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# SEC Proposals Impacting Broker-Dealers:

## Four proposals are the biggest overhaul the markets have seen in decades

On December 14, 2022, the Securities and Exchange Commission (SEC) approved four proposals that make significant changes to market regulations and aim to increase transparency, competition, and investor protections. The proposals cover 1) expansion of rule 605 reporting 2) Reg NMS changes for variable tick size and disclosure of fees 3) a new "Order Competition" rule including open auctions and 4) expansion of Best Execution requirements.

## 1. Increased Transparency through Expanded Rule 605 Reporting[1]:

The Division of Trading & Markets seeks to expand information available via Rule 605 reporting. The proposal:

A. Expands the scope of entities subject to Rule 605 and making public monthly reports on execution quality. Additional entities included in scope are large broker-dealers (>100k customer accounts), single dealer platforms, and entities that would operate proposed qualified auctions.

B. Requires additional information on "machine-readable" 605 reports, including percentage price improvement, new trade type categories, and time to execution statistics.

C. A new "human-readable" summary of execution quality for plain language explanations of the quantitative information about price improvement and execution speed.

D. Detailed 605 Report changes include:

   i. Separate 605 reports for "covered" orders in public auctions. Scope expanded to include not-held orders, special handling, and outside market hours. New categories for order types include marketable, beyond midpoint, non-market, and executable orders.

   ii. Average, median and 99% categories of time to execute to be reported in milliseconds.

   iii. Allocation of trade size categories including fractionals, odd lots and large lots.

   iv. Additional statistics and plain language reports.

   v. Current 605 is focused on market centers. Expanding to broker-dealers may boost transparency and competition for firms.

## 2. Reg NMS changes for variable tick size and disclosure of fees[2]:

The Division of Trading and Markets is proposing changes to Reg NMS, including reducing the minimum price increments (tick size) regardless of trading venue, adjusting the access fee caps, and standardization across round lots, odd lots and other share sizes.

A. The goal is to increase competition in exchange trades and level the playing field with other venues that trade at finer tick sizes allowing bid and offer movement into the spread. The SEC estimates that 42% of trades are in wholesale and dark pools. Changes in competitiveness of exchange markets could provide greater transparency to the 'lit' markets and promote fairness for investors. Lowering the tick size may improve price discovery by allowing for narrower spreads.

B. Changes to the NMS Rule 612 would establish a variable minimum price increment based on the time weighted average of trade spreads between Best Bid and Offer, to be calculated quarterly, in 7 tiers.

C. Changes to NMS rule 610 include reduced access fee caps to match the smaller tick sizes. Current fee cap of $0.003 per share on protected quotes could be reduced to as low as $0.0005:

   i. The goal of increasing transparency of trading fees at the time of execution potentially impacts volume-based fees including payment for order flow arrangements.

   ii. Proposed changes to the definition of round lots would be based on share price. Share prices less than $250 would remain at 100 shares. Proposal includes round lots of 10 shares for prices up to $1000 a share and round lots of 1 share for prices in excess of $10,000.

   iii. Proposed changes to the Order Protection Rule include a "best odd lot" definition for transparency of odd lot bid and offer prices to be included in Market data to allow investors to target the better priced liquidity. Odd lots have grown to 19% for corporate equity trades so fostering access to those lots may promote fairness and competition.

## 3. Order Competition Rule including Open Auctions[3]:

A. The Rule would require retail customer orders to be routed to an Open Auction (Qualified Auction) prior to being filled by a Restricted Competition Trading Center (RCTCs) such as a market maker, wholesalers, or internalizers.

B. The goal is to improve execution quality for retail orders. Currently, 90% of orders are routed to small group of wholesalers that have "first right" to fill them. Price improvement above the best bid and offer does occur, however, it is not fully competitive. Individual investors could receive greater execution quality with expanded order competition.

C. The proposed rule would allow for exceptions. "Segmented Orders" in NMS stocks include accounts for natural persons and trusts which trade less than 40 trades per day. Legal Entities and traders in excess of 40 trades per day are excluded. Certain order types are also excluded including customer limit orders better than midpoint prices, orders in excess of $200,000, and fractional shares if no auction is available.

D. Auction operating procedures would require the dissemination of the order, price ticks of $0.001 for shares over $1.00. and time limits also apply. Ranking based on price and customers take precedent. An estimated 7-10% of dollar volume is expected to execute on the auctions.

E. Challenges to implementation likely include the creation of Qualified Auctions where broker-dealers could route Segmented Orders, as well as identification of the orders that should be routed to the open auction while facilitating others that voluntarily participate.

## 4. Expansion of Best Execution Requirements[4]:

A. The proposal would establish an SEC standard for Best Execution covering all securities, including digital assets. The rule would establish that broker-dealers (including introducing brokers) have a duty of Best Execution on behalf of their clients. Best Execution policies, procedures, annual assessments, and regulatory reporting would be required for broker-dealers to confirm compliance with the new standard. Broker Dealers that have conflict of interest in retail orders such as executing an order as principal, routing an order/receiving an order from an affiliate and providing or receiving payment for order flow will require specific documentation of the compliance with the Best Execution standard.

B. Changes to three rules are being proposed:

i. Proposed Rule 1100 would exempt a broker-dealer from this standard when: (1) another broker-dealer is executing a customer order against the broker-dealer's quotation; (2) an institutional customer, exercising independent judgment, executes its order against the broker-dealer's quotation; or (3) 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 customers' order promptly and in accordance with the terms of the order.

ii. Rule 1101 would require broker-dealers (Introducing brokers are exempt) to create policies and documentation to comply with Best Execution standard, and those engaging in conflicted transactions will be subject to additional obligations. Broker-dealers should document efforts relating to improving best executions and arrangements.

iii. Rule 1102 requires broker-dealers to conduct annual or more frequent reviews on Best Execution procedures, which will be presented to the firm's board of directors. They should document reviews and prepare written reports that include deficiencies found and plans to resolve them.

The proposals reflect the SEC's skepticism of the practice of payment for order flow (PFOF). Collectively, they comprise the most significant proposed changes to market structure in more than a decade. The most controversial likely will be the "Order Competition" proposal, which challenges the existing business models of broker-dealers and market makers alike. The SEC has established approximately a 90-day comment period for all four proposals ending on March 31, 2023.


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# Endnotes

1. SEC rule proposal, Proposed rule: Disclosure of Order Execution Information, December 2022.

2. SEC rule proposal, Proposed rule: Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, December 2022.

3. SEC rule proposal, Proposed rule: Order Competition Rule, December 2022.

4. SEC rule proposal, Proposed rule: Regulation Best Execution, December 2022.

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