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SEC Rule 606 Endgame: The Guidance is Out

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The SEC staff released the long awaited and heavily anticipated guidance on Rule 606 to assist broker-dealers and the industry with implementation of the new disclosure requirements that were issued back in November 2018 and are scheduled to go into effect on October 1, 2019. There are 32 detailed questions and responses available for your reading pleasure on the SEC website and if the thought of slogging through the minutiae of the requirements appeals to you, have at it (and please get yourself some help). If you prefer a five-minute read with a consolidated synopsis of the most salient aspects of the guidance and potential impact, you've clicked on the correct link.

As you may already be aware, the new 606 requirements have bifurcated requirements for orders that are handled on a held (606(a)) and not-held (606(b)) basis with significantly more detail and data required for the reporting of not-held orders. As such, we address the particular guidance relevant to held and not-held orders separately below.

Not-held Orders – 606(b)

First and foremost, the SEC staff clarified the definition of "discretion" for 606(b) purposes. This was an open question since the requirement for more detailed reporting applies specifically when firms have been deemed to exercise discretion over not-held orders routed to another broker-dealer. The SEC FAQs made clear that virtually all circumstances under which Broker A utilizes the smart order router ("SOR") or algorithms ("algos") of Broker B to route orders will result in Broker A being deemed to have exercised discretion over the orders and implicating all of the reporting requirements of 606(b). It is really as simple as that. Unless, in the unlikely circumstances, that Broker A utilizes Broker B's SOR or algo but does not:

- select a particular algo/SOR/strategy when routing the order; or
- indicate whether the algo should passive/aggressive; or
- assist with pre-determined venue selections provided by Broker B; or
- assist with pre-determined venue prioritizations employed by Broker B; or
- negotiated economics on cost for the SOR/algo services that could have material impact on venue choices.

As mentioned above, if your firm is using another firm's SOR/algo, plan to include the activity in your 606(b) report as you will likely be deemed to have exercised discretion over the orders. Alternatively, plan for an extensive discussion with SEC examiners when they review your 606 report.

Next is the question of what venues to include on your 606(b) report. The answer is apparent now with the definition of discretion having been clarified. For those firms utilizing the SOR/algos of another firm, the SEC staff's expectation is that such firms will not only report the SOR/algo firms as venues but will also include the venues to which the SOR/algo firms subsequently routed their orders. I will give you a minute to go back and read that again. No, that was not a misprint or misinterpretation. That means two levels of venues on your 606(b). Consider this example: Broker A routes an order to Broker B and utilizes Broker B's SOR/algo (thus is deemed to have exercised discretion). Broker B then routes child orders to Broker C and Exchange D. The SEC staff expect Broker A to list Broker B, Broker C and Exchange D as venues on its 606(b) report and denote if the venue is a primary route, secondary route or execution venue. But what is not clear from the FAQs is precisely what information should be reported against what type of venue? Should the ultimate execution information be captured and reported against all venues thereby creating duplication within the report? And what does this mean practically for Broker A and Broker B? Broker B is going to have to provide a bit more information to Broker A than it does today (in many cases) in order for Broker A to fulfill its 606(b) obligations. Either that or compile the necessary statistics and pass those back to Broker A. This means you SOR/algo providing firms. I know what you're thinking, this was supposed to be the concise version. Trust me, this is critical detail as it has implications elsewhere in the 606(b) report with regard to fee and rebate reporting.

Speaking of fees and rebates, the new 606(b) requirements mandate that firms provide the average net fees/rebates paid to or received from a particular venue during the reporting period, as well as the specific fee/rebate average attributable to orders providing or taking liquidity. Given that we now know the expectations concerning discretion and venues, how are firms to distinguish fees/rebates amongst the various types of venues? The answer is that firms must do the following:

- associate any commission-related costs paid to their SOR/algo partners with such venues as primary routing venues on the 606(b) report; and
- associate any exchange fees passed back to them by their SOR/algo partners with the exchange venues listed on their 606(b) report as execution venues.

For further clarity, in a cost-plus arrangement between Broker A and Broker B, Broker B must pass back to Broker A specific detail on commissions per transaction and exchange fees/rebates per transaction such that Broker A can take that detail, aggregate it and report it against the appropriate venues on its 606(b) report. Again, what does this mean practically to our Broker A and Broker B? Broker B has some work to do (potentially) to provide the explicit detail on a per transaction basis to Broker A regarding commission/fees as well as pass back any client/order ID detail so that Broker A may associate the detail to particular clients (or alternatively compile the statistics on a client or order ID basis and pass it back). Broker A or Broker A's vendor must develop processes to take in the additional data, perform the necessary calculations and report the information upon request by the client.

Finally, the FAQs provided answers to certain data specific questions around the liquidity aspects of the reporting requirements and orders that are further routable. The SEC staff confirmed that there can be

orders that neither provide nor take liquidity and such activity will not be included in the liquidity specific sections of the 606(b) report. Additionally, with regard to orders that provided liquidity, the guidance for measuring the time between order entry and execution/cancellation is to begin with the time routed to the venue and either the ultimate cancellation or last execution of that order. Last but not least, orders are only to be considered not further routable if there is a specific order type/instruction that prohibits the further routing of the order, plain and simple.

Held Orders – 606(a)

The most crucial aspect of the guidance related to held orders concerns the definition of venue. The FAQs indicate that an entity is considered a venue for 606(a) purposes only if that entity executes orders. So, if orders are routed by Broker A to an agency broker-dealer that does not execute orders, Broker A would not list the agency broker-dealer as a venue in its 606(a) report. However, Broker A is not entirely off the hook in this scenario. Why not, you ask? In short, because the guidance says so. The FAQs indicate that Broker A still has the reporting responsibility even though the agency broker dealer is not a venue. Under these circumstances, Broker A would disclose the relationship with the agency broker dealer on the 606(a) report, including any payment for order flow, transaction fees, etc. Broker A could also separately contract with the agency broker-dealer to incorporate the 606(a) information from their report into Broker A's report to satisfy Broker A's obligations under 606(a). Oh, and Broker A would have to examine the agency broker dealer's report to confirm it does not have reason to believe that it materially misrepresents the order routing practices. Good times, right? Couple of issues/questions with this:

- ✓ Why must the agency broker dealer be referenced on Broker A's report if it is not considered a venue under the Rule 606(a) definition of venue?
- ✓ What if Broker A routes to Broker B and Broker B is a firm that does execute orders but did not execute any of the orders routed it by Broker A. How is Broker B treated on Broker A's 606(a) and what information must be disclosed?
- ✓ The agency broker dealer may only have other broker dealers as clients and thus no obligation to generate a 606(a) report.
- ✓ Broker A could not make any reasonable determination as to the representation of the order routing practices of the agency broker dealer without the underlying order routing data which is not available to Broker A.

Further clarity is needed on these questions to ensure accurate and consistent reporting across the industry.

Additional FAQs on held orders confirmed that marketability of limit orders is to be determined at the time of routing to the venue, not at the time of order receipt. With respect to options, consolidators can be considered a venue of execution and the criteria required to be reported under 606(a) would pertain directly to the relationship with the consolidator.

What's next?

Back in April, the SEC granted the Financial Information Forum's ("FIF") request and extended the deadline for compliance with the new requirements until October 1, 2019, as the industry awaited the necessary guidance. On August 2, 2019, FIF and the Security Traders Association ("STA") filed a joint letter with the SEC requesting delays in the implementation of the new 606(a) and 606(b) requirements pending receipt of the SEC guidance, however, the deadline remains October 1st as of the date of this article. The ask was a delay until beginning of 1Q 2020 (two months post guidance) for 606(a) and six-months post guidance (roughly 2Q 2020) for 606(b).

We encourage firms to now move forward with their development efforts and discussions internally or engage with their vendors to ensure that appropriate information is sourced and processes are in place for reporting. As this paper highlights, the 606 arena is a whole lot more complicated than it was in the past. At Jordan & Jordan, we have actively engaged with our 606 clients and their executing brokers to explain the breadth of the new requirements, the FAQs and SEC staff expectations. We continue to follow this space closely, contact us to assist with interpretation of the new requirements or to assist with your implementation.