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SEC Seeks to Drastically Revise U.S. Equity Market Structure and Expand Best Execution Requirements

By Wayne M. Aaron

On December 14, 2022, the U.S. Securities and Exchange Commission proposed a package of inter-connected rule proposals (the "Proposals") that, if adopted, would drastically rewire order handling for NMS securities, upend established equity market structure, and impose heightened and more complex best execution obligations upon market participants for all types and asset classes of securities. The proposed rules are controversial in that they favor one type of market structure and category of market participants — exchanges — over the OTC markets and the liquidity provided by wholesale market makers and other off-exchange trading venues.

The Proposals are comprised of four separate proposed sets of rules, as follows:

1. An **Order Competition Rule** (proposed Rule 615 under Regulation NMS), which would require broker-dealers that receive marketable orders from retail investors below a certain size to first route those orders to newly designed securities auctions, rather than execute them internally or with a market maker. While market makers and other internalizers currently provide price improvement to retail orders, the SEC believes that more price improvement might be available if these orders were exposed to competition through an exchange auction mechanism.

   This approach is controversial because it overlooks the role that market makers play in providing liquidity for a range of securities under varied market conditions. One can also question whether additional price improvement opportunities truly exist and whether the delay of seeking an auction execution will affect execution quality.

2. A new, SEC-based **Best Execution Requirement**, applicable to all securities. Proposed **Regulation Best Execution** would supplement FINRA and MSRB best execution requirements. More significantly, a federal best execution regulation would allow the SEC to directly charge and settle best execution cases, rather than frame them as disclosure or misstatement/omission cases. The SEC's proposed best execution framework goes beyond existing best execution rules by (a) requiring an annual review of best execution policies, with reporting to boards or other governing bodies and (b) setting requirements for "**conflicted transactions**" — transactions executed as principal, by an affiliate, or that are the subject of payment for order flow. Under the Proposal, brokers must adopt specific policies and procedures for such transactions and expressly document their compliance with best execution for such transactions, putting greater pressure on payment for order flow arrangements.

3. Proposed revisions to and expansion of **Rule 605 under Regulation NMS**, which requires public reporting on execution quality. The amendments would, among other things, but most significantly, do the following:

   - Require not just "market centers" that execute orders to report execution quality, but also require the **large broker-dealers** that route such orders to market centers to separately report on the quality of executions they receive from these market centers. This is designed to allow customers of such broker-dealers to assess the execution quality their brokers receive on their

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orders, and promote competition among such firms, even when those orders are routed to another market center.

- Require other participants, such as **single-dealer platforms** and **operators of qualified auctions** (operating under the Order Competition Rule), to make Rule 605 execution quality reports.

- Expand the types of orders subject to execution quality data reporting. If adopted, revised Rule 605 would require execution quality statistics on executions of **odd-lot orders**, orders for **fractional shares**, and larger-sized orders currently excluded from reporting. There would also be reporting on the amount of **size improvement** or **liquidity enhancement** provided on retail orders.

- Change the categorization of orders by **order size** (using a new dynamic round lot definition scaled by share price, rather than a static 100-share round lot) and **order types** (including "executable orders" and certain non-marketable limit orders), and remove the "time-to-execution" buckets. Finally, there would be new calculations focused on **realized spread**, **average effective spread**, **percentage spreads**, and **"E/Q,"** a commonly used statistic that generally measures how often orders are executed at (and how close to) the midpoint of the NBBO.

- Require reporting entities to provide **summary reports**, showing average amounts of price improvement, execution speed, effective spread, and other applicable statistics. This aspect of the Proposal recognizes that most Rule 605 data is stock-specific, both voluminous and granular in nature, and is machine-readable, making it far too difficult for the average investor to synthesize, much less draw conclusions from.

4. A proposal to revise the **pricing increments** or **"tick sizes"** under which NMS securities are quoted and trade from the current increment of one cent. Certain securities would be quoted in **one-half cent** ($0.005) increments, while others would be quoted in even more narrow increments of **two-tenths of a cent** ($0.0002) or **one-tenth of a cent** ($0.0001). This would allow exchanges (that due to their market structure can only trade at quoted prices) to be able to trade in sub-penny amounts, which only market makers (who can execute at prices other than quoted prices) presently do. Oddly, market makers would **no longer be permitted to execute** at prices finer than the new minimum pricing increments, removing a key price improvement capability of market makers. Finally, the **maximum fees** that exchanges and others could charge to access displayed quotations for stocks priced over $1 would be commensurately reduced from the current rate of 30 mils per share (30 cents per 100 shares) to 5 mils or 10 mils per share, depending on the applicable pricing increment. These changes are designed to narrow the trading spread further, hopefully reducing the implicit cost of execution without affecting the liquidity available from published quotations or market makers.

I. Order Competition Rule and Regulation Best Execution

Of the four Proposals, the two more significant ones are the Order Competition Rule, which mandates the handling of retail order flow, and Regulation Best Execution, which reiterates and codifies as federal regulation the existing duty of best execution, but adds numerous evaluation and assessment requirements that will be incredibly difficult to implement and, in turn, subject the broker-dealer to hindsight enforcement by a regulator that can easily apply an unclear standard to its benefit. These two Proposals passed narrowly by a 3-2 vote of the SEC Commissioners, with Commissioners Peirce and Uyeda voting against. Both Proposals, described more fully below, are likely to be the subject of significant industry comment and perhaps litigation to block its effectiveness.

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A. Order Competition Rule

The Order Competition Rule (newly proposed Rule 615) would completely rework the handling of retail-sized orders. It would apply to "segmented orders," defined generally as orders for a natural person, with a notional value of less than $200,000. Orders for a natural person who effects more than 40 daily trades on average in NMS stocks would be excepted from the definition, and there are other exceptions, for example, for orders executed at or better than the midpoint of the national best bid and offer at the time of receipt.

The rule would prohibit broker-dealers (self-servingly renamed by the rule as "restricted competition trading centers") from executing any segmented order before first exposing that order in a "qualified auction" at a limit price that the broker-dealer entering the order in the auction would specify. The auction operator is required to disseminate an electronic message to the marketplace, advising of the auction and inviting responses seeking to execute against the segmented order at the disseminated limit price or more favorable price to the segmented order. The auction operator is required to accept responses no less than 100 milliseconds but no more than 300 milliseconds after disseminating the auction message. That is, the segmented order would be exposed to the auction for one-tenth to three-tenths of a second. A market maker (including a market maker routing the order to the auction) or any other broker-dealer can submit a responding order, but there is the hope that institutions (which may have an interest in trading against retail order flow, as such orders are generally "uninformed" and small enough not to impact trading prices) would submit responses as well. If the segmented order is executed, it will have received the price improvement represented by the chosen limit price (or more favorable price, if the responder provided price improvement). If the segmented order is <u>not</u> executed in the auction, the broker-dealer that submitted the restricted order can now execute it, but only at the limit price submitted to the auction or better. Thus, the submitting broker-dealer will choose a limit price for the auction at which it would be willing to trade.

B. Regulation Best Execution

At first glance, Regulation Best Execution appears to be a routine codification of the long-stated best execution obligation in the requirements of applicable self-regulatory organizations and derived from the common law of agency. It appears to do no more than maintain the regulatory status quo, requiring broker-dealers to have policies and procedures reasonably designed to meet the best execution obligation, conduct a quarterly review of execution quality (many firms do this monthly), and document that review. A more detailed review, however, highlights a significant expansion of regulatory requirements, with detailed prescriptive requirements for the content of a firm's written supervisory procedures and for even more detailed procedures for types of transactions that the SEC views as "conflicted." The detail required for a firm's best execution procedures, and the number of variables and market scenarios they must take into account, make them virtually impossible for any firm to comply. Finally, in an additional new requirement, broker-dealers must perform a detailed annual review of their best execution policies and procedures and report on them to the broker-dealer's board of directors or other governing body.

The new level of detail required for best execution policies and procedures are set forth in six subparts of proposed Rule 1101(a). Three subparts require detail setting forth expressly, for all types of securities, how the broker will (a) obtain information on the different markets trading the applicable securities; (b) identify "material potential liquidity sources" — markets and other liquidity sources that might provide favorable pricing; and (c) incorporate those material potential liquidity sources into order handling practices. Against that backdrop, the procedures must then also specifically address how the broker will determine best markets and make routing decisions by (x) assessing prices, including price improvement and order exposure opportunities, (y) assessing attributes of customer orders in selecting the market most likely to provide the most favorable price, and (z) in sequencing which markets to access, balancing the likelihood of obtaining a better price against "the risk that delay could result in a worse price."

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When one considers all the permutations and combinations of order handling — different markets, different order types, and different market conditions at different times of the day — the application of the detailed and prescriptive standards above can be almost dizzying. But recall that Regulation Best Execution applies not only to equity securities, but to all securities of all asset classes. Presumably broker-dealers will need to craft a tailored set of written supervisory procedures, encompassing all the elements above, for each type of security traded, taking into account the markets for those securities, the data available with respect to them, possible price improvement opportunities, the nature of the order flow, and how to access those markets and in what order. Practitioners have long remarked that best execution analysis is more art than science. The prescriptive requirements of Rule 1101(a), however, require the artist to painstakingly detail his or her artistic method. This is no easy task and one that seems designed to allow for subjective enforcement based upon a regulator's hindsight assessment.

The policies and procedures requirement goes even further for what the SEC defines self-servingly as "conflicted transactions" — retail transactions executed as principal (including as riskless principal), routed to an affiliate, or for which a broker receives or provides payment for order flow. For those transactions, the policies and procedures must (x) address how the broker will assess information and identify markets beyond those identified as material liquidity sources;[1] (y) address how the broker will evaluate other markets; and (z) document the basis and information (i.e., mountains of historical trading data) the broker relied on to determine that the conflicted transaction complied with the best execution standard. Again, the requirements appear designed either to be so burdensome as to cause market participants not to internalize orders, route orders to affiliates, or receive or pay for order flow or to set broker-dealers up for failure with requirements for procedures that no firm reasonably could draft.

II. Analysis, Observations, and Conclusions

Certain of the Proposals — such as those modifying tick sizes and those requiring more disclosure of execution quality — will be costly and burdensome to implement, but should not have a drastic change on the operation of the securities markets. There are some elements of these Proposals that are misguided or misaligned, such as removing the ability of market participants to provide price improvement by executing at prices within the minimum tick size or treating certain agency orders as "covered orders" for Rule 605 purposes while carving out economically equivalent riskless principal orders from that definition solely because wholesale market makers execute orders in that manner. But on balance, these two Proposals appear designed to provide more information to the marketplace to allow participants to better assess their trading options.

The two other Proposals — the Order Competition Rule, mandating order routing to auctions, and the heavily prescriptive Regulation Best Execution — are much more problematic. Along with certain aspects of other Proposals, they appear designed to favor an exchange market structure over the wholesale market-making model. The economic analysis offered to support the proposed model shift basically amounts to a determination that market makers continue to earn a profit on retail customer orders (measured by positive realized spread) and therefore should or could allocate all or more of that profit to additional price improvement. This simplified analysis, however, does not take into account the other services market makers provide overall, such as providing liquidity to thinly traded securities and securities without sufficient market depth or other trading interest.

[1] This requirement is particularly perplexing, as if a broker should be accessing a market to evaluate how to execute a conflicted transaction, one would expect that the broker should already be evaluating that market as a material liquidity source for non-conflicted transactions.

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While the SEC staff claims that each Proposal is separate and distinct and were simply proposed at the same time as a package,[2] it is clear that they all have the same objective: to move retail order flow from market makers and other dealers trading as principal and redirect that order flow to securities exchanges.[3] This is clear from (a) the proposed Order Competition Rule itself, which would effectively require broker-dealers to route retail orders for execution on exchange-run qualified auctions, rather than for execution by a market maker or other broker-dealer;[4] (b) the provisions of proposed Regulation Best Execution, that characterizes internalized executions and the existing wholesaler practice of payment for order flow as "conflicted transactions"; (c) mandating detailed and burdensome best execution analysis for transactions subject to payment for order flow, effectively positioning payment for order flow against the newly stated best execution requirement; and (d) the proposed removal of a market participant's ability to provide price improvement by executing orders at a price within a securities minimum tick size, a practice engaged in currently only by market makers providing price improvement.

III. Next Steps

The Proposals are open for public comment at least through March 31, 2023, although that comment period could be extended if the Proposals are published in the Federal Register after January 30, 2023 (after which they would be subject to a 60-day public comment period).[5] The Proposals are controversial and therefore are expected to draw significant public comment, and some of them, if and when adopted, may very well be contested though litigation. Nonetheless, the SEC appears focused on adopting the Proposals, with key open questions on how any adopted rules might differ from those proposed based upon public comment. As such, broker-dealers that internalize customer orders, or route orders to broker-dealers that internalize orders as principal should begin to assess the application of the Order Competition Rule. Further, all broker-dealers, whether they effect transactions in NMS securities, OTC equities, options, corporate and municipal securities, government securities, or other securities (including digital asset securities) should begin to assess their order handling practices against the proposed best execution policies and procedures requirements, taking note of all potential sources of liquidity including (and as applicable to that market) undisplayed liquidity, midpoint pricing opportunities, RFQ systems (and the response times and other filters applicable to them), and last look functionalities.

If you would like to discuss any aspect of the Proposals, or the order handling or best execution policies and procedures implications of them, please contact **Wayne M. Aaron** at waaron@vedderprice.com or any of the other Vedder Price lawyers with whom you currently work.

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[2] The Director of the Division of Trading and Markets, Haoxiang Zhu, repeatedly emphasized at the Open Commission Meeting presenting the Proposals that they were individual proposals.

[3] This harkens back to the rescission over two decades ago of NYSE Rule 390. That rule, widely questioned for its anticompetitive effects, required certain NYSE-listed securities to be traded on the NYSE and other national securities exchanges and expressly prohibited (with some exceptions) NYSE members from trading those securities as principal off-exchange. *See* Order Approving Proposed Rule Change to Rescind Exchange Rule 390, Release No. 34-42758 (May 5, 2000), available at https://www.sec.gov/rules/sro/ny9948o.htm#P37_11258. Interestingly, one of the alternatives proposed and not adopted at the time was an "order exposure alternative" with a "a new high powered routing mechanism . . . to access and trade against 'exposed' orders." *Id*. at text following footnote 13. From the generalized description, this alternative appears similar to the now proposed Order Competition Rule.

[4] This would not only reduce the number of orders that market makers execute overall, but also would reduce the number of orders that market makers can execute profitably which would otherwise subsidize the ability to make markets in other less profitable securities.

[5] The Proposal relating to tick sizes and access fees was published in the Federal Register on December 29, 2022. Accordingly, comments on that Proposal are due by March 31, 2023.

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