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SEC Rule 606 – A Brief History

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Introduction

In the first quarter of 2020, new regulations that modify SEC Rule 606 will go into effect that require broker-dealers to disclose "enhanced information about the way they handle investors' orders."

For the first time, investment managers will have access to critical information needed to help assess which broker-dealers they should route their trades to in order to achieve best execution for their clients. The amended SEC Rule 606 also provides a unique opportunity for asset owners, as plan fiduciaries, to request their managers to assess this routing information to help minimize unnecessary trading costs and maximize fund returns. (See companion article: *SEC Rule 606 Provides Asset Owners with Another Tool for Protecting Fund Assets*)

Genesis and Rationales Behind the New 606 Rules

The original provisions of Rule 606 were adopted in the summer of 2000[1] in response to what the SEC viewed as a structural need to assist retail investors in making more informed trading decisions. In explaining their rationale, the SEC stated, "[i]n a fragmented market structure with many different market centers trading the same security, the order routing decision is critically important." Consequently, order routing decisions "must be well informed and fully subject to competitive forces."[2]

Importantly, when first adopted, Rule 606 was limited to smaller retail orders, not institutional sized orders. This was intentional and reflected a belief in the late-1990s that institutional orders required significant manual handling, and therefore would not benefit as much from the standardized order routing disclosures then mandated under Rule 606.[3]

Since that time, the US equity market structure has evolved into a highly automated collection of trading venues, much more complex than what existed in 2000. In this environment, the manual handling of institutional orders has become increasingly rare, and has been replaced by sophisticated institutional order execution algorithms and smart order routing systems. As a result, the SEC's views on the need for increased transparency have shifted as well.

The thrust of the new regulations was first articulated in June 2014 by then SEC Chair Mary Joe White, who observed that in the current "dispersed market ecosystem … monitoring the execution quality and costs of orders can be difficult for even the most sophisticated investors."[4] Chairperson White went on to describe the various ways trading venues compensate brokers for routing order flow to them, and noted that when brokers do not pass such payments on to their customers, those brokers face inherent conflicts of interest that are difficult to manage.

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[1] Rule 11 Ac1-6, SEC Act Release Nos. 43084 (July 28,2000), 65 FR 48406 (Aug 8, 2000)
[2] 65 FR 75415 (Dec 1, 2000)
[3] 65 FR 75426 (Dec 1, 2000)
[4] Speech to Sandler O'Neill & Partners, "Enhancing our Equity Market Structure," (June 5, 2014)

Indeed, Chairperson White specifically cited a case where the SEC brought charges against a broker who failed to disclose that they routed the vast majority of their orders to their affiliated trading venue.[5] Chairperson White concluded by noting that new rules were therefore "necessary to ensure that the disclosed information is useful, reliable, and uniformly available on request to all institutional customers."[6]

The new proposed rules were published in July 2016.[7] A little over two years later, after an extensive comment period in which more than 100 in-person meetings and/or written comments were submitted, the final rules were adopted in November 2018.

The Final Rules require a broker-dealer, upon request of a manager, to provide detailed customer-specific disclosures for all orders over which the broker-dealer had discretion in routing (a "not held order"[8]). This information is further required to be provided separately for directed orders and non-directed orders,[9] as well as marketable limit orders and non-marketable limit orders."[10]

From Chairperson White's initial comments through to the adoption of the final rules, the SEC has consistently articulated three considerations driving their regulatory action. Specifically, in the increasingly complex market structure, many managers had complained to the SEC about the extent to which broker-dealers' routing decisions were influenced by incentives offered by trading centers to attract order flow, that inefficiencies in order execution algorithms and smart order routing systems were potentially resulting in "information leakage," and that the complexity and opacity of order routing practices were frustrating the managers' ability to monitor execution quality.[11]

With respect to conflicts of interest, the SEC recognized that managing such conflicts was a key component of achieving best execution. To wit, broker-dealers faced a number of potential conflicts of interest when handling manager orders, which in turn, could influence their order routing practices.

For example, one potential conflict of interest cited by the SEC was the so-called ''maker-taker'' model, which involves the use of fees or rebates that are charged/paid by different venues. Specifically, broker-dealers often pay fees to, and/or receive rebates from, the venues they execute trades on (depending on whether the specific trade is viewed as providing or taking liquidity from that venue). However, broker-dealers generally do not pass those fees or rebates back to the managers. The prospect of

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[5] SEC Press Release 2011-220,"Alternative Trading System Agrees to Settle Charges that it Failed to Disclose Trading by an Affiliate" (October 24, 2011)
[6] Speech to Sandler O'Neill & Partners, "Enhancing our Equity Market Structure," (June 5, 2014)
[7] SEC Act Release Nos. 34-78309 (July 27, 2016) ("Proposed Rules")
[8] The Final Rules define a "not held" order as an order that typically provides the broker-dealer with price and time discretion in handling the order. In contrast, a broker-dealer must attempt to execute a "held" order immediately.
[9] Final Rules at 54-55.Directed Orders are defined as a customer order in which the customer specifically instructs the broker-dealer to route their trade to a specific venue for execution.
[10] The differentiation of directed and marketable orders is consistent with the SEC's focus on providing transparency regarding orders in which the broker-dealer is authorized to exercise discretion. For example, with respect to "non-directed orders," the SEC emphasized that separating directed from non-directed orders, would help managers evaluate, "*how their broker-dealers are achieving best execution for their non-directed … orders while managing the potential impact of information leakage and conflicts of interest.*" Similar comments were made with respect to "marketable" vs. "non-marketable limit orders." Final Rules at 93, 131, 133
[11] Id at 49436

receiving additional profits in the form of rebates from venues, or conversely, avoiding additional venue fees, could therefore potentially influence a broker-dealer's decision on where to route a manager's trades at the expense of getting the best execution price.[12]

Another potential conflict of interest arises when a broker-dealer internalizes order flow, routes order flow to affiliated venues, or routes orders to venues with which it has a payment for order flow arrangement. While not per se inappropriate, these practices may introduce additional conflicts of interest, as those venues do not always provide the most favorable execution terms.

The SEC therefore felt that access to standardized information was critical in helping managers understand and navigate the potential conflicts of interests faced by broker-dealers with respect to order routing.[13] Equally important, the SEC felt such transparency would discourage broker-dealers from making inappropriate use of the managers' orders and minimize information leakage.[14]

The SEC was also mindful that achieving best execution is heavily dependent upon minimizing the risk that an action by a broker-dealer could inadvertently signal the market that a manager's order was about to be executed. Such foreknowledge can result in other market participants positioning themselves in advance so as to take advantage of the subsequent transaction – to the detriment of the manager's trade.

To the greatest degree possible, broker-dealers should employ tactics to minimize the risk of such information leakage. This entails balancing the need to sufficiently expose the manager's trades to the market (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).

The SEC recognized this fact and the importance of managers being able to "control the information flow concerning their transactions.'' More specifically, the SEC observed that *"*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.*"* [15]

Consistent with this logic, the new rules apply not just to actual trades, but also Indications of Interest (IOI).[16] In explaining its intent to include IOIs within the scope of the new rules, SEC made clear that it

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[12] Id at 49438-40 An example provided by the SEC described a situation in which a broker-dealer trying to execute a manager's trade that is viewed as "taking liquidity" may try to minimize their costs by using a venue with very low "taker fees." Unfortunately, venues that charge very low fees, also typically pay very low rebates. As a consequence, that venue may not have a lot of other firms posting liquidity, and therefore offers less size or fewer opportunities for price improvement than may be available at a high rebate/fee venue.

[13] Id at 49438

[14] Id. at 49438

[15] This is the reason, for example, that Rule 604(b) of Regulation NMS exempts specialists and over-the-counter market makers from displaying customer block size orders. Final Rules at 60, referencing Securities Exchange Act Release No. 60997 (November 13, 2009), 74 FR 61208, 61219 (November 23, 2009) (''Regulation of Non-Public Trading Interest Proposing Release''). *See* 17 CFR 242.604(b)(4).

[16] IOIs are specific inquiries sent by a trading center (e.g. an ATS or an internalizing broker-dealer), to other market participants in an effort to attract immediately executable order flow. As long as the IOI identifies a specific security, the side (buy/sell) desired, the size of the desired trade, and offers a price equal or better than the national best bid or offer; it falls within the new disclosure requirements. Final Rules at 56-57

felt such information "would better enable customers to understand and evaluate how broker-dealers handle their orders, in particular with respect to the potential for information leakage stemming from broker-dealers' use of actionable IOIs."[17]

Ultimately, the SEC opined that the increased transparency engendered by the new rules was necessary to enable managers to assess best execution, minimize the risks associated with conflicts of interest, and manage the impact linked to information leakage. More to the point, the SEC noted that managers were fiduciaries to their asset owner clientele (*e.g.,* mutual funds, pension funds, etc.) and therefore had a fiduciary obligation to act in the best interests of their clients and seek best execution on each trade.[18] In emphasizing the importance of this obligation, the SEC stated that managers needed to execute asset owner trades "in such a manner that the total cost or proceeds are the most favorable under the circumstances."[19]

The SEC also noted that historically, broker-dealers were not required to disclose specific order handling information on institutional orders. As a consequence, managers had to engage in direct negotiation with each of their broker-dealers in order to obtain order handling information. Of course, as a practical matter, only a subset of managers had the size and negotiating wherewithal to actually obtain such data. It's no surprise that the scope and form of the information received varied widely.

To this end, the SEC stated, *"*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, greater transparency is critically important*."*[20] This, then, was the genesis of the new rules, which the SEC emphasized were designed to enable managers to:

1. Prudently utilize and navigate broker order routing tools/strategies
2. Ensure they obtain best execution on asset owner trades
3. Minimize the risks associated with the inherent conflicts of interest that all broker-dealers face when routing client trades to different execution venues
4. Minimize the potential leakage of information that could occur when executing large orders on behalf of asset owners

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For more information about this article and Abel Noser / Zeno AN Solutions, please see our website at www.abelnoser.com or contact the author, Steve Glass at sglass@abelnoser.com.

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[17] Final Rules at 57
[18] Id at 49438
[19] Id at 49438, referencing 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).
[20] Id at 49436