December 21, 2022

Proposed Equity Market Structure Reforms

The SEC's Proposed Rules Would Result in the Most Fundamental Changes to Securities Trading and Market Structure Regulation Since Regulation NMS In 2005.

SUMMARY

On December 14, the Securities and Exchange Commission (the "SEC" or "Commission") voted to propose new rules and rule amendments relating to four aspects of U.S. equity market structure: (1) a new proposed rule under Regulation NMS ("Reg NMS") regarding order competition; (2) amendments to certain rules under Reg NMS regarding tick sizes, access fees and transparency of better priced orders; (3) amendments to Rule 605 of Reg NMS regarding disclosure of order execution information; and (4) a new proposed rule regarding best execution standards.

This memorandum provides a high-level summary of the key points raised in each proposed rule. In the coming weeks, we will publish additional memoranda analyzing in detail each proposed rule.

Comments on each proposed rule are due on the later of (i) March 31, 2023 and (ii) 60 days following publication of the rule in the Federal Register.

ORDER COMPETITION RULE

The Order Competition Rule (which, if adopted, would become Rule 615 of Reg NMS) generally would require that individual investor orders be exposed to order-by-order competition in auctions designed, pursuant to specific SEC requirements, to obtain the best prices before such orders could be internalized by wholesalers or any other type of trading center that restricts order-by-order competition.[1] Adoption of the Order Competition Rule as proposed would represent a substantial shift in U.S. equity transaction execution. Currently, other than the Order Protection Rule (Rule 611 of Reg NMS)[2] and self-regulatory organization best execution standards and customer order priority requirements,[3] broker-dealers generally have significant discretion with respect to how they execute customers' equities orders and the prices at which they execute such orders. In this regard, retail-facing broker-dealers today exercise significant discretion in connection with how and where they route customer orders, including to wholesale broker-dealers that may also provide payment for order flow. The proposed Order Competition Rule would meaningfully alter current practice by imposing specific, prescriptive requirements on how certain orders are executed.

1. Segmented Orders

The Order Competition Rule would apply to "segmented orders," which the Rule would define as orders for NMS stocks[4] made for an account: (i) of a natural person or an account 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 six preceding calendar months.[5]

The Order Competition Rule would not apply with respect to: (i) segmented orders received and executed when no qualified auction (as described below) was being operated for such orders;[6] (ii) segmented orders with market values of at least $200,000;[7] (iii) segmented orders executed at prices that are equal to or more favorable for the orders than the midpoint of the national best bid and offer ("NBBO") when the orders were received;[8] (iv) segmented orders with customer-selected limit prices that are equal to or more favorable for the orders than the midpoint of the NBBO when the orders were received;[9] and (v) the fractional share portion of a segmented order received and executed when no qualified auction was being operated for such order that would accept the fractional share portion.[10]

2. Restricted vs. Open Competition Trading Centers

The auction requirement would apply with respect to "restricted competition trading centers," which the rule would define as trading venues other than any national securities exchange or alternative trading system ("ATS") that meets proposed requirements for an "open competition trading center."[11] Open competition trading centers would be defined as national securities exchanges or ATSs that meet proposed requirements for transparency, access, and volume (for example, in order to qualify, a national securities exchange must, among other things, have an average daily volume of one percent or more of the aggregate daily share volume for all NMS stocks during at least four of the preceding six calendar months).[12] Notably, ATSs that do not display quotations to the public or that (subject to minor exceptions) impose limits on which broker-dealers can become subscribers to the ATS would not qualify as open competition trading centers, nor would any internalizing, non-ATS broker-dealer.

Unless an exception applies, a restricted competition trading center would be prohibited from executing internally (i.e., where such trading center transacts bilaterally as principal with individual investor orders)[13] a segmented order for an NMS stock unless the order was first exposed to competition in a qualified auction operated by an open competition trading center.[14]

3. Qualified Auctions

The Order Competition Rule would establish requirements for qualified auctions, including: (i) auction messages being widely disseminated in consolidated market data; (ii) the duration of auctions being between 100 and 300 milliseconds; (iii) the minimum pricing increment being no less than $0.001 for segmented orders and auction responses with prices of $1.00 or more per share; (iv) no fee could be charged for submission of a segmented order (and any permissible fees and rebates would be capped at $0.0005 per share for segmented orders and auction responses with prices of $1.00 or more per share); and (v) execution priority requirements would, among other things, prohibit giving priority to the fastest auction response or to the auction response submitted by the broker-dealer that routed the segmented order to the auction.[15]

The Order Competition Rule would provide broker-dealers and other market participants with various options (subject to the requirements of the proposed rule and best execution obligations) with respect to order routing. A broker-dealer could route a segmented order: (i) directly to a qualified auction; (ii) directly to the continuous order book[16] of an open competition trading center or national securities exchange without exposure to a qualified auction; or (iii) to another entity (e.g., a routing broker-dealer, wholesaler or other restricted competition trading center), which could then further route the segmented order to a qualified auction, an open competition trading center or a national securities exchange.

For example, a broker-dealer could determine to route a customer segmented order to a wholesaler. That wholesaler could select a price at which it would be willing to execute the order internally, but would first be required to submit the order to a qualified auction with a specified limit price. The open competition trading center operating the qualified auction would disseminate the auction message, which would include the specified limit price. Any market participant with the technological capability to participate in the auctions (given, e.g., the proposed auction duration) could participate (including the wholesaler that submitted the order). If all or part of the segmented order can be executed in the qualified auction at the specified limit price or better, then the open competition trading center will execute the order pursuant to its execution priority rules (which must be consistent with proposed Rule 615(c)(5)). If a segmented order does not receive full execution in the qualified auction, then the unexecuted order (or any unexecuted portion of the order) would be returned to the wholesaler—that wholesaler can, but is not required to, execute the order internally.[17]

As another example, a retail broker could route a segmented order to a wholesaler (or other market participant) or directly to a qualified auction with a specified limit price. If the broker determines to route the order directly to the qualified auction, but the order does not receive an execution, the retail broker could then route the order to a wholesaler (along with a representation that the order did not receive an execution in the qualified auction). The wholesaler could: (i) execute that order internally at the specified limit price or better, (ii) return the order to the retail broker; (iii) resubmit the order to a qualified auction; or (iv) route the order to the continuous order book of an open competition trading center or national securities exchange.[18]

In all cases, a broker-dealer's determination of where and how to route a customer's segmented order and set the specified limit price would remain subject to best execution requirements. In this regard, the Commission notes its view that, while there might be market conditions in which a best execution analysis could indicate that a broker-dealer should route a segmented order directly to the continuous order book of an open competition trading center or national securities exchange, broker-dealers are "likely to obtain better prices for segmented orders" through qualified auctions.[19]

REGULATION NMS AMENDMENTS: MINIMUM PRICING INCREMENTS, ACCESS FEES, AND TRANSPARENCY OF BETTER PRICED ORDERS

The SEC proposed another rule that would amend Reg NMS with respect to minimum pricing increments ("tick sizes"), access fees and transparency of better priced orders (together, the "Reg NMS Amendments").[20]

1. Rule 612: Minimum Pricing Increments

Reg NMS Rule 612 sets a minimum pricing increment of $0.01 for quotes and orders in NMS stocks priced at or greater than $1.00, while the minimum pricing increment is $0.0001 for quotes and orders priced at less than $1.00.[21] The Commission intends to replace the current "one-size-fits-all" tick approach for stocks priced at $1.00 or more with an objectively calculated and varied approach that would determine the minimum pricing increments for particular stocks in a manner that reflects differences in their trading characteristics.[22] The Reg NMS Amendments would amend Rule 612 to establish a variable minimum pricing increment that would apply to the quoting and trading (on any national securities exchange or ATS, and also over-the-counter) of NMS stocks, subject to certain exceptions.[23] Specifically, the Reg NMS Amendments would establish the following tick sizes for quotations, orders, indications of interest and trades in NMS stocks priced equal to or greater than $1.00 per share:[24] The Commission proposes to stagger the implementation period of these changes over a 15-month period.

Minimum Pricing Increment	If the Time Weighted Average Quoted Spread[25] for the NMS stock during the Evaluation Period[26] was:
$0.001	Equal to or less than $0.008
$0.002	Greater than $0.008 but less than or equal to $0.016
$0.005	Greater than $0.016 but less than or equal to $0.04
$0.01	Greater than $0.04

2. Rule 610: Access Fees

Reg NMS Rule 610 regulates the fees that a trading center may permit or impose with respect to accessing "protected quotations."[27] A protected quotation is defined as a quotation in an NMS stock that: (i) is displayed by an automated trading center; (ii) is disseminated pursuant to an effective national market system plan; and (iii) is an automated quotation that is the best bid or best offer of a national securities exchange, the best bid or best offer of the Nasdaq Stock Market, Inc., or the best bid or best offer of a national securities association.[28] Among other reasons, the SEC initially adopted access fee caps with respect to protected quotations to prevent trading centers from being able to charge a higher fee for accessing such protected quote when investors had no other choice under the Order Protection Rule but to route an order to that quote. The Reg NMS Amendments would amend Rule 610 with respect to access fees as follows: (i) for quotations in NMS stocks priced at $1.00 or more, the access fee cap would be $0.0005 per share for NMS stocks that have a minimum pricing increment of $0.001, and $0.001 per share for NMS stocks that have a minimum pricing increment greater than $0.001; and (ii) for quotations in NMS stocks priced less than $1.00, the access fee cap would be 0.05 percent of the quotation price.[29]

The Reg NMS Amendments would also amend Rule 610 to require national securities exchanges to make the amount of all fees and rebates imposed or permitted determinable at the time of execution.[30]

3. Transparency of Better Priced Orders

In 2020, the SEC issued Market Data Infrastructure Rules ("MDI Rules").[31] Among other things, the MDI Rules include "new round lot" and "odd-lot information" definitions to expand the information required to be made available to the public in addition to exchanges' proprietary data feeds.[32] The Reg NMS Amendments would accelerate the compliance date with respect to these definitions to the date that is 90 days following publication in the Federal Register of any SEC adoption of an earlier implementation for these definitions.[33]

The Reg NMS Amendments would also: (i) require the existing exclusive securities information processors to collect, consolidate and disseminate odd-lot information and require exchanges and others to provide the data necessary to generate odd-lot information;[34] and (ii) amend the definition of odd-lot information to include a new data element that would identify the best odd-lot orders to buy and sell across all national securities exchanges and national securities associations.[35]

DISCLOSURE OF ORDER EXECUTION INFORMATION

Rule 605 of Reg NMS requires market centers (as defined below) to make available standardized, monthly reports of certain statistical information regarding their order executions.[36] According to the Commission, the proposed amendments to Rule 605 are intended to update the rule in light of technological and market developments in the years since the promulgation of Reg NMS.[37] Key proposed changes include:

1. **Entities subject to Rule 605 reporting:** Rule 605 currently requires "market centers," defined as "any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association,"[38] to comply with the monthly report requirement. The proposed amendments would expand the scope of entities required to make these monthly reports to include: (i) broker-dealers who introduce or carry 100,000 or more customer accounts;[39] (ii) entities that would operate proposed qualified auctions;[40] and (iii) single-dealer platforms.[41]

2. **Scope of Rule 605 reporting:** The proposed amendments would revise the standardized information required to be included in the monthly reports.[42] Key updates include:

   - Expanding the definition of "covered order" (currently defined to include "any market order or any limit order . . . received by a market center during regular trading hours at a time when the national best bid and national best offer is being disseminated, and, if executed, is executed during regular trading hours")[43] to add: (i) certain orders submitted outside regular trading hours if they become executable after the opening or reopening of trading during regular trading hours;[44] (ii) certain orders submitted with stop prices benchmarked against the time the stop order first becomes executable;[45] and (iii) non-exempt short sale orders.[46]
   - Modifying existing order size categories to be based on round lots (rather than number of shares) and to include additional order size categories for fractional share, odd-lot and orders with 5,000 or more shares.[47]
   - Creating new order-type categories for: (i) market orders; (ii) marketable limit orders; (iii) marketable immediate-or-cancel orders; (iv) beyond-the-midpoint limit orders; (v) executable non-marketable limit orders; and (vi) executable orders submitted with stop prices.[48]

3. **Content of Rule 605 reports:** The proposed amendments would also revise the content of required reports, including as follows:

   - The existing time-to-execution reporting categories would be replaced with: (i) average time-to-execution; (ii) median time-to-execution; and (iii) 99th percentile time-to-execution statistics, each as measured in increments of a millisecond or finer and calculated on a share-weighted basis.[49]
   - Realized spread statistics would be required to be calculated 15 seconds and one minute after execution instead of the current five minutes.[50]
   - New statistical measures of execution quality would be implemented and existing metrics redefined.[51]

The proposed amendments would also require every market center and broker-dealer to generate a summary report in a "human-readable format" in the most recent versions of the XML and PDF formats to enhance accessibility.[52]

REGULATION BEST EXECUTION

The SEC also proposed a new Regulation Best Execution that would supplement existing FINRA and Municipal Securities Rulemaking Board ("MSRB") best execution requirements.[53] The SEC notes that its proposed rule is consistent with the FINRA and MSRB best execution rules in many respects and is different from those rules in some other respects, but that, if one rule set would impose additional or more specific requirements than the other, a firm would be required to comply with those additional or more specific requirements.[54] Notably, the new requirements would apply to all types of securities transactions, including not only equities but also fixed income securities, securities derivatives and digital asset securities.[55] Key aspects of the proposed regulation include:

1. **Proposed Rule 1100:**

   - *Best execution standard*: 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.[56]

   - *Exemptions*: A broker-dealer is not subject to the best execution standard when: (i) another broker-dealer is executing a customer order against the broker-dealer's quotation; (ii) an institutional customer, exercising independent judgment, executes its order against the broker-dealer's quotation; or (iii) the broker-dealer receives an unsolicited instruction from a customer to route its order to a particular market for execution and the broker-dealer processes that customer's order promptly and in accordance with the terms of the order.[57]

2. **Proposed Rule 1101:** This proposed rule would require broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to comply with the best execution standard, including how a broker-dealer will identify material potential liquidity sources, determine the "best market" (which may take into account multiple factors other than price, such as opportunities for price improvement, the attributes of an order, the trading characteristics of the security, the size of the order, the likelihood of execution, the accessibility of the market and customer instructions) and make routing or execution decisions. The proposed rule further provides specific requirements for those policies and procedures, including with respect to potential conflicts of interest in connection with retail customer transactions.[58] The proposed rule would also exempt introducing brokers from the requirements of this rule if the introducing broker routes customer orders to an executing broker, provided that the introducing broker regularly reviews its execution quality.[59]

3. **Proposed Rule 1102:** This proposed rule would require broker-dealers to conduct an annual review of their best execution practices and to prepare and present written reports on the outcomes of their review, including any deficiencies, to their governing bodies.[60]

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ENDNOTES

[1] Order Competition Rule, Release No. 34-96495; File No. S7-31-22 (Dec. 14, 2022), *available at* https://www.sec.gov/rules/proposed/2022/34-96495.pdf.

[2] 17 C.F.R. § 242.611 (requiring trading centers to have policies and procedures reasonably designed to prevent trade-through with respect to protected quotations in NMS stocks).

[3] FINRA Rules 5310 and 5320; MSRB Rule G-18.

[4] NMS stock is defined as "any NMS security other than an option." 17 C.F.R. § 242.600(b)(55). NMS security means any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options. 17 C.F.R. § 242.600(b)(54).

[5] Order Competition Rule, at 14 n.19.

[6] *Id.* at 81.

[7] *Id*.

[8] *Id.* at 82.

[9] *Id.* at 102.

[10] *Id.* at 103.

[11] *Id.* at 97.

[12] *Id.* at 87, 96.

[13] *Id*. at 9 n.9.

[14] *Id.* at 104.

[15] *Id.* at 11, 105-120.

[16] Continuous order book is defined as a system that allows for orders for NMS stocks to be accepted and executed on a continuous basis. *Id.* at 119.

[17] *Id.* at 70-72.

[18] *Id.* at 72-74.

[19] *Id.* at 74-76.

[20] Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, Release No. 34-96494; File No. S7-30-22 (Dec. 14, 2022), *available at* https://www.sec.gov/rules/proposed/2022/34-96494.pdf.

[21] 17 C.F.R. § 242.612.

[22] Reg NMS Amendments at 14.

[23] *Id*. at 56.

[24] *Id.* at 59.

[25] Time Weighted Average Quoted Spread is defined as the average dollar value difference between the national best bid ("NBB") and national best offer ("NBO") during regular trading hours where each instance of a unique NBB and NBO is weighted by the length of time that the quote prevailed as the NBB or NBO. *Id.* at 68.

[26] Evaluation Period is defined as the last month of a calendar quarter (March in the first quarter, June in the second quarter, September in the third quarter and December in the fourth quarter) of a calendar year during which the primary listing exchange measures the Time Weighted Average Quoted Spread of an NMS stock that is priced equal to, or greater than, $1.00 per share to

determine the minimum pricing increment to be in effect for an NMS stock for the next calendar quarter. *Id.* at 69.

27 17 C.F.R. § 242.610(c) ("A trading center shall not impose, nor permit to be imposed, any fee or fees for the execution of an order against a protected quotation of the trading center or against any other quotation of the trading center that is the best bid or best offer of a national securities exchange, the best bid or best offer of The Nasdaq Stock Market, Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of The Nasdaq Stock Market, Inc. in an NMS stock that exceed or accumulate to more than the following limits: (1) If the price of a protected quotation or other quotation is $1.00 or more, the fee or fees cannot exceed or accumulate to more than $0.003 per share; or (2) If the price of a protected quotation or other quotation is less than $1.00, the fee or fees cannot exceed or accumulate to more than 0.3% of the quotation price per share.").

28 17 C.F.R. § 242.600(b)(71).

29 Reg NMS Amendments at 94.

30 *Id.* at 107.

31 Market Data Infrastructure, Release No. 34-90610, File No. S7-03-20 (Dec. 9, 2020), *available at* https://www.sec.gov/rules/final/2020/34-90610.pdf.

32 The MDI Rules adopted a new definition of "round lot," which assigns NMS stocks priced over $250 to round lot sizes that are less than the 100 share round lot size that is predominant today. *Id*. at 112-113. The MDI Rules also defined "odd-lot information" as (1) odd-lot transaction data, and (2) odd-lots at a price greater than or equal to the national best bid and less than or equal to the national best offer, aggregated at each price level at each national securities exchange and national securities association. *Id*. at 855.

33 Reg NMS Amendments at 133-134.

34 *Id*. at 127.

35 *Id*. at 141-142.

36 17 C.F.R. § 242.605.

37 Disclosure of Order Execution Information, Release No. 34-96493; File No. S7-29-22 (Dec. 14, 2022), *available at* https://www.sec.gov/rules/proposed/2022/34-96493.pdf at 3, 5-6 ("Rule 605 Amendments").

38 17 C.F.R. § 242.600(b)(46).

39 Rule 605 Amendments at 44. If required, ATSs must prepare a Rule 605 report separate from their broker-dealer operator's report. *Id.* at 77-78.

40 *Id.* at 70-71. The "Order Competition Rule" section of this memorandum discusses proposed qualified auctions in more detail.

41 *Id.* at 78-79.

42 *Id.* at 80.

43 *Id.* at 14-15.

44 *Id*. at 83.

45 *Id.* at 89.

46 *Id.* at 81, 93.

47 *Id.* at 98, 103-104.

ENDNOTES (CONTINUED)

[48] *Id.* at 105. "Beyond-the-midpoint limit orders" would be defined based on whether a NBBO is being disseminated and will include the information required for both marketable and non-marketable order types. *Id.* at 112-113.

[49] *Id.* at 122-124.

[50] *Id.* at 131.

[51] Specific revisions include: (i) expanding the average effective spread reporting requirements, *id.* at 133-134; (ii) requiring reporting of percentage effective and realized spread statistics, *id.* at 136; (iii) implementing a statistical metric for the average effective over quoted spread, *id.* at 139-140; (iv) reporting a size improvement benchmark metric for the cumulative number of shares of the full displayed size of the protected bid at the time of execution, *id.* at 142-143; (v) creating a carve out for reporting riskless principal orders, *id.* at 147; (vi) providing certain statistical measures that can assist in evaluating execution quality of non-marketable orders, *id.* at 156-159; and (vii) updating the definition for "best available displayed price" to provide additional price improvement statistics for market and marketable orders, *id.* at 149-153.

[52] *Id.* at 168.

[53] Regulation Best Execution, Release No. 34-96496; File No. S7-32-22 (Dec. 14, 2022), *available at* https://www.sec.gov/rules/proposed/2022/34-96496.pdf.

[54] *Id.* at 48.

[55] However, the SEC states that "the proposal would not have economic effects on the market structure or order handling practices in the markets for securities based swaps, asset-backed securities, and repurchase and reverse repurchase agreements because these markets are mostly dominated by institutional investors that do their own order handling." *Id.* at 177, n.264.

[56] *Id.* at 49.

[57] *Id.* at 51-52.

[58] Conflicted transactions are defined as any transaction in connection with a retail customer where the broker-dealer "(i) executes an order as principal, including riskless principal; (ii) routes an order to, or receives an order from, an affiliate for execution; or (iii) provides or receives payment for order flow. . . ." *Id.* at 100-101.

[59] *Id*. at 63, 66, 100, 144-145.

[60] *Id.* at 163.

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