

# SEC Proposes Equity Market Structure Revamp and Regulation Best Execution

January 3, 2022

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## Overview

On December 14, 2022, the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) voted to approve four proposals to modify the trading rules for equities and other securities, which, taken together, represent the most significant package of market structure reforms since Regulation NMS (“Reg NMS”) was adopted in 2005. Each of the proposals addresses a different aspect of market structure: (1) disclosure of order execution information (the “Rule 605 Proposal”);<sup>1</sup> (2) tick sizes, exchange access fees and order transparency (the “Rule 610/612 Proposal” and together with the Rule 605 Proposal, the “NMS Updates”);<sup>2</sup> (3) market segmentation for retail orders due to the practice of retail order “internalization” (the “Order Competition Proposal”);<sup>3</sup> and (4) broker-dealer best execution obligations (the “Best Execution Proposal”).<sup>4</sup> The Order Competition Proposal and Best Execution Proposal would impose substantial new duties on broker-dealers by requiring pre-internalization auctions for certain types of retail orders and establishing a new best-execution rule and related procedural requirements.

While Chair Gensler and the SEC staff emphasized during a marathon hearing that each of these proposals address a separate set of problems identified by the Commission, it is clear that the effects of these proposals would be aggregative and interactive. It is also clear that at least one target of the package as a whole is the role and practices of the six wholesale broker-dealers that execute a large percentage of retail orders in equity securities, and, in particular, their practice of providing payment for order flow (“PFOF”). While the proposed rules will not ban PFOF, as discussed below, the regulatory costs to accept PFOF would be substantially higher, while the ability of

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<sup>1</sup> Disclosure of Order Execution Information, available at <https://www.sec.gov/rules/proposed/2022/34-96493.pdf>.

<sup>2</sup> Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, available at <https://www.sec.gov/rules/proposed/2022/34-96494.pdf>.

<sup>3</sup> Order Competition Rule, available at <https://www.sec.gov/rules/proposed/2022/34-96495.pdf>.

<sup>4</sup> Regulation Best Execution, available at <https://www.sec.gov/rules/proposed/2022/34-96496.pdf>.

wholesale broker-dealers to monetize order flow obtained through PFOF would potentially be reduced.

Though concern about the role of wholesale broker-dealers is central to the proposals, retail broker-dealers also would face significant new requirements. In particular, the Rule 605 Proposal would impose new obligations on large retail broker-dealers, while the Best Execution Proposal would impose new obligations on introducing brokers that have historically relied on their clearing brokers to provide reviews of execution quality.

Further, while the proposals primarily impact the market for NMS stocks,<sup>5</sup> the Best Execution Proposal would apply to all securities, including options, bonds and crypto securities. The comment period for each proposal will remain open until the later of March 31, 2023 or 60 days after publication in the Federal Register.

Below, we summarize the key elements of each proposal and provide a brief discussion of the commentary and our own thoughts.

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## The NMS Updates

The NMS Updates aim to amend existing rules under Reg NMS to respond to technological advancements in the marketplace and other evolutionary developments. While significant, these rules are largely technical updates to the standards applicable in the national market system and are likely to be less controversial in broad terms than the Order Competition Proposal and the Best Execution Proposal. That said, the expansion of the Rule 605 Proposal (as described below) would impose material new obligations on large retail broker-dealers. Each of these proposals was approved unanimously by the Commission, though Commissioners Peirce and Uyeda raised various concerns.

### Rule 605 Proposal

Under current Rule 605, “market centers,” meaning national securities exchanges, alternative trading systems (“ATs”), exchange market makers and OTC market makers are required to make available standardized monthly reports concerning the rates, speeds and pricing at which orders in NMS stocks are executed. The purpose of the rule is to provide broker-dealers and the public with comparable data about execution quality for purposes of making informed routing decisions and fostering competition.

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<sup>5</sup> National market system stocks are stocks listed or traded on a national securities exchange. Related Rule 606 requires routing broker-dealers to publish quarterly reports on their routing of non-direct “held” orders in NMS stocks as well as in listed options and also requires the broker-dealer to provide customers (upon request) with specified information about how their orders are routed.

The Rule 605 Proposal would expand the scope of the rule and amend the information reporting standards to make the data more usable and informative. Specifically, the Commission's proposed amendments would:

- expand the scope of entities that must prepare Rule 605 reports to include larger broker-dealers that have a customer-facing line of business, single-dealer platforms and market centers;
- amend the definitions of "covered order" to include certain orders submitted outside of regular trading hours and orders submitted with stop prices;
- amend the categorization of information required to be reported including adding new order size categories for odd lots, fractional shares and larger-sized orders;
- group orders into separate categories for market orders, marketable limit orders, marketable immediate-or-cancel orders, beyond-the-midpoint limit orders, executable non-marketable limit orders and executable orders submitted with stop prices;
- replace the current time-to-execution buckets for all order types with average time to execution, share-weighted median time to execution and 99th percentile time to execution;
- require average realized spread calculations at intervals of 15 seconds and one minute after the execution; and
- require all reporting entities to produce new summary execution quality statistics.

Under the proposal, all broker-dealers that introduce or carry 100,000 or more customer accounts,<sup>6</sup> single-dealer platforms and entities that operate proposed qualified auctions (as defined in the Order Competition Proposal) would be subject to the rule. The Commission's rationale for the proposal is to allow the investing public to compare the execution quality provided by customer-facing broker-dealers. According to the Commission, current Rule 606 routing data produced by broker-dealers does not provide a clear view of execution quality when combined with Rule 605 market center data because the execution quality provided by market centers may vary across routing brokers.

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<sup>6</sup> The Commission estimates that this category would cover approximately 85 broker-dealers or 6.7% of customer-carrying broker-dealers. Rule 605 Proposal at p. 52.

## Rule 610/612 Proposal—Tick Sizes, Access Fees and Transparency of Better Priced Orders

This proposal would (i) amend the tick sizes under Rule 612 to establish variable minimum pricing increments based on observed trading characteristics; (ii) reduce existing access exchange fee caps; and (iii) accelerate the implementation of the round lot and odd-lot information definitions adopted in 2020 under the Market Data Infrastructure Rules (“MDI Rules”).<sup>7</sup>

### Minimum Tick Size Requirements

Rule 612 currently sets minimum pricing increments of \$0.01 for NMS stocks priced greater than \$1.00 and increments of \$0.0001 for stocks priced less than \$1.00. The proposed amendments would establish variable minimum pricing increments from \$0.001 to \$0.01 for stocks priced above \$1.00 based on the observed time-weighted average quoted spreads for the NMS stock during a backward-looking evaluation period. According to the Commission, this would reduce tick sizes for more liquid stocks where pricing is considered to be “tick-constrained,” permitting more competitive sub-penny pricing.

### Exchange Access Fee Caps

The Commission is proposing to amend Rule 610 in two ways. First, the amendments would recalibrate the caps that limit what a trading center can charge for the execution of orders against a protected quotation or any other quotation that is the best bid or best offer. These fee caps would be lower than they are currently (\$0.0005 or \$0.001 per share) and would be calibrated based on whether a security has a minimum pricing increment of \$0.001 or greater. For securities priced less than \$1.00, the cap would be 0.05% of the quotation price.

Second, the Commission is proposing to require national securities exchanges to make the amounts of all fees and rebates determinable at the time of execution.

### Transparency for Better-Priced Orders

The new rules would accelerate the compliance date for round-lot and odd-lot information requirements adopted under the MDI Rules to decouple them from other parts of the rulemaking that may proceed at a slower pace.<sup>8</sup> The rules reduce round-lot sizes for high-priced securities and expand the information required to be made available to the public with respect to odd-lot orders priced better than the national best bid and

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<sup>7</sup> Market Data Infrastructure, Release no. 34-90610 (December 9, 2020).

<sup>8</sup> The MDI Rules impose a phased transition from dissemination of market data by the exclusive SIPs under the CTA Plan and the UTP Plan to “competing consolidators.” The phased transition provides for a process to begin with amendments to the effective national market systems plans under Rule 614(e), however the amendments initially proposed by the Operating Committees of the CTA Plan and the UTP Plan on November 5, 2021 were rejected by the Commission on September 21, 2022.

offer (the “NBBO”). The reduction in round-lot sizes for securities priced greater than \$250.00 is expected to narrow spreads for protected orders at the NBBO.

The proposal would accelerate the compliance date with respect to these changes to a date that is 90 days from the publication in the Federal Register of any Commission adoption of an earlier implementation of the round-lot and odd-lot information definitions. In addition, the proposal would include a new data element for the best odd-lot orders available in the market.

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## Proposed Rule 615—The Order Competition Proposal

Proposed Rule 615 would effectively apply to wholesalers, other broker-dealers that internalize retail orders and ATSS that do not qualify as an “open competition trading center” as discussed below. The rule is designed to reduce the current “segmentation” of the market pursuant to which most retail orders are transmitted to wholesalers and internalized rather than transmitted to an exchange for execution. According to the analysis provided by the Commission staff, such internalization provides for substantial price improvement for retail orders relative to the prices they would receive if executed at the NBBO on exchanges. However, the Commission believes that wholesalers’ price improvement is less than could be available in a hypothetically more efficient market based on an analysis of “effective spreads”<sup>9</sup> versus surrogate measures of “realized spreads” produced using primarily nonpublic CAT data.<sup>10</sup> The rule is intended to redress this “competitive shortfall” by mandating order-by-order competition through auctions structured in accordance with the requirements of the proposed rule.

### Scope

The proposed rule would apply to “segmented orders,” which are defined to include orders for NMS stocks made for an account (i) of a natural person or held in legal form on behalf of a natural person or group of related family members; and (ii) in which the average daily number of trades executed in NMS stocks was less than 40 in each of the preceding six calendar months.

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<sup>9</sup> Effective spreads, or more technically half-spreads, measure the execution price for an order relative to the contemporaneous midpoint for the NBBO.

<sup>10</sup> In theory, realized spreads are the spreads achieved by an internalizer such as a wholesaler who executes as principal against a customer order and enters in to an offsetting market transaction at a different time. Realized spreads are estimated for the purpose of the SEC’s analysis by measuring the execution price of the customer order against the midpoint of the NBBO either 1 or 5 minutes later, which is after the market impact of the order is expected to be reflected in market prices. See Order Competition Proposal at footnotes 49 and 50 and accompanying text.

With respect to these segmented orders, a “restricted competition trading center” that received such an order would be prohibited from executing it internally (*i.e.*, either as principal or by crossing the order with another customer as agent) unless a broker-dealer has first exposed the order to competition in a qualified auction operated by an “open competition trading center.” For these purposes, an “open competition trading center” would be defined as a national securities exchange or ATS that meets certain standards for transparency, volume and fair access, including that it has an average daily share volume equal to at least 1% of the market and makes quotes available for public display.<sup>11</sup> Any trading center that is not an “open competition trading center” (meaning all wholesalers, unqualified ATSs and other internalizers) would be “restricted competition trading centers” subject to the rule.

Under the Order Competition Proposal, retail broker-dealers would retain flexibility as to how they could route orders for execution. For example, they could route the order directly to an exchange for participation in a qualified auction or to a wholesaler or ATS. However, the order would need to be identified as a segmented order, and if not first routed to a qualified auction for execution, the wholesaler or ATS receiving it would itself need to route it unless an exemption is available. Exceptions would be provided for orders: (i) received at a time when there is no qualified auction available; (ii) with a market value of \$200,000 or more; (iii) internalized at a price that is equal to or better than the midpoint for the contemporaneous NBBO; (iv) that are limit orders with limits more favorable to the customer than the midpoint of the NBBO; or (v) that are fractional share orders if no qualified auction accepts fractional share orders.

### **Auction Standards and Requirements**

The proposed rule defines “qualified auctions” as auctions inviting liquidity providers to bid for execution against an individual segmented order. Proposed Rule 615 would establish required standards for these auctions including that: (i) an auction announcement be disseminated widely in consolidated market data; (ii) the duration of the auction be between 100 and 300 milliseconds; (iii) execution priority be based on price but not time or the identity of the bidder (provided that an auction response on behalf of a customer would have priority over that of a broker-dealer); (iv) pricing be at specified minimum increments; and (v) the order also interacts with limit orders resting on the trading center’s central limit order book (displayed orders would have priority over auction responses at the same price while undisplayed orders would only have priority if better priced).

A broker-dealer sending a segmented order for auction would have the ability to set a limit price for the auction, but the order would only be eligible to be internalized at that

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<sup>11</sup> Notably, no ATS would currently qualify under these standards.

limit price or better in the event that the auction failed. The routing broker-dealer could also participate in the auction on equal terms.

The Order Execution Proposal was approved for publication by a 3-2 vote, with Commissioner Peirce and Commissioner Uyeda voting against the proposal.

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## Proposed Rules 1100-1102—The Best Execution Proposal

Regulation Best Execution would consist of three rules that would codify a best execution standard under federal law and impose separate policies and procedures requirements deemed necessary to satisfy the standard. The proposal would apply to brokers, dealers, government securities brokers and dealers, and municipal securities brokers and dealers, as well as to orders relating to all types of customers and securities (specifically including crypto securities). In addition, broker-dealers would still need to comply with FINRA and MSRB requirements.

In his official remarks during the hearing, Chair Gensler emphasized that he asked the staff to develop the proposal because “a best execution standard is too important, too central to the SEC’s mandate to protect investors, not to have [it] on the books as Commission rule text.”<sup>12</sup> The proposal would create additional supervision and enforcement authority compared to historical practice wherein the SEC enforced best execution violations under its general antifraud authority and FINRA enforced its more specific requirements. That said, the Best Execution Proposal would also impose heightened procedural requirements, narrow existing exemptions and create substantial disincentives for the practice of providing and accepting PFOF under anti-conflict rules described below.

### Proposed Rule 1100

Proposed Rule 1100 would establish the substantive best execution standard and also provide for several exemptions. The general standard would largely mirror FINRA’s current standard under FINRA Rule 5310 and the text is almost a word-for-word reproduction of the relevant portion of this rule. Specifically, the proposed rule provides that “in any transaction for or with a customer, or a customer of another broker-dealer, a broker-dealer, or a natural person who is an associated person of a broker-dealer, must use reasonable diligence to ascertain the best market for the security, and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.”

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<sup>12</sup> Chair Gensler, *Statement on Best Execution Proposal* (Dec. 14, 2022), available at <https://www.sec.gov/news/statement/gensler-best-execution-20221214>.

The proposed rule would exempt a broker-dealer from this standard under three circumstances:

- when another broker-dealer routes an order to the broker-dealer for execution against the broker-dealer's quotation;
- when an institutional customer (undefined), exercising independent judgment, executes its order against the broker-dealer's quotation; or
- when the broker-dealer receives an unsolicited instruction from a customer to route that customer's order to a particular market for execution and the broker-dealer processes that customer's order promptly in accordance with the terms of the order.

The first and third of these exemptions mirror FINRA interpretations, while the second is new and appears intended to specify that the obligation does apply to executions of retail orders against a broker-dealer's quotation.

### **Proposed Rule 1101**

The proposed rule would require broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to comply with the proposed rule's best execution standard. These policies and procedures would need to document how the broker-dealer will:

- obtain and assess reasonably accessible information about sources of liquidity, including about price, volume and execution quality;
- identify markets that are material potential liquidity sources;
- incorporate material potential liquidity sources into its order-handling practices and ensure it can efficiently access each such material potential liquidity source; and
- assess reasonably accessible and timely information with respect to the best displayed prices, opportunities for price improvement and order exposure opportunities.

Broker-dealers will also need to make additional assessments about (i) the attributes of customer orders; (ii) the trading characteristics of the security; (iii) any customer instructions; and (iv) the likelihood of obtaining better prices balanced against the risk that delay could lead to a worse price.

## Conflicted Transactions

Controversially, proposed Rule 1101 would also impose heightened policy and procedure requirements for “retail” customer transactions where the broker-dealer engages in specified types of “conflicted transactions.” While conflicts are always present in a principal-agent relationship, the specific “conflicted transactions” that would trigger these heightened duties would include: (i) executing a customer order as principal or riskless principal; (ii) routing an order to, or receiving an order from, an affiliate for execution; and (iii) providing or receiving PFOF as defined in Rule 10b-10(d)(8), including exchange rebates and non-monetary benefits such as research, clearance and custody.<sup>13</sup>

The heightened requirements would require the broker-dealer to address how it would:

- obtain and assess a broader range of information about sources of liquidity (including about price, volume and execution quality) beyond that which is reasonably accessible;
- evaluate a broader range of markets beyond those identified as material potential liquidity sources; and
- document compliance with the best execution obligation, including all efforts to enforce its policies and procedures and the basis on which it relied for its determination that a conflicted transaction would comply with the best execution standard.

These requirements would plainly discourage broker-dealers from engaging in “conflicted transactions,” notwithstanding the fact that the preamble of the Best Execution Proposal states that the rule is not designed to ban or eliminate conflicted transactions.<sup>14</sup>

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<sup>13</sup> Rule 10b-10(d)(8) defines payment for order flow as:

any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker or dealer’s unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation.

<sup>14</sup> Best Execution Proposal at page 111.

### Execution Quality Review

Proposed Rule 1101(c) would require broker-dealers to review the execution quality of customers' orders at least quarterly and document the results of the review. The review would include a comparison of execution quality that might have been obtained at other markets and a broker-dealer would specifically be required to revise its policies and procedures in accordance with the results of the review.

### Exemption for Introducing Brokers

Proposed Rule 1101(d) provides an exemption for introducing brokers to rely on best execution reviews conducted by their clearing brokers. Importantly, this exemption is much narrower than the corresponding carve-out from FINRA's rule. An introducing broker would be exempt from the general requirements of Rule 1101 (but not Rules 1100 or 1102) if it:

- establishes, maintains, and enforces policies and procedures to regularly review the execution obtained from its "executing broker";
- compares that quality against the quality that might have been obtained from other executing brokers; and
- revises its order-handling practices accordingly.

This exemption would only be available to a broker that (i) does not carry any customer accounts or hold any customer funds or securities; (ii) has entered into an arrangement with an unaffiliated broker-dealer for the handling and execution of all of the introducing broker's customer orders exclusively on an agency basis (except for fractional shares); and (iii) has not accepted any "monetary payment, service, property or other benefit that results in remuneration, compensation, or consideration" from its executing broker in exchange for routing orders to it.

### Proposed Rule 1102

Finally, Proposed Rule 1102 would require all broker-dealers that effect transactions for or with a customer to review their best execution policies and procedures at least annually. Broker-dealers would also be required to document the results of such execution quality reviews and present a report detailing the results to their boards of directors or equivalent governing bodies, including a description of any deficiencies and plans to address them.

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## Initial Takeaways

The task of analyzing these proposals from a legal and economic standpoint, considering their potential impacts on different business activities and providing meaningful comments to the Commission will be extremely challenging for market participants. Taken together, the four proposals are nearly 1,700 pages and include hundreds of specific requests for comments. While the SEC provided substantial background discussions and purported cost-benefit analyses for each rule, in each case the staff used the current market structure as the baseline for analysis; there was little attempt to consider how implementation of one proposal might affect the others or the related balance of costs and benefits. Commissioners Peirce and Uyeda, in particular, questioned the interactive effects of the rules during the open meeting, and the SEC staff was generally unable to provide detailed responses. Moreover, as noted by Commissioner Peirce, the Commission's use of confidential CAT data in its analysis creates an additional barrier to a fulsome comment process because industry participants are not able to review the staff's conclusions or even work from the same dataset. While the SEC has allocated three months for notice and comment, significantly more time is required for the Commission to receive comprehensive industry comments in this highly technical area.

The Order Competition Proposal is likely going to be the most impactful to the structure of equity trading as a whole. When Reg NMS was adopted in 2005, it reflected a clear balancing between required integration of the marketplace for the sake of ensuring competition among orders and the facilitation of venue competition to drive innovation. As noted by Commissioner Uyeda, this proposed rule would strongly tip the balance in favor of order-by-order competition within a venue structure that would be largely of the SEC's design. As such, it runs the risk of disrupting a marketplace that currently operates very well and has fostered continuous improvement in favor of locking the market into an experimental design with unknown risks and unproven benefits.

At the same time, the Best Execution Proposal will be of greatest concern to legal and compliance departments. A number of aspects of the proposal are likely to be controversial. For example, it is not at all clear how the heightened requirements for "conflicted transactions" could be complied with, or how they relate to the conflicts they are supposed to address. Nor is it clear that market participants could actually eliminate "conflicted transactions" and thereby avoid the additional requirements as the proposal seems to presuppose. Similarly, the stringent conditions for introducing brokers to rely on their clearing brokers seem to presuppose modes for introducing-clearing relationships and easy substitution among clearing relationships that market participants may find highly questionable.

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Please do not hesitate to contact us with any questions.

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