U.S. Securities and Exchange Commission
Equity Market Structure Advisory Committee

Recommendations Regarding Modifying Rule 605 and Rule 606

November 29, 2016

- The Customer Issues Subcommittee ("Subcommittee") was formed to consider initiatives to protect investor interests and promote investor confidence.

- As part of its deliberations, the Subcommittee considered input from market participants including retail broker dealers, industry groups, members of the SEC's Investor Advisory Committee as well as the SEC's Office of the Investor Advocate.

- The full Equity Market Structure Advisory Committee (EMSAC) discussed the Subcommittee's recommendations at its public meeting held on August 2, 2016 which included EMSAC and panel discussions.

- Additionally, the SEC has released the Order Handling Disclosure Proposal ("Proposal"). In making recommendations on Rule 605 and Rule 606 enhancements, the Subcommittee has reviewed the Proposal and comment letters submitted in response to the Proposal.

- Based on discussions and the opportunity for public comment, the EMSAC recommends consideration of additional changes to Rule 605 and Rule 606 as part of the current rule-making process associated with the Proposal.

Recommendation – Modify Rule 605 and Rule 606 to provide meaningful execution quality and order handling disclosures

- Distinguish between retail and institutional orders based on whether an order is classified as "held" or "not held."

- Expand the scope of Rule 606 reporters to include exchanges and ATSs that route orders.

- Engage the Division of Economic Research and Analysis to determine the role of SIP and proprietary feeds in Rule 605/606 reporting.

- Conduct further analysis on the impacts of payment for order flow on markets including potential for conflicts between broker dealers and investors as well as other inducements impacting the markets, e.g. soft dollars. As part of this analysis, the impact of the EMSAC-recommended Access Fee Pilot on exchange rebates should also be considered.

Recommendation (a): Modify Rule 605 and Rule 606 to provide meaningful execution quality and order handling disclosures from a <u>retail</u> perspective.

- Improve the accessibility of Rule 605 and 606 reports.

- Leverage the SEC's existing Market Structure Data and Analysis website as a central repository Rule 605 and 606 reports.

- Incorporate Rule 605 and 606 data into the SEC's Data Visualization Tool.

- Expand the scope of Rule 605 by requiring every broker-dealer to report with an exemption for broker dealers with de minimis order flow, aligning scope of Rule 605 reporting with Rule 606.

  - Today, Rule 605 requires market centers[1] to publish reports. Broker-dealers who route order flow to other execution venues only produce Rule 606 reports.

  - While there would be compliance and implementation costs, the use of third party vendors may mitigate some of these concerns.

  - By having all broker dealers provide Rule 605 data, there would be an opportunity for market participants, academics and the press to evaluate these statistics in a consistent manner.

- To further improve standardization and the consistency of reporting, the SEC could consider centralizing report creation in an unbiased and trusted source such as FINRA.

- Modify Rule 605 to reflect changes in market structure since the rule was initially adopted:

  - Include odd-lots

  - Segregate Immediate or Cancel (IOC) orders

  - Include the following new data elements: "quoted spread[2]" and "enhanced liquidity[3]"

  - Expand execution time buckets to include more granular measurements including: less than 50 milliseconds, 50 milliseconds – 500 milliseconds; 500 milliseconds to 1 second

  - Revise FAQs regarding methodology to assign an NBBO for orders received in the same second as a quote change such that all firms reference the NBBO from the closest millisecond prior to the receipt of a covered order.

- Modify Rule 606 enhancements to reflect changes in market structure since the rule was initially adopted:

---

[1] As defined by Regulation NMS, market center means any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.
[2] Quoted spread would be the prevailing National Best Bid or Offer ("NBBO") at the time a market center receives an order.
[3] Enhanced Liquidity would indicate for the proportion of shares greater than the available shares displayed at NBBO that were executed at or better than the NBBO.

  - Instead of dividing data by listing markets, divide by S&P 500 and other NMS equities

  - Include a new section for OTC Equity Data

  - Segregate data currently in the "Other" category with separate columns for market open/close orders and stop/stop on quote orders. Based on order attributes, odd lots would fall into the market, limit, market open/close, stop/stop on quote, or other category.

  - Segregate marketable limit orders from non-marketable limit orders

  - Consistently identify routing destinations across Rule 606 reporters

  - Include plain English descriptions, definitions and FAQs

  - Include execution quality statistics by routing destination, e.g., effective spread / quoted spread

- Maintain Proposal's requirement for additional disclosure of payment for order flow data ensuring plain English descriptions of material aspects of relationships with venues.

Recommendation (b): Modify Rule 605 and Rule 606 to provide meaningful execution quality and order handling disclosures from an <u>institutional</u> perspective.

- Eliminate Proposal's requirement to provide order routing strategy based on aggressive, passive and neutral designations.

- Provide clarity around the Proposal's requirement to provide data around Actionable IOIs. It should be clear that conditional orders are not included in the definition and that only IOIs that are automated and eligible for immediate execution are covered under the definition.

- Maintain Proposal's definition of "institutional customer" which currently refers to the sender of an institutional order.

- Establish consistency (e.g., via FIX Protocol) for the standardized dissemination of data via execution reports to allow all broker-dealers to meet the Proposal's requirements in an efficient manner.

- Maintain Proposal's scope of institutional order handling disclosures to NMS stocks.

- Exclude directed orders from institutional order handling disclosures.

Supporting Rationale

In addition to Subcommittee meetings with retail brokers and discussion at the August 2016 EMSAC meeting, the Subcommittee's discussion related to the recommendation also included a review of comment letters in response to the Proposal.

Panelists at the EMSAC meeting in August were generally supportive of the recommendation often highlighting the benefits of current mandatory and voluntary disclosures associated with order handling/execution quality disclosures. Nasdaq[4] raised some concerns regarding the recommendation including the benefits of aggregate data as opposed to the type of disaggregated data that will be produced by the Tick Size Pilot, the availability of commercial third party options for centralized Rule 605/606 reports, and costs associated with the use of proprietary feeds as part of Rule 605/606 reporting. Discussions during the EMSAC and within the Subcommittee included a review of these concerns which are discussed below.

- With respect to the production of aggregate statistics versus disaggregate statistics, the Subcommittee believes that more granular aggregate statistics combined with the Proposal's requirement to provide institutions with customer-specific data addresses the concern.

- Regarding third party sources of centralized Rule 605/606 reports, the Subcommittee recognizes the availability of third party consolidators of Rule 605/606 reports; however, the recommendation for centralization is focused on retail investors who should have public access to Rule 605/606 reports.

- Regarding the cost of using proprietary feeds in Rule 605/606 reporting, the Subcommittee's recommendation has been updated to state that the SEC's Division of Economic Research and Analysis should examine the issue to determine the role of proprietary feeds in Rule 605/606 reporting.

When the Subcommittee presented its preliminary recommendation to EMSAC in August 2016, the Subcommittee had yet to reach a conclusion with respect to payment for order flow. Discussions spanned several topics including prohibiting the use of payment for order flow, managing conflicts of interest and opportunities for enhancing existing or requiring new disclosures. After further deliberation and a review of the Proposal, the Subcommittee believes that the additional disclosure in the Proposal is warranted. Beyond that, the Subcommittee recommends that the SEC conduct further analysis on inducements including payment for order flow, exchange rebates and soft dollars. Justification for analyzing exchange rebates is discussed in the EMSAC Recommendation for an Access Fee Pilot. Considering changes to the use of soft dollars as required under MiFID II and the FCA inducement rules covering payment for order flow, we believe this analysis should consider the impact that regulating inducements has had in other markets.

In addition to responding to the Subcommittee's preliminary recommendation, EMSAC panelists and commenters provided additional feedback on retail and institutional order routing/execution

[4] Nasdaq was represented by Frank Hatheway, Ph.D., Senior Vice President and Chief Economist

quality as it relates to the Proposal. The Subcommittee met with two of the industry associations[5] responsible for the industry institutional disclosure template and reviewed comment letters submitted in response to the Proposal.

The recommendation of the Subcommittee focuses on ensuring consistency of reports, reflecting the characteristics of retail and institutional order flow, simplifying implementation and promoting a better understanding of payment for order flow as described below.

- The elimination of the subjective characterization of order routing strategies should promote consistency across reports and simplify implementation.

- Basing the definition of institutional and retail orders on whether an order is "held" or "not held" is consistent with how retail and institutional orders are handled.

- Use of standard FIX tags for passing required information between broker dealers and their institutional clients should simplify implementation and promote consistency.

- Clearly articulating payment for order flow terms in retail disclosures should promote an understanding of these practices.

[5] Representatives of the Managed Funds Association (MFA) and the Investment Company Institute (ICI) met with the Subcommittee on September 23, 2016.