



RISK ALERT

DIVISION OF EXAMINATIONS

November 10, 2022

Observations Related to Regulation NMS Rule 606 Disclosures¹

I. Introduction

The Division of Examinations (“EXAMS” or “Staff”) conducted a series of examinations regarding how broker-dealers were complying with the new Regulation NMS Rule 606 (“Rule 606”) disclosure requirements. Staff focused on two aspects of the public reports broker-dealers prepare under Rule 606(a): (1) broker-dealer figures reported in public disclosures and (2) broker-dealer descriptions of the material aspects of their relationships with each specific venue. EXAMS is issuing this Risk Alert to highlight observations during the examinations and to remind broker-dealers of their obligations under the new and enhanced Rule 606(a) requirements.² FINRA has also been reviewing firms’ compliance with Rule 606 and has noted similar observations as described in its 2022 Report on FINRA’s Examination and Risk Monitoring Program.³

In November 2018, the Commission adopted amendments to Rule 606 to require broker-dealers to provide enhanced disclosures regarding the handling of their customers’ orders in the firms’ public Rule 606(a) reports.⁴ As amended, Rule 606(a) requires a broker-dealer to provide a

¹ The views expressed herein are those of the EXAMS staff. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (“SEC” or “Commission”). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by EXAMS staff and is not legal advice.

² EXAMS’ 2021 Priorities included a focus on broker-dealer compliance with the recently amended Rule 606 order routing disclosure rules. SEC EXAMS 2021 Examination Priorities Report at 31, available at <https://www.sec.gov/files/2021-exam-priorities.pdf>.

³ 2022 Report on FINRA’s Examination and Risk Monitoring, Market Integrity – Disclosure of Routing Information (Feb. 9, 2022), available at <https://www.finra.org/rules-guidance/guidance/reports/2022-finras-examination-and-risk-monitoring-program/disclosure-routing-information>.

⁴ Securities Exchange Act Release No. 34-84528 (Nov. 2, 2018), 83 FR 58338 (Nov. 19, 2018), Final Rule: Disclosure of Order Handling Information (“Adopting Release”), available at <https://www.sec.gov/rules/final/2018/34-84528.pdf>. The effective date was January 18, 2019, but the compliance date was later postponed to May 29, 2020 for Q1 2020 Rule 606 firm disclosures. See Securities Exchange Act Release No. 34-85714 (Apr. 24, 2019), 84 FR 18136 (Apr. 30, 2019) Final Rule; extension of compliance date for certain requirements, available at <https://www.sec.gov/rules/final/2019/34-85714.pdf>.

publicly available quarterly report on its routing of non-directed orders from its customers that are: (1) for NMS stock and submitted on a held basis; or (2) for an NMS security that is an option contract with a market value less than \$50,000.⁵ The report's disclosures are aggregated across all of the qualifying orders that the broker-dealer routes on behalf of all of its customers.

The public report is designed to provide better insight into factors that may influence a broker-dealer's order routing decisions.⁶ In particular, broker-dealer customers can view the material aspects of their firm's payment for order flow ("PFOF") arrangements and disclosures on how the firm routes non-directed orders for execution. The public report must contain a discussion of the material aspects of the broker-dealer's relationships with each specified venue, 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."⁷

Broker-dealers may have conflicts of interest from compensation arrangements as well as conflicts of interest from a number of monetary and non-monetary order routing incentives. PFOF may present a potential conflict of interest because the PFOF receiving firm may be incentivized to route order flow to maximize PFOF revenue, including only routing orders to venues that agree to pay a certain level of PFOF,⁸ which may come at the expense of their customers' order execution quality. The Rule 606 disclosure requirements are intended to allow broker-dealer customers to better evaluate their firm's routing services and how well they manage potential conflicts of interest.⁹

⁵ Typically, not held orders provide a broker-dealer with price and time discretion in the handling of such orders. Held orders typically are orders that a broker-dealer must attempt to execute immediately. If either type of order is non-directed, then the broker-dealer typically has discretion to determine the execution venue.

⁶ See Adopting Release at 156 (describing Commission's belief that Rule 606(a) "provides an appropriate level of insight into the widespread financial arrangements between broker-dealers and execution venues that may affect broker-dealers' order routing decisions....").

⁷ 17 C.F.R. § 242.606(a)(1)(iv).

⁸ See Adopting Release at 143 ("[B]ecause 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 believes that disclosure of such information will 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 their orders are routed.")

⁹ See Adopting Release at 13 ("[S]implifying and enhancing the current publicly available disclosures, particularly with respect to financial inducements from trading centers, should assist customers in evaluating better the order routing services of their broker-dealers and how well they manage potential conflicts of interest.").

II. Staff Observations

In examinations of Rule 606(a) reports produced since 1Q 2020, Staff observed issues with firms' quantifiable disclosures and material aspects disclosures.

A. Issues with Quantifiable Disclosures

Staff observed issues in how firms identified venues, classified orders, and calculated aggregate net rebates in reports required by Rule 606(a)(1). For example, the Staff observed the following deficiencies with respect to firms' quantifiable disclosures:

- Routing of all orders to a clearing firm without either creating a Rule 606 report or incorporating by reference, the clearing firm's Rule 606 report.¹⁰
- Improperly identifying routing firms rather than the venues to which they routed orders "for execution" as required by Rule 606(a)(1)(ii).¹¹ For example, identifying a routing-only broker-dealer as a venue per Rule 606(a)(1)(ii) on the 606 reports and omitting the names of the actual venues to which the routing-only broker-dealer relayed orders for execution.
- Inaccurately classifying order percentages among the four order type categories (market orders, marketable limit orders, non-marketable limit orders, and other orders),¹²

¹⁰ A firm must disclose information about the venues to which it routed orders for execution in accordance with Rule 606(a)(1)(ii), (iii), and (iv). Alternatively, a firm may disclose its relationship with a routing broker (such as a clearing firm), including any PFOF received from the routing broker, and adopt by reference the routing broker's reports. See Responses to Frequently Asked Questions Concerning Rule 606 of Regulation NMS ("Rule 606 FAQs"), Question 12.01, available at <https://www.sec.gov/tm/faq-rule-606-regulation-nms> (The Division of Trading and Markets ("TM") published frequently asked questions related to Rule 606).

¹¹ Rule 606(a)(1) requires that firms include a section in the report for NMS stocks separated by securities in the S&P 500 Index and other NMS stocks, and a separate section for NMS securities that are options contracts. Rule 606(a)(1)(ii) requires that each section of the report identify the top ten venues to which a firm routes orders for execution and the percentages of those orders classified into each of four mutually exclusive order types: market, marketable limit, non-marketable limit, and other.

¹² 17 C.F.R. § 242.606(a)(1)(i) and (ii) (requiring disclosures of non-directed orders related to four order types (market orders, marketable limit orders, non-marketable limit orders, and other orders)). TM has issued statements addressing classification of orders among these four order types. See, e.g., Div. of Market Reg., Staff Legal Bulletin No. 13, "Frequently Asked Questions About Rule 11Ac1-6" (Jun. 22, 2001), available at <https://www.sec.gov/interps/legal/mrslb13.htm> (classifying market, limit, and other orders under Rule 11Ac1-6, now known as Rule 606, at Question 9, in relation to the definitions of those order types for purposes of Rule 11Ac1-5, now known as NMS Rule 605); accord TM, Responses to Frequently Asked Questions Concerning Rule 605 of Regulation NMS (Feb. 22, 2013) (explaining that all non-exempt short sales should be classified as other orders), available at <https://www.sec.gov/divisions/marketreg/nmsfaq605.htm>.

including use of conflicting methods for classifying order percentages and aggregate amounts of net rebates received in terms of the four order types.¹³

- Disclosing inaccurate amounts of net aggregate rebates received for each of the four order types.¹⁴
- Using the incorrect dates for determining inclusion of a stock in the S&P 500 index.¹⁵

B. Issues with Material Aspects Disclosures

Staff observed firms that did not disclose the material aspects of their relationship with their routing broker or execution venues as required by Rule 606(a)(1)(iv), which included omitting a description of any payment for order flow arrangement and any profit-sharing relationship that may influence a firm's routing decision.¹⁶ For example, the Staff observed the following deficiencies with respect to firms' material aspects disclosures:

- Regarding PFOF arrangements with non-exchange venues, not disclosing the specific per share PFOF rebate applicable to different sizes and order types under each PFOF arrangement.¹⁷ Instead, these firms typically included the following general terms in their materials aspects disclosures:

¹³ Rule 606(a)(1)(iii) requires each report section to disclose the aggregate net rebates received both as a total dollar amount and per share for each of the four order types from each venue.

¹⁴ *Id.*

¹⁵ Firms should categorize whether securities are included in the S&P 500 index as of the first day of each quarter. *See* 17 C.F.R. § 242.606(a)(1).

¹⁶ Rule 606(a)(1)(iv) requires each quarterly report on order routing to include "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." *See also* Adopting Release at 140 (acknowledging that PFOF arrangements are "intensively fact-based in nature and may vary across broker-dealers").

¹⁷ 17 C.F.R. § 242.606(a)(1)(iv) (requiring a description of any terms of PFOF arrangements with the specified venues that may influence the firm's order routing decision). *See also* Adopting Release at 142 (noting that 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 order routing decision that are required to be disclosed). *See also* Adopting Release at 142 n.397 ("If a broker-dealer receives variable payments or discounts based on order types and the amount of such orders sent to a Specific Venue, e.g., marketable orders, non-marketable orders, or auction orders, then all terms of that arrangement must be disclosed."). *See also* Rule 606 FAQs, Question 14.02, available at <https://www.sec.gov/tm/faq-rule-606-regulation-nms> ("In the view of staff, the details of any arrangement

- general information that the firm received PFOF;
 - average per share rebates;
 - the use of “may receive” when the firm in fact received PFOF;
 - relying on references to the remuneration in the tables contained within the 606 report; and
 - generally stating that the firm received the same rebate from all market makers.¹⁸
- Not disclosing that they had arrangements with or provided attestations to venues to route retail orders.¹⁹ Deficiencies included firms that did not disclose that they represented to their routing or executing brokers that they would provide exclusively retail order flow to the routing broker in order to receive PFOF under arrangements with their routing brokers.
 - Not disclosing that they had a rebate arrangement and a rebate split with their venues. Deficiencies included firms that did not disclose the details of PFOF revenue split arrangements with their clearing firm or routing broker.²⁰ This disclosure is applicable to firms that have PFOF arrangements with their routing brokers even if the firm chooses the approach of adopting by reference the routing brokers’ reports.²¹
 - While firms had discussions with their execution venues regarding an increase (decrease) in PFOF for a corresponding decrease (increase) in price improvement (“PI”) and thereby

could include the amount of price improvement (*i.e.*, the level of execution quality), the amount of payment for order flow that is negotiated, and the details of any arrangement where the execution quality or payment for order flow provided by the venue varies based on the characteristics or categories of the order flow that the broker-dealer routes to the venue.”).

¹⁸ Some firms informed Staff that they had eliminated any PFOF conflicts by negotiating the same PFOF rates for all of the execution venues and not factoring those payments into the firms’ routing decisions. However, those inducements for routing orders must still be disclosed because the firm may be influenced, for example, not to route orders to venues that do not pay the same PFOF as the firm’s current execution venues. It is the broker-dealer customer that will evaluate the potential conflict of interest with the firm’s PFOF arrangements. *See* Adopting Release at 143 (“The Commission further believes that providing customers a comprehensive description of such quantifiable terms of a broker-dealer’s relationship with a Specified Venue will 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.”).

¹⁹ *See* 17 C.F.R. § 242.606(a)(1)(iv) (requiring a discussion of the material aspects of the firm’s relationship with a venue identified pursuant to Rule 606(a)(1)(ii)).

²⁰ *See id.* PFOF revenue split arrangements were typically documented in clearing agreements.

²¹ *See* 17 C.F.R. § 242.606(a)(1)(iv). *See also* Rule 606 FAQs, Question 12.01, available at, <https://www.sec.gov/tm/faq-rule-606-regulation-nms>.

lower (higher) execution quality (“EQ”), firms did not disclose the PFOF and PI/EQ trade-off in their Rule 606 reports.²² Moreover, firms that refuse to route orders to execution venues unless such venues agree to pay a level of PFOF specified by the firm must disclose when the PFOF negotiated by the firms reduces the PI and EQ opportunities for the firms’ customers. This disclosure is required regardless of any specific conversation with execution venues surrounding a trade-off between PFOF and PI or EQ. Additionally, Rule 606’s requirement that a firm describe the material aspects of its relationship with the executing venue, along with a description of the terms of any PFOF arrangements imposes an affirmative duty to disclose such a trade-off. For this reason, failing to disclose such a trade-off in a firm’s Rule 606 reports could be interpreted by a firm’s customers as a representation that the level of PFOF required by a firm as a condition for routing customer orders to an execution venue does not affect the customers’ PI or EQ opportunities.

- When adding new venues to their 606 report under Rule 606(a)(1)(ii), firms did not include any corresponding material aspects disclosures for those newly added venues despite those venues having PFOF arrangements with the firms.
- Not disclosing the material aspects of their PFOF arrangements with exchange venues.²³ For example, firms either did not disclose any material terms of the PFOF arrangements with exchanges or included hyperlinks to exchanges’ fee schedules, which did not describe the firms’ incentive for routing to particular exchanges along with the quantifiable terms. An exchange’s fee schedule may include many available tiers with different requirements to earn specified rebates. Therefore, as part of the firm’s material aspects discussion, firms should describe the specific rebate tier applicable to the firm.²⁴

²² See Adopting Release, n. 397, at 142-143; Rule 606(a)(1)(iv) (requiring a discussion of the material aspects of the firm’s relationship with a venue identified pursuant to Rule 606(a)(1)(ii), which includes a description of the PFOF arrangement that may influence the firm’s order routing decision); See Rule 606 FAQs, Question 14.02, available at <https://www.sec.gov/tm/faq-rule-606-regulation-nms>.

²³ The rebates paid by exchanges to broker-dealers, regardless of whether or not those rates are negotiated, are PFOF. See Securities Exchange Act of 1934 Rule 10b-10(d)(8) (“Payment for order flow shall mean any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any...national securities exchange...in return for the routing of customer orders by such broker or dealer to any...national securities exchange...”).

²⁴ Rule 606 requires firms to provide a description of the PFOF arrangements, including terms, with the venues identified pursuant to Rule 606(a)(1)(ii), which includes any exchanges that pay rebates to the firm. See Adopting Release, at 144, n. 403 (noting that there is no expectation that firms duplicate an exchange’s rule filing). See 17 C.F.R. § 242.606(a)(1)(iv) (requiring firms to disclose a description of their PFOF arrangements that influence their order routing); See, e.g., Rule 606 FAQs, Question 12.02, available at <https://www.sec.gov/tm/faq-rule-606-regulation-nms> (explaining that the material aspects of the broker-dealer’s relationship with that venue that are required to be disclosed to the customer include a description of all of the pricing tiers offered by the venue, the pricing for each tier, and the tier that applied to the broker-dealer).

C. Supervision

Staff observed issues regarding FINRA Rule 3110(b)(1) and its requirement to establish or enforce an adequate system of supervisory controls reasonably designed to ensure compliance with Rule 606(a)(1). Firms did not have adequate written supervisory procedures (“WSPs”) to ensure the accuracy of the Rule 606(a) reports or the accuracy of the material aspects disclosures. In addition, firms did not sufficiently review the data quality underlying the reports, which led to facially inconsistent disclosures in the reports. Firms that rely on commercial vendors to produce some or all of the report remain responsible for the accuracy of the report disclosures.

III. Conclusion

Broker-dealer customers should feel confident in relying upon the completeness and accuracy of their firms’ Rule 606 reports when evaluating the firm’s routing decisions. These customers should also be able to effectively assess any incentives that may influence those routing decisions. EXAMS encourages broker-dealers to review their policies and procedures related to the new and enhanced information requirements under Rule 606 and reevaluate the accuracy and specificity of their current Rule 606(a) disclosures within the context of these exam observations.

This Risk Alert is intended to highlight for firms risks and issues that EXAMS staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm’s business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
