INVESTMENT COMPANY INSTITUTE

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SEC Issues Proposals on Equity Market Structure Reform

[34678]

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TO: Equity Markets Advisory Committee
Fixed-Income Advisory Committee
SEC Rules Committee RE: SEC Issues Proposals on Equity Market Structure Reform

On December 14, 2022, the SEC issued four new proposals that if adopted would represent the most sweeping overhaul of the U.S. equity market structure since the adoption of Regulation NMS in 2005. While Director Zhu, Division of Trading and Markets, stated at the open meeting that each proposal is targeted to address a specific issue the SEC staff believes exists in the equity markets, as noted in statements made by several of the Commissioners throughout the meeting, these proposals are interrelated and the totality of the market impact will be sweeping. For each proposal, the public comment period will remain open until March 31, 2023, or until 60 days after the date of publication of the proposing release in the Federal Register, whichever is later.

ICI is reviewing the proposals and will provide more detailed information on the proposals as soon as possible, along with information on upcoming member outreach. Please get in touch with me (kevin.ercoline@ici.org) or Sarah Bessin (sarah.bessin@ici.org) if you have any questions or initial comments on the proposals. Each proposal is summarized below.

Disclosure of Order Execution Information

Approved unanimously, Disclosure of Order Execution Information (Exchange Act Release No. 96493) seeks to update the disclosure required under Rule 605 of Regulation NMS for order executions in national market system (NMS) stocks, which are stocks listed on a national securities exchange. Specifically, the proposed amendments would:

- Expand the scope of entities subject to Rule 605 by requiring broker-dealers with a larger number of customer accounts, single dealer platforms, and entities that would operate qualified auctions (as proposed and defined in the Order Competition Rule) to make available to the public monthly execution quality reports;
- Amend the definition of "covered order" to include certain orders submitted outside of regular trading hours and certain orders submitted with stop prices;

- Amend the categorization of information required to be reported under the rule, including changing the order type categories and the order size categories to include fractional share orders, odd-lot orders, and larger-sized orders;
- Eliminate time-to-execution categories in favor of average time to execution, median time to execution, and 99th percentile time to execution statistics, each as measured in increments of a millisecond or finer;
- Amend the information required to be reported under the rule; and
- Enhance the accessibility of the required reports by requiring all entities subject to Rule 605 to make a summary report available.

The full proposal is available at https://www.sec.gov/rules/proposed/2022/34-96493.pdf; the SEC Fact Sheet at https://www.sec.gov/files/34-96493-fact-sheet.pdf; and press release at https://www.sec.gov/news/press-release/2022-223.

SEC Chair Gary Gensler and Commissioners Peirce, Crenshaw, Uyeda, and Lizárraga delivered statements on the proposal:

- Chair Gensler stated that the proposal would make it easier for investors to evaluate key metrics related to execution quality, require larger brokers to disclose critical information about execution quality, apply to a larger range of order sizes, and require market centers and broker-dealers to produce summary reports on execution quality that everyday investors can read. The Chair's full statement is available at https://www.sec.gov/news/statement/gensler-order-execution-quality-20221214.
- Commissioner Peirce stated that the order execution disclosure proposal appears to be a "reasonable attempt" to address shortcomings of the current Rule 605 but noted that the Commission will still require input from market participants to make a final judgment. Commissioner Peirce's full statement is available at https://www.sec.gov/news/statement/peirce-order-execution-20221214.
- Commissioner Crenshaw requested from commenters insight into whether the SEC should modernize Rule 605 reporting obligations by additionally mandating reporting from all broker-dealers, standardizing formatting, or making this information accessible in a central location. Commissioner Crenshaw's full statement is available at https://www.sec.gov/news/statement/crenshaw-insider-trading-20221214-0.
- Commissioner Uyeda stated that extending Rule 605 reporting obligations to larger broker-dealers would increase transparency into the differences in execution quality achieved by broker-dealers when they route customer orders to execution venues. The Commissioner did raise concern about how the proposal would interact with the three other equity market structure proposals. Commissioner Uyeda's full statement is available at https://www.sec.gov/news/statement/uyeda-order-execution-20221214.
- Commissioner Lizárraga said the proposed amendments to Rule 605 are well-tailored and reflect that trading patterns have changed in recent years. Commissioner Lizárraga's full statement is available at https://www.sec.gov/news/statement/lizarraga-rule-605-20221214.

Tick Sizes, Access Fees, and Transparency of Better Priced Orders

Approved unanimously, Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders (Exchange Act Release No. 96494) seeks to relieve "tick-constraint," reduce access fees, and accelerate the implementation of the odd-lot information and round lot definition adopted under the Market Data Infrastructure Rules ("MDI Rules") from 2020. Specifically, the proposal would:

- Amend the minimum pricing increments, also known as tick sizes, under Rule 612 of Regulation NMS to establish a variable minimum pricing increment model that would apply to both the quoting and trading of NMS stocks, regardless of trading venue. The minimum pricing increment for quoting and trading of NMS stocks would vary based on the time weighted average quoted spread for the NMS stock during a defined evaluation period;
- Reduce the access fee caps under Rule 610 of Regulation NMS in conjunction with the reduction of the minimum pricing increments. The proposed amendments to Rule 610 would also prohibit a national securities exchange from imposing, or permitting to be imposed, any fee, or providing, or permitting to be provided, any rebate or other remuneration for the execution of an order in an NMS stock unless such fee, rebate, or other remuneration can be determined at the time of execution. Any national securities exchange that imposes a fee or provides a rebate that is based on a certain volume threshold, or establishes tier requirements or tiered rates based on minimum volume thresholds, would be required to set such volume thresholds or tiers using volume achieved during a stated period prior to the assessment of the fee or rebate;
- Accelerate the implementation of the round lot and odd-lot information definitions under the MDI Rules, which would require the existing exclusive securities information processors to collect, consolidate, and disseminate odd-lot information and require national securities exchanges and associations to provide the data necessary to generate odd-lot information. Additionally, the proposal would amend the odd-lot information definition to require the identification of the best odd-lot orders to buy and sell across all national securities exchanges and national securities associations.

The full proposal is available at https://www.sec.gov/rules/proposed/2022/34-96494.pdf; the SEC Fact Sheet at https://www.sec.gov/files/34-96494-fact-sheet.pdf; and press release at https://www.sec.gov/news/press-release/2022-224.

SEC Chair Gary Gensler and Commissioners Peirce, Crenshaw, Uyeda, and Lizárraga delivered statements on the proposal:

- Chair Gensler discussed how the proposal would help level the playing field between the dark and lit markets, narrow the average tick size, lower access fee caps, bring more quotes into the National Best Bid and Offer, implement a modernized, more flexible definition for round lots, and enhance core data in our national market system. The Chair's full statement is available at https://www.sec.gov/news/statement/gensler-tick-size-20221214.
- Commissioner Peirce supported putting the proposal out for public comment, saying that she thinks that some stocks trading on our national securities exchanges are "tick-constrained." The Commissioner noted that commenters will decide whether the proposal gets tick sizes correct. Regarding access fees, she said that although she would prefer that the Commission "get out of the rate-setting business altogether," the proposal appears to be a reasonable attempt to set access fee caps at a level that does not create unnecessary market disruption. Commissioner Peirce's full statement is available at https://www.sec.gov/news/statement/peirce-tick-size-20221214.

- Commissioner Crenshaw noted that there are tradeoffs to lowering the minimum tick size as doing so allows for more efficient pricing but also adds complexity and can increase the chances of a market participant posting an insignificant price improvement to get ahead of other orders on the exchange. Regarding the other parts of the proposal, she additionally added that by requiring all exchange fees and rebates to be determinable at the time an order is executed should help broker-dealers make better order routing decisions. Commissioner Crenshaw's full statement is available at https://www.sec.gov/news/statement/crenshaw-insider-trading-20221214-0.

- Commissioner Uyeda stated that the majority of current trading volume appears to be "tick-constrained," and it is appropriate for the Commission to consider whether any regulatory changes are needed. The Commissioner said that while he does not agree with all components of the proposal, he looks forward to public comment. Commissioner Uyeda's full statement is available at https://www.sec.gov/news/statement/uyeda-tick-size-20221214.

- Commissioner Lizárraga supported the proposal for addressing inefficiencies in "tick-constrained" stocks, preventing other stocks from becoming "tick-constrained," and reducing costs, while also preserving displayed liquidity. He stated that the proposal would even the playing field between on and off-exchange trading by applying the new variable ticks to the quoting and trading of NMS stocks. Commissioner Lizárraga's full statement is available at https://www.sec.gov/news/statement/lizarraga-rule-605-20221214.

Proposed Rule to Enhance Order Competition

Approved by a 3-2 vote, the Order Competition Rule (Exchange Act Release No. 96495) seeks to enhance competition for the execution of marketable orders of individual investors by requiring such orders to be exposed to competition in fair and open auctions before they can be executed internally by any trading center that restricts order-by-order competition. The rule would apply to "segmented orders," which would be orders for NMS stocks made for an account:

- Of a natural person or an account held in legal form on behalf of a natural person or group of related family members; and

- In which the average daily number of trades executed in NMS stocks was less than 40 in each of the six preceding calendar months.

Absent an exception, a "restricted competition trading center," which would be a trading venue other than any national securities exchange and those alternative trading systems that meet the proposed requirements for an "open competition trading center," would be prohibited from executing internally a segmented order for an NMS stock unless the order first was exposed to competition in a qualified auction operated by an open competition trading center. Exceptions would be provided for:

- Segmented orders received and executed when no qualified auction was being operated for such orders;

- Segmented orders with market values of at least $200,000;

- 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;

- 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; and
- 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.

If a segmented order does not receive an execution in the qualified auction at a specified limit price or better, then a restricted competition trading center may, as soon as reasonably possible, execute the order internally at a price that is equal to or more favorable for the segmented order than the specified limit price.

The full proposal is available at https://www.sec.gov/rules/proposed/2022/34-96495.pdf; the SEC Fact Sheet at https://www.sec.gov/files/34-96495-fact-sheet.pdf; and press release at https://www.sec.gov/news/press-release/2022-225.

SEC Chair Gary Gensler and Commissioners Peirce, Crenshaw, Uyeda, and Lizárraga delivered statements on the proposal:

- Chair Gensler said the proposal is designed to bring greater competition into the marketplace for retail market orders, noting that investors may not be getting the benefit of full competition in the wholesalers' market. He argued that order-by-order competition would lead to significantly better prices for retail investors and estimated that the current competitive shortfall could be worth about $1.5 billion annually. The Chair's full statement is available at https://www.sec.gov/news/statement/gensler-order-competition-20221214.
- Commissioner Peirce stated that the Commission has "not done the work necessary to justify the extensive changes" being considered. The Commissioner took issue with the proposal's suggestion that retail brokers not choosing among wholesalers on an order-by-order basis is anti-competitive. She added that the proposal might result in customers paying higher commissions than they do now and raised concerns about the proposal's unintended impact on liquidity during market volatility. Commissioner Peirce's full statement is available at https://www.sec.gov/news/statement/peirce-order-competition-20221214.
- Commissioner Crenshaw said the proposal is designed to make the trading of NMS stocks more competitive, transparent, and efficient, for the benefit of investors. She highlighted the high level of concentration that has become a "feature of retail trading in the equity markets." However, she acknowledged that there may be unintended consequences from changing market rules and urged commenters to consider all the alternatives presented in the proposal and if there are any potential drawbacks to the proposed approach that are not addressed. Commissioner Crenshaw's full statement is available at https://www.sec.gov/news/statement/crenshaw-insider-trading-20221214-0.
- Commissioner Uyeda stated that the venue competition model that currently exists in the U.S. equity market has delivered significant benefits for retail investors, including tighter spreads, commission-free trading, and the elimination of minimum balance requirements, among others. The Commissioner recognized that realized spreads on trade executions tend to be larger for wholesalers than for exchanges, but exchanges and wholesale market makers have fundamentally different cost structures. He

argued that dynamic venue competition works and mandating a particular order flow denies the market the benefits of this competition. Commissioner Uyeda's full statement is available at https://www.sec.gov/news/statement/uyeda-order-competition-20221214.

- Commissioner Lizárraga advocated for increasing competition for retail order flow and expressed concerns about excess concentration among wholesalers. The Commissioner noted that while the potential impact of the proposal on overall market quality "may be difficult to assess," the potential benefits are worth exploring. Commissioner Lizárraga's full statement is available at https://www.sec.gov/news/statement/lizarraga-rule-605-20221214.

Regulation Best Execution

Approved by a 3-2 vote, Regulation Best Execution (Exchange Act Release No. 96496) would establish a best execution rule at the Commission-level. Specifically, in any transaction for or with a customer or a customer of another broker, dealer, government securities broker, government securities dealer, or municipal securities dealer (collectively "broker-dealers"), a broker-dealer (or a natural person who is an associated person of the broker-dealer) would be required to 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. While a best execution rule was first established in 1968 by the National Association of Securities Dealers, Inc., the predecessor to the Financial Industry Regulatory Authority, Inc., there has not previously been a rule established by the Commission. Regulation Best Execution would, among other things:

- Establish a best execution standard. Broker-dealers would only be exempt 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 customer's order promptly and in accordance with the terms of the order.
- Require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to comply with the best execution standard;
- Require more robust policies and procedures for broker-dealers that engage in certain conflicted transactions for or with a retail customer. A conflicted transaction would be any transaction where a broker-dealer: (1) executes an order as principal, including riskless principal; (2) routes an order to or receives an order from an affiliate for execution; or (3) provides or receives payment for order flow;
- Require broker-dealers to review the execution quality of their customer transactions at least quarterly;
- Exempt broker-dealers that qualify as "introducing brokers" from certain requirements if they establish, maintain, and enforce specified policies and procedures; and
- Require broker-dealers to review their best execution policies and procedures at least annually and present a report detailing the results of such review to their boards of directors or equivalent governing bodies.

The full proposal is available at https://www.sec.gov/rules/proposed/2022/34-96496.pdf; the

SEC Fact Sheet at https://www.sec.gov/files/34-96496-fact-sheet.pdf; and press release at https://www.sec.gov/news/press-release/2022-226.

SEC Chair Gary Gensler and Commissioners Peirce, Crenshaw, Uyeda, and Lizárraga delivered statements on the proposal:

- Chair Gensler stated that a Commission-level best execution standard would enhance investor protection by providing for additional enforcement capabilities. He discussed how the proposal would enhance the requirements for transactions involving conflicts of interest with retail investors, narrow the scope of introducing brokers that would be exempt from certain best execution requirements, and specify the policies and procedures that brokers need to adopt with respect to best execution. The Chair's full statement is available at https://www.sec.gov/news/statement/gensler-best-execution-20221214.

- Commissioner Peirce criticized the proposal for supplanting brokers' judgment with the Commission's own prescriptive approach to achieving best execution. She raised concerns about the proposal overlapping with FINRA's and MSRB's existing best execution rules. The Commissioner also discussed how the proposed rule makes price the broker's primary objective but noted that institutional investors may have other important objectives, such as speed and minimizing the effect of information leakage on price. Commissioner Peirce's full statement is available at https://www.sec.gov/news/statement/peirce-best-execution-20221214.

- Commissioner Crenshaw said the proposal should help provide consistency and clarity with respect to the duty of best execution, while also elevating standards applicable to the conflicted transactions and by better reflecting the role of the introducing broker. She asked the public to comment on whether heightened standards for conflicted transactions should be limited to retail trades only and if the proposed requirements provide too much flexibility to broker-dealers in designing and applying their policies and procedures. Commissioner Crenshaw's full statement is available at https://www.sec.gov/news/statement/crenshaw-insider-trading-20221214-0.

- Commissioner Uyeda said there seems to be an "evidentiary hiatus" regarding any real need for this proposal, arguing that the existing best execution regulatory regimes are working well. He raised concerns about the proposal increasing costs for many market participants, causing retail broker-dealers to reconsider routing outsourcing. He also took issue with the proposal for failing to consider the interplay between the potential adoption of the order execution disclosure, tick size, and order competition proposals. Commissioner Uyeda's full statement is available at https://www.sec.gov/news/statement/uyeda-best-excution-20221214.

- Commissioner Lizárraga said the proposal would improve consistency in best execution practices across asset classes and encourage better execution for customer orders, while also facilitating enhanced regulatory oversight and enforcement by the Commission. Commissioner Lizárraga's full statement is available at https://www.sec.gov/news/statement/lizarraga-rule-605-20221214.

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