friction, which limits the ability for prices to fully reflect a stock's underlying value.<sup>355</sup> Stoll (2000) defines friction as follows: "Friction in financial markets measures the difficulty with which an asset is traded."<sup>356</sup> Stoll follows Demsetz (1968)<sup>357</sup> to "view friction as the price paid for immediacy." Thus, higher transaction costs imply higher friction in the market. Friction makes it more costly to trade and makes investing less efficient. Further, friction limits the ability for arbitrageurs or informed customers to push prices to their underlying values, and thus friction makes prices less efficient.

As a result of the inefficiencies discussed above, a potential increase in transaction costs in particular, may cause customers not to rebalance their portfolios as often as might otherwise be optimal and security prices may less fully reflect true underlying values. This, in turn, may limit efficient allocation and capital formation, as those issuers that have the best ideas may not get the capital needed to fund them. In particular, the less perfectly efficient prices are, the less able customers are to identify the issuers with the most profitable projects and thus the demand for the stock of those issuers may not fully reflect these opportunities. Less demand could result in a lower stock price, which would make it harder for these issuers to raise capital and result in less favorable conditions for the capital they raise.<sup>358</sup>

#### 9. Request for Comment

The Commission requests comments on its baseline analysis. In particular, the Commission solicits comment on the following:

124. Do customers currently request institutional order handling reports from their broker-dealers? Are those reports generally provided and if so, what information do they generally

contain? Are there differences in the responsiveness of broker-dealers to requests from different customers and/or over time? Are there differences in the quality or detail of the reports by different broker-dealers? If so, what impact do the differences have on the costs and benefits of the reports? If possible, please provide specific estimates and data.

125. Do broker-dealers already have systems in place to produce order handling reports?

126. Do customers currently receive institutional order handling reports that are comparable to the public reports as proposed by Rule 606(c)? If so, what information is contained in such reports and how, if at all, do those reports differ from the proposed public reports? How do the costs and benefits of those reports compare to the reports as proposed by Rule 606(c)? Please be specific and, if possible, provide specific estimates or data.

127. Do commenters believe that the Commission's assessment of the baseline for the economic analysis is correct? Why or why not? Please be specific.

128. Do commenters believe that the baseline discussion provides a fair representation of current practices under Rules 600, 605, and 606?

129. Do commenters believe that the Commission's description of the competitive landscape for broker-dealers is accurate?

130. Do commenters believe that the market participants identified by the Commission as being affected by the proposed amendments to Rules 600, 605, and 606 is correct?

131. Do commenters believe that the Commission's description of what information market participants currently receive is accurate?

132. Do commenters believe that the Commission's description of the potential conflicts of interest broker-dealers face when routing institutional or retail orders is accurate? Why or why not? Please be specific in your response.

133. Do commenters believe that the Commission's description of the current quality of broker-dealer order routing practices for institutional orders is accurate? Why or why not? Please be specific in your response.

134. Do commenters believe that the Commission's description of the current use of actionable IOIs is accurate? Why or why not? Please be specific in your response.

135. Do commenters believe that the Commission's description of the current level of competition, efficiency, and innovation is accurate? Why or why not? Please be specific in your response.

<sup>351</sup> See *supra* Section V.B.3. regarding the conflicts of interest broker-dealers have when routing customer orders.

<sup>352</sup> The Commission derived this estimate for purposes of the PRA based on the following: 236 OTC market makers (not including market makers claiming an exemption from the reporting requirements of the Rule), plus 12 exchanges, 1 securities association, 86 exchange market makers, and 45 ATSS.

<sup>353</sup> See, e.g., Securities Exchange Act Release No. 67347 (July 3, 2012), 77 FR 40673 (July 10, 2012) for the NYSE and NYSE MKT pilot; Securities Exchange Act Release No. 68303 (November 27, 2012), 77 FR 71652 (December 3, 2012) for the Bats BZX pilot; Securities Exchange Act Release No. 71176 (December 23, 2013), 78 FR 79524 (July 30, 2013) for the NYSE Arca pilot; and Securities Exchange Act Release No. 73702 (November 28, 2014), 79 FR 72049 (December 4, 2014) for the Nasdaq BX pilot.

<sup>354</sup> See Hans R. Stoll, *Friction*, 55 Journal of Finance 1479 (August 2000).

<sup>355</sup> See *id.*

<sup>356</sup> See *id.*

<sup>357</sup> See Harold Demsetz, *The Cost of Transacting*, 82 Quarterly Journal of Economics 33 (February 1968).

<sup>358</sup> The Commission also notes that less efficiently allocated capital could result in too much relative funding available for unprofitable projects, which erode capital. In other words, allocative inefficiency could mean that some issuers with unprofitable projects could raise capital too easily.

### C. Costs and Benefits

The Commission preliminarily identified costs and benefits associated with the proposed amendments to Rules 600, 605, and 606, which are discussed in this section. Many of these costs and benefits are difficult to quantify, especially as the practices of market participants are expected to evolve and may change due to the information on order routing and execution quality that is required to be reported under the proposed amendments to Rules 600, 605, and 606. Therefore, much of the discussion is qualitative in nature but, where possible, the Commission quantifies the costs.

Many, but not all, of the costs of the proposed amendments to Rules 600, 605, and 606 involve a collection of information, and these costs and burdens are discussed in the Paperwork Reduction Act Section above, with those preliminary estimates being used in the economic analysis below.<sup>359</sup>

#### 1. Disclosures for Institutional Orders

##### a. Definition of Institutional Order in Rule 600(b)(31)

###### i. Benefits

Proposed Rule 600(b)(31) defines an institutional order as an order to buy or sell an NMS stock that is not for the account of a broker-dealer and is an order for a quantity of an NMS stock having a market value of at least \$200,000. The \$200,000 threshold determines the number of institutional orders included in the proposed reporting requirements of Rule 606, as orders less than \$200,000 in market value are excluded from Rules 606(b)(3) and (c) for reporting purposes. The Commission preliminarily estimates that at least 5% of the total executed volume in NMS securities would meet this threshold.<sup>360</sup> The Commission preliminarily believes that the proposed definition is simple and straightforward, as the same threshold would be applied to all NMS stocks independent of the liquidity and other characteristics of the specific stock. In addition, the definition of an institutional order in proposed Rule 600(b)(31) is the complement to the current definition of a “customer order,” which would be renamed “retail order” under the

proposed amendment to Rule 600(b)(18) (renumbered as 600(b)(19)). Specifically, proposed Rule 600(b)(19), as amended, defines a “retail order” for NMS stocks as an order to buy or sell an NMS stock that is not for the account of a broker-dealer and is an order for a quantity of an NMS stock having a market value of less than \$200,000. The definition of institutional order would dovetail with the definition of retail order such that all customers’ orders would be covered by order routing disclosure rules. Moreover, because there would be no overlap in the definitions of retail and institutional orders—that is, an order would be classified as either retail or institutional—there should be no double reporting for any order.<sup>361</sup>

###### ii. Costs

As noted above, the same threshold would be applied to all NMS stocks independent of a stock’s liquidity. This uniform standard may, however, result in orders submitted by institutions that are quite large when considering a stock’s activity level not meeting the definition of institutional order. For example, an order for \$200,000 in a small-cap stock that is illiquid is very different from an order for \$200,000 in a large-cap stock that is very liquid.<sup>362</sup> The Commission recognizes that orders meeting the \$200,000 threshold may not be as common for illiquid stocks, and institutional customers may use orders smaller than \$200,000, as supported by staff analysis described below. As a result, the proposed definition may result in institutional customers who submit such smaller orders in illiquid stock not obtaining the benefits from the disclosures required in the proposed amendments to Rule 606, although the existing requirements of Rule 606 for retail orders would still apply.

To determine the extent of institutional orders that would not meet this threshold, the Commission staff examined a set of orders from institutions and found that 83.2% of the total number of orders are smaller than

\$200,000.<sup>363</sup> However, 92% of total dollar volume from orders of institutions in the data meets the proposed definition of an institutional order, *i.e.*, an order to buy or sell a quantity of an NMS stock having a market value of at least \$200,000. The percentage of orders from institutions that would meet the definition varies by activity level of the stock, with a higher proportion meeting the definition in more active stocks. While approximately 20% of orders from institutions in the group of most active stocks would meet the proposed definition, less than 3% of orders from institutions in the group of least active stocks would meet the proposed definition.<sup>364</sup> Therefore, the proposed definition of institutional order covers a lower proportion of orders submitted by institutions in less active stocks than it does in more active stocks.

The Commission notes that using any fixed threshold may have another drawback. For example, market participants may change their behavior or stock prices may change over time. Fixed thresholds generally provide an incentive for those affected by the threshold to alter their actions to control whether the action is above or below the threshold. With respect to the threshold in the definition of institutional order, customers may have an incentive to increase their order sizes to exceed the threshold if they can get better information about routing and execution quality for orders exceeding the threshold.<sup>365</sup> If such changes result in

<sup>363</sup> Information on institutional equity trading for the sample period of 2013–2014 is obtained from Abel Noser Solutions, Ltd. According to an academic study by Puckett and Yan (2011), the dataset contains detailed equity trading information for each Abel Noser client and includes a representative set of institutional investors including pension plan sponsors (*e.g.*, CalPERS, the Commonwealth of Virginia, and YMCA retirement fund) and money managers (*e.g.*, Massachusetts Financial Services (MFS), Putnam Investments, and Lazard Asset Management). These clients accounted for at least 10% of the total trading volume from 1999–2005, according to Puckett and Yan (2011). The Commission assumes for purposes of this analysis that clients have continued to account for at least this volume during its sample period. *See, e.g.*, Andy Puckett and Xuemin (Sterling) Yan, *The Interim Trading Skills of Institutional Investors*, 66 *Journal of Finance* 601 (April 2011).

<sup>364</sup> A stock is sorted into a decile according to average monthly dollar volume. The most active stocks are defined as being those in the 10th decile of the distribution of stocks as measured by the average monthly dollar volume, and the least active stocks are defined as being those in the 1st decile of the distribution of stocks as measured by the average monthly dollar volume.

<sup>365</sup> The Commission understands that customers currently split large orders across multiple broker-dealers for reasons such as limiting the information that broker-dealers have about the full order. On the margin, the proposed threshold could provide the

Continued

<sup>359</sup> *See supra* Section IV.

<sup>360</sup> Commission staff calculated this estimate using a sample of institutional orders purchased from Abel Noser Solutions, Ltd., a provider of TCA. The Commission recognizes that this data may not include all institutional orders, but cannot predict how incomplete the data are. The more incomplete this data set is, the more this statistic underestimates the prevalence of institutional orders.

<sup>361</sup> Current Rule 600(b)(18) defines a customer order and the definition is identical to the definition of a retail order in proposed Rule 600(b)(19). Throughout this proposal, we use the term “retail order” rather than “customer order,” even if we describe current rules and practices, because “retail order” is the amended terminology proposed and the definitions are identical.

<sup>362</sup> For example, a \$200,000 order in a liquid stock could be very small relative to the total activity level of that stock whereas a \$150,000 order in an illiquid stock could be half the typical trading volume of that stock. The execution quality of the order in the illiquid stock could be much more dependent on the routing practices of the broker-dealer than the execution quality of the order in the liquid stock.

an increase in the size of orders submitted by institutional customers, such that more orders from institutional customers are meeting the \$200,000 threshold to qualify as an “institutional order,” the proposed amendments to Rule 606 would apply to a bigger proportion of all orders submitted by institutional customers. This would increase the benefits of the proposed amendments to Rule 606 because institutional customers and the public would receive order handling information for a larger proportion of all orders submitted by institutional customers. However, it would also increase the costs of the proposed amendments to Rule 606 because the information required by proposed Rules 606(b)(3) and (c) would have to be disclosed for a larger proportion of all orders submitted by institutional customers. The Commission preliminarily believes that the increase in costs would be negligible because the broker-dealers’ systems to generate the reports would already be in place and the marginal costs of adding one order in a report is likely to be low as it would use only little additional computing time. Nonetheless, the Commission preliminarily believes that these incentives may not significantly alter customer order sizes. In particular, if a customer is able to obtain the same level of detail on the routing of all of their orders from broker-dealers, regardless of whether the orders exceed the threshold to be institutional orders, that customer may have little benefit in submitting their orders in larger pieces. Further, an institution that splits its orders to avoid the risk of leaking information to its broker-dealer, would incur information leakage costs with larger order sizes.

Conversely, if changes in market participants’ behavior or stock prices resulted in a decrease in the size of orders submitted by institutional customers, such that fewer orders meet the \$200,000 threshold for “institutional orders,” then the proposed disclosure amendments to Rule 606 pertaining to institutional order handling would apply to a smaller proportion of all orders by institutional customers. This would lead to the public receiving order handling information for a smaller proportion of all orders submitted by institutional customers and therefore would reduce the benefits of the proposed amendments to Rule 606. Still, a decrease in the size of orders submitted by institutional customers could also decrease the costs associated with the institutional order handling

incentive to avoid splitting orders to pieces of less than \$200,000.

disclosure required by the proposed amendments to Rule 606 (since fewer orders would qualify as “institutional orders”). The Commission preliminarily believes, however, that this potential decrease in costs would be negligible since the marginal cost of providing additional information on institutional orders once systems were in place to produce such reports would be negligible. Moreover, under this scenario, the Commission notes that while there may be a decrease in costs associated with institutional order handling disclosures, broker-dealers may experience an increase in the number of orders covered in retail order routing disclosure reports (because the orders that do not qualify as “institutional orders” would nonetheless qualify as “retail orders” based on size). However, the Commission preliminarily believes that any increase in the number of orders in retail order routing reports would result in minimal costs as retail reports do not require extensive order routing information, the system to generate the reports would already be in place, and the marginal costs of adding additional orders would require little computing time.

### iii. Request for Comment

The Commission seeks comment on the definition of institutional order as proposed in Rule 600(b)(31) and its analysis of the costs and benefits. In particular, the Commission solicits comment on the following:

136. Do commenters believe that the Commission’s proposed definition of institutional order is appropriate from a costs and benefits perspective? If not, please provide alternative definitions with a detailed discussion of what the advantages and costs of those alternatives would be. For example, should the threshold be different for different stocks? If yes, how? Should the threshold be a fixed dollar amount or should it be variable over time or defined differently, *e.g.*, relative to the average daily volume of a stock? Please provide data and analysis to support your view.

### b. Customer Requests for Information on Institutional Order Handling Under Proposed Rule 606(b)(3)

#### i. Benefits

The proposed amendments to Rule 606 would provide transparency about order routing and execution quality for institutional orders. Proposed Rule 606(b)(3) would require standardized reports on institutional order handling,

which would be made available to customers upon request.

Competition in the market for brokerage services could be further promoted by more transparent order routing practices and execution quality. The disclosures proposed in Rule 606(b)(3) would provide customers who submit institutional orders, including investment fund managers, standardized information regarding their broker-dealers’ order routing practices and execution quality. To the extent that the reports required by proposed Rule 606(b)(3) increase the transparency of institutional order routing and execution quality, broker-dealers would be better able to compete along the execution quality dimensions provided in the reports, such as the fill rate, percentage of shares executed at the midpoint and priced at the near or far side of the quote, and average time between order entry and execution or cancellation for orders posted to the limit order book, in addition to commissions and other considerations that they currently compete on. The Commission preliminarily believes that broker-dealers would have an additional incentive to improve their order routing decisions as customers submitting institutional orders could use the reports required by the proposed amendments to Rule 606 to compare broker-dealers, which in turn could lead to better execution quality for institutional orders.

There could also be an effect on the competition between trading centers. If broker-dealers improve their order routing decisions for institutional orders, thereby routing orders to the trading centers that are more beneficial for their customers, this could further promote competition between trading centers and spur innovation on execution quality. To illustrate, if broker-dealers change their institutional order routing decisions to focus more on execution quality and route fewer orders to a given trading center, that trading center would have an incentive to take measures to attract and gain back order flow by innovating on execution quality.

In addition to comparing broker-dealers based on the reports, customers may also initiate a dialogue with their broker-dealers, or broker-dealers they are considering to use, about their institutional order routing practices to better match the needs of the customers with the order routing practices of the broker-dealers to whom they send orders.

As discussed in Section II.C., some customers currently request and receive reports about order routing and execution quality of their institutional

orders from their broker-dealers. However, these reports are not standardized and as a result, it may be difficult to compare broker-dealers based on those reports. In addition, the availability, detail, and quality of such reports likely differ across customers, *e.g.*, it might be the case that customers placing a greater volume of institutional orders have easier access to such reports compared to customers with a smaller volume of institutional orders. Moreover, the information provided by a broker-dealer may vary over time without any standardized or required content for the reports. Proposed Rule 606(b)(3) addresses both of these concerns as the reports would be standardized for all broker-dealers and all institutional customers, making comparisons easier and analysis more useful. Furthermore, every institutional customer would be able to receive reports upon request from their broker-dealer.

However, for customers who already receive reports from their broker-dealers on the handling of their institutional orders, the benefits of the reports required by proposed Rule 606(b)(3) may be modest or even non-existent, depending on the information the customers currently receive. For example, the reports that customers already receive may be more detailed and tailored to the particular customer. The reports also may provide different and potentially more information than what proposed Rule 606(b)(3) requires. Therefore, the proposed disclosure's benefits to customers who may continue to receive detailed tailored reports is preliminarily estimated to be minimal. Nevertheless, these customers would be able to more readily compare broker-dealers due to the proposed requirement that the disclosures be standardized.

Additionally, proposed Rule 606(b)(3) requires that a broker-dealer assign its order routing strategies to one of three categories and that the reports contain information grouped by those order routing strategies: Passive, neutral, and aggressive. Proposed Rule 606(b)(3)(v) defines "passive order routing strategy" as "one that emphasizes minimization of price impact over the speed of execution"; "neutral order routing strategy" as one "that is relatively neutral between minimization of price impact and the speed of execution of the entire institutional order"; and "aggressive order routing strategy" as "one that emphasizes the speed of execution of the entire institutional order over minimization of price impact." The Commission preliminarily believes that the requirement to group information by specified order routing

strategy categories should make comparisons among broker-dealers by customers placing institutional orders as well as by the public possible because it would allow customers to control for the fact that broker-dealers may get different types of order flow. For example, to satisfy customer order instructions one broker-dealer may tend to use an aggressive order routing strategy and another broker-dealer may tend to use a passive order routing strategy, and simply comparing these two broker-dealers without considering the order routing strategy category may lead to incorrect or misleading conclusions.

Customers preferring passive order routing strategies may be willing to wait longer for an execution but may want to limit price impact. Customers preferring aggressive order routing strategies, however, may endure some price impact to trade quickly. Therefore, a broker-dealer implementing a passive order routing strategy may, compared to an aggressive order routing strategy, tend to route to a dark pool where execution may be less certain, but likely at a better price.<sup>366</sup> Similarly, a broker-dealer implementing passive order routing strategies may be able to place orders providing liquidity more often, thereby capturing more rebates.<sup>367</sup> As a result, the routing statistics of a broker-dealer that implements predominantly passive order routing strategies should differ from those of a broker-dealer that implements predominantly aggressive order routing strategies. Therefore, including the categories of order routing strategies in the order handling report can facilitate an assessment of how well a broker-dealer manages its conflicts of interest and provides execution quality

<sup>366</sup> See, *e.g.*, Albert J. Menkveld, Bart Zhou Yueshen, and Haoxiang Zhu, *Shades of Darkness: A Pecking Order of Trading Venues*, Working Paper (2015). The authors find that there exists a pecking order of trading venues that puts low-cost-low-immediacy venues on top and high-cost-high-immediacy venues at the bottom. This suggests that if an order is a passive order and executed with passive order routing strategy, the broker-dealer would prefer low-cost-low-immediacy venues, which the paper identifies as dark pools that execute at the midpoint.

<sup>367</sup> Compared to an aggressive order routing strategy, a passive order routing strategy may reduce transaction costs and allow the capture of rebates, but immediate execution is not certain. See Lawrence Harris and Joel Hasbrouck, *Market vs. Limit Orders: The SuperDOT Evidence on Order Submission Strategy*, 31 *Journal of Financial and Quantitative Analysis* 213, 230 (June 1996) (concluding that passive order routing strategies achieve better average performance than aggressive order routing strategies in certain markets). See also *Maker-Taker Memo*, *supra* note 55, at 18 (discussing maker-taker fees in U.S. equity markets). A broker-dealer can be more patient in implementing a passive order routing strategy and does not have to seek immediate execution.

that matches customer preferences because it provides information on the preferences communicated by that broker-dealers' customers. It can also assist in comparing broker-dealers that may not receive the same mix of order instructions from customers.

The requirement to differentiate the proposed disclosures into the three order routing strategy categories should help mitigate the possibility that the reports could be interpreted incorrectly. However, there could still be differences among broker-dealers in how they classify orders into the three strategy categories, which could make straight comparisons between broker-dealers difficult. Proposed Rule 606(b)(3)(v) requires broker-dealers to "assign each order routing strategy that it uses for institutional orders to one of [the] three categories in a consistent manner for each report it prepares," to "promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments," and to "document the specific methodologies it relies upon for making such assignments." The proposed Rule defines the general characteristics of the three order routing strategies in terms of the trade-off between the minimization of price impact and the speed of execution of the entire institutional order. However, the proposed Rule does not prescribe how this trade-off should be taken into consideration. Broker-dealers would have discretion to determine how to do this when establishing their methodologies to assign categories in a consistent manner and when applying the methodologies to assign into categories the routing strategies and, as a result, broker-dealers might not have the exact same definitions for the three order routing strategy categories.

Under proposed Rule 606(b)(3), customers can obtain detailed information on the broker-dealer internalization rate and payment for order flow received. Currently, broker-dealers may prefer to internalize uninformed order flow.<sup>368</sup> Under proposed Rule 606(b)(3), a customer would have information on whether its order flow is being internalized and could use this information in its relationships with its broker-dealers. Similarly, a customer would be able to examine the payment for order flow to determine if its order flow is sold to a third-party. In addition, customers may be interested in how maker-taker fees affect where broker-dealers route their

<sup>368</sup> See Hitesh Mittal, *Are You Playing in a Toxic Dark Pool? A Guide to Preventing Information Leakage*, 3 *Journal of Trading* 20 (Summer 2008).

institutional orders. If a customer pays a flat-rate commission to its broker-dealer, and any fraction of the rebate is retained by the broker-dealer, then the broker-dealer has a financial incentive to route the order to the trading center offering the highest rebate or lowest fee.<sup>369</sup> At present, the brokerage commission, which is known to the customer, may be lowest when a broker-dealer concentrates order flow in a high rebate and/or low fee trading center.<sup>370</sup> Customers might be concerned if orders routed to a high-rebate destination do not execute or do so with a delay, as information about the order may leak into the market, thereby affecting price impact.

Proposed Rule 606(b)(3) requires the inclusion of actionable IOIs in institutional order handling disclosures. Proposed Rule 600(b)(1) defines an actionable IOI as “any indication of interest that explicitly or implicitly conveys all of the following information with respect to any order available at the venue sending the indication of interest: (1) Symbol; (2) side (buy or sell); (3) a price that is equal to or better than the national best bid for buy orders and the national best offer for sell orders; and (4) a size that is at least equal to one round lot.”

The inclusion of actionable IOIs in the proposed reporting requirements of broker-dealers should provide customers a more complete picture of how their institutional orders are handled. Since actionable IOIs can convey similar information as an order, a response to an actionable IOI may result in an execution at the venue of the IOI sender and thus can represent a portion of the liquidity available at a given price and time. The Commission therefore preliminarily believes that actionable IOIs should be included in the required disclosure of how institutional orders are handled. In addition, because an actionable IOI can convey similar information as an order, the use of actionable IOIs may contribute to information leakage in a similar way as the use of orders.<sup>371</sup> Excluding actionable IOIs therefore would not provide a complete picture of institutional order routing and executions and could provide broker-

dealers with an incentive to use actionable IOIs instead of orders to circumvent the proposed disclosure requirements in Rule 606.

The proposed definition of actionable IOI in Rule 600(b)(1), however, may limit the benefits achieved. Specifically, the proposed definition is substantively similar to the description of actionable IOI in the Regulation of Non-Public Trading Interest Release. Comments received on the Regulation of Non-Public Trading Interest Release indicated that some commenters are concerned that the discussion of actionable IOIs in that release was too stringent.<sup>372</sup> If the proposed definition of actionable IOIs is, in fact, too stringent, then some IOIs would not be included in the definition of actionable IOI and would not be captured by the proposed reports on institutional order handling. Consequently, it is possible that institutional customers might find the reports to be less informative on institutional order handling than if the definition of actionable IOIs was broader. This suggests that defining actionable IOIs too narrowly may limit the benefits of the proposed amendments.

An additional benefit of having the institutional order handling information available upon request is that institutional customers could combine the order handling information with existing TCA or enhance their TCA. As noted above, institutional customers often work with independent third-party vendors to perform TCA as a means of evaluating the cost and quality of brokerage services. Institutional customers can also conduct their own TCA in-house. TCA, whether conducted in-house or by a third-party, generally analyzes data on the parent orders, but typically cannot analyze data on the child orders because of the lack of standardization of the current ad hoc order handling information. As a consequence, existing TCA typically does not incorporate information on how many child orders exist, a broker-dealer’s institutional order routing strategy, nor cost, routing, and execution quality for individual child orders. The disclosures required by proposed Rule 606(b)(3) would close this informational gap, so that customers would have more information on how broker-dealers handle and

execute parent and child institutional orders.

With this additional information, institutional customers or their third-party vendors could combine the routing information with execution information to conduct a more thorough TCA than they can currently. In particular, the information in proposed Rule 606(b)(3) may be a factor that can explain transaction cost variations and thus, the reports from the proposed amendments could be combined with TCA to help explain differences in transaction costs and in performance as measured by TCA across broker-dealers. For example, TCA often includes transaction cost measures such as implementation shortfall, but proposed Rule 606(b)(3) would not.<sup>373</sup> With TCA alone, a customer may observe different implementation shortfall across broker-dealers. The proposed amendments could allow the customers or their third-party vendors to correlate implementation shortfall with the routing decisions of the broker-dealers. This could assist the customers in assessing the execution quality provided by their broker-dealers. In summary, the Commission preliminarily believes that proposed Rule 606(b)(3) may complement and enhance all customers’ evaluations of institutional order handling quality, including those of customers who use TCA.

Finally, proposed Rule 606(b)(3) would require reports to be made available using an XML schema and associated PDF renderer to be published on the Commission’s Web site.<sup>374</sup> The benefits, as well as the costs, associated with this requirement are discussed in Section V.C.4.

#### ii. Costs

As discussed above, some customers currently request reports about the handling of their institutional orders from their broker-dealers and those reports may be less or more detailed and provide different and potentially less or potentially more information than proposed Rule 606(b)(3) would require. If the reports broker-dealers currently provide to a customer more or different information, proposed Rule 606(b)(3)

<sup>369</sup> A broker-dealer may take into account rebates when setting its flat-rate commission by asking for a lower commission. As long as the rebates are not passed through to the customer, however, the broker-dealer still has the incentive to maximize rebate capture.

<sup>370</sup> See Shawn O’Donoghue, *The Effect of Maker-Taker Fees on Investor Order Choice and Execution Quality in U.S. Stock Markets* (January 23, 2015), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2607302](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2607302).

<sup>371</sup> See *supra* Section II.C.4.

<sup>372</sup> Comments on the proposed rule for Regulation of Non-Public Trading Interest are available at <http://www.sec.gov/comments/s7-27-09/s72709.shtml>. Comments on actionable IOIs can be found in the following letters: <http://www.sec.gov/comments/s7-27-09/s72709-46.pdf> and <http://www.sec.gov/comments/s7-27-09/s72709-8.pdf>.

<sup>373</sup> For example, proposed Rule 606(b)(3) would not require reports to contain any information on implementation shortfall costs of parent orders, which are a key focus for investors placing institutional orders. In general, the proposed amendments are not intended to replace TCA and, therefore, do not include many metrics common to TCA. However, the Commission recognizes that the ability to use the proposed amendments to enhance TCA may make TCA more valuable and increase the incentives for customers to use TCA, either in-house or through a third-party vendor.

<sup>374</sup> See *supra* Section III.A.3.

could impose a cost on such a customer to the extent broker-dealers stop providing the more detailed or additional information and instead provide only the data required for institutional order handling by proposed Rule 606(b)(3). The Commission preliminarily believes that this scenario is not very likely because, even if Rule 606(b)(3) is adopted, customers could still request additional information or customized reports from their broker-dealers and broker-dealers are likely to satisfy such requests, to the extent they currently do, to retain their customers. As discussed above, the willingness of broker-dealers to provide such customized reports to customers and how detailed such a report is might depend on the business relationship between the broker-dealer and the customer. Customers who send or may send a large number of orders to a broker-dealer might be able to get customized reports more easily compared to customers who send fewer orders, and those reports might be more detailed compared to reports that customers who send fewer orders receive. While proposed Rule 606(b)(3) mitigates this issue in that every customer would be able to request the standardized reports required by proposed Rule 606(b)(3), the Commission recognizes that to the extent large institutional customers are able to receive customized reports that provide information not contained in the required reports, those large institutional customers would continue to have an advantage over smaller institutional customers who are not able to receive the same reports.

In addition, the greater transparency provided as a result of the new reports required under proposed Rule 606(b)(3) might lead broker-dealers to change how they handle institutional orders. Given that broker-dealers would be aware of the metrics to be used a priori, they might route institutional orders in a manner that promotes a positive reflection on their respective services but which may be suboptimal for their customers. Any changes to broker-dealers' order routing decisions due to proposed Rule 606(b)(3) may be intended to benefit customers placing institutional orders, but if broker-dealers and customers focus exclusively on the metrics in the reports required by proposed Rule 606(b)(3), the order routing decisions could also be viewed as suboptimal for some customers.

For example, suppose a broker-dealer routes institutional orders so that the orders execute at lower cost with a higher fill rate, shorter duration, and more price improvement than the

broker-dealer's competitors. However, it could be the case that, in order to achieve these objectives, the broker-dealer routes the majority of non-marketable limit order shares to the trading center offering the highest rebate. An institutional customer that reviews the proposed routing reports might suspect that the broker-dealer acted in its self-interest by selecting the highest rebate venue in order to maximize rebates when in fact, the broker-dealer made the decision based on other variables, which might not be completely reflected in the proposed reports. Under the proposed amendments to Rule 606, the broker-dealer may be concerned about the perception of acting on a conflict of interest, when the broker-dealer is in fact acting in the customers' interests. As a result, a broker-dealer may be incentivized to route fewer non-marketable limit order shares to the trading center offering the highest rebate, even if this imposes additional costs on the broker-dealer's customers, in an effort to ensure that a customer does not misconstrue the intent behind the broker-dealer's routing decisions. Such a potential outcome could reduce the intensity of competition between broker-dealers on the dimension of execution quality.

In addition, as noted above, proposed Rule 606(b)(3) requires the inclusion of actionable IOIs in the reports on institutional order handling broker-dealers would provide to their customers. The Commission expects that broker-dealers will incur costs from the inclusion of actionable IOIs in the reports as a result of having to process additional data and run additional calculations. The estimated cost of including actionable IOIs in the proposed reports is included in the aggregate costs described in the discussion below and in greater detail in Section IV.D.1.

The disclosure requirements of proposed Rule 606(b)(3) would also impose a monetary cost, as the required disclosures could entail some reprogramming by broker-dealers that execute or route institutional orders. These costs may be low for a given broker-dealer if the broker-dealer already supplies similar reports on institutional order handling upon requests by their customers. In addition to reprogramming, receiving and processing customer requests as well as preparing and transmitting the data to customers on request would impose costs.

As discussed in Section IV.D.1., the Commission preliminarily estimates that the one-time, initial burden for a

broker-dealer that routes institutional orders that does not currently retain the proposed order handling information to program systems in-house to implement the requirements imposed by the proposed amendments to Rule 606 would be 200 hours resulting in a monetized cost burden of \$60,420 per broker-dealer.<sup>375</sup> The Commission preliminarily estimates the one-time, initial burden for a broker-dealer that routes institutional orders that does not currently create the proposed order handling information to engage a third-party to program their systems to implement the requirements of the proposed amendments to Rule 606(b)(3) to be 50 hours resulting in a monetized cost burden of \$15,125 per broker-dealer.<sup>376</sup> In these cases, the Commission further preliminarily estimates a fee of \$35,000 per broker-dealer to engage the third-party service provider.<sup>377</sup> The Commission preliminarily believes that most broker-dealers either have systems that currently retain the information required by the proposed rule, or use third-party vendors who have systems that retain such information. The Commission therefore preliminarily estimates that 25 broker-dealers that route institutional orders do not currently have systems that retain the information required by the proposed amendments or use a third-party vendor to retain such information.<sup>378</sup> The Commission preliminarily estimates that of the 25 broker-dealers that route institutional orders who do not currently have systems in place to retain the information required by the proposed rule, 10 such broker-dealers will perform the necessary programming upgrades in-house, and 15 will engage a third-party to perform the programming upgrades. Additionally, of the 25 broker-dealers that route institutional orders who do not currently have systems in place to retain the information required by the rule, the Commission preliminarily estimates that 10 such broker-dealers will need to purchase hardware and software upgrades to fulfill the requirements of the proposed rule at an average cost of \$15,000 per broker-dealer, and that the remaining 15 broker-dealers have adequate hardware and software to retain the information proposed by the rule. Therefore, the total initial burden for all broker-dealers that route institutional orders who do not currently retain order handling

<sup>375</sup> See *supra* note 237.

<sup>376</sup> See *supra* note 238.

<sup>377</sup> See *supra* note 239.

<sup>378</sup> See *supra* note 236.

information required by the proposed rule to program systems to comply with the proposed rule change is 2,750 hours resulting in a monetized cost burden of \$831,075, plus an additional fee of \$675,000 to engage the third-party service providers.<sup>379</sup>

As discussed in Section IV.D.1., the Commission preliminarily estimates the average cost for a broker-dealer who routes institutional orders who already retains information required by the proposed rule to format its systems to produce a report to comply with the proposed rule to be 40 hours resulting in a monetized cost burden of \$12,084.<sup>380</sup> The Commission preliminarily estimates the average burden for a broker-dealer who routes institutional orders who uses a third-party service provider to work with such service provider to ensure proper reports are produced to be 20 hours resulting in a monetized cost burden of \$5,726.<sup>381</sup> In these cases, the Commission further preliminarily estimates a fee of \$5,000 per-broker to engage the third-party service provider.<sup>382</sup> The Commission preliminarily estimates that, of the 175 broker-dealers who route institutional orders who currently retain the information required pursuant to the rule and need only format their systems to produce a report required by the rule, 50 such broker-dealers will use a third-party vendor to ensure proper reports are produced and the remaining 125 broker-dealers will perform the necessary work in-house. Thus, the total cost for all broker-dealers who route institutional orders who only need to format their systems to prepare a report to comply with the proposed rule is preliminarily estimated to be 6,000 hours resulting in a monetized cost burden of \$1,796,800, plus an additional fee of \$250,000 to engage the third-party service providers.<sup>383</sup> Therefore, the total initial burden for all broker-dealers to comply with proposed Rule 606(b)(3) is preliminarily estimated to be 8,750 hours resulting in an estimated cost of \$2,627,875, plus an additional fee of \$925,000 to engage the third-party service providers.<sup>384</sup>

As discussed in Section IV.D.1, the Commission preliminarily estimates that an average response to a Rule 606(b)(3) request for a broker-dealer who handles its own responses will take approximately 2 hours per response

resulting in a monetized cost burden of \$380.<sup>385</sup> For a broker-dealer that routes institutional orders who will use a third-party service provider to respond to requests pursuant to Rule 606(b)(3), the Commission preliminarily estimates the burden to be 1 hour per response resulting in a monetized cost burden of \$283.<sup>386</sup> In these cases, the Commission preliminarily estimates an additional third-party service provider fee of \$100 per response.<sup>387</sup> The Commission preliminarily estimates that an average broker-dealer will receive approximately 200 requests annually.<sup>388</sup> Therefore, the total annual burden for all 200 broker-dealers that route institutional orders to comply with the customer response requirement in proposed Rule 606(b)(3) is preliminarily estimated to be 67,000 hours, resulting in a monetized cost burden of \$13,939,000, plus an additional fee of \$1,300,000 to compensate third-party service providers for producing the reports.<sup>389</sup>

Further, as a result of proposed Rule 606(b)(3), broker-dealers that route institutional orders would likely re-evaluate their best execution methodologies to take into account the availability of new statistics and other information that may be relevant to their decision making. This may impose a cost only to the extent that broker-dealers choose to build the proposed statistics into their best execution methodologies. In addition, they may only choose to do so if the benefits justify the costs.

Another potential cost of proposed Rule 606(b)(3) is that the reports could be viewed as a replacement of TCA and therefore have a negative impact on the market for TCA. Specifying a minimum length of time for making the Rule 606 reports publicly available may further impose a cost on third-party vendors that aggregate the time series of the reports. For example, suppose that a customer chooses to no longer purchase TCA once reports from proposed Rule 606(b)(3) become available, because the customer decides that the information contained in proposed Rule 606(b)(3) reports is sufficient. If fewer customers purchase TCA, it would have a negative impact on third-party providers of TCA as well as third-party data vendors, *e.g.*, in terms of less demand for their services, and the quality of TCA provided by third-parties may decrease because third-party providers of TCA

might have fewer resources for the development and maintenance of their product offerings and because fewer customers may also lead to less data the third-party providers can base their models on.<sup>390</sup> However, as discussed in Section V.C.1.b.i, the reports required by proposed Rule 606(b)(3) would provide information that could be complementary to TCA. As discussed above, in fact, proposed Rule 606(b)(3) could make TCA more useful and provide incentives to customers to use TCA. As a result, the Commission preliminarily believes that proposed Rule 606(b)(3) will not replace TCA.

As discussed in Section V.C.1.b.i, proposed Rule 606(b)(3) would require differentiating order routing strategies for institutional orders into three types: Passive, neutral, and aggressive order routing strategies. The Commission preliminarily believes that broker-dealers would incur costs associated with creating their methodologies, assigning each order routing strategy for institutional orders into one of these three categories according to the methodologies, promptly updating the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments, and documenting the specific methodologies it relies upon for making such assignments. The Commission preliminarily estimates the one-time, initial burden for a broker-dealer that routes institutional orders to establish and document in-house its specific methodologies for assigning order routing strategies as required by proposed Rule 606(b)(3)(v) to be 40 hours resulting in a monetized cost burden of \$12,620.<sup>391</sup> The Commission preliminarily estimates the one-time, initial burden for a broker-dealer that routes institutional orders who will work with a third-party service provider to assign into categories its current order routing strategies and establish and document its specific methodologies as required by Rule 606(b)(3)(v) to be 10 hours resulting in a monetized cost burden of \$2,896 plus an additional fee of \$5,000 to the third-party service provider.<sup>392</sup> These figures are based on the estimated number of hours to establish and review such methodologies. As noted above, the

<sup>390</sup> Based on staff experience, the Commission understands that customers of third-party TCA providers typically transmit their execution data to their TCA providers. The third-party TCA providers in turn base their models on the data they receive from all their customers. Having more data to base models on is generally beneficial and may result in better models.

<sup>391</sup> See *supra* note 277.

<sup>392</sup> See *supra* notes 279 and 280.

<sup>379</sup> See *supra* note 240.

<sup>380</sup> See *supra* note 242.

<sup>381</sup> See *supra* note 243.

<sup>382</sup> See *supra* note 244.

<sup>383</sup> See *supra* note 245.

<sup>384</sup> See *supra* note 247.

<sup>385</sup> See *supra* note 250.

<sup>386</sup> See *supra* note 254.

<sup>387</sup> See *supra* note 255.

<sup>388</sup> See *supra* note 251.

<sup>389</sup> See *supra* notes 259 and 260.

Commission preliminarily estimates that 135 broker-dealers who route institutional orders will create the required reports themselves while 65 such broker-dealers will use a third-party service provider to create the required reports. Therefore, the total initial burden for all broker-dealers that route institutional orders to assign its routing strategies into passive, neutral, and aggressive strategies is preliminarily estimated to be 6,050 hours resulting in a monetized cost burden of \$1,891,940 plus an additional fee of \$325,000 to the third-party service providers.<sup>393</sup>

Once the methodologies are established and documented, broker-dealers that route institutional orders would be required to assign each order routing strategy for institutional orders into one of these three categories according to the methodologies in a consistent manner and promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignments.<sup>394</sup> The Commission preliminarily estimates that the annual cost for a broker-dealer who will assign its order routing strategies to one of the three categories and update such assignments in-house to comply with Rule 606(b)(3)(v) will be 15 hours resulting in a monetized cost burden of \$3,500.<sup>395</sup> The Commission preliminarily estimates that the annual burden for a broker-dealer who routes institutional orders who engages a third-party service provider to assign the order routing strategies into categories to comply with Rule 606(b)(3)(v) will be 5 hours resulting in a monetized cost burden of \$1,609 plus an additional third-party service provider fee of \$1,000.<sup>396</sup> As noted above, the Commission preliminarily estimates that 135 broker-dealers who route institutional orders will create the required reports themselves while 65 such broker-dealers will use a third-party service provider to create the required reports. Therefore, the total annual burden for broker-dealers that route institutional orders to assign the routing strategies of their institutional orders into passive, neutral, and aggressive strategies is preliminarily estimated to be 2,350 hours resulting in a monetized cost burden of \$577,085 plus an additional third-party service provider fee of \$65,000.<sup>397</sup>

<sup>393</sup> See *supra* notes 283 and 284.

<sup>394</sup> For example, a broker-dealer may develop new order routing strategies, change existing order routing strategies, or change the descriptions of existing order routing strategies.

<sup>395</sup> See *supra* note 285.

<sup>396</sup> See *supra* notes 287 and 288.

<sup>397</sup> See *supra* notes 291 and 292.

### iii. Request for Comment

The Commission requests comment on the Commission's analysis of the costs and benefits of the proposed amendments in Rule 606(b)(3). In particular, the Commission solicits comment on the following:

137. Are the assumptions underlying the Commission's estimates for the costs of implementation and ongoing costs to comply with the proposal appropriate? Please provide data and analysis to support your view.

138. Do commenters believe that broker-dealers currently have systems that contain the data that would be used in the reports? What data would be incremental to that already maintained by broker-dealers? What incremental costs would be necessary to modify and maintain information systems architecture?

139. Do commenters believe there are additional costs or benefits that could be quantified or otherwise monetized? If so, please identify these costs and benefits. Please explain and provide specific data and estimates.

140. Do commenters believe there are any additional costs or benefits that may arise from the proposal? Are there costs and benefits described that would likely not result from the proposed amendments? Are there any unintended consequences that have not been discussed that may result from the proposal?

141. Do commenters believe that there are methods by which the Commission could reduce the costs imposed by the proposal, while still achieving its stated goals? Please explain in detail.

The Commission also seeks comment on the analysis of the costs and benefits for the definition of an actionable IOI in proposed Rule 600(b)(1). In particular, the Commission solicits comment on the following:

142. Do commenters believe that the Commission's proposed definition of actionable IOI is appropriate in light of the estimated costs and benefits? If not, please provide alternative definitions with a detailed discussion of what the benefits and costs of those alternatives would be. Please provide data and analysis to support your view.

### c. Public Reports for Institutional Orders Under Proposed Rule 606(c)

#### i. Benefits

Proposed Rule 606(c) would require public quarterly reports broken down by calendar month on the order routing and execution quality of institutional orders by each broker-dealer. As a result, proposed Rule 606(c) would provide the public with standardized

information regarding all broker-dealers' institutional order routing practices and execution quality aggregated across each broker-dealer's customers.

While these reports would be aggregated across all customers a broker-dealer serves, the reports would allow current and prospective customers to compare broker-dealers' institutional order routing practices and execution quality and ultimately, to inform their choice of broker-dealers. For example, customers may use the quarterly public reports broken down by calendar month to decide whether they should enter into a business relationship with broker-dealers to whom they do not currently send orders. Additionally, the reports may allow customers to compare the execution services of their current broker-dealers with other competitors, who might offer the same execution quality at lower costs, improved execution quality at the same costs, or lower cost services and better execution quality.

As discussed in Section V.C.1.b.i, greater transparency about order routing practices and execution quality may promote competition in the market for brokerage services and between trading centers. The Commission preliminarily believes that public aggregated institutional order handling reports required by proposed Rule 606(c) would increase the transparency of institutional order routing and execution quality and provide additional information to customers beyond that provided by customer-specific reports required by proposed Rule 606(b)(3). Customers would be able to compare their broker-dealers not just based on the orders they send to the broker-dealers, but also based on all institutional orders handled by the broker-dealers. In addition, customers would be able to evaluate the order routing and execution quality of broker-dealers they do not send orders to and could determine whether to send orders to a given broker-dealer based on such evaluation.

Broker-dealers, in turn, might be able to adjust their business practices to compete better, specifically along the dimensions of order routing and execution quality and, through the public aggregated institutional order handling reports, try to attract orders from customers with whom they do not yet have a business relationship. The Commission preliminarily believes that the broker-dealers would have greater incentive to route institutional orders in a manner beneficial to a customer in order to attract additional order flow from those customers who may use the public aggregated institutional order

handling reports required by proposed Rule 606(c) to compare relative broker-dealer execution quality. Ultimately, greater transparency may increase competition in the brokerage services market, thereby potentially reducing costs to customers in terms of cost of services and execution quality for institutional orders, of which transaction costs is one measure.

As discussed in Section V.C.1.b.i, if broker-dealers change their institutional order routing decisions, it might promote competition among trading centers. The public aggregated institutional order handling reports required by proposed Rule 606(c) would allow trading centers to compare the execution quality of orders on different trading centers as well as the routing behavior of broker-dealers. The trading centers would have a further incentive to improve execution quality to attract order flow and the public aggregated institutional order handling reports that are broken down by month would allow them to see the effects of any changes they implement. In addition, this may lead to innovation by existing trading centers and it may attract new entrants and the formation of new trading centers.

As discussed for the customer-specific reports required by proposed Rule 606(b)(3) in Section V.C.1.b.i, customers may also initiate a dialogue with their broker-dealers, or broker-dealers they are considering to use, based on the public aggregated institutional order handling reports required by proposed Rule 606(c). This dialogue may include discussions about conflicts of interest<sup>398</sup> and how to match the needs of customers with the order routing practices of the broker-dealers to whom they send orders.

Further, third-party vendors offering analytical services may use the information in the public aggregated institutional order handling reports in an attempt to sell customized reporting tools and services. These types of consulting services may allow customers and the public to better identify the potential conflicts of interest that broker-dealers face with directing order flow to trading centers offering liquidity rebates and fees.

<sup>398</sup> As noted above, institutional customers may be able to utilize the customer-specific reports as required by proposed Rule 606(b)(3) to examine the venues their broker-dealers are routing orders to and the rebates received and fees paid. The Commission notes that similar information would be reflected in the public aggregated institutional order handling reports and could be useful for institutional customers to discuss order routing practices and management of conflicts of interest with broker-dealers or prospective broker-dealers.

Greater transparency of institutional order routing and execution could help shed light on the effect of today's dispersed and complex market structure on order routing decisions and related execution quality. The Commission preliminarily believes that the requirement in proposed Rule 606(c) for quarterly disclosure on order routing, order execution, and orders that provide and remove liquidity for each venue broken down by order routing strategy should provide the public with a better understanding of the operating procedures of broker-dealers and how their decisions are affected by the current market structure. In addition, the information on rebates and fees broker-dealers receive or incur would allow the public to assess how broker-dealers manage potential conflicts of interest they face when routing institutional orders.

As discussed for the customer-specific reports required by proposed Rule 606(b)(3) in Section V.C.1.b.i, the public aggregated institutional order handling reports broken down by calendar month required by proposed Rule 606(c) would also give customers information about broker-dealer internalization rates and the rebates received and fees paid by broker-dealers. As described above, the public aggregated institutional order handling reports would require the disclosure of information by all broker-dealers that receive institutional orders. Customers would be able to compare internalization rates of their broker-dealers and rebates received and fees paid by their broker-dealers to those of broker-dealers they do not send orders to. As such, the information about broker-dealer internalization rates, rebates, and fees in the public aggregated institutional order handling reports required by proposed Rule 606(c) would be complementary to the customer-specific reports required by proposed Rule 606(b)(3), which would provide customers only information about their orders rather than all orders a given broker-dealer receives.

In addition, proposed Rule 606(c) would require the public aggregated institutional order handling reports to be posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site. This requirement would allow customers and the public to readily access historical data for at least three years without the need to download the reports frequently, *e.g.*, quarterly, or purchasing the data from a third-party vendor. Customers and the public could analyze the historical data and evaluate

the order routing decisions and execution quality provided by broker-dealers based on the historical data.

Further, the public aggregated institutional order handling reports required by proposed Rule 606(c) could improve the extent and quality of information available to the Commission and other regulatory agencies, thereby assisting in the regulatory oversight of broker-dealers' operations.

Finally, proposed Rule 606(c) would require the public aggregated institutional order handling reports be made available using an XML schema and associated PDF renderer to be published on the Commission's Web site.<sup>399</sup> The benefits and costs associated with this requirement are discussed in Section V.C.4.

#### ii. Costs

The Commission considered whether the public aggregated institutional order handling reports that would be required pursuant to proposed Rule 606(c) may disclose information about specific institutional orders that currently is not publicly available, and preliminarily believes that the possibility of such disclosure and associated costs are small. First, the reports required by proposed Rule 606(c) would be quarterly reports broken down by calendar month made public within one month after the end of the quarter. As a result, it is very unlikely that the reports would contain any information about orders that are being worked by broker-dealers at the time of publication. Second, the reports would be aggregated across all customers a broker-dealer serves. To the extent that a broker-dealer serves multiple customers placing institutional orders, it would be difficult to identify the orders of a particular customer in the proposed reports. However, it is possible that, for example, a smaller broker-dealer may have one customer placing institutional orders that represents the majority of its business and this may be known to other market participants. In this case, it may be possible to learn from the reports some information about the order flow of that customer, particularly the order flow given to the specific broker-dealer. This information would not be about active orders but could provide historical information about the general characteristics of the customer's order flow, *e.g.*, how much of its order flow has been handled using aggressive or passive order routing strategies. To the extent that these characteristics apply to future orders, this information

<sup>399</sup> See *supra* Section III.A.3.

may be useful to other market participants. Such a potential outcome could put smaller broker-dealers (that is, those with a small set of customers or handling a relatively small number of institutional orders) at a competitive disadvantage relative to larger broker-dealers, as customers might avoid using smaller broker-dealers to avoid possible disclosure that could be traced back to the customer. However, because the proposed public aggregated institutional order handling report would not disclose the specific orders and the historical data would reflect prior calendar quarters, the Commission preliminarily believes that the potential risks and costs due to this would be small.

Proposed Rule 606(c) would require each broker-dealer to post the public aggregated institutional order handling report for a period of three years from the initial date of posting on the Internet Web site. As noted above, the Commission preliminarily believes that, once the report is posted, maintaining the report on the Web site will not impose any additional burden on broker-dealers, and thus any additional costs to maintain the report on the Web site would be negligible.

The disclosure requirements of proposed Rule 606(c) would impose a cost, as they would require some reprogramming by broker-dealers that handle institutional orders. In addition, preparing and disseminating the data to the public in the form required by proposed Rule 606(c) would impose costs on such broker-dealers. However, a broker-dealer could use the infrastructure and processes they put in place for the customer-specific reports required by proposed Rule 606(b)(3) such that the additional cost to comply with proposed Rule 606(c) may be low. The Commission preliminarily estimates that a broker-dealer who handles institutional orders and formats and creates public aggregated institutional order handling reports itself will incur an initial burden of 20 hours resulting in a monetized cost burden of \$4,990 to comply with the quarterly reporting requirement of proposed Rule 606(c).<sup>400</sup> The Commission preliminarily estimates that a broker-dealer who uses a third-party service provider to create the public aggregated institutional order handling reports would incur an initial burden of 5 hours resulting in a monetized cost burden of \$1,415 plus an additional third-party service provider fee of \$2,500.<sup>401</sup> As noted above, the

Commission preliminarily estimates that 135 broker-dealers who route institutional orders will create the required reports themselves while 65 such broker-dealers will use a third-party service provider to create the required reports. Therefore, the total initial burden for broker-dealers that route institutional orders to produce the quarterly report is preliminarily estimated to be 3,025 hours resulting in a monetized cost burden of \$765,625 plus an additional \$162,500 fee to compensate third-party service providers for producing the reports.<sup>402</sup>

Further, the Commission preliminarily estimates that each broker-dealer that routes institutional orders who prepares its own reports will incur an average burden of 10 hours resulting in a monetized cost burden of \$1,600<sup>403</sup> to prepare, disseminate, and keep for a period of three years a quarterly report required by proposed Rule 606(c), or a burden of 40 hours resulting in a monetized cost burden of \$6,400 per year.

The Commission preliminarily estimates that each broker-dealer that routes institutional orders that uses a third-party service provider to prepare the reports required under proposed Rule 606(c) will incur an average burden of 2 hours resulting in a monetized cost burden of \$443 plus an additional third-party service provider fee of \$500<sup>404</sup> to prepare and make publicly available a quarterly report, or a burden of 8 hours resulting in a monetized cost burden of \$1,772 plus an additional third-party service provider fee of \$2,000 per year.<sup>405</sup> As noted above, the Commission preliminarily estimates that 135 broker-dealers who route institutional orders will create the required reports themselves while 65 such broker-dealers will use a third-party service provider to create the required reports. Therefore, the total burden per year for all broker-dealers who route institutional orders to comply with the reporting requirement in proposed Rule 606(c) is preliminarily estimated to be 5,920 hours resulting in a monetized cost burden of \$979,180 plus an additional third-party service provider fee of \$130,000.<sup>406</sup>

### iii. Request for Comment

The Commission requests comment on the Commission's analysis of the costs and benefits of the proposed amendments in Rule 606(c). In

particular, the Commission solicits comment on the following:

143. Do commenters believe that the assumptions underlying the Commission's estimates for the costs of implementation and ongoing costs to comply with the proposal are appropriate? Please provide data and analysis to support your view.

144. Do commenters believe there are additional costs or benefits that could be quantified or otherwise monetized? If so, please identify these costs and benefits. Please explain and provide specific data and estimates.

145. Do commenters believe there are any additional costs or benefits that may arise from the proposal? Are there costs and benefits described that would likely not result from the proposed amendments? Are there any unintended consequences not discussed above that may result from the proposal?

146. Do commenters believe that there are methods by which the Commission could reduce the costs imposed by the proposal, while still achieving its stated goals? Please explain in detail.

## 2. Disclosures for Retail Orders

Rule 606(a) requires each broker-dealer to make publicly available quarterly reports on its routing of non-directed orders in NMS securities. The Commission preliminarily believes that the proposed amendments to Rule 606(a) would increase the level of transparency about order routing and execution quality for retail orders through the enhanced disclosure of data regarding order routing and execution. The proposed amendments to Rule 606(a) require that the public quarterly reports be broken down by calendar month and differentiate between marketable and non-marketable limit orders. The proposed amendments also would remove the requirement that the quarterly reports be divided into three separate sections for securities that are listed on the NYSE, Nasdaq, and Amex. The proposed amendments to Rule 606(a)(1)(iii) also require that the reports include for Specified Venues the net aggregate amount of any payment for order flow, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received, both as a total dollar amount and on a per share basis, for specified types of orders. The proposed amendment to Rule 606(a)(1)(iv) would add the requirement that broker-dealers describe any terms of payment for order flow arrangements and profit-sharing relationships with Specified Venues that may influence their order routing decisions, including, among other things: (1) Incentives for equaling or

<sup>402</sup> See *supra* note 264.

<sup>403</sup> See *supra* note 266.

<sup>404</sup> See *supra* notes 269 and 270.

<sup>405</sup> See *supra* notes 271 and 272.

<sup>406</sup> See *supra* notes 275 and 276.

<sup>400</sup> See *supra* note 261.

<sup>401</sup> See *supra* notes 262 and 263.

exceeding an agreed upon order flow volume threshold, such as additional payments or a higher rate of payment; (2) disincentives for failing to meet an agreed upon minimum order flow threshold, such as lower payments or the requirement to pay a fee; (3) volume-based tiered payment schedules; and (4) agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue.<sup>407</sup> In addition, the proposed amendments to Rule 606(a) would require broker-dealers to keep their reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site, and would require such reports to be made available using an XML schema and associated PDF renderer to be published on the Commission's Web site.

The benefits and costs of each of these proposed amendments are discussed below. Wherever possible, we quantify cost estimates for a given amendment. For the remaining amendments concerning retail orders, we provide total quantitative cost estimates for these amendments in Section V.C.2.e.

#### a. Marketable Limit Orders and Non-Marketable Limit Orders

##### i. Benefits

The proposed amendments to Rule 606(a), which applies to retail orders, would require broker-dealers to differentiate between marketable and non-marketable limit orders. Marketable and non-marketable limit orders generally are handled differently, *i.e.*, non-marketable limit orders are typically posted to an order book, which may result in a different fee or rebate compared to a marketable limit order that may be immediately executed and not posted to the book.

The proposed amendments could allow the public, including customers placing retail orders, to better understand the potential for conflicts of interest broker-dealers face when routing retail orders. For example, if a broker-dealer routes all non-marketable limit orders to the trading centers that pay the highest rebate for orders providing liquidity, the broker-dealer may be maximizing its revenue potentially to the detriment of execution quality. Recent academic research has identified indications of such routing behavior for retail orders.<sup>408</sup> On examining the order routing of ten broker-dealers, the researchers find that

four of the broker-dealers sell market orders to market makers and route limit orders to market makers or exchanges offering the largest liquidity rebates. In addition, their study indicates that a negative relation exists between take fees and the likelihood that a limit order fills and the speed and realized spread of the associated fill.<sup>409</sup> The disclosure of order routing data broken down by marketable and non-marketable limit orders could incentivize broker-dealers to better manage these and other potential conflicts of interest, which may result in improved order routing decisions and execution quality for retail orders. The disclosure could also help customers and others to assess if and how well broker-dealers manage the potential conflicts of interest they face when routing retail orders, and would be a way for broker-dealers to show that they are indeed managing these potential conflicts of interest.

In addition, if the additional proposed disclosure results in broker-dealers improving their order routing for retail orders, which, in turn, may change which trading centers the broker-dealers route retail orders to, the proposed disclosure could further promote competition among trading centers. The new information that would be in the public reports required by proposed Rule 606(a)(1) would allow trading centers to compare the order routing decisions of broker-dealers and the trading centers retail orders are routed to, which could then inform how the trading centers attempt to attract retail order flow. The quarterly public reports, which would be broken down by month, would allow trading centers to see effects of any adjustments they implement in response to broker-dealers changing their order routing strategies. In addition, this proposed new disclosure may lead to innovation by existing trading centers and it may attract new entrants and the formation of new trading centers.<sup>410</sup>

##### ii. Costs

The proposed amendments to Rule 606(a) to require broker-dealers to differentiate between marketable and non-marketable limit orders would impose costs on broker-dealers. Preliminary estimates for compliance costs are contained in the estimates for

<sup>409</sup> See *id.*

<sup>410</sup> In particular, a trading center that loses order flow to venues that offer better execution quality would have the incentive to innovate to improve its execution quality. Therefore, because the proposed disclosures may encourage broker-dealers to route for better execution quality, they may lead to innovation on trading centers.

the costs of producing the reports discussed in Section V.C.2.e.

##### iii. Request for Comment

The Commission requests comment on the Commission's analysis of the costs and benefits of the proposed amendments in Rule 606(a). In particular, the Commission solicits comment on the following:

147. Do commenters believe that the assumptions underlying the Commission's estimates for the costs of implementation and ongoing costs to comply with the proposal are appropriate? Please provide data and analysis to support your view.

148. Do commenters believe there are additional costs or benefits that could be quantified or otherwise monetized? If so, please identify these costs and benefits. Please explain and provide specific data and estimates.

149. Do commenters believe there are any additional costs or benefits that may arise from the proposal? Are there costs and benefits described that would likely not result from the proposed amendments? Are there any unintended consequences not discussed above that may result from the proposal?

150. Do commenters believe that there are methods by which the Commission could reduce the costs imposed by the proposal, while still achieving its stated goals? Please explain in detail.

#### b. Net Payment for Order Flow and Transaction Fees and Rebates by Specified Venue

##### i. Benefits

Under the proposed amendments to Rule 606(a)(1)(iii), for retail orders, broker-dealers would be required to publicly report the net aggregate amount of any payment for order flow, payment from any profit-sharing relationship received, the transaction fees paid, and transaction rebates received, both as a total dollar amount and on a per share basis, for each of the following order types: market orders, marketable limit orders, non-marketable limit orders, and other orders.

Similarly to differentiating marketable and non-marketable limit orders discussed in Section V.C.2.a.i, the information required by proposed Rule 606(a)(1)(iii) could also allow the public, including customers placing retail orders, to better understand the potential conflicts of interest broker-dealers face when routing retail orders.<sup>411</sup> The proposed disclosure of information could provide additional

<sup>411</sup> See *supra* Section II.C. for an example of routing decisions being affected by conflicts of interest.

<sup>407</sup> See proposed Rule 606(a)(1)(iv).

<sup>408</sup> See Battalio, Corwin, and Jennings Paper, *supra* note 57.

incentives to broker-dealers to monitor the potential conflicts of interest, and to review and alter how they route retail orders, which could result in improved order routing decisions and execution quality for retail orders. The disclosure could also help the public to assess better if and how well broker-dealers manage the potential conflicts of interest they face when routing retail orders.

Under proposed Rule 606(a)(1)(iii), broker-dealers would be required to disclose on a quarterly basis more detailed information on net payment for order flow, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received per share and in total. Customers and the public could use this information to gauge whether payments for order flow or maker-taker fees affect the order routing decisions of broker-dealers. For example, if a customer pays a flat-rate commission to its broker-dealer, and any rebate received, or any fraction thereof, is retained by the broker-dealer, then the broker-dealer may have a financial incentive to route the retail order to the trading center offering the highest rebate or lowest fee.<sup>412</sup> Brokerage commissions, which are known to the customer, may depend on the rebates and take fees collected or paid by broker-dealers.<sup>413</sup> For example, broker-dealers that collect more in rebates may pass this income on to customers by charging lower commissions. However, routing solely to maximize rebates or minimize take fees may result in lower execution quality than other routing strategies. Without the proposed disclosures customers might take only brokerage commissions into account and might, therefore, suboptimally choose the lowest commission broker-dealer, without considering other relevant costs. Such customers could, in fact, end up paying higher net costs if the lower commission broker-dealers do not obtain good execution quality for the retail orders. The information required by proposed Rule 606(a)(1)(iii), together with the proposed amendments to Rule 606(a) requiring differentiating of marketable and non-marketable limit orders, would give customers additional information to make decisions based on more than the brokerage commissions.

In addition, as discussed in Section V.C.2.a.i, if broker-dealers improve their order routing for retail orders, which

may result in changes to which trading centers they route retail orders to, it could promote competition between trading centers. The trading centers could gauge, like customers, whether payment for order flow or maker-taker fees affect the order routing decision of broker-dealers. The trading centers may change their fees or attempt otherwise to attract retail order flow and the quarterly public reports that are broken down by calendar month would allow them to see effects of any changes they implement. In addition, this may lead to innovation by existing trading centers and it may attract new entrants and the formation of new trading centers.

#### ii. Costs

Proposed Rule 606(a)(1)(iii) would impose initial costs on broker-dealers in creating a new process to complete the reports and increase ongoing costs related to incorporating additional information into the reports. Preliminary estimates for the compliance costs are contained in the estimates for the costs of producing the reports discussed in Section V.C.2.e. It is possible that increased transparency about the net aggregate amount of any payment for order flow, payment from any profit-sharing relationship, transaction fees paid, and transaction rebates received, and subsequent scrutiny by retail customers, the public, academics, regulators, and the financial media, may lead broker-dealers to decrease the degree to which they internalize orders and route orders to high rebate or low fee exchanges to avoid the perception of conflicts of interest. Broker-dealers might do this if they perceive the potential costs from increased public scrutiny that would result from the enhanced disclosures to be relatively high compared to the benefit from sending retail orders to internalizers or routing retail orders to high rebate and low fee trading centers. If this were to occur then these retail orders might be more likely to be routed to trading centers other than internalizers, such as exchanges or alternative trading systems,<sup>414</sup> regardless of potential execution quality differences such as relatively less price improvement, or they might be more likely to be routed to other lower rebate or higher fee venues, regardless of the potential execution quality differences. In addition, if broker-dealers were to reduce the retail order flow sent to internalizers who pay for it, the broker-dealers would receive less payment for retail order flow and might pass the lost payments onto their retail customers by

raising brokerage commissions or other fees. Similarly, if broker-dealers were to route retail orders to trading centers with lower rebates and higher fees, they might pass the reduction in rebate revenue and increase in fee costs on to their retail customers by raising brokerage commissions or other fees.

It is possible that increased transparency about net payment for order flow and payments from profit-sharing relationships, and subsequent scrutiny by retail customers, the public, academics, regulators, and the financial media, might lead broker-dealers to alter their payment for order flow or profit-sharing relationships or not enter such relationships. Broker-dealers might do this if they perceive the potential costs from increased public scrutiny to be relatively high compared to a broker-dealer's benefit from such relationships. This could lead to lower payments received from such relationships. The affected broker-dealers might offset these lower revenues or higher costs by increasing brokerage commissions or other fees for retail customers.

#### iii. Request for Comment

The Commission requests comment on the Commission's analysis of the costs and benefits of the proposed amendments in Rule 606(a)(1)(iii). In particular, the Commission solicits comment on the following:

151. Do commenters believe that the assumptions underlying the Commission's estimates for the costs of implementation and ongoing costs to comply with the proposal are appropriate? Please provide data and analysis to support your view.

152. Do commenters believe there are additional costs or benefits that could be quantified or otherwise monetized? If so, please identify these costs and benefits. Please explain and provide specific data and estimates.

153. Do commenters believe there are any additional costs or benefits that may arise from the proposal? Are there costs and benefits described that would likely not result from the proposed amendments? Are there any unintended consequences not discussed above that may result from the proposal?

154. Do commenters believe that there are methods by which the Commission could reduce the costs imposed by the proposal, while still achieving its stated goals? Please explain in detail.

#### c. Discussion of Arrangement Terms With a Specified Venue

##### i. Benefits

As discussed in Section III.B.3., the proposed amendment to Rule

<sup>412</sup> See, e.g., Battalio, Corwin, and Jennings Paper, *supra* note 57.

<sup>413</sup> The Commission notes that it does not believe that fees and rebates are the only determinants of brokerage commissions.

<sup>414</sup> See *supra* note 3.

606(a)(1)(iv) would require broker-dealers to describe in their quarterly public report any terms of payment for order flow arrangements and profit-sharing relationships, whether written or oral, with a Specified Venue that may influence their order routing decisions, including, among other things: (1) Incentives for equaling or exceeding an agreed upon order flow volume threshold, such as additional payments or a higher rate of payment; (2) disincentives for failing to meet an agreed upon minimum order flow threshold, such as lower payments or the requirement to pay a fee; (3) volume-based tiered payment schedules; and (4) agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue. The Commission preliminarily believes that the description provided by proposed Rule 606(a)(1)(iv) would help ensure consistent, accurate, and comprehensive disclosure of terms of payment for order flow and profit-sharing relationships that influence broker-dealer order routing decisions. This would make the public reports required by amended Rule 606(a) more useful to customers and the public, and the benefits of the description required by proposed Rule 606(a)(1)(iv) are similar to the benefits of the disclosures of the net payment for order flow and transaction fees and rebates by Specified Venue required by proposed Rule 606(a)(1)(iii) and discussed in Section V.C.2.b.i.

The disclosures required by proposed Rule 606(a)(1)(iv) could allow the public, including customers placing retail orders, to better understand the potential conflicts of interest broker-dealers face when routing retail orders.<sup>415</sup> Together with the proposed amendments to Rule 606(a) concerning differentiating marketable and non-marketable limit orders and with proposed Rule 606(a)(1)(iii), proposed Rule 606(a)(1)(iv) could give customers placing retail orders useful information about potential conflicts of interest. The disclosures required by Rule 606(a)(1)(iv) would give customers access to information on the terms of payment for order flow arrangements and profit-sharing relationships between broker-dealers and Specified Venues. Customers could use that information to gauge whether those arrangements affect the order routing decisions of broker-dealers. The proposed disclosures could incentivize broker-dealers to monitor their potential conflicts of interest, and to review and alter how they route retail

orders, which could result in improved order routing decisions and execution quality for retail orders. The disclosure could also help the public to assess if and how well broker-dealers manage the potential conflicts of interest they face when routing retail orders.

In addition, as discussed in Section V.C.2.a.i, if broker-dealers improve their order routing for retail orders, which may result in changes to which trading centers they route retail orders to, it could promote competition between trading centers. The trading centers could gauge, like customers, whether payment for order flow arrangements and profit-sharing relationships between broker-dealers and Specified Venues affect the order routing decisions of broker-dealers. The trading centers may change their payment for order flow arrangements and profit-sharing relationships with broker-dealers or attempt otherwise to attract retail order flow and the quarterly public reports that are broken down by calendar month would allow them to see effects of any changes they implement. In addition, this may lead to innovation by existing trading centers and it may attract new entrants and the formation of new trading centers.

#### ii. Costs

Given that the proposed changes to Rule 606(a)(1)(iv) constitute an amendment to an existing disclosure, the Commission preliminarily estimates the initial paperwork burden for a broker-dealer that handles retail orders to review and assess its payment for order flow arrangements and profit-sharing relationships, whether written or oral, with a Specified Venue that may influence their order routing decisions, and describe terms of such arrangements to be 10 hours resulting in a monetized cost burden of \$3,155.<sup>416</sup> With 266 broker-dealers that route retail orders required to comply with the rule, the Commission preliminarily estimates the total initial paperwork burden for complying with proposed Rule 606(a)(1)(iv) to be 2,660 hours resulting in a cost of \$839,230.<sup>417</sup> The Commission preliminarily estimates the annual paperwork burden for a broker-dealer that handles retail orders to describe and update any terms of payment for order flow arrangements and profit-sharing relationships, whether written or oral, with a Specified Venue that may influence their order routing decisions to be 15 hours resulting in a monetized cost

burden of \$3,500.<sup>418</sup> With 266 broker-dealers that route retail orders required to comply with the rule, the Commission preliminarily estimates the total annual paperwork burden for complying with proposed Rule 606(a)(1)(iv) to be 3,990 hours resulting in a cost of \$931,000.<sup>419</sup>

Increased disclosure about payment for order flow arrangements and profit-sharing relationships may lead broker-dealers to decrease the amount of internalization used in the execution of market and marketable limit orders and to alter such arrangements and relationships. Section V.C.2.b.ii. discusses this in detail and the associated costs and other effects.

#### iii. Request for Comment

The Commission requests comment on the Commission's analysis of the costs and benefits of the proposed amendments in Rule 606(a)(1)(iv). In particular, the Commission solicits comment on the following:

155. Do commenters believe that the assumptions underlying the Commission's estimates for the costs of implementation and ongoing costs to comply with the proposal are appropriate? Please provide data and analysis to support your view.

156. Do commenters believe there are additional costs or benefits that could be quantified or otherwise monetized? If so, please identify these costs and benefits. Please explain and provide specific data and estimates.

157. Do commenters believe there are any additional costs or benefits that may arise from the proposal? Are there costs and benefits described that would likely not result from the proposed amendments? Are there any unintended not discussed above consequences that may result from the proposal?

158. Do commenters believe that there are methods by which the Commission could reduce the costs imposed by the proposal, while still achieving its stated goals? Please explain in detail.

#### d. Additional Amendments to Retail Disclosures

In addition to the amendments discussed above, the Commission is proposing to amend disclosures for retail orders by aggregating reports across listing exchanges, requiring quarterly reports to be broken down by month, and providing reports in a specific format that are available for a minimum length of time. The benefits and costs of these additional amendments are discussed below.

<sup>415</sup> See *supra* Section II.C. for an example of routing decisions being affected by conflicts of interest.

<sup>416</sup> See *supra* note 318.

<sup>417</sup> See *supra* note 319.

<sup>418</sup> See *supra* note 323.

<sup>419</sup> See *supra* note 324.

## i. Aggregated Reporting

## (a) Benefits

The proposed amendment to Rule 606(a)(1) that requires reports on retail orders be aggregated across all securities may reduce the ongoing costs of the Rule 606(a) reports. Current Rule 606(a)(1) requires that NMS stocks be “divided into three separate sections for securities that are listed on the New York Stock Exchange, Inc., securities that are qualified for inclusion in The Nasdaq Stock Market, Inc., and securities that are listed on the American Stock Exchange LLC or any other national securities exchange.” To satisfy this requirement, broker-dealers have to determine the primary listing of all NMS stocks and incur a cost on an ongoing basis in doing so. Eliminating this requirement would save broker-dealers this cost. In addition, new broker-dealers currently have to create the initial report format for the three groups of NMS stocks, which also imposes a one-time cost.<sup>420</sup> Under the proposed amendment, new broker-dealers would not incur that cost.

## (b) Costs

The Commission’s proposal to aggregate reports on retail order routing across listing exchanges would also impose costs, according to a staff analysis.<sup>421</sup> In particular, the staff analysis indicates that the aggregation

across listing exchanges would reduce the value of the 606 reports for monitoring execution quality from broker-dealers because it would make it harder for retail customers to assess the execution quality provided by their broker-dealers. This section describes the staff’s analysis.

The staff’s analysis focuses on whether customers or others can use the market-specific routing information to assess the execution quality they get from their broker-dealers. Specifically, if the order routing decisions by broker-dealers differ for stocks listed on different exchanges, *e.g.*, if broker-dealers route orders differently for NYSE-listed stocks compared to NASDAQ-listed stocks, the proposed aggregated reports would not provide this information to customers and the public.<sup>422</sup> Such information can be useful for customers and the public as long as order routing decisions determine execution quality and execution costs. Specifically, Commission staff analyzed execution costs as measured by effective spreads from Rule 605 reports (“Rule 605 data”) for common stocks with different primary listing exchanges and on different market centers to determine whether the cost of executing a market or a marketable limit order for common stock varies across market centers and primary listing exchange.<sup>423</sup> The staff’s analysis controls for stock and order

characteristics.<sup>424</sup> Accordingly, the staff’s analysis considers whether execution quality depends on primary listing exchanges, and specifically which market centers provide better execution, as a means to assess whether the proposal might reduce the usefulness of the reports.<sup>425</sup>

While the staff’s analysis is not a direct test of whether order routing differs for stocks with different primary listing exchanges,<sup>426</sup> it does directly measure one important factor in whether such routing information would be useful—differences in execution costs. Information on both execution costs and routing allows customers (or someone acting on behalf of customers) to assess the extent to which their broker-dealer routes customer orders to the market centers with the lowest execution costs. If the execution cost measures show that listing exchange matters for which market centers offer better execution quality, then aggregating the routing information across listing exchanges could reduce the ability for customers to assess one of the components of best execution. Hence, the staff’s analysis provides some indication of whether aggregated reporting, as required by the proposed amendment, would deprive customers and the public of useful information regarding the impact of routing decisions.

TABLE 1—ASSOCIATION BETWEEN TRADING CENTER AND MEAN EFFECTIVE SPREAD FOR COMMON STOCKS BY LISTING EXCHANGE

	Mean effective spread (basis points)		
	(1)	(2)	(3)
	NYSE-listed	NASDAQ-listed	NYSE MKT-listed
Intercept .....	*** 18.02 (227.48)	*** 92.01 (412.45)	*** 177.29 (122.39)
BATS BYX .....	*** -4.12 (-48.43)	*** -35.78 (-141.56)	*** -37.58 (-20.35)
BATS BZX .....	*** -7.04 (-77.28)	*** -40.70 (-161.74)	*** -50.60 (-31.87)
BX .....	*** -1.31 (-14.26)	*** -29.21 (-107.52)	*** -34.06 (-19.01)
CBSX .....	*** 1.12 (8.76)	*** -17.02 (-41.94)	*** 14.94 (4.70)
CHX .....	*** -2.27 (-10.93)	*** -37.72 (-43.53)	*** -21.04 (-2.90)
EDGA .....	*** -4.69 (-55.75)	*** -35.49 (-131.77)	*** -41.53 (-25.03)
EDGX .....	*** -4.28 (-48.53)	*** -27.64 (-96.80)	*** -29.09 (-15.71)

<sup>420</sup> NYSE Arca, Inc. (“NYSE Arca”) and Bats BZX are also listing exchanges but only for exchange traded funds not stocks.

<sup>421</sup> In addition, this proposed amendment would impose an initial cost for broker-dealers who currently capture the data required by the proposed modification to Rule 606(a) to change the process for preparing the reports. These costs are reflected in the cost estimates discussed in Section V.C.2.e.

<sup>422</sup> The Commission notes that there are differences in order routing decisions depending on primary listing exchange due to existing rules, regulations, and practices. For example, the NYSE does not trade NASDAQ- or NYSE MKT-listed stocks. As a result, orders for a NYSE-listed stock can be routed to the NYSE, NASDAQ, and other market centers, whereas orders for NASDAQ-listed

stocks can be routed to NASDAQ and other market centers, but not to the NYSE. This level of information would be lost in aggregated reports.

<sup>423</sup> The Commission purchased the Rule 605 data from CoreOne Technologies, a provider of financial data. The data used in this analysis spans the period from January 1, 2012 through December 31, 2014. The CRSP US Stock Database from Wharton Research Data Services contains daily and monthly market and corporate action data for securities, and is used to estimate control variables.

<sup>424</sup> Specifically, the analysis consists of a regression that uses dollar volume, market capitalization, and mean variance of daily returns to control for stock characteristics, and order type and order size to control for order characteristics.

<sup>425</sup> Similarly, if any of the information required to be disclosed by proposed Rules 606(a)(iii) and (iv) differs for stocks with different listing exchanges, then the proposed aggregation will reduce the information content of the reports, provided that information is valuable to institutions as discussed in Section II.C. For example, it may be the case that payment for order flow arrangements are different for stocks with different primary listing exchanges or an exchange may implement different fees and rebates for stocks with a different primary listing exchange.

<sup>426</sup> Commission staff was unable to obtain historical quarterly reports for retail orders required by current Rule 606(a). Therefore, the Commission staff did not analyze current 606 reports to see if routing differs by listing exchange of the stock.

TABLE 1—ASSOCIATION BETWEEN TRADING CENTER AND MEAN EFFECTIVE SPREAD FOR COMMON STOCKS BY LISTING EXCHANGE—Continued

	Mean effective spread (basis points)		
	(1)	(2)	(3)
	NYSE-listed	NASDAQ-listed	NYSE MKT-listed
NASDAQ .....	*** 1.63 (17.33)	.....	** 3.98 (2.53)
NSX .....	*** -2.85 (-28.76)	*** -37.17 (-118.44)	*** -41.72 (-22.17)
NYSE ARCA .....	*** -5.75 (-70.19)	*** -36.71 (-152.46)	*** -48.49 (-30.82)
NYSE MKT .....	.....	*** -57.02 (-113.92)	.....
Off Exchange .....	*** -3.08 (-43.57)	*** -31.85 (-168.35)	*** -34.54 (-26.76)
PSX .....	*** -3.10 (-39.77)	*** -57.54 (-256.34)	*** -81.01 (-54.98)
Marketable limit order .....	-0.004 (-.11)	*** 2.90 (28.78)	*** -10.83 (-15.95)
500–1,999 shares .....	*** 0.67 (15.32)	*** -2.32 (-21.67)	* -1.23 (-1.87)
2,000–4,999 shares .....	*** 2.22 (44.37)	*** -3.31 (-26.89)	** 1.87 (2.37)
≥5,000 shares .....	*** 3.41 (61.79)	*** -4.23 (-28.66)	*** 2.98 (3.12)
Dollar volume .....	*** -2.86E-08 (-178.5)	*** 2.21E-09 (11.38)	-3.04E-08 (-1.49)
Market capitalization .....	*** 8.03E-12 (12.49)	*** -3.65E-10 (-121.35)	*** -1.96E-08 (-57.69)
Variance of daily return .....	*** 334.54 (21.14)	*** 438.14 (11.66)	*** 877.18 (11.53)
H <sub>0</sub> : All exchange dummies = 0			
Chi-square .....	*** 17,580	*** 75,339	*** 6,346
H <sub>0</sub> : EDGX = Bats BYX			
Chi-square .....	** 4.13	*** 806.78	*** 18.70
Observations .....	9,792,105	10,764,324	688,305
Adjusted R <sup>2</sup> .....	1.02%	1.18%	1.98%
Year fixed effects .....	Yes	Yes	Yes

**Note:** Data are SEC Rule 605 data purchased from CoreOne Technologies and CRSP, and include years 2012–2014. The mean effective spread is equally-weighted by stock. The variable categories that are dropped are: One trading center, market orders (for the regressions involving mean effective spreads), inside-the-quote limit orders (for regressions involving mean realized spreads), order size from 100–499 shares, and the 2012 calendar year. The Chi-square test is used to test the null hypothesis that all of the exchange coefficients, with the exception of the intercept coefficient, are jointly zero. The null hypothesis would imply that all exchanges would not be associated with a mean effective spread different from that associated with NYSE-listed stock orders executed at NYSE. T-statistics estimated from White standard errors are in parentheses. \* indicates significance of a 2-tailed test at the 10% level; \*\* at the 5% level; \*\*\* at the 1% level.

Table 1 presents the results of the staff’s analysis of effective spreads for common stocks listed on the NYSE, NASDAQ, and NYSE MKT. Columns 1 through 3 report the results for each of these primary listing exchanges.<sup>427</sup> The market center rows in the table report the basis point difference between the average effective spreads on that market center and the average effective spreads on the primary listing exchange. In tests of whether effective spreads of each market center are the same as the listing exchange, the rows with stars indicate that the market center effective spreads are statistically significantly different, with more stars indicating stronger confidence in the significance. For illustration, the intercept in Column 1 indicates that the average effective spread for market orders for NYSE-listed stocks that are executed on the NYSE is 18.02 basis points and the -4.12 estimate for Bats BYX Exchange, Inc. (“Bats BYX”) indicates that the effective spreads for NYSE-listed stocks on Bats BYX are 4.12 basis points lower after

<sup>427</sup> The Rule 605 data and, thus, this analysis weight the effective spread statistics equally by stock. Therefore, these effective spreads appear larger than if they were weighted by dollar volume or by share volume.

controlling for differences due to stock and order characteristics.<sup>428</sup>

Table 1 indicates that the average effective spreads vary significantly by the market center where the orders were executed. Table 1 shows that most market center effective spreads are significantly different than those of the listing exchange. For example, Column 1 shows that, for NYSE-listed stocks, the average effective spread on Bats BZX is 7.04 basis points less than on the NYSE itself, and the average effective spread on NASDAQ is 1.63 basis points higher than on the NYSE. In addition, some differences in effective spreads are also economically meaningful. For example, Column 2 reports that the average effective spread for orders in NASDAQ-listed stocks that are executed on NASDAQ is 92.01 basis points and the

<sup>428</sup> For perspective, a one penny effective spread on a \$40 stock is 2.5 basis points. A 2.5 basis point cost on a 100 share trade in a \$40 stock would be \$1.00. An ordinary least squares estimate is consistent when the explanatory variables are exogenous, perfect multicollinearity does not exist, and optimal in the class of linear unbiased estimators when the errors are homoscedastic and serially uncorrelated. Under these assumptions, the method of ordinary least squares provides minimum-variance mean-unbiased estimates when the errors have finite variances. If any one or more of these assumptions does not hold then the estimate may not be the best linear unbiased estimator.

average effective spread for such orders that are executed on NYSE Arca is 36.71 basis points lower, which corresponds to a 55.3 basis point difference and represents a reduction of almost 40%.<sup>429</sup> Differences of such magnitude may be important to broker-dealers when making order routing decisions and to customers in monitoring the execution quality their broker-dealers provide as measured by the current Rule 605 reports.

Table 1 also indicates that the average effective spreads vary significantly by listing exchange. The staff’s analysis suggests that NASDAQ-listed stocks tend to have higher average effective spreads than NYSE-listed stocks because the intercept estimates are much larger in Column 2 compared to Column 1.<sup>430</sup> Table 1 also shows that NYSE MKT-listed stocks tend to have even higher average effective spreads

<sup>429</sup> 36.71/92.01 = 39.9%.

<sup>430</sup> The Commission recognizes that the staff analysis did not control for stock and order characteristic differences across the columns and the staff did not estimate a matched-sample comparison. These other analysis types would facilitate a more fulsome comparison of effective spreads in similar stocks by listing exchange than the staff’s analysis in Table 1. However, because the 606 reports do not distinguish individual stocks, the Commission preliminarily believes that the staff analysis is appropriate for assessing the costs of the proposed amendments.

than NASDAQ-listed stocks by comparing the results in Column 3 with those in Column 2. The Commission notes that neither this result alone nor this result in conjunction with the results in the previous paragraph directly measure whether the proposed amendment would reduce the usefulness of the Rule 606 routing information.

However, a deeper analysis of Table 1 can inform on these costs. Specifically, the results in the table suggest that because the relative ranking of each market center changes depending on the listing exchange, the proposed amendment to aggregate routing information across listing exchanges could reduce the usefulness of Rule 606 reports. Commission staff compared the effective spreads across the various market centers for stocks listed on each of the primary listing exchanges, as indicated by Table 1.

If the ranking of the effective spreads on each market center were the same across the three primary listing exchanges, where a stock is listed would have little or no relationship to whether order routing information informs on execution quality. Such a result would imply that aggregating the reports across primary listing exchanges would not reduce the amount of information in the reports. However, upon examination, Table 1 shows that the ranking of the market centers by effective spreads is different depending on the primary listing exchange. For example, the coefficient estimates in Table 1 suggest that for NYSE-listed stocks, Bats EDGX Exchange, Inc. (“EDGX”) has lower execution costs than Bats BYX, but for NASDAQ-listed stocks, EDGX has higher execution costs than Bats BYX. In Column 1 for NYSE-listed stocks, the differential cost of trading a stock on EDGX versus Bats BYX is small, 0.17 basis points, but statistically significant. However, in Column 2 for NASDAQ-listed stocks, the stocks differ in cost by a statistically significant 8.14 basis points between the same two exchanges. This indicates that there seem to be differences between market centers in terms of effective spreads for stocks with different primary listings that, together with routing information by listing exchange, may inform customers in assessing the execution quality their broker-dealers provide. Therefore, the staff’s analysis indicates that aggregating the reports, as in the proposed amendment, could result in an informational cost to customers and the public.

As noted above in Section III.B.4., while the Commission recognizes that eliminating the division of reports by

the three distinct listing markets may potentially cause some reduction in informational content, as indicated in the analysis above, the Commission preliminarily believes that any diminution in granular listing market data is appropriate in light of the proposed requirement to provide retail customers with pertinent order routing data that reflects today’s multiple trading centers and practices. The Commission solicits comment on the foregoing.

ii. Other Proposed Amendments to Reporting

The Commission is also proposing to require that the quarterly public retail order routing reports required by Rule 606(a)(1) be broken down by calendar month. Current Rule 606(a)(1) requires broker-dealers to make retail order routing reports publicly available for each calendar quarter, and such reports contain aggregate quarterly information on the routing of retail orders. As noted above, the Commission understands that trading centers frequently change their fee structures, including the amount of fees and rebates, in order to attract order flow, and these changes typically occur at the beginning of a calendar month. The changes in fee structures at trading centers likely will affect a broker-dealer’s routing decisions. Disclosing retail order routing information on an aggregated quarterly basis can mask changes in routing behavior in response to changes in a trading center’s fee structure. The Commission preliminarily believes that disclosing the information contained in the public retail routing reports by calendar month would allow customers to better assess whether their broker-dealers’ routing decisions are affected by changes in fee structures and the extent to which such changes affect execution quality. This proposed amendment would, however, require an initial cost to change the process for completing the reports. The Commission preliminarily believes this cost to be small because broker-dealers typically process data daily and reporting the data broken down by month would only be a change in the aggregation of the data, from quarterly to monthly.

In addition, the Commission is proposing that the public retail order routing report required by Rule 606(a)(1) and customer-specific order routing report required by Rule 606(b)(1) be made available using an XML schema and associated PDF renderer to be published on the Commission’s Web site. The benefits and costs associated with this requirement are discussed in Section V.C.4. The Commission

preliminarily believes that requiring both the public and customer-specific retail order routing reports to be provided in this format should be useful to customers as it would allow them to more easily analyze and compare the data provided in both types of reports across broker-dealers, for the reasons discussed above.<sup>431</sup> The proposed amendments to Rule 606(a)(1) and Rule 606(b)(1) would require an initial cost to change the process for completing the reports.<sup>432</sup> The benefits and costs associated with this requirement are discussed in further detail in Section V.C.4.

Finally, the Commission is proposing to amend Rules 605(a)(2) and 606(a)(1) to require market centers and broker-dealers to keep the reports posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years. Requiring that data be available to customers and the public for three years could be useful to those seeking to analyze past execution quality by market center and routing behavior of broker-dealers. Such analysis may lead to increased transparency with regards to execution quality and may lead broker-dealers to compete along this dimension through routing decisions, resulting in a higher probability of execution and improved execution in terms of costs. Current Rules 605 and 606 do not specify the minimum length of time that market centers need to publish the order execution reports and broker-dealers need to publish the retail order routing reports, respectively. As a result, the public may not be able to examine the order execution of a market center and the routing of retail orders by a broker-dealer through time if past reports are not currently available or they have to rely on third-party vendors to supply past reports.

The requirement to make the reports available for three years may also produce costs. As noted above, however, the Commission preliminarily believes that, once the report is posted, maintaining the reports on the Web site will not pose any additional burden on broker-dealers, and thus any additional costs to maintain the report on the Web site would be negligible. Any costs of maintaining the report are included in the Commission’s estimates of the costs broker-dealers will incur to produce the reports, as explained above.<sup>433</sup> In addition, third-party vendors that

<sup>431</sup> See *supra* Section III.A.3.

<sup>432</sup> The benefits and costs associated with this requirement more generally are discussed in Section V.C.4.

<sup>433</sup> See *infra* Section V.C.1.c.ii.

aggregate the time series of 605 and 606 reports may find that their data is less useful, particularly for the three years that the reports are publicly available.

### iii. Request for Comment

The Commission requests comment on the Commission's analysis of the costs and benefits of the proposed amendments in Rule 605(a)(2), 606(a)(1) and 606(b)(1). In particular, the Commission solicits comment on the following:

159. Do commenters believe that the assumptions underlying the Commission's estimates for the costs of implementation and ongoing costs to comply with the proposal are appropriate? Please provide data and analysis to support your view.

160. Do commenters believe there are additional costs or benefits that could be quantified or otherwise monetized? If so, please identify these costs and benefits. Please explain and provide specific data and estimates.

161. Do commenters believe there are any additional costs or benefits that may arise from the proposal? Are there costs and benefits described that would likely not result from the proposed amendments? Are there any unintended consequences that may result from the proposal?

162. Do commenters believe that there are methods by which the Commission could reduce the costs imposed by the proposal, while still achieving its stated goals? Please explain in detail.

### e. Compliance Costs for Retail Order Routing Reports

As discussed in more detail in Section IV.D.4., the Commission preliminarily estimates the costs to comply with the proposed amendments to Rule 606(a) that require broker-dealers to distinguish between marketable and non-marketable limit orders and with proposed Rule 606(a)(1)(iii) that requires disclosure of net payment for order flow and transaction fees and rebates by Specified Venue as follows. The Commission preliminarily estimates that most of the 266 broker-dealers that route retail orders already obtain the information required by the proposed rule and that 50 broker-dealers do not currently obtain such information. The Commission preliminarily estimates that the initial burden for a broker-dealer who routes retail orders to update its systems to capture the information required by proposed Rule 606(a) and format that information into a report to comply with the rule will be 80 hours resulting in a

cost of \$22,648.<sup>434</sup> The Commission preliminarily estimates that 25 broker-dealers whose systems do not currently capture all of the information required by proposed Rule 606(a) will engage a third-party service provider to perform the necessary upgrades. The Commission preliminarily estimates that the initial burden for a broker-dealer that routes retail orders to engage a third-party to perform the necessary system updates to comply with proposed Rule 606(a) will be 20 hours resulting in a monetized cost burden of \$5,985 plus an additional third-party service provider fee of \$10,000.<sup>435</sup> Therefore, the Commission preliminarily estimates the total initial burden for all 50 broker-dealers who need to update their systems and create a new report to be 2,500 hours resulting in a monetized cost burden of \$715,825 plus an additional \$250,000 fee to the third-party service providers.<sup>436</sup>

For the remaining 216 broker-dealers who the Commission preliminarily estimates currently capture the data required by the proposed modifications to Rule 606(a), such broker-dealers would need only to format their reports to incorporate such data. The Commission preliminarily estimates for broker-dealers that already capture such data, 108 would format the reports in-house. The cost to format that data into its existing reports in-house is preliminarily estimated to be 20 hours resulting in a monetized cost burden of \$4,975.<sup>437</sup> The Commission preliminarily estimates that 108 broker-dealers currently engage a third-party service provider to provide reports pursuant to existing Rule 606(a) and such broker-dealers would continue to use third-party service providers to format reports to comply with proposed Rule 606(a). The Commission preliminarily estimates the initial burden for a broker-dealer who engages a third-party service provider to format reports to comply with proposed Rule 606(a) would be 8 hours resulting in a monetized cost burden of \$2,555 plus an additional fee of \$2,000.<sup>438</sup> As such, the Commission preliminarily estimates that the total cost for the 216 broker-dealers who the Commission preliminarily estimates currently capture the data required by proposed Rule 606(a) to format their reports to incorporate such data to be 3,024 hours resulting in a monetized cost burden of \$813,240 plus an additional \$216,000

third-party service provider fee.<sup>439</sup> Therefore, the Commission preliminarily estimates that the total initial burden to comply with Rule 606(a) for all 266 broker-dealers which the Commission preliminarily estimates route retail orders is 5,524 hours resulting in a monetized cost burden of \$1,529,065 plus an additional fee of \$466,000 to third-party service providers.<sup>440</sup>

The Commission preliminarily believes that once the initial costs, described above, have been incurred to allow a broker-dealer to obtain the required information, the cost to produce a quarterly report would remain the same compared to a quarterly report required under current Rule 606(a).<sup>441</sup> However, broker-dealers would need to monitor payment for order flow or profit-sharing relationships and potential SRO rule changes that could impact their order routing decisions and incorporate any new information into their reports. Thus, the Commission preliminarily estimates the annual burden for a broker-dealer to comply with the proposed amendments to Rule 606(a)(1)(i)–(iii) to be 10 hours resulting in a monetized cost burden of \$3,155.<sup>442</sup> With 266 broker-dealers that route retail orders required to comply with the proposed amendments, the Commission preliminarily estimates the total annual burden to be 2,660 hours resulting in a monetized cost burden of \$839,230.<sup>443</sup>

### i. Request for Comment

The Commission requests comment on the Commission's discussion of implementation considerations of the proposed amendments in Rules 606(a)(1) and 606(b)(1). In particular, the Commission solicits comment on the following:

163. Do commenters agree with the Commission's estimates of the costs to comply with the proposed amendments in Rules 606(a)(1) and 606(b)(1) for retail orders? Specifically, do commenters agree with the Commission's estimates for initial costs and for ongoing costs? Please be specific in your response and provide data to support your response.

### 3. Disclosure of Order Execution Information

The proposed amendment to Rule 605(a)(2) requires market centers to keep reports required pursuant to Rule

<sup>434</sup> See *supra* note 299.

<sup>435</sup> See *supra* notes 301 and 302.

<sup>436</sup> See *supra* notes 304 and 305.

<sup>437</sup> See *supra* note 306.

<sup>438</sup> See *supra* notes 308 and 309.

<sup>439</sup> See *supra* notes 312 and 313.

<sup>440</sup> See *supra* notes 314 and 315.

<sup>441</sup> See *supra* Section IV.D.4.b.

<sup>442</sup> See *supra* note 321.

<sup>443</sup> See *supra* note 322.

605(a)(1) posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

#### a. Benefits

Similar to the analogous requirements proposed in Rules 606(a) and 606(c) described above, the Commission preliminarily believes that requiring the previous three years of past order execution information to be available to customers and the public generally should be useful to those seeking to analyze historical order execution information at various market centers. Currently, customers and the public who want to analyze historical order execution information have to either download the data every quarter or they have to rely on third-party vendors to get access to such data. The proposed requirement to make the data readily accessible to the public for three years would allow customers and the public to access and analyze historical order execution information more easily by requiring that historical data are kept posted by the market centers. The public includes other market participants. For example, the proposed requirement to make the data readily accessible to the public for three years would benefit broker-dealers, market centers, and third-party vendors in that it would allow them to access and analyze historical order execution information more easily. This would allow broker-dealers to compare different market centers more easily, market centers to compare themselves to other market centers more easily, and third-party vendors to provide their services based on the data more easily.

#### b. Costs

The Commission preliminarily believes that the costs to market centers for making the order execution reports readily accessible to the public for a period of three years from the date of initial publication are negligible as it amounts to posting the currently-required reports for the three-year time period. In addition, some market centers may already make their reports available to the public for an extended period of time. The requirement to post and maintain reports on an Internet Web site that is free of charge and readily accessible to the public for a period of three years would begin at the adoption of the proposed amendments to Rule 605(a)(2) and apply going forward. Affected entities (the market centers) would not be required to post reports created and posted prior to the proposed Rule's effectiveness.

The Commission notes that specifying a minimum length of time for making the Rule 605 reports available may make the data owned by third-party vendors aggregating the time series of 605 reports less useful because, for three years, the data would be publicly available and more easily accessible.

#### c. Request for Comment

The Commission requests comment on the Commission's analysis of the costs and benefits of the proposed amendments in Rule 605(a)(2). In particular, the Commission solicits comment on the following:

164. Do commenters believe that there are benefits to making order execution reports readily available for three years? If so, please explain.

165. Do commenters agree with the Commission's analysis that the costs are negligible? Why or why not?

#### 4. Structured Format of Reports

The Commission is proposing to require that the retail order routing and institutional order handling reports be made available using the Commission's XML schema and associated PDF renderer. As discussed earlier, the Commission preliminarily believes that requiring the reports to be made available in an XML format will facilitate enhanced search capabilities, and statistical and comparative analyses across broker-dealers and date ranges.<sup>444</sup> In addition, the associated PDF renderer would provide users with an instantly human-readable format for those who prefer to review manually individual reports, while still providing a uniform presentation.

The Commission understands that there are varying costs associated with varying degrees of structuring. Most, if not all, broker-dealers already have experience applying the XML format to their data. For example, all FINRA members must use FINRA's Web EFT system, which requires that all data be submitted in XML.<sup>445</sup> For the end users, with the data in the reports structured in XML, they could immediately download the information directly into databases and analyze it using various software. This would enhance their ability to conduct large-scale analysis and immediate comparison of broker-dealers, and across date ranges. Moreover, as an open standard, XML is widely available to the public at no cost.

The Commission also preliminarily believes that if the reports are provided in a structured format, users could avoid

costs associated with third-party sources who might otherwise extract and structure the data, and then charge for access to that structured data. Users could also avoid the additional time it would take for them to manually review and individually structure the data if they wanted to conduct large-scale analysis, comparison, or aggregation.

The XML schema would also incorporate certain validations to help ensure consistent formatting among all reports, in other words, to help ensure data quality. Validations are restrictions placed on the formatting for each data element so that comparable data is presented comparably. However, these validations would not be designed to ensure the underlying accuracy of the data. Any reports made available by broker-dealers pursuant to the proposal would have to comply with validations that are incorporated within the XML schema, otherwise the reports would not be considered to have been made available using the most recent version of the Commission's XML schema.

XML is an open standard that is maintained by an organization other than the Commission and undergoes constant review. As updates to XML or industry practice develop, the Commission's XML schema may also have to be updated to reflect the updates in technology. In those cases, the supported version of the XML schema would be made available on the Commission's Web site and the outdated version of the schema would be removed in order to maintain data quality and consistency with the standard.

The Commission considered alternative formats to XML, such as comma-separated values ("CSV") and XBRL. The Commission does not believe the CSV format is suitable because it does not lend itself to validations. As a result, the data quality of the reports would likely be diminished as compared to XML, impairing comparability, aggregation, and large-scale analysis. While the XBRL format enables users to capture the rich complexity of financial information presented in accordance with U.S. Generally Accepted Accounting Principles, XBRL is not necessary to accurately capture the information for the proposed reports. The Commission preliminarily believes the simpler characteristics of the information in the required reports are better suited for XML.

#### a. Request for Comment

The Commission requests comment on the Commission's analysis of the proposed structured format for the

<sup>444</sup> See *supra* Section III.A.3.

<sup>445</sup> See <http://www.finra.org/industry/web-crd/web-eft-schema-documentation-and-schema-files>.

proposed reports. In particular, the Commission solicits comment on the following:

166. Should the Commission require a structured format other than XML? If so, please identify the other format; identify how the other format could be used for aggregation, comparison, and large-scale analysis; and identify how the Commission can similarly ensure data quality.

167. As proposed, the public reports will be made available on each broker-dealers' Web site. Are there any benefits to the public or to broker-dealers if the reports were also submitted to the Commission's EDGAR system? If so, please identify those benefits and any associated costs.

168. How and in what format do broker-dealers currently provide their reports for retail orders required by Rule 606(a)(2)?

169. Broker-dealers currently provide reports about order routing and execution quality to institutional customers upon request on a voluntary basis. How and in what format do broker-dealers currently provide those ad-hoc reports?

170. Market centers publish current Rule 605(a) reports in a pipe-delimited ASCII format. Should the Commission require a different structured format for the reports required by Rule 605(a)? Why or why not? If yes, should the Commission require that the reports required by Rule 605(a) be made available using an XML schema and associated PDF renderer published on the Commission's Web site? Why or why not? Please be specific in your response. If commenters believe another format would be more appropriate, please identify the other format and identify how the other format can also be used for aggregation, comparison, and large-scale analysis; and identify how the Commission can similarly ensure data quality. Please identify any benefits and associated costs.

## 5. Other Definitions in Proposed Amendments to Rule 600

### a. Definition of Non-Marketable Limit Order in Proposed Rule 600(b)(51)

Proposed Rule 600(b)(51) defines a non-marketable limit order to mean any limit order other than a marketable limit order. The Commission preliminarily believes that proposed Rule 600(b)(51) would ensure consistent and correct interpretation and application of the proposed amendments to Rule 606(a)(1) for retail orders. The Commission also preliminarily believes that there are no costs associated with proposed Rule 600(b)(51) because it is a definition that is widely used by market participants.

b. Definitions of "Orders Providing Liquidity" and "Orders Removing Liquidity" in Proposed Rule 600(b)(55) and (56)

Proposed Rule 600(b)(55) defines "orders providing liquidity" to mean orders that were executed against after resting at a trading center. Proposed Rule 600(b)(56) defines "orders removing liquidity" to mean orders that were executed against resting trading interest at a trading center. The Commission preliminarily believes that proposed Rules 600(b)(55) and (56) would ensure consistent and correct interpretation and application of proposed Rule 606(b)(3) for institutional orders. The Commission also preliminarily believes that there are no costs associated with proposed Rules 600(b)(55) and (56) because the Commission understands that the two definitions are widely used by market participants.

### c. Request for Comment

The Commission requests comment on the Commission's analysis of the proposed definitions. In particular, the Commission solicits comment on the following:

171. Do commenters agree with the definitions? If not, please provide alternative definitions and describe the benefits and costs of those alternatives as compared to the proposed definitions. Please be specific.

172. Do commenters agree with benefits and costs of the proposed definitions as described by the Commission? Please be specific.

173. Do commenters believe that the proposed definitions are widely used and accepted by market participants? Please be specific.

### D. Alternatives Considered

#### 1. Definition of Institutional Order in Proposed Rule 606(b)(31)

The Commission considered one alternative to the proposed definition of institutional order in Rule 600(b)(31) that would specify different thresholds for NMS stocks based on trading volume. This alternative would more finely tailor the definition for different types of NMS stocks, as described in Section V.C.1.a.ii. However, this alternative approach would add complexity to the proposed definition, and analysis of data on orders from institutions does not indicate any natural breakpoints.<sup>446</sup> The absence of natural breakpoints makes it more

difficult to draw definitive conclusions about what thresholds, if any, would be appropriate in a definition.

In addition to the concern that the threshold of a market value of at least \$200,000 may not capture large (measured by shares) orders in illiquid NMS stocks, Section V.C.1.a.ii. also discusses the incentives that market participants may have to change their behavior as stock prices may change over time, which may affect the proportion of orders that fall under the proposed definition of institutional order.

The Commission considered another alternative to the definition in proposed Rule 600(b)(31) that would address both concerns. The alternative would be to have customers identify their orders as institutional orders subject to Rule 606. This alternative approach would address the issue of having the same thresholds for all NMS stocks, independent of the trading volume of the stocks. Since this approach would require each customer to identify institutional orders, there would be a risk that customers may apply different criteria in identifying institutional orders. To the extent broker-dealers receive institutional orders that take different approaches, the usefulness of the reports for the purpose of comparing broker-dealers would be lower than with a consistently applied definition. However, the Commission notes that the alternative of allowing institutions to identify their orders as institutional orders would not reduce the usefulness of the information if the public reports contained specified thresholds as in the proposal. This alternative may not be significantly more costly for broker-dealers to implement than the proposal. After identifying the orders to be included in the calculations, all calculations would be the same for the alternative as for the proposal. On the other hand, if the alternative requires a specified threshold for disclosure on public reports, the public reports would require separate processing because they would involve calculations on different underlying orders. In this case, the alternative would be more costly than the proposal.

#### 2. Limited or No Public Disclosure of Institutional Order Routing and Execution Quality (Proposed Rule 606(c))

The Commission considered requiring broker-dealers to make publicly available only a subset of the information on institutional order handling required by proposed Rule 606(c). For instance, order routing and execution could be disclosed, but not

<sup>446</sup> See Section V.C.1.a.ii. for a discussion of Commission staff analysis of a set of orders from institutional customers.

information on orders providing liquidity or orders removing liquidity. Although this alternative would enhance the quality of the disclosure provided by broker-dealers relative to the disclosure under current Rule 606, which does not apply to institutional orders, it would shed less light on how order routing affects execution quality and, thus, provide less information on the potential for conflicts of interest relative to proposed Rule 606(c). As such, the benefits that would be achieved by this alternative are smaller relative to the benefits proposed Rule 606(c) would offer. Additionally, the Commission preliminarily believes that the costs to broker-dealers of this alternative would only be marginally less expensive in than proposed Rule 606(c), because a process would still be required to create the report.

The Commission also considered not requiring broker-dealers to make publicly available any of the information required by proposed Rule 606(c) (but still proposing to require disclosure pursuant to the amendments to Rule 606(b)(3) regarding customer requests for institutional order handling information). As for limited public disclosure just discussed, this alternative would improve the quality of the disclosure provided by broker-dealers relative to the disclosure under current Rule 606, but it would shed even less light on how order routing affects execution quality and thus provide even less information on the potential for conflicts of interest relative to proposed Rule 606(c). As such, the benefits that would be achieved by this alternative would not only be smaller relative to the benefits proposed Rule 606(c) would offer, but also smaller relative to the benefits of the alternative of limited public disclosure. The alternative of no public disclosure would result in cost savings compared to proposed Rule 606(c) because the process to create the public report would not be required under this alternative.

### 3. More Frequent Public Disclosure of Institutional Order Routing and Execution Information (Proposed Rule 606(c))

The Commission considered requiring broker-dealers to make the aggregated public disclosure of their institutional order routing and execution information available on a more frequent basis than in proposed Rule 606(c) (*i.e.*, monthly rather than quarterly). This alternative would increase the frequency of order routing and execution disclosure, but at an additional cost to broker-dealers relative to proposed Rule 606(c).

Specifically, additional costs would accrue from creating and disseminating the reports more frequently than quarterly. Monthly public reports as compared to quarterly public reports would result in having to run the production process to create and disseminate the reports twelve rather than four times per year.

The Commission preliminarily estimates that each broker-dealer that routes institutional orders will incur an average burden of 10 hours resulting in a cost of \$1,600<sup>447</sup> to prepare and disseminate a quarterly report required by proposed Rule 606(c).<sup>448</sup> The Commission preliminarily believes that the costs for a monthly report would be similar to the costs of a quarterly report. Hence, the Commission preliminarily estimates that each broker-dealer that routes institutional orders would incur an average burden of 120 hours resulting in a cost of \$19,200 per year to prepare and disseminate monthly reports. This compares to a burden of 40 hours resulting in a cost of \$6,400 per year for quarterly reports as required by proposed Rule 606(c), that is, the costs for each broker-dealer that routes institutional orders would be three times higher. The Commission preliminarily estimates the costs to produce a report would remain the same each month, as the cost of the report is more related to the act of producing the report, as opposed to how much data the report contains (one month vs. three months). The difference in costs for each broker-dealer to provide monthly reports as compared to quarterly reports as required by proposed Rule 606(c) is preliminarily estimated to be \$12,800 per year.<sup>449</sup> With an estimated 200 broker-dealers that route institutional orders, the total additional burden per year to comply with a monthly reporting requirement as compared to a quarterly reporting requirement as in proposed Rule 606(c) is preliminarily estimated to be 16,000 hours resulting in a cost of \$2,560,000.<sup>450</sup>

More frequent reports compared to the proposed quarterly frequency, although broken down by month, would have the benefit of providing the public

with information that is more timely. However, the Commission preliminarily believes that the value of having monthly rather than quarterly reports is small because the Commission understands that analysis of order handling data generally is based on data comprising more than one month. While this may be, at least partially, due to the fact that current Rule 606 requires quarterly reports, staff experience suggests that the analysis of order handling data would be based on more than one month of data even if data were available at a higher frequency. This is because order handling data are inherently noisy and a large sample size is necessary to ensure a robust analysis. To that extent, from staff experience, the Commission understands that data spanning several months or even years are used in the analysis of order handling data. The Commission notes that using data spanning several months or even years does not preclude analyzing the data for trends, especially recent trends.<sup>451</sup>

In addition, more frequent disclosure could allow sensitive trading information to be disclosed. For example, as discussed earlier, if a customer placing large institutional orders primarily engages one broker-dealer and that broker-dealer has few, if any, other customers placing significantly sized institutional orders, then other market participants may be able to decipher the customer's trading interest, particularly if the customer is building up or selling off a large position over a longer period of time. The risk of such disclosure of sensitive trading information is greater for monthly reporting frequency compared to the proposed quarterly frequency because, by construction, quarterly reporting provides the data for the first two months in the quarter with a delay compared to if the data for those two months were to be released monthly. As a result, it is less likely that data for those two months contain information about a customer's current and ongoing trading interests.

### 4. Automatic Provision of Customer-Specific Institutional Order Handling Report (Proposed Rule 606(b)(3))

The Commission considered an alternative to proposed Rule 606(b)(3)

<sup>447</sup> See *supra* note 266.

<sup>448</sup> See *supra* Section IV.D.2.d.

<sup>449</sup> \$19,200 annually per broker-dealer for monthly reports—\$6,400 annually per broker-dealer for quarterly reports = \$12,800 annually per broker-dealer.

<sup>450</sup> 80 hours more annually per broker-dealer that routes institutional orders × 200 broker-dealers that route institutional orders = 16,000 hours. The Commission preliminarily estimates the total monetized burden for this requirement to be \$2,560,000 (\$12,800 more annually per broker-dealer that routes institutional orders × 200 broker-dealers that route institutional orders = \$2,560,000).

<sup>451</sup> One way to analyze the data for trends would be to look at subsamples within the full sample. For example, one could consider quarters within a full calendar year of data. Another way would be to employ a rolling window. For example, one could use a twelve-month rolling window, that is, the analysis would use data comprising twelve months of data and then replace the oldest data with more recent data one month at a time.

that would not require that customers request customer-specific standardized reports on institutional order handling, but would instead require broker-dealers to provide them to customers automatically, either by sending the reports out or by providing a portal where customers can view or download the reports. The alternative could reduce the cost to customers, compared to both the baseline and the proposal, of acquiring the institutional order handling reports, because customers would not need to request the reports. At the same time, it is difficult to determine whether there is any additional benefit to customers compared to the proposal. It is possible that not all customers would use the reports provided to them, and under the proposal, those customers that see enough value in the reports would incur the cost of requesting them.

With respect to the costs to broker-dealers, the alternative would impose additional initial costs compared to the baseline, as the broker-dealers would be required to automatically provide reports to all customers, not just those that request reports, and would have to build infrastructure to generate these reports. The Commission preliminarily believes, however, that the alternative would involve slight modifications to the systems that produce the institutional order handling reports and thus preliminarily believes that these initial costs likely would be minimal.

The effect of this alternative on the costs to broker-dealers, compared to the proposal, is unclear. On the one hand, the Commission preliminarily believes the alternative could impose additional, albeit minimal, initial costs associated with developing systems to automatically generate the reports compared to the proposal as well as to the baseline, as described above. On the other hand, the Commission preliminarily believes the alternative could avoid the initial costs associated with the proposed rule for those broker-dealers who do not currently have systems in place to receive and respond to requests because they would not have to develop and deploy such systems under this alternative, as they would under the proposal. Any related initial or ongoing cost savings compared to the proposal may be minimal, as, in either case, such broker-dealers would need to develop systems to generate customer-specific reports and broker-dealers could add the customer requests to a list for individual report generation under the proposal just as they add customers to a list for automated reports under the alternative. The alternative may reduce ongoing personnel costs compared to

the proposal because under the proposal, broker-dealers would have to answer emails, phone calls, or other forms of requests for ad-hoc reports. However, the brokerage industry is a relationship business and the Commission understands that broker-dealers communicate frequently with their customers, especially their larger customers. Further, the alternative may also result in additional ongoing personnel costs compared to the proposal if customers who would not have requested reports contact the broker-dealers to discuss reports they would receive automatically under the alternative. In addition, the Commission notes that, even under the proposal, broker-dealers could choose to provide reports automatically to their customers if this is more cost effective for them.

##### 5. Submission of Institutional Order Handling Reports (Proposed Rules 606(b)(3) and 606(c))

The Commission considered an alternative to proposed Rules 606(b)(3) and 606(c) that would require the customer-specific institutional order handling reports and the public aggregated institutional order handling reports to be submitted to the Commission. While Commission staff may be able to replicate much of the information in the reports were the proposed Consolidated Audit Trail to be approved,<sup>452</sup> the reports would contain some information not included as data in the Consolidated Audit Trail (“CAT Data”), such as information on the use of aggressive and passive order routing strategies. In addition, the institutional order handling reports would be already assembled, making access to the reports more efficient than assembling the analogous information from CAT Data. With direct access to the reports under this alternative, Commission staff could potentially use the reports, for example, to investigate best execution concerns, assist in risk-based examination decisions, and/or conduct market analyses on order handling to promote data-driven rulemaking. These activities could, in turn, benefit investors and the market in the form of enhanced investor protection and better informed rulemaking. The alternative would also establish a central location for all reports and could reduce the burden for Commission staff to seek out and obtain the reports. Notably, under the proposal,

<sup>452</sup> See Securities Exchange Act Release No. 77724 (April 27, 2016), 81 FR 30614 (May 17, 2016) (File No. 4-698) (Joint Industry Plan; Notice of Filing of the National Market System Plan Governing the Consolidated Audit Trail), available at <https://www.sec.gov/rules/sro/nms/2016/34-77724.pdf>.

the Commission could acquire the public aggregated institutional order handling reports as described in Rule 606(c), though not the customer-specific institutional order handling reports as described in Rule 606(b)(3), from broker-dealer Web sites. The proposal thus does not preclude the Commission from obtaining the public aggregated institutional order handling reports to achieve some of the benefits of this alternative.

While providing some benefits, this alternative would also impose additional costs to broker-dealers to submit their reports to the Commission. For example, under this alternative, broker-dealers would incur additional costs to transmit the reports directly to the Commission including any initial costs of setting up the connection to the Commission’s repository, though the Commission preliminarily believes that these costs will not be significant. Further, the Commission preliminarily believes that acquiring the reports from each broker-dealer may impose burdens on Commission resources,<sup>453</sup> though the magnitude of those burdens is unknown. Receiving customer-specific institutional order handling reports, which include sensitive information, e.g., PII or sensitive proprietary information, could impose further costs to the Commission as the Commission would need to take steps to safeguard this information, though the Commission may be able to leverage its experience dealing with the receipt of sensitive information in other contexts to minimize those costs.

##### 6. Disaggregate Categories of NMS Stocks for Rule 606(a)

The Commission considered an alternative to current Rule 606(a) that would not require reports for retail orders be aggregated across all NMS stocks, but rather would require that those reports be divided into categories, e.g., into Exchange-Traded Products (“ETPs”) and all other NMS stocks, or into groups of stocks with different trading volume. The Commission considered this alternative in addition to or instead of the requirement of current Rule 606(a) to divide the reports by listing markets. This would increase the costs of producing the reports relative to the proposal, but it also would provide more information.

For example, one such alternative could require that broker-dealers

<sup>453</sup> The Commission recognizes that third party vendors could collect and sell the broker-dealer reports at a price that could reduce the burdens on Commission resources compared to the burdens of Commission staff directly collecting the reports from broker-dealers.

separately report the routing of ETPs and the routing of non-ETP NMS stocks. The costs of producing the reports under this alternative would be higher than the costs of the proposal because such an alternative would require broker-dealers to classify NMS stocks into categories, *e.g.*, into ETPs and non-ETP stocks. There would be an initial cost for the classification of all stocks and an ongoing cost to maintain the classification.

Because some ETPs trade differently than non-ETP NMS stocks, broker-dealers may route them differently. To the extent that broker-dealers vary their order routing decisions for ETP and non-ETP stocks, broker-dealer customers may benefit from the more targeted information that would be provided for each type of stock under this alternative compared to the proposed amendments to Rule 606(a). Specifically, the additional information concerning each type of stock contained in the divided reports would allow customers, broker-dealers, trading centers, and the public more generally to better evaluate and compare the order routing of retail orders for each type stock, whereas under the proposed rule information on order routing is provided for both ETPs and non-ETPs in the aggregate. While the consumers of such reports would benefit from the reports being more informative with respect to the order routing for each type of stock, broker-dealers would incur higher costs in processing the additional information provided by the reports. To use the additional information, customers, broker-dealers, trading centers, and the public more generally would have to process the additional information and incorporate it in their analyses and models when evaluating and comparing the order routing of retail orders, which could result in higher costs compared to the proposed amended Rule 606(a).

#### 7. Disclosure of Additional Information About Institutional Order Routing and Execution

The Commission considered requiring additional information to be disclosed to customers and the public relating to institutional order routing and execution quality. The Commission considered requiring additional measures to be included in proposed Rule 606(b)(3) and proposed Rule 606(c) reports for institutional orders. For example, the Commission considered requiring that proposed Rule 606(b)(3) and proposed Rule 606(c) reports contain time to execution, or implementation shortfall, which are dimensions of execution quality. In

addition, the Commission considered making the reports more detailed by requiring segmentation of the data along additional dimensions, not only on order routing strategy.

In general, transaction costs of institutional orders depend on, among other factors, stock characteristics, order characteristics, and market conditions at the time of order arrival and during order execution. The reports could be segmented by any of these factors. Examples of stock characteristics are liquidity or volatility of a stock.<sup>454</sup> Examples of order characteristics are order size, usually measured as relative order size in relation to average daily volume,<sup>455</sup> or whether an order is generated by a momentum strategy, where a customer buys a stock while the stock is increasing in price and sells a stock while the stock is falling in price. Examples of market conditions are the current liquidity in a stock, *e.g.*, measured by the most recent volume or bid-ask spread compared to historical values and the current volatility in a stock, *e.g.*, compared to historical values. Requiring any of this additional information in proposed Rule 606(b)(3) and proposed Rule 606(c) reports would increase the costs of producing the reports as well as the costs of using the reports relative to proposed Rules 606(b)(3) and 606(c), but it would also increase the information content and the usefulness of the reports relative to proposed Rules 606(b)(3) and 606(c).<sup>456</sup>

For some data items, the computation costs would be larger than for others. For example, computing the implementation shortfall for an order is more involved than computing the time to execution and thus would result in larger computational costs. Further, unlike the proposed amendments, implementation shortfall and time to

execution could involve running calculations on data received on other systems and from others who handle orders later in their lifecycle. This may make these fields more computationally costly than those proposed. However, with the addition of other relevant information, the reports under this alternative might be more useful than the proposed reports.

In addition, determining categories by metrics such as trading volume or volatility would add complex definitions to the reports and the Commission is not aware of any natural breakpoints that would simplify the identification of appropriate thresholds to classify stocks into groups of varying trading volume or volatility. Setting thresholds at levels that do not meaningfully distinguish routing activity or execution quality would be more costly than the proposed amendments without providing greater benefits.

The Commission could later evaluate data that would be disclosed pursuant to proposed Rules 606(b)(3) and 606(c), if adopted, to inform any decision as to whether additional data items or other changes might be appropriate.

#### 8. Institutional Order Handling Reports at the Stock Level (Proposed Rule 606(b)(3))

The Commission also considered requiring the institutional order handling information required by proposed Rule 606(b)(3) to be reported at the individual stock level rather than aggregated across stocks. This alternative would enhance transparency to customers relative to proposed Rule 606(b)(3) because the reports would be more detailed. Specifically, order handling information calculated at the stock level may be more informative than aggregated data because trading centers may not charge the same maker-taker fee for all stocks. It is possible for a given trading center to use inverted and non-inverted fees for different stocks at the same time. If this is the case, the reports as proposed by Rule 606(b)(3) could potentially mask conflicts of interest because routing decisions may be different for different stocks on the same trading center due to differing maker-taker fees across the stocks, particularly if some stocks have inverted and other stocks have non-inverted fees on the same trading center.

Because the reports would be more detailed, however, this alternative would increase the costs of producing the reports as well as the costs of using the reports relative to proposed Rule 606(b)(3). The Commission preliminarily believes that any potential

<sup>454</sup> See, *e.g.*, Zhuo Zhong, *The Risk Sharing Benefit versus the Collateral Cost: The Formation of the Inter-Dealer Network in Over-the-Counter Trading*, Working Paper (2014). Zhong argues that broker-dealers at the center of a dealer network are better able to work off the inventory risk earned from executing orders containing volatile stocks, which in turn will determine which broker-dealers receive orders in volatile stocks. *Id.*

<sup>455</sup> Zhong suggests that broker-dealers at the center of the dealer network are better able to work off the inventory earned from executing large orders, which in turn will determine which broker-dealers receive large orders. *See id.*

<sup>456</sup> The costs of this alternative would be higher than the proposed amendments because it would require that broker-dealers compute additional data items. For purposes of the PRA, the Commission estimated the costs associated with the rule as proposed. *See supra* Sections IV.D.1. and 2. The Commission does not currently have information on how extensive the programming would be for broker-dealers to adapt their systems to combine data that they may not yet combine to calculate these statistics.

increase in costs of producing the reports would be negligible because broker-dealers already process the data order-by-order and to aggregate orders by stock and venue, rather than only by venue, should not increase significantly programming costs and processing time. While the Commission preliminarily believes that the production of these voluminous reports itself may not result in significantly higher costs than for the proposed reports, the size of the reports may result in higher costs to deliver the reports to customers. For example, the report could be hundreds of pages in hard copy, which would result in costs to print and deliver the report; likewise, a broker-dealer could incur higher costs to send a report electronically, depending on the size of the file that has to be sent to customers.<sup>457</sup> Moreover, given the thousands of securities in existence, requiring reporting metrics be broken down at the stock level would produce voluminous reports that would be difficult and costly to process for all but the most sophisticated customers. For these reasons, the Commission is proposing to have the reports broken down by venue and aggregated across stocks.

#### 9. Alternative to Three-Year Posting Period (Proposed Amendments to Rules 605(a)(2) and 606(a)(1), and Proposed Rule 606(c))

The Commission considered requiring broker-dealers and market centers to make both institutional and retail reports available for a minimum length of time less than three years or more than three years. If public reports are available for less than three years, then historical data may not be as readily available to customers and the public who are seeking to analyze past routing behavior of broker-dealers or past execution quality of market centers as it would be under the proposal of a three-year posting period. Customers and the public would either have to download the data more often or have to rely on third-party vendors who download and aggregate the data. For example, if a broker-dealer or market center posted the reports for only one quarter, customers and the public would have to download the data every quarter if they wanted access to data that is older than three months. Third-party vendors also would have to download the data with sufficient frequency to capture historical data without gaps. This would have the effect of reducing the transparency of broker-dealer routing decisions for customers placing both retail and

institutional orders and of the execution quality of market centers compared to the proposal of a three-year posting period. The benefit of a shorter minimum length of time would be that any costs broker-dealers incurred associated with posting reports would be less than under the proposal of a three-year posting period. However, as discussed above, the Commission preliminarily believes these incremental costs to be small and that the cost savings associated with a shorter minimum length of time would not justify the costs of historical data potentially being less readily available to customers and the public.

If public reports are available for more than three years, the historical data would be even more readily available to customers and the public who are seeking to analyze past routing behavior of broker-dealers or past execution quality of market centers as it would be under the proposal of a three-year posting period. Customers and the public would have to download the data less frequently to have access to historical data that is older than the minimum length of time required. However, the Commission preliminarily believes that the additional benefit of a minimum length of time of more than three years would be small because three years is a meaningful time period considering the rapid changes in financial markets and customers and the public would only need to download data every three years to be able to access historical data older than three years. The Commission understands that maintaining public reports for more than three years may represent a burden and result in an additional cost to broker-dealers. However, as discussed above, the Commission preliminarily believes the additional cost to be small. Nevertheless, the Commission preliminarily believes that a minimum length of time of three years is appropriate.

#### 10. Request for Comment

The Commission requests comment on the Commission's analysis of potential alternatives as described above and the costs and benefits associated with such alternatives. In particular, the Commission solicits comment on the following:

174. Do commenters believe that the alternatives that the Commission considered are appropriate? Do commenters believe that the analysis of the associated costs and benefits of the alternatives is accurate? If not, please provide alternative costs and benefits, including any data or statistics that supports those costs and benefits.

175. Are there other alternatives that the Commission should consider? If so, please provide additional alternatives and how their costs and benefits would compare to the proposal.

176. Do commenters believe the reports for retail orders should contain information required by proposed Rule 606(b)(3) for institutional orders that is not currently required by Rules 606(a)(1) and 606(b)(1) for retail orders? Why or why not? If yes, what additional information should be required? Please be specific in your response.

177. Do commenters believe the Commission should require that the reports for institutional orders required by proposed Rule 606(b)(3) include information about payment for order flow and payment from profit-sharing relationships as would be required by proposed Rule 606(a)(1)(iii) for retail orders? Why or why not? Similarly, do commenters believe the Commission should require that the reports for institutional orders required by proposed Rule 606(b)(3) include a discussion of the material aspects of the broker-dealer's relationship with each venue as would be required by amended Rule 606(a)(1)(iv) for retail orders? Why or why not? Please be specific in your response.

178. Do commenters have information on the costs and benefits of any of these alternatives? If so, please provide any data or statistics to support the estimates.

#### *E. Economic Effects and Effects on Efficiency, Competition, and Capital Formation*

Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the anti-competitive effects of any rules it adopts.<sup>458</sup> Specifically, Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>459</sup> Furthermore, Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>460</sup> We consider these effects below.

<sup>458</sup> 15 U.S.C. 78c(f).

<sup>459</sup> *Id.*

<sup>460</sup> 15 U.S.C. 78w(a)(2).

<sup>457</sup> For example, there typically are limitation to the size of files that can be sent through email.

## 1. Effects of Proposed Amendments on Efficiency and Competition

### a. Proposed Amendments to Disclosures for Retail Orders

As a result of the proposed amendments to Rule 606(a)(1), broker-dealers that route retail orders would be required to make public enhanced aggregated reports detailing retail order routing practices and information regarding marketable and non-marketable limit orders in addition to information on payment for order flow arrangements, payment from any profit-sharing relationship received, and transaction fees paid and rebates received per share and in aggregate for such orders. *In addition, the proposed amendments would require those reports to be made available using an XML schema and associated PDF renderer on the Commission's Web site and to be maintained on an Internet Web site that is free and readily accessible to the public for a period of three years.*<sup>461</sup> As explained in detail below, the Commission preliminarily believes that these enhanced disclosures, which require broker-dealers to describe any terms of payment for order flow arrangements and profit-sharing relationships with Specified Venues that may influence their order routing decisions for retail orders, should promote competition and enhance efficiency.

First, per the discussion above, the additional information required by the amendments relative to the information required by current Rule 606(a)(1) would allow customers to better assess the order routing and execution quality provided by their broker-dealers,<sup>462</sup> which, in turn, would enable the customers to more efficiently evaluate and select broker-dealers.<sup>463</sup> The

<sup>461</sup> Consistent with the proposed amendments to Rule 606, the Commission is proposing to amend Rule 605(a)(2) to require market centers to keep public execution reports required by the rule posted on an Internet Web site that is free of charge and readily accessible to the public for a period of three years from the initial date of posting. The Commission preliminarily believes that making past order execution information available to customers and the public generally will be useful to those seeking to analyze historical order execution information from different market centers. The proposed requirement to keep public execution reports required by Rule 605 for a period of three years is expected to make it easier, and thus more efficient, for the public to collect historical data for analysis. The Commission preliminarily believes the proposed requirement could enhance efficiency in the data collection process of those seeking to retrieve and analyze historical order execution information from different market centers.

<sup>462</sup> See *supra* Section V.C.2.

<sup>463</sup> The proposed amendments to Rule 606(a)(1) which would no longer require reports be divided into separate sections for stocks listed on different exchanges may be an exception to this. As

proposed amendments to Rule 606(a) would require broker-dealers, for retail orders, to differentiate between marketable and non-marketable limit orders and to publicly report the net aggregate amount of any payment for order flow, payment from any profit-sharing relationship received, the transaction fees paid, and transaction rebates received, both as a total dollar amount and on a per share basis, for each of the following order types: market orders, marketable limit order, non-marketable limit orders, and other orders. As discussed in Sections V.C.2.a. and V.C.2.b., the Commission preliminarily believes that this would allow customers and the public to better understand the potential conflicts of interest broker-dealers may face when routing retail orders and to assess if and how well broker-dealers manage these potential conflicts of interest. This would enable customers to make a more informed decision as to which broker-dealers to use for retail orders. The Commission preliminarily believes that this would enhance the competition for retail order flow between broker-dealers, which might result in better execution quality for customers. In addition, if broker-dealers change their routing behavior in response to the public reports required by proposed Rule 606(a)(1), the Commission preliminarily believes that competition between trading centers might be enhanced as trading centers could better compete for retail order flow, which might result in better execution quality for retail orders and innovation by existing or new trading centers. As discussed in Section V.C.1.c.i, one way a trading center can attract order flow is through innovation thereby differentiating itself from other trading centers.

Further, to the extent that the proposed amendments to Rule 606(a) lead to better execution quality provided by broker-dealers and trading centers, the Commission preliminarily believes that the proposed amendments would lead to lower transaction costs for customers. Because transaction costs can be viewed as a measure for efficiency in the trading process, lower transaction costs would indicate enhanced efficiency in the trading process. In addition, to the extent that

discussed below, to the extent that order routing decisions may differ for stocks that are listed on different exchanges, the reports that aggregate the data as required by the proposed amendments to Rule 606(a)(1) may provide less information to retail customers and the public and therefore may reduce the efficiency with which customers and the public are able to evaluate and select broker-dealers based on the order routing and execution quality they provide.

the proposed amendments to Rule 606(a) make the trading process more efficient by lowering trading costs, the Commission preliminarily believes the proposed amendments would reduce market friction and therefore have a positive effect on the efficiency of prices.

As discussed above, however, the proposed amendments to Rule 606(a)(1) could result in costs that may have an effect on efficiency and competition. For example, the proposed amendments would impose certain costs on broker-dealers who currently route retail orders, as well as on broker-dealers who would like to start routing retail orders and will also have to comply with the proposed amendments to Rule 606(a)(1). To the extent that the costs for a broker-dealer entering the market for retail orders are higher under the proposed amended Rule 606(a)(1) than under the current Rule 606(a)(1), these higher costs could lead to a higher barrier to entry and thereby reduce competition. However, the Commission preliminarily believes that any difference in costs under the proposed amended Rule 606(a)(1) and the current Rule 606(a)(1) to be relatively small as to not alone deter broker-dealers from entering the market for retail brokerage.

Under the proposed amendments to Rule 606, the broker-dealer may be concerned about the perception of acting on a conflict of interest. As a result, a broker-dealer may be incentivized to route fewer non-marketable limit orders to the trading center offering the highest rebate, even if this affects execution quality, in an effort to ensure that a customer does not misconstrue the intent behind the broker-dealer's routing decisions. Such a potential outcome could reduce to some degree the intensity of competition between broker-dealers on the dimension of execution quality. However, the Commission preliminarily believes that such a scenario is not likely as customers are likely to review the 606 reports in conjunction with execution quality statistics currently required pursuant to Rule 605 and can discuss with their broker-dealers the order routing and execution quality the broker-dealer provides.

### b. Proposed Rules for Disclosures for Institutional Orders

For institutional orders, proposed Rules 606(b)(3) and (c) would require broker-dealers that route institutional orders to provide detailed reports to customers who submit such orders upon the request of the customer, and to make public on a quarterly basis broken down by calendar month, a report that

aggregates the information. In addition, these proposed rules would require reports on institutional orders to be made available using an XML schema and associated PDF renderer to be published on the Commission's Web site and to be maintained for a period of three years. As discussed below, the Commission preliminarily believes that these disclosures of order routing decisions by broker-dealers for institutional orders could promote competition and enhance efficiency.

First, the disclosures required by the proposal, both on an individualized and aggregated basis, would inform customers as to the institutional order routing practices of and the execution quality provided by a particular broker-dealer, as described in further detail above. As a result, customers would be able to use that information to compare the institutional order routing and execution quality of their broker-dealers based on the institutional orders submitted to those broker-dealers as reported in the customer-specific reports required by proposed Rule 606(b)(3). In addition, a customer placing institutional orders would be able to compare the order routing practices and execution quality of each broker-dealer based on the public aggregated institutional order handling reports required under proposed Rule 606(c), independent of whether the customer submits orders to a specific broker-dealer. Further, a customer would be able to compare the order routing and execution quality of its institutional orders submitted to a specific broker-dealer as reflected in the customer-specific reports required by proposed Rule 606(b)(3) to the order routing and execution quality of all orders that the broker-dealer handled contained in the public aggregated institutional order handling reports required by proposed Rule 606(c).

These enhanced disclosures would better enable customers to analyze institutional order routing and execution quality provided by broker-dealers, which would allow customers to more efficiently monitor, evaluate, and select broker-dealers. In addition, customers and broker-dealers would be able to evaluate execution quality of institutional orders on different trading centers more efficiently.<sup>464</sup> Customers also would be better informed as to the institutional order routing and execution quality they received from a particular broker-dealer. If a customer feels it received poor order routing and execution quality from a particular broker-dealer, the customer could

initiate a dialogue with the broker-dealer for an explanation, which may lead to better order routing decisions and execution quality by the broker-dealer. The customer may also decide to use different broker-dealers in order to seek better order routing and execution quality. This could enhance competition between broker-dealers.

Further, the Commission preliminarily believes that proposed Rules 606(b)(3) and (c) might enhance competition between trading centers. First, if broker-dealers change their routing decisions in response to the reports required by proposed Rules 606(b)(3) and (c), trading centers would have an additional incentive to compete for institutional order flow. Second, the reports required by proposed Rules 606(b)(3) and (c) are structured by trading center, so that the execution quality at each trading center would be clearly visible. This may lead broker-dealers to change their routing behavior, but also, more directly, trading centers could compare the execution quality of all trading centers, which may again lead to enhanced competition among trading centers. The Commission preliminarily believes that the enhanced competition between trading centers could lead to innovation by existing and new trading centers, resulting in better execution quality for customers placing institutional orders. As discussed in Section V.D.1.a if a trading center were to lose order flow to other trading centers due to lower execution quality it would have the incentive to innovate to improve its execution quality.

To the extent that proposed Rules 606(b)(3) and (c) lead to better execution quality being provided by broker-dealers and trading centers, the Commission preliminarily believes that the proposed amendments might lead to lower transaction costs for institutional orders. As discussed above, lower transaction costs indicate enhanced efficiency in the trading process and the Commission preliminarily believes as a result, the proposed rules would reduce market friction and therefore have a positive effect on the efficiency of prices.

In addition, the Commission preliminarily believes that the requirement of standardized customer-specific and standardized public aggregated institutional order handling reports in proposed Rules 606(b)(3) and (c) would enhance efficiency for customers and the public in processing the information contained in the reports, as compared to the ad-hoc reports customers may currently receive

from their broker-dealers.<sup>465</sup> Because the data will be presented in a standardized format, customers and the public would be able to more efficiently aggregate, compare, and analyze the data, as opposed to reconciling dissimilar formats, which may not always be possible, before trying to aggregate, compare, and analyze the data.

In addition, as discussed above, the Commission understands that many broker-dealers that handle institutional orders currently voluntarily provide reports to institutional customers upon request. However, the Commission understands that how willing a broker-dealer is to provide such reports and how detailed the reports are might depend on the size of an institutional customer. To that extent, larger institutional customers have an advantage over smaller institutional customers. Proposed Rules 606(b)(3) and (c) would provide access to reports on institutional order handling to all institutional customers, regardless of their size.

The Commission notes that, even without the proposed rule amendments, institutional customers can still request customized reports from their broker-dealers and broker-dealers would have an incentive to provide such reports in order to attract institutional order flow. As is currently the case, broker-dealers might be more willing to provide such customized reports to larger institutional customers and the customized reports might provide more detailed information for larger institutional customers. While the Commission preliminarily believes that proposed Rules 606(b)(3) and (c) mitigate the advantage of larger institutional customers in that respect, the Commission preliminarily believes that larger institutional customers are likely to continue to have an advantage over smaller institutional customers to the extent that they are able to obtain customized reports more easily and that those customized reports contain information not contained in the reports required by proposed Rules 606(b)(3) and (c). The Commission preliminarily believes that by reducing the informational advantage of larger institutional customers over smaller institutional customers, proposed Rules 606(b)(3) and (c) would improve fairness between institutional customers. Smaller institutional customers would be able to evaluate and

<sup>465</sup> See *supra* Section V.B.1. for a discussion of the ad-hoc reports and *supra* Section V.C.4. for a discussion of the standardization and format for the reports required by proposed Rules 606(b)(3) and (c).

<sup>464</sup> See *supra* Section V.C.1.

select their broker-dealers with efficiency more similar to larger institutional customers, thereby increasing the efficiency of their investment process. The Commission preliminarily believes that this would provide smaller institutional customers with information to select the broker-dealers that promote better execution quality, to the benefit of their investors.

As discussed above, however, proposed Rules 606(b)(3) and (c) could result in certain costs to broker-dealers who currently route institutional orders, as well as those who would like to start routing institutional orders and thus would have to comply with proposed Rules 606(b)(3) and (c). These costs could lead to a higher barrier to entry and thereby reduce competition.

However, the Commission preliminarily believes that the costs associated with proposed Rules 606(b)(3) and (c) are not large enough to meaningfully affect the barriers to entry and the level of competition due to potential new entrants into the market for institutional orders. In addition, the Commission preliminarily believes that any negative effect on competition due to heightened barriers to entry are justified by the expected positive effect on competition of the disclosures required by proposed Rules 606(b)(3) and (c).

In addition, the proposed amendments may cause broker-dealers to change how they handle institutional orders. Given that broker-dealers would be aware of the metrics to be used a priori, they may handle institutional orders in a manner that promotes a positive reflection on their respective services but customers could erroneously view a broker-dealer's handling as suboptimal.<sup>466</sup> Any changes to broker-dealers' order routing decisions due to proposed Rule 606(b)(3) may well be to the benefit of customers placing institutional orders, but if broker-dealers and customers focus exclusively on the metrics in the reports required by proposed Rule 606(b)(3), the order routing decisions could also be viewed as suboptimal for the customers. Customers' preferences could, therefore, be skewed toward the metrics as opposed to their true objectives, which could skew broker-dealer incentives, potentially limiting the efficiency and competition benefits of the proposed amendments.

For example, suppose a broker-dealer routes institutional orders so that the

orders execute at lower cost with a higher fill rate, shorter duration, and more price improvement than the broker-dealer's competitors. However, it could be the case that, in order to achieve these objectives, the broker-dealer routes the majority of non-marketable limit order shares to the trading center offering the highest rebate. An institutional customer that reviews the proposed order handling reports might suspect that the broker-dealer acted in its self-interest by selecting the highest rebate venue in order to maximize rebates when in fact, the broker-dealer made the decision based on factors that might not be completely reflected in the proposed reports.<sup>467</sup>

## 2. Effects of Proposed Amendments on Capital Formation

The Commission preliminarily believes that the proposed amendments to Rules 600, 605, and 606 might have positive effects on capital formation, but the Commission notes that predicting the magnitude of such effects is difficult as the effects likely would be indirect rather than directly resulting from the proposed amendments.

As discussed, the Commission preliminarily believes the proposed amendments to Rules 600, 605, and 606 would enhance competition among broker-dealers and trading centers resulting in better execution quality for customers that place retail and institutional orders and to the extent that better execution quality would lead to lower friction in the trading process, the proposed amendments would increase market efficiency in both the trading process and asset pricing. This could lead to more efficient asset allocation because better execution quality and greater market efficiency leads to more efficient investment decisions by customers that place retail and institutional orders.<sup>468</sup> For example, lower transaction costs could allow customers to rebalance their portfolios more frequently and more efficiently and at more efficient prices that better reflect the true underlying value. More efficient asset allocation could have a positive impact on capital formation as capital is allocated to firms with the most profitable projects, which ultimately would allow these firms to raise capital more easily.<sup>469</sup>

<sup>467</sup> *Id.*

<sup>468</sup> More efficient investment decisions means investing in the securities with the expected risk and return that better fit the customer's investment objectives.

<sup>469</sup> See *supra* Section V.B.8. for a discussion of how asset allocation can relate to capital formation.

In addition, there is a relation between liquidity of an asset and the required rate of return for that asset.<sup>470</sup> The less liquid an asset is, *e.g.*, the higher transaction costs are to buy or sell it, the higher rate of return customers could demand as compensation. For example, lower transaction costs for stocks could result in lower required rates of return for stocks. This in turn could lead to lower cost of capital for the firms, which could have a positive impact on capital formation because it would allow firms to raise capital at more favorable conditions.

## 3. Request for Comment

In sum, the Commission preliminarily believes that as a result of the disclosures required by the proposal bringing competitive forces to bear on the market, the proposed amendments should enhance competition among broker-dealers as well as trading centers to provide customers placing both retail and institutional orders with enhanced quality of execution. The Commission preliminarily believes that this enhanced quality of execution should promote efficiency in the trading process as well as pricing, which should also have a positive impact on capital formation.

The Commission requests comment on its analysis of the proposal's economic effects and effects on efficiency, competition, and capital formation. In particular, the Commission solicits comment on the following:

179. Do commenters believe that the Commission's analysis of the potential economic effects of the proposal, including potential effects on efficiency, competition, and capital formation is accurate? Why or why not? Please provide analysis and empirical data to support your views.

180. Are there other effects of the proposal that the Commission should consider? If so, please explain and provide support for your views.

181. Do commenters believe there are alternative mechanisms for achieving the Commission's goal of enhancing transparency for order routing practices while promoting efficiency, competition and capital formation? If so, what would be the potential impacts on promotion of efficiency, competition, and capital formation? For example, what would be the effect of requiring broker-dealers to provide the public reports for retail orders, on a monthly basis, rather than

<sup>470</sup> See Yakov Amihud and Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 Journal of Financial Economics 223 (December 1986).

<sup>466</sup> The Commission preliminarily believes that the set of metrics provide customers with the most cost effective view of broker-dealer order handling practices, but recognizes a risk that the information from the disclosures may not perfectly align routing practices and execution quality.

quarterly? What would be the effect of requiring broker-dealers to provide the public quarterly reports for retail orders, proposed in Rule 606(a), broken down into exchange-traded products (ETP) and non-ETP NMS stocks? Would the effects be the same for institutional orders under proposed Rules 606(b) and 606(c)? Please explain and provide support for your arguments.

182. Do commenters believe that market participants would change their behavior in response to the proposal? If so, which market participants and how? What would be the costs and benefits of these changes? How would such changes affect efficiency, competition, and capital formation? Would these changes affect market quality and market efficiency? Please explain.

## VI. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”),<sup>471</sup> the Commission requests comment on the potential effect of the proposed amendments on the United States economy on an annual basis. The Commission also requests comment on any potential increases in costs or prices for consumers or individual industries, and any potential effect on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

## VII. Regulatory Flexibility Analysis

The Regulatory Flexibility Act (“RFA”)<sup>472</sup> requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)<sup>473</sup> of the Administrative Procedure Act,<sup>474</sup> as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on “small entities.”<sup>475</sup> Section 605(b) of the RFA states that this requirement shall not apply to any proposed rule or proposed rule

<sup>471</sup> Pub. L. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

<sup>472</sup> 5 U.S.C. 601 *et seq.*

<sup>473</sup> 5 U.S.C. 603(a).

<sup>474</sup> 5 U.S.C. 551 *et seq.*

<sup>475</sup> Although Section 601(b) of the RFA defines the term “small entity,” the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term “small entity” for purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0–10, 17 CFR 240.0–10. See Securities Exchange Act Release No. 18451 (January 28, 1982), 47 FR 5215 (February 4, 1982) (File No. AS–305).

amendment, which if adopted, would not have significant economic impact on a substantial number of small entities.

For purposes of the Commission rulemaking in connection with the RFA<sup>476</sup> as it relates to broker-dealers, a small entity includes a broker-dealer that: (1) Had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) under the Exchange Act,<sup>477</sup> or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization.<sup>478</sup>

Based on the Commission’s analysis of existing information relating to broker-dealers that would be subject to the proposed amendments to Rule 606, the Commission preliminarily believes that such broker-dealers do not fall within the definition of “small entity,” as defined above.<sup>479</sup> Further, the proposed amendments to Rule 605 to require reports to remain posted on an Internet Web site for a specified period of time will not have a significant impact on small entities affected by the proposed Rule.<sup>480</sup> For the foregoing reasons, the Commission certifies that the proposed amendments to Rules 600, 605, and 606 would not have a significant economic impact on a substantial number of small entities for the purposes of the RFA.

The Commission requests comment regarding this certification. In particular, the Commission solicits comment on the following:

183. Do commenters agree with the Commission’s certification? If not, please describe the nature of any impact on small entities and provide empirical data to illustrate the extent of the impact.

## VIII. Statutory Authority and Text of the Proposed Rule Amendments

Pursuant to the Exchange Act, and particularly Sections 3(b), 5, 6, 11A, 15, 17, and 23(a) thereof, 15 U.S.C. 78c, 78e, 78f, 78k–1, 78o, 78q, and 78w(a), the Commission proposes to amend

<sup>476</sup> See *id.*

<sup>477</sup> 17 CFR 240.17a–5(d).

<sup>478</sup> See 17 CFR 240.0–10(c).

<sup>479</sup> The Commission considered FOCUS Report data in making this determination.

<sup>480</sup> See *supra* Section IV.D.5.

Sections 240.3a51–1, 240.13h–1, 242.105, 242.201, 242.204, 242.600, 242.602, 242.605, 242.606, 242.607, 242.611, and 242.1000 of Chapter II of Title 17 of the Code of Federal Regulations in the manner set forth below.

## List of Subjects

### 17 CFR Part 240

Brokers, Dealers, Registration, Securities.

### 17 CFR Part 242

Brokers, Reporting and recordkeeping requirements, Securities.

For the reasons stated in the preamble, the Commission is proposing to amend Title 17, Chapter II of the Code of Federal Regulations as follows:

## PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 1. The authority citation for part 240 continues to read in part as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c–3, 78c–5, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78n–1, 78o, 78o–4, 78o–10, 78p, 78q, 78–q1, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, 7201 *et seq.*, and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111–203, 939A, 124 Stat. 1376, (2010); and Pub. L. 112–106, sec. 503 and 602, 126 Stat. 326 (2012), unless otherwise noted.

\* \* \* \* \*

### § 240.3a51–1 [Amended]

■ 2. Section 240.3a51–1, paragraph (a) introductory text, is amended by removing the text “§ 242.600(b)(47)” and adding in its place “§ 242.600(b)(49)”.

### § 240.13h–1 [Amended]

■ 3. Section 240.13h–1, paragraph (a)(5), is amended by removing the text “Section 242.600(b)(46)” and adding in its place “§ 242.600(b)(48)”.

## PART 242—REGULATIONS M, SHO, ATS, AC, NMS AND SBSR AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

■ 4. The authority citation for part 242 continues to read as follows:

**Authority:** 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 78mm, 80a23, 80a–29, and 80a–37.

### § 240.105 [Amended]

■ 5. Section 242.105 is amended by:

- a. In paragraph (b)(1)(i)(C), removing the text “§ 242.600(b)(22)” and adding in its place “§ 242.600(b)(23)”.
- b. In paragraph (b)(1)(ii), removing the text “§ 242.600(b)(64)” and adding in its place “§ 242.600(b)(69)”.

#### § 240.201 [Amended]

- 6. Section 242.201 is amended by:
  - a. In paragraph (a)(1), removing the text “§ 242.600(b)(47)” and adding in its place “§ 242.600(b)(49)”.
  - b. In paragraph (a)(2), removing the text “§ 242.600(b)(22)” and adding in its place “§ 242.600(b)(23)”.
  - c. In paragraph (a)(4), removing the text “§ 242.600(b)(42)” and adding in its place “§ 242.600(b)(44)”.
  - d. In paragraph (a)(5), removing the text “§ 242.600(b)(49)” and adding in its place “§ 242.600(b)(52)”.
  - e. In paragraph (a)(6), removing the text “§ 242.600(b)(55)” and adding in its place “§ 242.600(b)(60)”.
  - f. In paragraph (a)(7), removing the text “§ 242.600(b)(64)” and adding in its place “§ 242.600(b)(69)”.
  - g. In paragraph (a)(9), removing the text “§ 242.600(b)(78)” and adding in its place “§ 242.600(b)(83)”.

#### § 240.204 [Amended]

- 7. Section 242.204, paragraph (g)(2), is amended by removing the text “Rule 600(b)(64) of Regulation NMS (17 CFR 242.600(b)(64))” and adding in its place “§ 600(b)(69) of Regulation NMS (17 CFR 242.600(b)(69))”.
- 8. Section 242.600 is amended by:
  - a. Redesignating paragraphs (b)(52) through (83) as (b)(57) through (88);
  - b. Adding new paragraphs (b)(55) and (56);
  - c. Redesignating paragraphs (b)(49) through (51) as (b)(52) through (54);
  - d. Adding new paragraph (b)(51);
  - e. Redesignating paragraphs (b)(30) through (48) as (b)(32) through (50);
  - f. Amending newly redesignated paragraph (b)(50) by removing the word “customer” and adding in its place “retail”;
  - g. Adding new paragraph (b)(31);
  - h. Redesignating paragraphs (b)(1) through (b)(29) as (b)(2) through (b)(30);
  - i. Adding new paragraph (b)(1).
  - j. Amending newly redesignated paragraph (b)(19) by removing the word “Customer” and adding in its place “Retail”;
  - k. Amending newly redesignated paragraph (b)(20) by removing the word “customer” and adding in its place “retail”;
  - l. Amending newly redesignated paragraph (b)(24)(ii) by removing the word “customer” and adding in its place “retail”;

The additions read as follows:

#### § 242.600 NMS security designation and definitions.

\* \* \* \* \*

(b) \* \* \*

(1) *Actionable indication of interest* means any indication of interest that explicitly or implicitly conveys all of the following information with respect to any order available at the venue sending the indication of interest:

- (i) Symbol;
- (ii) Side (buy or sell);
- (iii) A price that is equal to or better than the national best bid for buy orders and the national best offer for sell orders; and
- (iv) A size that is at least equal to one round lot.

\* \* \* \* \*

(31) *Institutional order* means an order to buy or sell an NMS stock that is not for the account of a broker or dealer and is an order for a quantity of an NMS stock having a market value of at least \$200,000.

\* \* \* \* \*

(51) *Non-marketable limit order* means any limit order other than a marketable limit order.

\* \* \* \* \*

(55) *Orders providing liquidity* means orders that were executed against after resting at a trading center.

(56) *Orders removing liquidity* means orders that executed against resting trading interest at a trading center.

\* \* \* \* \*

#### § 242.602 [Amended]

- 9. Section 242.602 is amended by:
  - a. In paragraph (a)(5)(i) removing the text “§ 242.600(b)(73)” and adding in its place “§ 242.600(b)(78)”.
  - b. In paragraph (a)(5)(ii) removing the text “§ 242.600(b)(73)” and adding in its place “§ 242.600(b)(78)”.
- 10. Section 242.605 is amended by:
  - a. Revising the introductory text designated as a Preliminary Note; and
  - b. Adding a sentence at the end of paragraph (a)(2).

The addition reads as follows:

#### § 242.605 Disclosure of order execution information.

This section requires market centers to make available standardized, monthly reports of statistical information concerning their order executions. This information is presented in accordance with uniform standards that are based on broad assumptions about order execution and routing practices. The information will provide a starting point to promote visibility and competition on the part of market centers and broker-dealers, particularly on the factors of execution price and speed. The

disclosures required by this section do not encompass all of the factors that may be important to investors in evaluating the order routing services of a broker-dealer. In addition, any particular market center’s statistics will encompass varying types of orders routed by different broker-dealers on behalf of customers with a wide range of objectives. Accordingly, the statistical information required by this section alone does not create a reliable basis to address whether any particular broker-dealer failed to obtain the most favorable terms reasonably available under the circumstances for retail orders.

(a) \* \* \*

(2) \* \* \* Every market center shall keep such reports posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

\* \* \* \* \*

- 11. Section 242.606 is revised to read as follows:

#### § 242.606 Disclosure of order routing information.

(a) *Quarterly report on retail order routing.* (1) Every broker or dealer shall make publicly available for each calendar quarter a report on its routing of non-directed orders in NMS securities during that quarter broken down by calendar month and keep such report posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site. Such report shall include a section for NMS stocks and a separate section for NMS securities that are option contracts. Such report shall be made available using the most recent versions of the XML schema and the associated PDF renderer as published on the Commission’s Web site for all reports required by this section. Each section in a report shall include the following information:

(i) The percentage of total retail orders for the section that were non-directed orders, and the percentages of total non-directed orders for the section that were market orders, marketable limit orders, non-marketable limit orders, and other orders;

(ii) The identity of the ten venues to which the largest number of total non-directed orders for the section were routed for execution and of any venue to which five percent or more of non-directed orders were routed for execution, the percentage of total non-directed orders for the section routed to the venue, and the percentages of total non-directed market orders, total non-

directed marketable limit orders, total non-directed non-marketable limit orders, and total non-directed other orders for the section that were routed to the venue;

(iii) For each venue identified pursuant to paragraph (a)(1)(ii) of this section, the net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received, both as a total dollar amount and per share, for each of the following non-directed order types:

- (A) Market orders;
- (B) Marketable limit orders;
- (C) Non-marketable limit orders; and
- (D) Other orders.

(iv) A discussion of the material aspects of the broker's or dealer's relationship with each venue identified pursuant to paragraph (a)(1)(ii) of this section, including a description of any arrangement for payment for order flow and any profit-sharing relationship and a description of any terms of such arrangements, written or oral, that may influence a broker's or dealer's order routing decision including, among other things:

(A) Incentives for equaling or exceeding an agreed upon order flow volume threshold, such as additional payments or a higher rate of payment;

(B) Disincentives for failing to meet an agreed upon minimum order flow threshold, such as lower payments or the requirement to pay a fee;

(C) Volume-based tiered payment schedules; and

(D) Agreements regarding the minimum amount of order flow that the broker-dealer would send to a venue.

(2) A broker or dealer shall make the report required by paragraph (a)(1) of this section publicly available within one month after the end of the quarter addressed in the report.

(b) *Customer requests for information on order routing.* (1) Every broker or dealer shall, on request of a customer, disclose to its customer the identity of the venue to which the customer's retail orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders. Such disclosure shall be made available using the most recent versions of the XML schema and the associated PDF renderer as published on the Commission's Web site for all reports required by this section.

(2) A broker or dealer shall notify customers in writing at least annually of the availability on request of the

information specified in paragraph (b)(1) of this section.

(3) Every broker or dealer shall, on request of a customer that places, directly or indirectly, an institutional order with the broker or dealer, disclose to such customer within seven business days of receiving the request, a report on its handling of institutional orders for that customer for the prior six months by calendar month. Such report shall be made available using the most recent versions of the XML schema and the associated PDF renderer as published on the Commission's Web site for all reports required by this section. For purposes of such report, the handling of an institutional order includes the handling of all smaller orders derived from the institutional order. Such report shall include, with respect to the order flow sent by the customer to the broker or dealer, the total number of shares of institutional orders sent to the broker or dealer by the customer during the relevant period; the total number of shares executed by the broker or dealer as principal for its own account; the total number of institutional orders exposed by the broker or dealer through an actionable indication of interest; and the venue or venues to which institutional orders were exposed by the broker or dealer through an actionable indication of interest. Such report also shall include the following columns of information for each venue to which the broker or dealer routed institutional orders for the customer, in the aggregate and broken down by passive, neutral, and aggressive order routing strategies as defined in paragraph (b)(3)(v) of this section:

(i) *Information on Order Routing.* (A) Total shares routed;

(B) Total shares routed marked immediate or cancel;

(C) Total shares routed that were further routable; and

(D) Average order size routed.

(ii) *Information on Order Execution.* (A) Total shares executed;

(B) Fill rate (shares executed divided by the shares routed);

(C) Average fill size;

(D) Average net execution fee or rebate (cents per 100 shares, specified to four decimal places);

(E) Total number of shares executed at the midpoint;

(F) Percentage of shares executed at the midpoint;

(G) Total number of shares executed that were priced on the side of the spread more favorable to the institutional order;

(H) Percentage of total shares executed that were priced at the side of

the spread more favorable to the institutional order;

(I) Total number of shares executed that were priced on the side of the spread less favorable to the institutional order; and

(J) Percentage of total shares executed that were priced on the side of the spread less favorable to the institutional order.

(iii) *Information on Orders that Provided Liquidity.* (A) Total number of shares executed of orders providing liquidity;

(B) Percentage of shares executed of orders providing liquidity;

(C) Average time between order entry and execution or cancellation, for orders providing liquidity (in milliseconds); and

(D) Average net execution rebate or fee for shares of orders providing liquidity (cents per 100 shares, specified to four decimal places).

(iv) *Information on Orders that Removed Liquidity.* (A) Total number of shares executed of orders removing liquidity;

(B) Percentage of shares executed of orders removing liquidity; and

(C) Average net execution fee or rebate for shares of orders removing liquidity (cents per 100 shares, specified to four decimal places).

(v) For the purposes of paragraph (b)(3) of this section:

(A) A *passive order routing strategy* is one that emphasizes the minimization of price impact over the speed of execution of the entire institutional order;

(B) A *neutral order routing strategy* is one that is relatively neutral between minimization of price impact and the speed of execution of the entire institutional order; and

(C) An *aggressive order routing strategy* is one that emphasizes the speed of execution of the entire institutional order over minimization of price impact.

The broker or dealer shall assign each order routing strategy that it uses for institutional orders to one of these three categories in a consistent manner for each report it prepares pursuant to paragraph (b)(3) of this section, promptly update the assignments any time an existing strategy is amended or a new strategy is created that would change such assignment, and document the specific methodologies it relies upon for making such assignments. Every broker or dealer shall preserve a copy of the methodologies used to assign its order routing strategies and maintain such copy as part of its books and records in a manner consistent with § 240.17a-4(b) of this chapter.

(c) *Quarterly report on institutional order handling.* A broker or dealer that receives institutional orders shall make publicly available a report that aggregates the information required by paragraph (b)(3) of this section, whether or not requested by a customer, on its handling of all institutional orders for all customers for each calendar quarter by calendar month within one month after the end of the quarter. Such report shall be made available using the most recent versions of the XML schema and the associated PDF renderer as published on the Commission's Web site for all reports required by this section. Every broker or dealer shall keep such report posted on an Internet Web site that is free and readily accessible to the public for a period of three years from the initial date of posting on the Internet Web site.

(d) *Exemptions.* The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

**§ 240.607 [Amended]**

- 12. Section 242.607 is amended by:
- a. In paragraph (a)(1) removing the words "customers' orders" and add in its place "customers' retail orders" and removing the word "customer" and add in its place "retail".
  - b. In paragraph (a)(2) removing the word "customer" and add in its place "retail".

**§ 240.611 [Amended]**

- 13. Section 242.611, paragraph (c) is amended by removing the text "§ 242.600(b)(30)" and adding in its place "§ 242.600(b)(32)".

**§ 240.1000 [Amended]**

- 14. In Section 242.1000 amend the definition of *Plan processor* by removing the text "§ 242.600(b)(55)" and adding in its place "§ 242.600(b)(60)".

By the Commission.

Dated: July 13, 2016.

**Robert W. Errett,**

*Deputy Secretary.*

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