SEC Rule 606 Provides Asset Owners with Another Tool for Protecting Fund Assets

Five Important Questions to ask your Fund Managers in Light of the Amended Regs

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In the first quarter of 2020, new regulations are scheduled to go into effect which amends SEC Rule 606 to require that broker-dealers disclose "enhanced information about the way they handle investors' orders."[1] Broadly speaking, these amendments will collectively enable managers to:

1. Discern where their orders were exposed, routed, and executed
2. Quantify the extent to which those orders provided or removed liquidity, and the amount of rebates/fees that were thereby received by/or paid by the broker-dealer
3. Monitor potential conflicts of interest faced by their broker-dealers (due to the various financial incentives offered by different trading venues)
4. Assess the degree to which their trades were exposed to "information leakage" during the broker-dealer's routing of their orders
5. Improve their evaluation of whether broker-dealers provided best execution.

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. As discussed more fully below, this in turn will provide asset owners with a new and powerful tool for enhancing their fiduciary stewardship of fund assets.

This article begins with a brief description of the genesis and rationale for the new rules[2], then explains why asset owners (in addition to their investment managers) should care about these rules. It concludes with a set of questions every asset owner should ask their managers to better safeguard the assets of their fund.

Rule Background

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."[3] Chairperson White went on to describe the various ways trading venues compensated brokers for routing order flow to them, and noted that when brokers did not pass such payments on to their customers, those brokers faced inherent conflicts of interest that were difficult to manage appropriately

The new proposed rules were published in July 2016.[4] A little over two years later, after an extensive comment period in which more than 100 in-person meetings were held and/or written comments were submitted, the Final Rules were adopted in November 2018. From Chairperson White's initial comments, through the adoption of both the proposed and 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

[1] SEC Act Release Nos. 34-84528 (November 2, 2018), 17 CFR Parts 240 and 242 ("Final Rules")
[2] For a fuller description of the history and background of the new rules, see, *Brief History of Rule 606* posted on Abel Noser's website.
[3] Speech to Sandler O'Neill & Partners, "Enhancing our Equity Market Structure," (June 5, 2014)
[4] SEC Act Release Nos. 34-78309, 81 FR 49432 (July 27, 2016) ("Proposed Rules")

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.[5]

In responding to manager concerns about information leakage, the SEC observed 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 to take advantage of the subsequent transaction to the detriment of the manager's trade.

Specifically, the SEC noted, "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." [6] Broker-dealers should employ tactics to minimize this dynamic to the greatest degree possible, which necessarily entails balancing the need to sufficiently expose the manager's trades (to achieve execution) against the risk that such exposure might cause prices to move in a less favorable direction. Just as important, as part of their fiduciary obligation to obtain best execution, managers have a concomitant duty to ensure their broker-dealers achieve that optimal balance.

With respect to conflicts of interest, the SEC recognized that managing this risk was a key component of achieving best execution. To wit, broker-dealers faced a number of potential conflicts when handling manager orders, which in turn, could influence their order routing practices. The SEC therefore felt that access to standardized information was critical in helping managers navigate those challenges.[7] Equally important, the SEC felt such transparency would discourage broker-dealers from making inappropriate use of the managers' orders, minimize information leakage, and mitigate any conflicts of interest.[8]

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) and therefore had a fiduciary obligation to act in the best interests of their clients and seek best execution on each trade.[9] 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."[10]

Every Basis Point Counts!

Importantly, the notion that increased transparency into broker-dealer order routing practices can improve execution efficiency is more than just esoteric theory. In January 2019, FINRA published a quantitative study

[5] Proposed Rules at 49436

[6] 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).

[7] Id at 49438

[8] Id. at 49438

[9] Proposed Rules at 49438

[10] 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).

on the costs associated with broker order routing practices.[11] The purpose of the study was to ascertain whether broker-dealers favored their own ATSs when routing customer orders, and if so, whether that impacted the level of costs incurred on those trades.

Ultimately, the study found that not all brokers showed a preference to using their affiliated ATSs. However, some brokers did. More importantly, the brokers who routed a significant percentage of their orders to an affiliated ATS venue experienced dramatically different trading outcomes than the brokers who did not route to affiliated venues.

As noted in Table 1 below, the top third of brokers (in terms of utilizing affiliated ATS venues) sent 64% of their orders to ATSs, with half of that amount being routed to their affiliated ATS. In contrast, brokers who did not use affiliated ATSs sent just 10% of their overall orders to ATSs. Further, the brokers who utilized affiliated ATSs needed to route their shares to an average of 17 different venues before being executed. Conversely, brokers who did not use affiliated ATSs routed their shares to less than five venues before being executed.[12]

Table 1 – Order Routing Practices

Broker Tercile	% of trades routed to any ATS	% of trades routed to affiliated ATS	Avg # of venues each share was routed to before being executed	% of trade volume ultimately executed on exchanges
Brokers having the greatest use of affiliated ATS	64%	50%	17	70%
Brokers having the least use of affiliated ATS	10%	0%	5	77%

Of course, routing a higher percentage of trades to ATSs does not, in and of itself, imply that those trades received poor execution quality. Indeed, in many instances, the routing to ATS venues can provide superior execution quality. The study therefore analyzed the execution quality obtained by the brokers who favored their affiliated ATSs, versus the brokers who did not use affiliated ATSs.

Unfortunately, as shown in Table 2 below, the trades routed by brokers who emphasized their affiliated ATSs, received *statistically significant* worse executions. These quantitative differences included worse fill rates,[13] higher spread costs,[14] and higher overall implementation shortfall costs.[15] In point of fact, the trades executed by the brokers favoring their affiliated ATSs incurred costs that were on average 8-10 bp worse than trades executed by brokers who did not use affiliated ATSs.[16] The study also found that those trades were potentially exposed to greater information leakage.[17]

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[11]Anand, Samadi, Sokobin, Venkataraman, *Institutional Order Handling and Broker-Affiliated Trading Venues*, FINRA Office of the Chief Economist (Working Paper), January 2019 ("Institutional Order Handling Paper")

[12] Institutional Order Handling Paper at 3

[13] "Fill Rate," as used in this Study represents the percentage of the total order that was executed at those venues. The portion of the order that is not filled must then be subsequently traded elsewhere – often at a worse price.

[14] "Spread Costs" as used in this study calculates the costs of a trade by comparing the price of just the filled portion of an order with the price of that security as of the time the order arrived at the ATS. It ignores the costs subsequently incurred on the portion of the order that was subsequently traded elsewhere.

[15] "Implementation Shortfall Costs" as used in this study calculates the costs of a trade by aggregating up all spreads, market-impact, and price drift that occurred during an order's entire lifecycle.

[16] Institutional Order Handling Paper at 13-15

[17] Id. at 14

Table 2 –Best Execution on Order Routing

Broker Tercile	Fill Rate	Spread Costs	Implementation Shortfall Costs
Brokers having the greatest use of affiliated ATS	17%	-3 bp	-11bp to -21bp
Brokers having the least use of affiliated ATS	44%	-1 bp	-3bp to -11bp

What makes this revelation immediately actionable is that the study also concluded order routing behavior was highly persistent, staying consistent over time.[18] Accordingly, since the brokers' routing behavior stayed consistent over time, so did their fill rates, and the costs associated with that order routing.

Thus, the study found that managers could select brokers based on their past experience with brokers.[19] Indeed, the study specifically referenced the new rules adopted by the SEC, stating, "Our study provides empirical support for recent regulatory initiatives that attempt to improve the disclosure of potential broker conflicts and increase transparency on handling of institutional order flow."[20]

Why Should Asset Owners Care?

Given that the new rules are intended to provide investment managers with additional information to help navigate broker-dealer order routing practices, asset owners may wonder what this has to do with them. The answer is quite simple. As prudent fiduciaries, asset owners should ensure that managers, to whom they've delegated fiduciary responsibility for investing fund assets, are taking all possible steps to maximize returns and grow the assets of their funds.

In this regard, the SEC warned that while many managers currently employ transaction cost analysis (TCA) to help assess execution quality, these efforts were limited by the data currently available. Indeed, the SEC explicitly opined that the data available pursuant to the new rules would help make the managers' TCA efforts more effective. In particular, the SEC stated, *"*While many institutional customers regularly conduct … transaction cost analysis (TCA) of their orders to assess execution quality against various benchmarks, the …comprehensiveness of such analysis could be enhanced with more granular order handling information*."*[21] From a compliance perspective, the SEC also felt the new disclosures would assist managers in verifying that their broker-dealers followed the managers' order handling instructions.[22]

While the new rules are designed to assist managers in navigating the risks discussed above, asset owners need to understand that information will be disclosed *only if managers request it*.[23] If a manager doesn't specifically request this data, broker-dealers don't have to provide it.

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[18] Id. at 13
[19] Id. at 16
[20] Id. at 19
[21] Proposed Rules at 49434
[22] Final Rules at 13
[23] Final Rules at 24.

This was not an oversight by the SEC. Instead, they made clear that the rules were not intended to require automatic provision of the reports in the absence of such a request.[24] In explaining their rationale, the SEC noted that some managers may not want to review this data, and the rules were therefore intended to, "strike an appropriate balance between broker-dealers and customers, and does not … require the disclosure of order information when it is not requested by the customer."[25]

Equally important, unless asset owners are trading the securities themselves (i.e. through an internal trading operation), they are prohibited from requesting this data from broker-dealers. Indeed, the SEC specifically denied a request to extend the rules to end users such as asset owners, stating, "the Commission does not believe it is appropriate to require a broker-dealer to create individualized order handling reports for and make its execution data available to an end user with whom the broker-dealer may have no direct relationship."[26] Rather, the SEC stressed that the rules should only require the "broker-dealer to provide detailed information to the person that is responsible for making the routing and execution decisions…"[27]

Where Does this Leave Asset Owners?

As much as one can hope that managers will always use whatever information is available to make the most informed decision, as recognized by the SEC's reasoning described above, that doesn't always happen. Happily, while broker-dealers are not required to provide these reports to asset owners, that does not preclude asset owners from requesting such information from their *managers*.

As prudent fiduciaries, asset owners have a right to expect their managers to both request these reports, as well as evaluate the execution quality obtained on each venue shown on those reports. Equally important, depending on what the manager uncovers, the manager should, if necessary, alter their routing strategies/tactics so as to maximize the overall efficiency of their trading process.

Five Questions to Ask Managers

The SEC specifically observed that managers, as fiduciaries, should already be conducting TCA to ensure their trades received best execution, and emphasized that the new rules were intended as a means to improve those efforts. This is why Zeno AN Solutions recommends that asset owners ask the following five questions of each of their managers:

1. Do you currently conduct TCA on the overall execution costs incurred by your trading desk and broker-dealers (i.e. to ascertain whether you obtained best execution)?
2. Do you currently analyze the order routing practices of your algos and broker-dealers?
3. Do you currently conduct TCA on the shares executed at each trading venue to which your broker-dealers routed your orders?
4. Do you plan on requesting each of your broker-dealers to provide you with the new reports required pursuant to Rule 606 (b)(3)?
    a. If yes, please forward copies of each of the reports for which our fund assets participated in the orders involved.
    b. If no, please explain your reasons and rationale for not requesting these additional disclosures.

[24] Id. at 86
[25] Id. at 87
[26] Id. at 67
[27] Id. at 67

5. To the extent you plan on requesting these reports, please describe the manner in which you anticipate utilizing such reports to inform and improve your current trading process.

Importantly, the above requests require no additional out-of-pocket expenses by managers; only a willingness to request this information from their brokers. Bottom-line, the amended SEC Rule 606 provides a unique opportunity for asset owners to exercise their authority as the plan fiduciary so as to help minimize unnecessary trading costs and help maximize fund returns.

"Thus do many calculations lead to victory, and few calculations to defeat…."
(Sun Tzu, The Art of War, 500 BC)

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