HEALTHY MARKETS
TRANSPARENCY & TRUST

December 11, 2018

Via Electronic Mail

Brett Redfearn, Director
Division of Trading and Markets
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Disclosure of Order Handling Information, Rel. No. 34-84528; File No. S7-14-16

Dear Director Redfearn:

On November 2, 2018, the Commission adopted long-awaited order handling and routing disclosure reforms.[1] While we appreciate the requirement that brokers who receive significant amounts of "not held" orders must now provide much greater details to investors who ask for them, we believe the Final Rule will likely have significant, negative, unintended consequences for many smaller brokers, advisers, and investors. As detailed below, we urge you to assist the Commission in adopting several changes to the Final Rule without delay.

Negative Consequences From Using Order Type As a Proxy for the Type of Investor

In announcing the Final Rule, you declared "[a]ll investors, from Main Street investors to sophisticated asset managers that manage pensions and other funds, deserve to receive information from their brokers about how their orders are executed within our complex stock trading environment."[2] We agree. However, rather than do that, the Final Rule only requires greater disclosures of some orders sent by some institutions (typically, just very large ones) to some brokers (generally, those that do not have large retail businesses). In fact, by the Commission staff's own analysis, the Final Rule will exclude from its definition of "institutional order" as much as 60% or more of all orders from institutions.[3]

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[1] Disclosure of Order Handling Information, SEC, Rel. No. 34-84528, Nov. 2, 2018, available at https://www.sec.gov/rules/final/2018/34-84528.pdf ("FInal Rule").

[2] Statement of Brett Redfearn, SEC, *Statement on Enhancing Order Handling Disclosures*, Nov. 2, 2018, *available at* https://www.sec.gov/news/public-statement/redfearn-statement-enhancing-order-handling-disclosures.

[3] Final Rule, at 207. At the same time, the Final Rule will likely include a non-trivial number of "individual" orders.

As the economic analysis in the Final Rule explains:

> The staff studied orders submitted from customer accounts of 120 randomly selected NMS stocks listed on NYSE during the sample period of December 5, 2016, to December 9, 2016, consisting of 40 large-cap stocks, 40 mid-cap stocks, and 40 small-cap stocks. Consistent with the comments, the staff analysis confirms that orders received from institutional accounts are more likely to be not held orders than orders received from individual accounts. Specifically, the staff analysis found that among the orders received from the institutional accounts, *about 69% of total shares and close to 39% of total number of orders in the sample are not held orders*.[4]

Only firms that send a significant volume of “not held” orders to brokers that also happen to have “not held” orders comprise a significant chunk of their overall businesses will benefit from the new detailed order handling disclosures. All other orders -- including all orders from the majority of investment advisers overseen by the Commission and state securities regulators -- are likely excluded.

We understand why larger financial firms appreciate the enhanced disclosures, which they -- and we -- appreciate. We also appreciate that the Final Rule covers more orders than the proposed rule, which had included an ill-advised distinction for orders totalling more than $200,000 in value.[5] The largest investment advisers will get most of what they would like to perform high quality transaction cost analyses and best execution reviews.

However, when adopting the Final Rule, the Commission did not thoroughly explore the disparate impacts of its choice to distinguish between customers based on order types. It did not analyze how the distinction would impact asset owners or advisers of different sizes, nor did it adequately explain why simply distinguishing institutional orders as those coming from institutions would be ineffective, more burdensome, or otherwise inferior to the complex and flawed approach it ultimately adopted.

Had the Final Rule explored these issues, it would have found that many smaller advisers typically do not have “institutional” brokerage coverage and thus generally send orders through predominantly “retail” channels. These advisers do not benefit from the Final Rule’s enhanced disclosures, which they could have used to perform their best execution analyses. Nor will smaller advisers likely be able to provide comparable reports to their underlying asset owners as their larger competitors.

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[4] Final Rule, at 207 (emphasis added). At the same time, the study found that, for orders from “individual accounts, about 19% of total shares and about 12% of total number of orders in the sample are not held orders.” Id.

[5] The $200,000 order size distinction was nearly universally panned by commenters.

For example, assume a large pension fund with a mandate to promote smaller advisers and brokers sends out a request for proposals to a $20 billion AUM adviser and a $1 trillion AUM adviser. The request will likely include a requirement that the adviser provide the asset owner with details regarding execution quality and costs.

Because of the Final Rule, the larger adviser will be able to provide the pension fund with detailed quarterly reports on how its orders are handled, as well as assurances that it is able to effectively measure its execution quality. Put simply, it will be able to show -- in detail -- how it fulfills its best execution obligations. The smaller adviser, by contrast, will likely have no detailed order routing reports or execution quality analysis. While the Final Rule expressly protects the larger firm's access to that information (even though the firm may already have sufficient market power to compel it), the Final Rule offers no such protection for the smaller adviser (who also likely lacks the market power to compel it).

As a representative of one of the largest pension funds in the world has already explained to the Commission staff, as a fiduciary, a pension fund executive will likely feel compelled to utilize a firm that is capable of providing the minimum essential services.[6] The ability to measure, evaluate, and improve execution quality is increasingly one of its minimum expectations. In this scenario, even if the two advisers have similar returns and services, we would expect the pension fund to invest in the larger adviser, and not the smaller one--merely because the smaller adviser is unable to fulfill the basic requirements of the proposal.

In addition, any "held" vs. "not held" distinction also allows for potential gaming and other concerns. For example, an investor could send "held" orders to a broker to avoid the institutional reporting mechanism. Further, trading practices have evolved dramatically over the past several years. In recent years, amidst rising concerns with brokers' conflicts of interests, some institutional investors have come to use "held" orders. These investors would be denied the benefits of the additional institutional reporting regime for a portion of their orders. Again, institutions would not get this valuable information on all of their orders, and some investors may get none of this important information at all. Further, as trading practices evolve over time, institutional and retail order type usage may change, which may have dramatic impacts on the utility of the reports.

In sum, the order type-based distinction will not cover the majority -- much less all -- of orders sent by institutions, which is one of the most-important objectives of the rule. The order type distinction is particularly bizarre, given that broker-dealers already segregate their customer orders into "institutional" and not.[7] Additionally, the institutional/retail classification is readily available today within the exchange traded options space.

[6] Meeting with Healthy Markets Association members and Commission Staff, Nov. 14, 2018.

[7] In fact, in analyzing the Final Rule, the Commission staff used data obtained from FINRA's Order Audit Trail System (OATS), which segregates customers into account classifications. See, Final Rule, at 207, n. 642.

Proposed Revision

We believe that all investors -- regardless of size -- deserve to know how their orders are routed and executed, and so we urge the Commission to revise the Final Rule to treat all orders as if they were “institutional orders.” If this is too dramatic of an improvement, given that the order sender’s regulatory status determines its obligations (e.g., for best execution) and competitive pressures, we recommend strongly that the Commission revise the Final Rule to distinguish between orders submitted by institutional investors and all others. This distinction is already made for reporting and recordkeeping purposes, and would avoid some of the massive negative consequences (including burdens on competition) that are created by the Final Rule.

Negative Consequences From the Treatment for White Labelling

The Final Rule does not ensure that brokers who offer “white labelled” products are able to obtain the information they need to provide reports to their customers.

Due to the increasing complexity of trading in the modern markets, many smaller brokers (including those who provide investment research for small cap stocks), use trading technology and infrastructure that is licensed from larger broker dealers, a process that is often referred to as “white-labelling.” Put simply, the resources necessary to develop modern order routing technology is often too great for many smaller firms.

Under the Final Rule, a small broker that is providing its customers with a “white-labelled” product may be unable to provide its investor customer with the information it requests. Its service provider may simply decline to offer the details. We see little reason for a white label provider to offer these details to its customer, the smaller broker dealer, given that the details could enable the smaller broker to more cheaply develop its own product. Further, the firm providing the white-labelled products to the smaller broker is unlikely to even be able to comply with the request unless the small broker separately identifies customers (presumably using anonymous numbers) when it submits the orders to the larger firm.

On the one hand, the Final Rule’s adopting release explains that “the Rule 606(b)(3) report requirement covers instances where an order is handled either directly by the broker-dealer or indirectly through systems provided by the broker-dealer.”[8] On the other hand, the Final Rule did not “change the existing definition of customer in Rule 600(b), which states that “customer” means any person that is not a broker-dealer,”[9] meaning that “under Rule 606(b)(3) as adopted, a broker-dealer is required to provide the report only to non-broker-dealers.”[10]

[8] Final Rule, at 67.
[9] Final Rule, at 66.
[10] Final Rule, at 67. See also, Id., at 69 (“The Commission further notes that, because it is not altering the broker-dealer exclusion from the definition of customer, and because Rule 606(b)(3) utilizes this defined term, the rule does not require a broker-dealer to report to another broker-dealer.”).

The adopting release then explains that brokers who use white labelled products

> typically have access or rights to the execution data for trades made using algorithms or other technology that they license or outsource. As such, the Commission believes that most broker-dealers *should be well-positioned to provide the Rule 606(b)(3) information to their customers for orders* (or child orders thereof) that they routed or executed using a trading algorithm or other type of technology offering. Ultimately, however, when relying on third-party technology in this manner, broker-dealers will need to ensure that they can provide the information required by Rule 606(b)(3), should it be requested by a customer.[11]

We do not have confidence that this belief is sufficiently robust so as to rest the fate of this common and essential industry practice. Nor do we think "should" is good enough.

The ability to offer sophisticated trading platforms that the smaller broker may not otherwise capable of building and operating directly benefits both smaller brokers and their customers. This is particularly true because this trading technology and infrastructure may allow the smaller broker accept commission payments for separately-provided research. If the smaller broker was unable to provide this execution capability, then it may not be able to accept payment for investment research in a competitive manner.

Lastly, the Final Rule provides no time extension for smaller brokers in this scenario. While we agree with the Commission's determination that investors should be able to obtain this information in a timely manner, we also believe that it is important for the Commission to reflect the operability of its own rule. Given that the smaller broker must request the information, obtain it (from its service provider who appears to have no obligation to provide it), and then turn it around to its underlying investor customers, we believe that 7 days may be too stringent.

Proposed Revision

The Commission should revise the final rule to expressly require "white label" providers to provide their broker-dealer customers with compliant order routing reports, upon request. This would require a few simple word changes in the rule. The Commission should also extend the compliance period in such instances by 3 business days so as to permit the transmission of information between the smaller broker and its white-label product provider.

Negative Consequences From the De Minimis Exceptions

[11] Final Rule, at 72 (emphasis added).

The Final Rule includes two deeply troubling *de minimis* exceptions -- each of which harms smaller investment advisers. One exception alleviates any broker-dealer to provide the report to any customer if not held NMS stock orders constitute less than 5% of the total shares of NMS stock orders that the broker-dealer receives from all of its customers over the prior six months. Of course, many smaller advisers, who send their orders to firms where they are often custodied (*e.g.*, Schwab or TD Ameritrade), may be denied these reports because those firms' overall mix of business likely doesn't reach 5%.

Further, in some cases, an investor may not know whether it can ever get a report from its broker because it may not know whether the rest of the brokers' business includes more than 5% "not held" orders. In fact, this may include even very large banks that provide so-called "sponsored access" and maintain significant prime brokerage businesses. For example, Rule 606 reports of some large bank broker-dealers reflect that only a small percentage of all customer orders may be non-directed. Accordingly, as constructed, it is possible that very large brokers who handle massive amounts of institutional investor order volume may not have any reporting obligations under the new rule because of the 5% de minimis threshold, or may be able to restructure themselves to avoid the obligation.

The second exception is that a broker-dealer is not obligated to provide the institutional level of reports to a customer if that customer has traded on average less than $1 million of notional value of not-held orders in NMS stocks.[12] Facially, this may exclude smaller brokers. We also worry about how this may impact brokers that might otherwise only receive smaller orders from a particular adviser. But again, this will likely exclude many smaller advisers.

Both of these exceptions dramatically impair the ability of smaller investment advisers to get information from their brokers. Importantly, it's worth noting that even larger firms that will have the benefit of the reports generally may still fall into one of the exceptions. The $1 million "not held" exception will likely further push for even larger investment advisers to consolidate their order flow, so as to ensure they are able to obtain enhanced reporting. But while larger investment advisers may still be able to use their market power to compel voluntary reporting, smaller firms will likely be unable to do so.

Proposed Revisions

The "de minimis" exemptions should be removed, or if not removed, significantly limited. For example, the 5% de minimis for brokers should not be available for firms that still

[12] Interestingly, just days before the adoption of the release, Citadel and Schwab both commented on this aspect of the proposal. Letter from Stephen John Berger, Citadel, to Brent J. Fields, SEC, Oct. 23, 2018, *available at* https://www.sec.gov/comments/s7-14-16/s71416-4555724-176189.pdf; Letter from Jeff Brown, Schwab, to Brent J. Fields, SEC, Oct. 30, 2018, *available at* https://www.sec.gov/comments/s7-14-16/s71416-4582131-176304.pdf. The next-most-recent comment letter received on the rule proposal was nearly a full year prior, so the timing of the two letters raises some significant questions for us.

receive significant amounts of "not held" orders, even if those orders may not exceed 5% of its overall orders received.

Negative Consequences From the Failure to Include Public Information

The Final Rule inexplicably declines the opportunity to provide smaller investment advisers, competing broker dealers, the public, and the Commission with meaningful, improved, aggregated order flow information. Unfortunately, this information may be the only source of information for smaller advisers and brokers, against which they may be able to benchmark or compare their order routing practices. Further, similar to FINRA's declaration that brokers need to review potential execution venues in order to fulfill their best execution responsibilities, many investment advisers feel that they should--to benefit their customers--attempt to review brokers with whom they do not currently conduct business for potential usage. These reports would have been one of the key mechanisms through which this standardization and competition could be effectively performed.

But perhaps the most immediate impact of the Final Rule will be on the Commission's proposed Transaction Fee Pilot. Proponents and opponents of the fee pilot alike have argued that the Commission and public need detailed order routing information in order to evaluate the impacts of fee changes on order routing behavior. Unfortunately, by declining to include any meaningful, improved public disclosures in the Final Rule, the Commission has denied both the public and itself of the opportunity to see the impact of its proposed changes to order routing incentives and the ability of many firms to perform peer analysis. This may undermine some of the value of the proposed transaction fee pilot, and potentially leave the long-overdue study subject to significant legal challenge.

Propose Revision

Adopt the proposed public disclosures, as revised to reflect the changes in the individually collected information.

Negative Consequences Regarding the Definitions of Indications of Interest

The Final Rule adopted a definition of actionable Indication of Interest (IOI) that potentially created even more unintended consequences as some forms of "standing IOIs" may circumvent the actionable IOI definition.

Proposed Revision

Consider adjusting the definition to reflect scenarios wherein an IOI clearly is intended to be actionable.

Conclusion

We appreciate the Commission's efforts to improve disclosures for investors on how their orders are handled. However, the approach taken in the Final Rule discriminates -- strongly -- against smaller investment advisers, smaller brokers, and investors. We encourage you to revise it and finalize the rule without delay. By adopting much-needed reforms to order routing and execution reports, the SEC will be arming investors with the information they need to protect themselves and their customers. We thank you for undertaking this important task.

Sincerely,

Executive Director

cc: John Roeser