

Public Disclosure of Order Execution and Routing Practices

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Rules 605 and 606 under the U.S. Securities Exchange Act of 1934, as amended (the “Exchange Act”), require that certain broker-dealers publicly disclose their order execution and routing practices.

Under Rule 605, “market centers” that trade national market system (“NMS”) securities are required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality. As required by the rule, the national securities exchanges trading NMS stocks and the Financial Industry Regulatory Authority (“FINRA”) (collectively, the “SROs”) jointly prepared, and the Securities and Exchange Commission (“SEC” or the “Commission”) approved, a NMS plan establishing procedures for market centers to follow in making their monthly reports available to the public.

Under Rule 606, broker-dealers that route customer orders in equity and option securities are required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. Broker-dealers also are required to disclose to customers, on request, the venues to which their individual orders were routed.

These reports must be posted on a free and readily accessible website.

Rule 605: Disclosure of Order Execution Information

Rule 605 requires “market centers”¹ to prepare and make available to the public monthly reports in electronic form that categorize their order executions and include statistical measures of execution quality. In order to facilitate comparisons across market centers, the rule sets forth basic measures of execution quality (e.g., effective spread, rate of price improvement and disimprovement, fill rates, and speed of execution) and specific instructions on how the measures are to be calculated. The statistical information must be presented by individual security, by five types of orders (i.e., market, marketable limit, inside-the-quote limit, at-the-quote limit, and near-the-quote limit), and four order sizes (i.e., 100-499 shares, 500-1,999 shares, 2,000-4,999 shares, and 5,000 or more shares). For each security, order type and order size, the rule provides for eleven columns of information that must be provided. The first five columns pertain to general information on the orders received by a market center in a subcategory and the disposition of those orders. Thereafter, the rule requires statistical information, which is expressed either in number of shares or in share-weighted amounts.

Market centers are given some discretion in determining how to summarize and analyze the statistical information gathered. Users of the data are able to analyze order executions for a particular security or for a group of securities, as well as for any size or type of order across groups of securities. By its terms, Rule 605 is limited in scope to market centers, covered orders, and NMS stocks.

¹ “Market center” is defined in Rule 600(b)(38) as “any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.”

As noted, the definition of the term “market center” includes (among other things) any OTC market maker or exchange market maker.² Thus, the definition is intended to cover those entities that hold themselves out as willing to accept and execute orders in NMS stocks. The reporting entities for the vast majority of orders are exchange specialists, OTC market makers, and alternative trading systems.

Rule 605 limits the market center’s disclosure requirements under the rule to “covered orders.” The rule applies only to market orders or limit orders that are received by a market center during regular trading hours, and, if executed, executed during such time. Further, covered orders must be received during the time that a consolidated best bid and offer is being disseminated. The definition of “covered order” in Rule 605(b)(15) excludes any orders for which the customer requested special handling for execution. The types of orders that are specifically excluded from the rule include, but are not limited to, orders to be executed at a market opening or closing price, stop orders, orders such as short sales that must be executed on a particular tick or bid, order submitted on a “not held” basis, orders for other than regular settlement, all-or-none orders, and orders to be executed at prices unrelated to the market price at the time of execution. The SEC has also issued exemptions from the provisions of Rule 605 relating to manually-received orders, orders affected by crossed markets, and orders affected by trading halts. These exemptions are set forth in a letter from the Commission staff to the Securities Industry Association (n/k/a Securities Industry and Financial Markets Association, “SIFMA”).³

Rule 605 applies only to securities that are designated as “NMS stocks” as defined in Rule 600(b)(47) and 600(b)(48).⁴ Accordingly, the rule generally applies to exchange-listed equities (including equities listed on the Nasdaq Stock Market) but does not apply to OTC Bulletin Board securities or exchange-listed options.

Rule 606: Disclosure of Order Routing Information

Rule 606 requires every broker-dealer that routes orders in NMS securities on behalf of customers to prepare quarterly reports that disclose the identity of the venues to which the broker-dealer routed such orders for execution. The reports must be divided into the following four sections with regard to four different types of covered securities: (1) equity securities listed on the New York Stock Exchange; (2) equity securities qualified for inclusion in the Nasdaq Stock Market; (3) equity securities listed on the American Stock Exchange or any other national securities exchange; and (4) NMS securities that are options. For each of the four sections, the broker-dealer must give a quantitative description of the nature of its order flow in the aggregate. Each description must include the percentage of total customer 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 each description must include the identity of the ten venues to which the largest number of non-directed orders for a section were routed for execution, as well as any venue to which five percent or more of non-directed orders were routed.

The quarterly reports also must describe material aspects of the broker-dealer’s relationship with each of the ten venues referenced above, including a description of any arrangements for payment for order flow or profit sharing. The disclosure is intended to alert customers to potential conflicts of interest that may

² The term “OTC market maker” is defined in Rule 600(b)(52) as “any dealer that holds itself out as being willing to buy from and sell to its customers, and others, . . . a national market system security for its own account on a regular or continuous basis otherwise than on a national securities exchange in amounts less than block size. The term “exchange market maker” is defined in Rule 600(b)(24) as “any member of a national securities exchange that is registered as a specialist or market maker pursuant to the rules of such exchange. A “national securities exchange” is defined in Rule 600(b)(45) as an exchange registered under Section 6 of the Exchange Act.

³ See Letter dated March 12, 2001, from Annette L. Nazareth, Director, SEC Division of Market Regulation, to Stuart Kaswell, SVP and General Counsel, Securities Industry Association, available at <http://www.sec.gov/divisions/marketreg/mr-noaction/siaexemp.htm>.

⁴ Rule 600(b)(47) defines “NMS stock” as “any NMS security other than an option.” “NMS security” is defined in Rule 600(b)(48) as “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.”

influence the broker-dealer's order-routing practices. The description of any payment for order flow arrangement with a venue must include disclosure of the material terms of the relationship, including a description of the amounts per share or per order that the broker-dealer receives. Similarly, a broker-dealer describing a profit-sharing arrangement with a venue should disclose the extent to which it would share in profits derived from the execution of non-directed orders. The rule, however, does not require that the broker-dealer provide a quantitative estimate of the aggregate dollar amount of payment for order flow received during a quarter from each order execution venue.

The quarterly reports are designed to provide customers with a useful picture of the broker-dealer's order routing practices as a whole. In order for customers to obtain routing information concerning their own orders, Rule 606 requires that a broker-dealer, upon request, disclose the identity of the venue to which a customer's order was routed for execution in the six months preceding the request. The rule further obligates broker-dealers to inform customers, at least annually, that they are entitled to such information.

Rules 605 and 606: Duty of Best Execution

Rules 605 and 606 were designed to foster greater transparency in connection with broker-dealers' "best execution" responsibilities. The SEC believes that requiring broker-dealers to publicize detailed execution information will enable customers and broker-dealers themselves to make more informed decisions about where to place their orders, thereby obtaining the best execution possible and promoting fair competition.⁵

The duty of best execution is a legal concept derived from Rule 10b-5 under the Exchange Act and is incorporated in SRO rules. The duty, which requires that a broker obtain the best reasonably available for its customers' orders, is premised on principles of agency law.

The reports required under Rule 605 are intended to serve three functions in promoting broker-dealers' best execution responsibilities. First, investors will be able to use these reports to personally assess the efficiency of their own brokers to determine whether they are receiving the best executions possible. Second, broker-dealers are expected to use the information compiled pursuant to Rule 605 to evaluate their own trade execution performance relative to other firms. (Since SEC and FINRA rules already require broker-dealers to conduct "regular and rigorous" reviews of their order routing and trade execution practices, information from Rule 605 reports should be considered in these reviews.) Finally, FINRA advises members who direct orders to other broker-dealers for execution to evaluate the executing broker-dealers' Rule 605 reports to determine whether or not the introducing broker is receiving quality executions for its customers' orders. If not, the introducing broker should justify the use of its executing broker-dealers in light of their performance as described in their Rule 605 disclosure, or consider routing its customers' orders to other broker-dealers for execution.

While the statistical information on order execution and order routing practices is expected to be useful in determining whether a broker-dealer has fulfilled his best execution obligation in routing customer orders to other broker-dealers generally, the Commission has expressly stated that this information standing alone does not demonstrate whether the broker-dealer has satisfied its duty in connection with any individual order.

The disclosures mandated by Rule 606 are intended to allow customers to assess whether a broker-dealer specializes in the types of orders that the customer customarily employs and to evaluate the probability that an order will be routed to a particular venue. The SEC envisions that Rule 606 reports will be used as a complement to Rule 605 reports in gauging whether a customer is receiving the best execution possible.

⁵ See NASD Notice to Members 01-22 (April 2001), at 201-02 & n. 4 (When a broker-dealer accepts a customer's order it implicitly accepts this duty, and subsequent failure to secure the best execution can subject it to liability for misrepresentation and even fraud citing *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (3d Cir. 1998)); see also, e.g., *Geman v. SEC*, 334 F.3d 1183 (10th Cir. 2003); *Last Atlantis Capital LLC v. AGS Specialist Partners*, 749 F. Supp. 2d 828 (N.D. Ill. 2010).

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Please contact us if you have any questions regarding the topics addressed herein.

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