
SEC Holiday Reading List: Four Rule Proposals That Would Overhaul Market Structure and How Retail Orders Are Executed

DECEMBER 16, 2022

On December 14, 2022, the Securities and Exchange Commission (“SEC” or “Commission”) released four sweeping rulemaking proposals that would change market structure as we currently know it and introduce a new federal standard for a broker-dealer’s duty of best execution.¹

We have summarized the key provisions of the proposals and provide some of the Commissioners’ initial reactions, including particularly divergent views with respect to the proposed Order Competition Rule and Regulation Best Execution. Given their length and breadth, we are continuing to review the proposals—please stay tuned for additional updates with our key takeaways. The comment period for each of the proposals ends on the later of March 31, 2023, or 60 days after publication in the Federal Register.

1. Disclosure of Order Execution Information: Expansion of Rule 605 under Regulation NMS

Rule 605 of Regulation NMS currently requires “market centers” to make available standardized, monthly reports of statistical information concerning the executions of “covered orders” in NMS stocks that the market center received for execution from any person. The SEC proposes to expand the scope of Rule 605 reporting to new entities and new order information and require the publication of monthly summary order execution data reports.

¹ Disclosure of Order Execution Information, available at <https://www.sec.gov/rules/proposed/2022/34-96493.pdf>; 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>; Order Competition Rule, available at <https://www.sec.gov/rules/proposed/2022/34-96495.pdf>; Regulation Best Execution, available at <https://www.sec.gov/rules/proposed/2022/34-96496.pdf>.

Key Provisions

- **Expanded Scope of Rule 605.**
 - *Expanded In-Scope Entities.* Today, Rule 605 applies to “market centers,” defined as “any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.” The proposal would expand the reporting requirement of Rule 605 to include: (1) broker-dealers that introduce or carry 100,000 or more customer accounts trading NMS stocks; (2) single-dealer platforms and alternative trading systems (separate from the broker-dealer operator’s other activities); and (3) entities that would operate “qualified auctions” under the proposed Order Competition Rule (discussed below).
 - *New Order Categories.*
 - The proposal would expand the definition of “covered order” under Regulation NMS to include certain orders submitted outside of regular trading hours, certain orders submitted with stop prices, and non-exempt short sale orders.
 - The proposal would modify order size categories to base them on “round lots” instead of specific share quantities and establish new order size categories for fractional share, odd-lot, and block orders.
 - The proposal would create a new order type category for marketable immediate-or-cancel orders and replace three existing categories of non-marketable order types with three new categories of order types (beyond-the-midpoint limit orders, executable non-marketable limit orders, and executable orders with stop prices).
 - *Additional Reported Data and Execution Quality Statistics.* The proposal would require Rule 605 reporters to provide more granular statistics regarding execution quality, including enhanced statistics regarding speed of execution and effective over quoted, percentage effective and realized spread. The proposal also would introduce new reportable statistics regarding price and size improvement.
- **Summary Reports.** In addition to standard Rule 605 reports, the proposal would require Rule 605 reporters to publish in a “human-readable” format monthly summary statistics on executions of certain covered orders.

Initial Commissioner Reactions²

The Commission unanimously approved this proposal. No Commissioners seemed to take major exception to the content of this proposal; they generally agreed that updates were “long overdue” for Rule 605, which was adopted in 2000. However, Commissioners Peirce and Uyeda expressed concerns regarding the proposal’s costs in light of the many other recent proposals and rules applicable to broker-dealers and market centers. Commissioners Crenshaw and Peirce also raised questions regarding the utility and presentation of Rule 605 data to investors and whether the proposal captured the appropriate scope of entities.

2. Amendments to Certain Rules under Regulation NMS: Minimum Pricing Increments (“Tick Sizes”), Access Fees, and Transparency of Better Priced Orders

This proposal would amend three aspects of Regulation NMS by: (1) establishing new pricing increment (or tick size) requirements for quoting and trading NMS stocks; (2) changing permissible exchange access fees and rebates; and (3) outlining an odd-lot market data framework, which would accelerate implementation of certain parts of the SEC’s Market Data Infrastructure (“MDI”) Rules.³

Key Provisions

- **Variable Minimum Tick Size Requirements.** Rule 612 under Regulation NMS currently requires quotations in NMS stocks priced equal to or greater than \$1.00 to have a minimum tick size of \$0.01. The proposal would prescribe variable pricing increments between \$0.01 and \$0.001 that would apply uniformly to quoting and trading, whether on exchanges, alternative trading systems, or over the counter, depending on the stock’s time weighted average quoted spread over a specified historical evaluation period. These determinations would be conducted on a quarterly basis for each NMS stock priced equal to or greater than \$1.00.

² Chair Gary Gensler, *Statement on Proposed Amendments Regarding Order Execution Quality* (Dec. 14, 2022), <https://www.sec.gov/news/statement/gensler-order-execution-quality-20221214>; Comm’r Hester M. Peirce, *Statement on Disclosure of Order Execution Information* (Dec. 14, 2022), <https://www.sec.gov/news/statement/peirce-order-execution-20221214>; Comm’r Caroline A. Crenshaw, *Statement on Proposals Related to Equity Market Structure* (Dec. 14, 2022) (“Crenshaw Statement”), <https://www.sec.gov/news/statement/crenshaw-insider-trading-20221214-0>; Comm’r Mark T. Uyeda, *Statement on Proposed Rule Regarding Disclosures of Order Execution Information* (Dec. 14, 2022), <https://www.sec.gov/news/statement/uyeda-order-execution-20221214>; Comm’r Jaime Lizarraga, *Increasing Competition and Improving Transparency in U.S. Equity Markets* (Dec. 14, 2022), <https://www.sec.gov/news/statement/lizarraga-rule-605-20221214> (“Lizarraga Statement”).

³ Market Data Infrastructure, 86 Fed. Reg. 18596 (Apr. 9, 2021) (among other things, defining round lot and odd lot information).

- **Lower Exchange Access Fee Caps and Fee Transparency.** The proposal also would reduce Rule 610's cap on exchange access fees from 30 mills to 10 mills or 5 mills per share, depending on a stock's price and minimum pricing increment. Additionally, the proposal would prohibit a national securities exchange from charging fees or providing rebates or other remuneration unless such amounts can be determined at the time of execution. This could change the pricing or rebate structures of exchanges that offer, for example, tiered pricing or rebates based on volume of order flow over time.
- **Implementation of Odd-Lot Market Data.** The proposal would accelerate the compliance period for the MDI Rules regarding odd-lot orders, implementing the MDI Rules' definitions for odd lots and round lots and requiring exchanges to provide odd-lot market data to securities information processors for collection, consolidation, and dissemination rather than only for round-lot market data. The proposal also would amend "odd-lot information" to include a new data element to identify an "odd-lot NBBO."

Initial Commissioner Reactions⁴

The Commission unanimously approved this proposal. While Chair Gensler and Commissioners Lizarraga and Crenshaw praised the increased efficiency, transparency, and competition that they believed could be realized by this proposal, Commissioners Peirce and Uyeda expressed concerns regarding the proposal's potential "unintended consequences," including how this proposal could interact with the other proposals released as part of this rulemaking package. Commissioners Peirce and Uyeda also questioned the validity of the "enhanced competitive effect" envisioned by the proposal and praised by other Commissioners. Commissioner Peirce was critical of the access fee caps, stating her preference that "the Commission get out of the rate-setting business." She also questioned whether it was reasonable to accelerate implementation of the MDI Rules.

3. New Order Competition Rule: Proposed Rule 615

The proposed Order Competition Rule would establish a new requirement that, subject to certain exceptions, retail order flow must "be exposed to competition in fair and open auctions, before such orders could be executed internally by trading centers that restrict order-by-order competition."

⁴ Chair Gary Gensler, *Statement on Minimum Price Increments, Access Fee Caps, Round Lots, and Odd-Lots* (Dec. 14, 2022), <https://www.sec.gov/news/statement/gensler-tick-size-20221214>; Comm'r Hester M. Peirce, *Statement on Proposal to Amend Rules Governing Access Fees and Tick Sizes and to Accelerate Certain Market Data Changes* (Dec. 14, 2022), <https://www.sec.gov/news/statement/peirce-tick-size-20221214>; Crenshaw Statement; Comm'r Mark T. Uyeda, *Statement on Proposed Rule Regarding Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders* (Dec. 14, 2022), <https://www.sec.gov/news/statement/uyeda-tick-size-20221214>; Lizarraga Statement.

Key Provisions

- **Enforced Auction Process for Retail Order Flow.** The proposal would require order-by-order competition for “segmented orders”—orders in NMS stocks by certain retail investors—by prohibiting a “restricted competition trading center” from executing such orders until they are exposed to competition in a “qualified auction” on an “open competition trading center.” A “restricted competition trading center” would be a trading venue other than a national securities exchange or alternative trading system that meets certain transparency, access, and volume requirements for qualification as an “open competition trading center.”
- **Exceptions.** The proposal would except certain types of orders from the auction requirement:
 - An order received and executed when no qualified auction was being operated for the order;
 - An order with a market value of \$200,000 or more; and
 - An order with execution prices at or above the midpoint of the NBBO.

*Initial Commissioner Reactions*⁵

Chair Gensler and Commissioners Crenshaw and Lizarraga approved this proposal; Commissioners Peirce and Uyeda voted against it. The Commissioners who supported the proposal cited the value of increased transparency and the potential that customer orders might be exposed to more order-by-order competition and therefore better prices under the new framework.

During the Commission’s open meeting, Commissioners Peirce and Uyeda raised concerns regarding the lack of evidence supporting the proposal, emphasizing that it is impossible to predict the proposal’s unintended consequences on a market that is relatively efficient for retail customers (e.g., by providing tight spreads, low or no commissions, etc.). Commissioner Peirce also expressed concerns that the proposal may be based on an incorrect premise and may cause bigger problems than it intends to solve. Commissioner Peirce noted it was unclear whether the proposal would achieve its goals of increased competition and raised the possibility that the proposal could cause retail customers to pay higher commissions. Commissioner Peirce also acknowledged that while the order-by-order competition requirement might improve execution quality in some cases during “normal times,” the SEC may not be able to anticipate how the proposal will affect liquidity in more volatile market conditions. Commissioner Peirce separately questioned whether the proposal is too prescriptive and exceeds the SEC’s authority from

⁵ Chair Gary Gensler, *Statement on Proposal to Enhance Order Competition* (Dec. 14, 2022), <https://www.sec.gov/news/statement/gensler-order-competition-20221214>; Comm’r Hester M. Peirce, *Ordering Competition* (Dec. 14, 2022), <https://www.sec.gov/news/statement/peirce-order-competition-20221214>; Crenshaw Statement; Lizarraga Statement.

Congress “to facilitate the establishment of a national market system for securities,” and criticized the imposition of additional fee caps, characterizing the practice as another example of “government price setting.”

4. New Federal Rules for Best Execution: Regulation Best Execution

Proposed Regulation Best Execution (proposed rules 1100-1102) would codify a federal standard for a broker-dealer’s duty of best execution. The proposal would apply to brokers, dealers, government securities brokers, government securities dealers, and municipal securities dealers (collectively, “broker-dealers”) as well as to the handling of orders of all customers (both institutional and retail) and, unlike the other three proposals, all securities (e.g., stocks, bonds, and options). This departs from the Commission’s historic practice of treating substantive best execution issues as violations of the antifraud provisions of the securities laws, while leaving self-regulatory organizations (“SROs”), such as FINRA and the MSRB, to establish order handling requirements for their members.

Key Provisions

- **Best Execution Standard.** The proposal would codify a new federal best execution standard. Specifically, in any transaction for or with a customer, or a customer of another broker-dealer, a broker-dealer (or its natural associated person) “shall 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.” Proposed rule 1100 defines this price as the “most favorable price.” Although certain aspects of the SEC’s best execution standard are familiar from SRO rules, the proposal would introduce certain new considerations.
- **Requirements.**
 - *Policies and Procedures.* The proposal would require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to comply with the best execution standard. These policies would need to address, among other things: (1) how the broker-dealer will obtain and assess reasonably accessible information, including information about price, volume, and execution quality; (2) how the broker-dealer will identify markets that may be reasonably likely to provide the most favorable prices (“material potential liquidity sources”); and (3) how the broker-dealer will incorporate material potential liquidity sources into its order handling practices and ensure it can efficiently access such sources. Broker-dealers will need to conduct related, but additional assessments for customer orders they receive, including (1) assessing opportunities for price improvement that may result in the

most favorable price; (2) assessing the attributes of customer orders and selecting the most likely market to provide a favorable price based on those attributes; and (3) reasonably balancing the likelihood of obtaining better prices with the risk that delay could create worse prices.

- *Best Execution Reviews.* Like FINRA requirements, the proposal would require broker-dealers to review the execution quality of customer orders at least quarterly.
 - *“Conflicted Transactions” with Retail Customers.* The proposal would require more robust policies and procedures and heightened best execution requirements for broker-dealers that engage in “conflicted transactions” for or with a retail customer. Among other things, the broker-dealer will need to consider a broader range of markets beyond those identified as material potential liquidity sources and a broader range of order exposure opportunities. “Conflicted transactions” are broadly defined to include certain transactions with or for a retail customer where the broker-dealer (1) receives or pays for order flow, (2) routes an order to or receives an order from an affiliate for execution, or (3) acts as principal or riskless principal—even though riskless principal transactions are the economic equivalent of agency transactions and principal transactions are primarily how trading occurs in the fixed income markets.
 - *Annual Reviews and Board Reporting.* Broker-dealers would be required at least annually to assess the overall effectiveness of their best execution policies and procedures and prepare a report detailing the results of that assessment to be presented to the broker-dealer’s board of directors.
 - *Recordkeeping.* Broker-dealers would be required to keep and preserve records evidencing the various requirements for its best execution program.
- **Exceptions.** The proposed best execution standard generally would not apply when: (1) a broker-dealer executes a customer order against the quote of another broker-dealer; (2) an institutional customer, using its independent judgment, executes its order against a broker-dealer’s quote; and (3) a broker-dealer receives an unsolicited directed order from a customer and the broker-dealer promptly processes the customer order in accordance with its terms. Separately, certain narrowly defined “introducing brokers” would not be required to comply with certain aspects of proposed Regulation Best Execution if they establish, maintain, and enforce policies and procedures to regularly review the execution quality obtained from the executing broker, compare it with the execution quality that may have been obtained from other executing brokers, and revised its order handling practices accordingly. Notably, for purposes of this exception, “introducing broker” does not include brokers that route to affiliates or receive payment for order flow.

*Initial Commissioner Reactions*⁶

Chair Gensler and Commissioners Crenshaw and Lizarraga approved this proposal; Commissioners Peirce and Uyeda voted against it. The Commissioners in favor of the proposals cited the goals of investor protection, modernization (e.g., the FINRA best execution rule has not been updated since 2014), and—notably—easier enforcement by SEC and FINRA staff of broker-dealers' compliance with their best execution obligations. They appreciated that the proposal substantively heightens the best execution requirements applicable to transactions that involve conflicts of interest (such as payment for order flow). Commissioner Crenshaw asked whether the proposal should be taken even further—whether the heightened standards for conflicted transactions should apply to all transactions and whether the policies and procedures nature of the proposal provides too much flexibility to broker-dealers.

Commissioner Peirce criticized the proposal for being too prescriptive. Per Commissioner Peirce, the proposal would supplant brokers' judgment with the SEC's own "step-by-step guide" to achieve best execution. Notably, Commissioner Peirce said that she could have supported a principles-based SEC rule proposal on best execution; however, as proposed, Regulation Best Execution is "unduly prescriptive" and "seems less concerned about whether customers actually get best execution than if brokers implement a checklist." Commissioner Peirce further remarked that the proposal may not be in the best interests of retail investors. In particular, the heightened standard for "conflicted transactions" could lead retail brokers to alter their business models, including by introducing or raising commissions paid by customers. In her view, the proposal "does not take serious account of the potential for increased commissions when it assesses likely changes in execution quality." Commissioner Uyeda also criticized the proposal for being based on "theory" rather than evidence and for being duplicative of existing requirements. Commissioner Uyeda noted that the proposal failed to analyze the interaction with the potential adoption of the other proposals being considered and could significantly impact how broker-dealers conduct their best execution obligations under existing obligations and SRO rules.

⁶ Chair Gary Gensler, *Statement on Best Execution Proposal* (Dec. 14, 2022), <https://www.sec.gov/news/statement/gensler-best-execution-20221214>; Comm'r Hester M. Peirce, *Is this the Best Execution We Can Get?* (Dec. 14, 2022), <https://www.sec.gov/news/statement/peirce-best-execution-20221214>; Crenshaw Statement; Comm'r Mark T. Uyeda, *Statement on Proposed Rule Regarding Best Execution* (Dec 14, 2022), <https://www.sec.gov/news/statement/uyeda-best-exccution-20221214>; Lizarraga Statement.

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