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January 12, 2023

SEC Issues Proposal on Tick Sizes, Access Fees, and Transparency of Better Priced Orders

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TO: Closed-End Investment Company Committee
Equity Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee
SEC Rules Committee
Security Valuation Operations Committee RE: SEC Issues Proposal on Tick Sizes, Access Fees, and Transparency of Better Priced Orders

On December 14, 2022, the Securities and Exchange Commission (SEC or "Commission") issued a proposal ("Proposal") to amend certain rules of Regulation National Market System ("Reg NMS") under the Securities Exchange Act of 1934 ("Exchange Act") to adopt variable minimum pricing increments for both the quoting and trading of NMS stocks, reduce the access fee caps, and enhance the transparency of better priced orders.[1] The Proposal is one of four proposals the Commission issued on December 14 that, if adopted, would represent the most sweeping overhaul of the US equity market structure since the adoption of Reg NMS in 2005.[2]

Given the breadth and complexity of the four proposals, we have prepared a separate member memo on each proposal. The proposals are interrelated, however, and it will be important to analyze the implications of each proposal for the others, as well as the implications of the proposals in total. As of today, comments are due on the Proposal and the Auction Proposal on March 31, with the comment deadline for the Best Execution Proposal and Rule 605 Proposal remaining 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. We will hold an initial 75-minute member call on Thursday, January 19, at 12:00 Noon (ET) to discuss these proposals and ICI's response. If you would like to join that call, the Zoom participation information is:

https://ici-org.zoom.us/j/94142244626?pwd=ZWdDNzdiYUlJZkE3SVZzQlRDTmlFdz09

Meeting ID: 941 4224 4626

Passcode: 898596

Amendment to Rule 612 of Reg NMS: Minimum Pricing Increment

The SEC's proposed amendments to Rule 612 of Regulation NMS—the "Sub-Penny Rule"—flow from two primary concerns. First, the SEC notes that the current minimum pricing increment ("tick size") of one penny[3] for displayed quotes has not kept pace with developments in the equity markets and has contributed to the existence of "tick constrained" stocks—stocks that could be priced more aggressively within the spread if tick sizes were smaller. Second, the SEC is concerned that trading volume is being increasingly routed off-exchange to over the counter (OTC) market-making firms because these firms (unlike national securities exchanges and alternative trading systems (ATSs) as a practical matter) can more readily execute trades in sub-penny increments, which Rule 612 currently does not address.[4]

Therefore, for NMS stocks priced at or above $1.00 a share, the SEC proposes to amend the current one-penny tick size to establish a variable "bucketing" approach that would assign tick size increments to NMS stocks based on time-weighted average quoted spread. These tick sizes would apply to bids or offers, orders, and indications of interest, as well as executed trades.[5] Further, these tick sizes would apply to "all trading - on exchanges, ATSs, and OTC."[6]

- If time-weighted average quoted spread was equal to or less than $0.008, then the minimum tick size would be $0.001;
- If time-weighted average quoted spread was greater than $0.008 but equal to or less than $0.016, then the minimum tick size would be $0.002;
- If time-weighted average quoted spread was greater than $0.016 but equal to or less than $0.04, then the minimum tick size would be $0.005; and
- If time-weighted average quoted spread was greater than $0.04, then the minimum tick size would be $0.01.

The time-weighted average quoted spread[7] of an NMS stock would be determined by the stock's primary listing exchange on a quarterly basis over a month-long evaluation period.[8] NMS stocks that trade at prices below $1.00 per share would continue to have a minimum tick size of $0.0001.

The SEC states that the proposed $0.001, $0.002, and $0.005 tick size increments are appropriate based on its belief that many investors are familiar or aware of trades that happen in these increments—in particular, it notes that two of the most common increments for price improvement for OTC trades are $0.001 and $0.002, while price improvement on exchanges and ATSs often occur through midpoint executions in a $0.005 increment. Further, the SEC acknowledges that many market participants have recommended a single $0.005 reduction for tick-constrained stocks, but it believes that this would not address many tick-constrained stocks that currently trade with a $0.011 average quoted spread.

The proposed rule would provide exceptions from these minimum tick size increments for orders that execute at (but are not explicitly priced at) the national best bid and best offer (NBBO) midpoint or the midpoint between the best protected bid and best protected offer (PBBO). Further, the Proposal would provide an exception for orders that execute at a price not based on the quoted price at the time of execution and for which material terms were not reasonably determinable at the time the commitment to execute the order was made, including volume-weighted average price (VWAP) and time-weighted average price (TWAP) trades.[9] The SEC states that midpoint and benchmark orders are widely used and viewed by liquidity providers as important options for handling orders and implementing trading strategies that can reduce the market impact of their trades. Further, the Commission would also retain its authority under Rule 612 to create further exemptions.

The Commission acknowledges several possible alternatives[10] to its proposed tick size regime. For alternatives approaches based on a quoted spread, the SEC is considering:

- Three tick size tiers (instead of four tiers as proposed) of no smaller than $0.0025, $0.005, and $0.01 for NMS stocks with time-weighted average quoted spreads of less than $0.01, greater than $0.01 but equal to or less than $0.02, and greater than $0.02, respectively.
- A two-tiered framework for tick-constrained stocks (i.e., with time-weighted average quoted spreads less than or equal to $0.011). Those stocks would receive a tick size of $0.005, while all other stocks would retain a tick size of $0.01.
- Expansion of the Proposal to also include ticks wider than $0.01 for stocks with spreads wider than $0.04.
- An approach based on the 2019 Nasdaq Intelligent Ticks white paper,[11] where stocks trading with duration weighted average quoted spreads below $0.011 would have a $0.005 tick size; stocks with spreads between $0.01 and $0.02 would have a $0.01 tick size; stocks with spreads between $0.02 and $0.05 would have a $0.02 tick size; stocks with spreads between $0.05 and $0.10 would have a $0.05 tick size; stocks with spreads between $0.10 and $0.25 would have a $0.10 tick size; and stocks with spreads above $0.25 would have a tick size of $0.25.

In addition to these quoted spread-based alternatives, the SEC also is considering other possible approaches, including a uniform $0.005 tick size; variable tick sizes based solely on the share price of a stock;[12] and an approach based on Cboe's proposal, which would apply three criteria to determine if a stock qualifies for a $0.005 tick size: (i) the stock is tick-constrained, i.e., it trades with an average daily quoted spread at or below $0.011; (ii) the stock has a high quote-size-to trade-size ratio; and (iii) the stock has high average daily notional turnover.[13]

With respect to applying the proposed tick sizes to executed trades, the SEC also cites three other possible alternatives, including using a separate $0.0001 trading increment in lieu of relying on the same tick sizes that would apply to quotes; not applying the proposed new tick sizes to trading, thereby maintaining "the current baseline"; and targeting a tick size reduction to or exempting altogether "segmented trades,"[14] such as most retail trades.

Amendments to Rule 610 of Reg NMS: Reduction of Access Fee Cap

The SEC has also proposed amendments to Rule 610 that would reduce the current $0.0030 access fee cap for protected quotations.[15] The SEC states that this reduction is intended to reflect the reduction in trading costs due to market efficiencies since the rule was first adopted and minimize the potential impact of reduced fees and rebates on trading centers' business models. Second, the SEC considers these amendments to be a necessary complement to its proposed minimum tick sizes.[16] The SEC believes that reducing the access fee caps to reflect the proposed tick sizes could have the "ancillary effect" of reducing the rebates exchanges pay to attract order flow.

The Proposal would establish the following variable access fee structure:

- If the price of a protected quotation or other quotation is $1.00 or more, fees could not exceed $0.0005 per share for an NMS stock with a pricing increment of $0.001, and $0.001 per share for an NMS stock with a pricing increment greater than $0.001.
- If the price of a protected quotation or other quotation is less than $1.00, execution fees would not be allowed to exceed 0.05% of the quotation price per share.

These proposed fee caps correspond in part to the SEC's proposed variable minimum tick sizes. However, for quotes of $1.00 or greater, the SEC notes that it is not proposing an individual access fee cap for each of the four proposed tick size increments because it believes doing so would impose unnecessary complexity to exchange fee and rebate schedules. Ultimately, the Proposal seeks to ensure that access fees do not exceed half of the minimum tick size, while preserving the ability of trading centers to use flexible fee structures in maintaining their business models.[17]

Importantly, the Proposal would also prohibit exchanges from imposing fees or providing rebates (or other form of remuneration) for the execution of an order in an NMS stock unless the fee or rebate can be determined at the time of execution. The SEC explains that exchange fees and rebates currently are calculated at the end of each month, which prevents market participants from fully understanding the costs of a transaction at the time of execution. The SEC believes that the uncertainty resulting from this practice has implications elsewhere, such as for broker-dealers conducting best execution analyses or making routing decisions. Therefore, the Commission believes that the Proposal would increase the transparency of exchange fees and reduce broker-dealer conflicts of interest by making it easier to pass rebates on to customers.[18]

The Commission considered alternative access fee caps, including those that would be higher or lower than those proposed for both stocks priced below and above $1.00.[19] The SEC also considered setting access fee caps that apply in proportion to the proposed tick size increments, while maintaining the current proportion of 30% between the current access fee cap of $0.0030 and the current $0.01 tick size increment. Thus, for the proposed $0.001, $0.002, $0.005, and $0.01 tick sizes, the corresponding access fee caps that would apply would be $0.0003 (3 mils), $0.0006 (6 mils), $0.0015 (15 mils), and $0.0030 (30 mils), respectively.[20] Another alternative would impose a uniform $0.0010 (10 mils) access fee cap without regard to tick size. An additional alternative would impose a uniform access fee cap on protected quotes priced at or above $1.00 per share regardless of tick size that would be set as low as possible to allow most exchanges to maintain an estimated 0.0002 (2 mil) net capture on protected transactions. For example, the Commission believes that setting the cap at 3 mils would achieve this objective, while also leaving little to no excess revenue for exchanges to fund rebates or volume-based tiering. For protected quotes priced at less than $1.00, the SEC considered harmonizing the access fee with that for quotes priced at or above $1.00.[21] Finally, the Commission considered explicitly banning rebates, while either leaving the access fee cap unchanged or lowering the fee cap to 10 mils for protected quotes priced equal to or above $1.00.[22]

Transparency of Better Priced Orders

The SEC also proposes to accelerate the inclusion of the new round lot sizes and odd lot quote information into SIP core data, which the SEC previously adopted as part of its final market data infrastructure (MDI) rule in December 2020.[23] The SEC notes that this process will be significantly delayed due to the MDI rule's current implementation schedule, which assumed that competing consolidators to be operational and collecting, calculating, and disseminating market data in place of the exclusive SIPs, among other steps.[24] Therefore, the SEC seeks to accelerate this implementation by requiring the exclusive SIPs to take steps to disseminate the new round lot and odd lot data as part of SIP core data.[25]

The new round lot sizes are as follows:

Stock Price Group	Round Lot Size
$0.00 - $250.00	100 shares
$250.01 - $1000.00	40 shares
$1000.01 - $10,000.00	10 shares
$10,000.01 +	1 share

Odd-lot quote data, which would be included following the introduction of the new round-lot sizes, consists of all odd-lot quotes that are priced at or better than the NBBO, aggregated at each price level at each exchange.[26]

The SEC also proposes to require the exclusive SIPs (and later, competing consolidators and self-aggregators) to calculate and disseminate a specified best odd-lot order to buy and a best odd-lot order to sell (BOLO). For each NMS stock, the best odd-lot order to buy would be "the highest priced odd-lot order to buy that is priced higher than the national best bid," and the best odd-lot order to sell would be "the lowest priced odd-lot order to sell that is priced lower than the national best offer."[27] If two or more national securities exchanges or securities associations provide odd-lot orders at the same price, then the exclusive SIPs, would determine the best odd-lot order by ranking all odd-lot buy orders or sell orders based on size (giving the higher ranking to the biggest order), and then based on time (giving the higher ranking to the order that was received first).[28] The SEC states that determining the best odd-lot price among multiple prices that are better than the NBBO would enhance the ability of market participants to trade and route orders effectively, as well as facilitate best execution.

The proposed compliance date for these amendments would be 90 days from Federal Register publication of any applicable Commission final rule adoption.

Sarah A. Bessin
Deputy General Counsel - Markets, SMAs & CITs

Nhan Nguyen
Assistant General Counsel, Securities Regulation

Thomas Archer
Legal Intern

Notes

[1] See Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, Securities Exchange Act Release No. 34-96494, available at https://www.sec.gov/rules/proposed/2022/34-96494.pdf ("Proposing Release").

[2] See Regulation Best Execution, Exchange Act Release No. 34-96496 (Dec. 14, 2022) ("Best Execution Proposal"), available at https://www.sec.gov/rules/proposed/2022/34-96496.pdf; Order Competition Rule, Exchange Act Release No. 34-96945 (Dec. 14, 2022) ("Auction Proposal"), available at https://www.sec.gov/rules/proposed/2022/34-96495.pdf; Disclosure of Order Execution Information, Exchange Act Release No. 34-96493 (Dec. 14, 2022) ("Rule 605 Proposal"), available at https://www.sec.gov/rules/proposed/2022/34-96493.pdf.

[3] Rule 612 currently prohibits displaying, ranking, or accepting a "bid or offer, an order, or an indication of interest" in an NMS stock trading at or above $1.00 that is priced in increments less than one penny. See 17 C.F.R. 242.612(a).

[4] See Proposing Release at 12.

[5] See Proposed 17 C.F.R. 242.612(b).

[6] Proposing Release at 72.

[7] "Time-weighted average quoting spread" would be defined under new Rule 612(a) to mean "the average dollar value difference between the NBB and 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." See Proposing Release at 345.

[8] The evaluation period would be defined under the new Rule 612(a) to mean "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 shall measure 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, as set forth by paragraph (c) of this section." See Proposing Release at 345.

[9] Proposing Release at 72-73.

[10] See Proposing Release at 280. The SEC also proposes to add to any quoted spread approach a "step-up/step-down" mechanism to prevent stocks from transitioning more than one tick size tier at a time.

[11] Nasdaq, Intelligent Ticks: A Blueprint for a Better Tomorrow (2019), available at https://www.nasdaq.com/docs/2019/12/16/Intelligent-Ticks.pdf.

[12] The SEC suggests the following price tiers and associated tick sizes: (i) stocks priced at less than $1 would have a tick size of $0.0001; (ii) stocks priced between $1 and $10 would have a tick size of $0.001; (iii) stocks priced between $10 and $50 would have a tick size of $0.005; and (iv) stocks greater than $50 would have a $0.01 tick size.

[13] Cboe, Cboe Proposes Tick-Reduction Framework to Ensure Market Structure Benefits all Investors (2022), available at https://www.cboe.com/insights/posts/cboe-proposes-tick-reduction-framework-to-ensure-market-structure-benefits-all-investors/.

[14] The SEC suggests defining "segmented orders" in this context as orders for the account of a natural person or an account held in legal form on behalf of a natural person or group of related family members, where the average daily number of trades executed in NMS stocks must be less than 40 in each of the preceding six calendar months. The SEC states that this definition is intended to capture marketable orders of individual investors.

[15] Access fee caps would continue to only apply to executions against protected quotations, so the fees of non-exchange trading centers (e.g., ATSs or OTC market makers that do not display protected quotes) would not be subject to Rule 610(c) access fee caps. Proposing Release at n. 286.

[16] According to the SEC, if the proposed tick size increments were adopted without adjusting the $0.0030 current access fee cap, then access fees would account for a larger proportion of a per share quotation price than they currently do, which the Commission believes "could lead to unintended market distortions and undermine price transparency." Proposing Release at 95-96. The Commission provides an example of this, stating that "[i]f the access fee cap for protected quotations that have a minimum pricing increment of $0.001 were kept at the current level of $0.0030, an access fee set at the maximum allowed under rule 610(c) would add an undisplayed additional three ticks per share to the displayed price." See Proposing Release at 99.

[17] Proposing Release at 97-98.

[18] Proposing Release at 96. The Commission reasons that greater transparency would result in customers benefiting from rebates because broker-dealers, who could more readily pass fees and rebates to customers, would no longer have a direct financial interest in the level of the rebate and would be able to better assess best execution for each customer's order. See Proposing Release at 96 n.290.

[19] See Proposing Release beginning at 296.

[20] Proposing Release at 300.

[21] This would mean, for example, that an access fee cap of 10 mils on transactions greater than $1.00 would be accompanied by an access fee cap of 0.10% for transactions below $1.00. See Proposing Release at note 715.

[22] Proposing Release at 307.

[23] For a summary of the final MDI rule, please see ICI Memorandum No. 33240 (March 17, 2021), available at https://www.ici.org/memo33240.

[24] The SEC estimates that under the current implementation schedule, the new round lot

sizes would not be introduced until at least two years after the relevant NMS equity data plans are amended and approved, which has not yet occurred.

[25] For example, quotation sizes in SIP data are currently presented in terms of the number of round lots. Under the new round lot sizes, the SEC believes that this approach would likely be confusing. Therefore, the Commission is proposing to require exclusive SIPs to "represent quotation sizes in SIP data in terms of the number of shares and to round quotation sizes, except for odd-lot quotations, down to the nearest multiple of a round lot." Proposing Release at 132.

[26] Aggregated odd-lot quote data would also be presented in another way: a BBO, NBBO, and depth of book would include odd-lot quotes aggregated across multiple prices that, when aggregated, are equal or greater than a round lot size, would be disseminated at the least aggressive price. As a result, odd-lots priced at or better than the NBBO could be both included in the NBBO and displayed in the aggregate at each price level by exchange.

[27] Proposing Release at 141-42.

[28] Proposing Release at 142.