

**MEMO# 34802**

January 12, 2023

## **SEC Proposes Order Competition Rule**

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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 Proposes Order Competition Rule

On December 14, 2022, the SEC proposed the Order Competition Rule ("Proposal"), which would add proposed Rule 615 to Regulation National Market System ("Reg NMS").<sup>[1]</sup> The Proposal would require that individual investor orders be exposed to "qualified auctions," as established by proposed Rule 615, before being executed internally by trading centers, such as wholesalers and internalizing broker-dealers. 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.<sup>[2]</sup>

Given the breadth and complexity of the four proposals, we have prepared a separate member memo on each proposal. This memorandum will detail proposed Rule 615. 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 Tick Size 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=ZWdDNzdiYUIjZkE3SVZzQIRDtMlFdz09>

Meeting ID: 941 4224 4626

Passcode: 898596

While the Proposal directly impacts retail order flow and certain broker-dealers, there are likely secondary impacts to asset managers. We are interested in members' reactions to the Proposal. For example, a fundamental premise of the Proposal is that institutional

investors, primarily asset managers, will step into the auctions to execute against the retail order flow required to be routed to the auctions. We are interested in members' feedback as to whether the SEC's assumption is accurate. We are also interested in members' feedback as to how this Proposal, if adopted, would affect firms' execution quality and available liquidity. A summary of the Proposal is below.

## **The Operation of Qualified Auctions Under the Proposal**

Proposed Rule 615 would prohibit a "restricted competition trading center"[\[3\]](#) from internally executing a "segmented order"[\[4\]](#) for a national market system (NMS) security until after a broker-dealer exposes the order to competition at a specified limit price in a "qualified auction"[\[5\]](#) operated by an "open competition trading center,"[\[6\]](#) unless an exception applies. A restricted competition trading center would be permitted to execute, as soon as reasonably possible, the segmented order internally, at a price equal to or more favorable for the segmented order than the specified limit price provided to the qualified auction, only if the order fails to execute in the qualified auction.

Proposed Rule 615(c) would govern five aspects of a qualified auction, which could be operated only by national securities exchanges and NMS Stock ATSS that meet the definition of an open competition trading center. The five aspects governed by Rule 615(c) are: auction messages, auction responses, pricing increments, fees and rebates, and auction execution priority. Each proposed requirement is detailed further below.

### **Auction Messages**

The auction message would announce the beginning of the qualified auction and would be required to be disseminated in consolidated market data. Each auction message would include the following information:

- Disclosure that the auction is for a segmented order;
- Identity of the open competition trading center;
- NMS stock symbol;
- Side (either buy or sell);
- Size of the order;
- Limit price; and
- Identity of the originating broker.

If there is more than one broker that qualifies as an "originating broker," then the designation of the originating broker would fall to the broker-dealer responsible for approving the opening of accounts with customers.[\[7\]](#) The SEC recognizes that some originating brokers or their customers may not wish to have the identity of the originating broker publicly disseminated. In these circumstances, the originating broker could either allow its identity to be disclosed in an auction message or it could withhold this information by certifying that it has established, maintained, and enforced written policies and procedures reasonably designed to assure that its identity will not be disclosed, directly or indirectly, to any person that potentially could participate in the qualified auction or otherwise trade with the segmented order, and the originating broker's certification is communicated to the open competition trading center conducting the auction.

### **Auction Responses**

Proposed Rule 615(c) would mandate that once an auction message is disseminated in consolidated market data, a qualified auction must be no shorter than 100 milliseconds and

no longer than 300 milliseconds. According to the Proposal, the Commission expects that most individual investors will submit their orders manually to their broker-dealers, so the proposed time frame is intended to ensure that investors' segmented orders are exposed to competition for order flow while being executed as close as possible to the best available price at the time the investor submitted their order. Auction responses would remain undisplayed during the auction period and would not be disseminated at any time thereafter to prevent information leakage and prevent market participants with the fastest systems from observing prices and submitting their auction response at the end of the auction period.

### **Pricing Increment**

Pricing increments for segmented orders would differ based on the share price of the order. Segmented orders and auction responses priced at \$1.00 or more per share would be priced in increments of \$0.001. Segmented orders and auction responses priced at less than \$1.00 per share would be priced in increments of \$0.0001. Alternatively, prices could be submitted at the national best bid and best offer (NBBO) midpoint price.

### **Fees and Rebates**

Proposed Rule 615(c) would implement rules for fees and rebates of open competition trading centers with respect to qualified auctions. First, no fee could be charged for submission or execution of a segmented order, or for submission of an auction response. Second, the fee for execution of an auction response could not exceed \$0.0005 per share for auction responses priced at \$1.00 per share or more, could not exceed 0.05% of the auction response price per share for auction responses priced at less than \$1.00 per share, and otherwise would have to be the same rate for executed auction responses in all auctions. Third, and similarly, any rebate for the submission or execution of a segmented order or for the submission or execution of an auction response could not exceed \$0.0005 per share for segmented orders or auction responses priced at \$1.00 per share or more, could not exceed 0.05% of the segmented order or auction response price per share for segmented orders or auction responses priced at less than \$1.00 per share, and otherwise must be the same rate for segmented orders in all auctions and must be the same rate for auction responses in all auctions. The SEC believes that open competition trading centers could fund their operation of qualified auctions solely through imposing fees on auction responses that execute against segmented orders.

### **Auction Execution Priority**

Proposed Rule 615(c) would specify five proposed requirements for the execution priority of auction responses and orders resting on the continuous order book of an open competition trading center:

1. The most favorable price for the segmented order would have priority of execution.
2. Customer accounts would have priority with respect to their auction responses. This means that, for example, if a customer account (including that of an asset manager) and a broker-dealer account both have the best price in an auction response, the customer account's auction response would have execution priority.
3. The proposed rule would prohibit a time priority to prevent auctions from turning into speed races.
4. The rule would prohibit giving priority to the originating broker, the broker-dealer who

routed the order to the auction, the open competition trading center operating the auction, or any affiliate of those entities.

5. The proposed rule would govern how auction responses integrate with the continuous book of an open competition trading center. Orders resting on a continuous order book would have priority over auction responses at a less favorable price for the segmented order. Displayed orders resting on a continuous book would have priority over auction responses at the same price, whereas undisplayed orders resting on a continuous book would not have priority over auction responses at the same price.

In addition to the preceding execution priority requirements, open competition trading centers would have flexibility to develop additional execution priority rules for their auction mechanisms, as long as they are consistent with the proposed requirements.

## **Exceptions to Proposed Rule 615**

The SEC proposes five exceptions to proposed Rule 615's qualified auction requirements. If any of the following exceptions apply, a restricted competition trading center may internally execute a segmented order for an NMS stock without exposing the order to competition in a qualified auction. These five exceptions are:

1. If no open competition trading centers are operating qualified auctions when the restricted competition trading center receives the order, the segmented order would not be subject to the auction requirement. It is notable that proposed Rule 615 does not specify any particular time period during which an open competition trading center must operate a qualified auction, but pursuant to the proposed rule such auction can only be operated when facilities for consolidated market data dissemination are open, which currently is 4 am to 8 pm ET.
2. If the market value of the segmented order is at least \$200,000, as measured by the midpoint price of the NBBO at the time of order receipt, the segmented order would not be subject to the auction requirement. While these larger orders are eligible for an exception, they still would meet the definition of a segmented order and could be routed for execution to a qualified auction if the broker-dealer handling the order determines that such routing would promote best execution of the segmented order.
3. If the restricted competition trading center can execute the segmented order at a price that is equal to or better than the NBBO midpoint price as measured at the time of order receipt, the segmented order would not be subject to the auction requirement.
4. If the segmented order is a limit order where the customer set a limit price that is equal to or better than the NBBO midpoint price for the segmented order as measured at the time of order receipt, the segmented order would not be subject to the auction requirement.
5. If the segmented order is for a fractional share or has a fractional share component, that fractional share or fractional share component would not be subject to the auction requirement.

Notably, the SEC explicitly states in the Proposal that there is no exception for orders directed by a customer to a particular restricted competition trading center for execution. Further, while not an exception per se, the SEC clarifies that proposed Rule 615 only applies to segmented orders executed at restricted competition trading centers and the definition of "restricted competition trading center" explicitly excludes open competition trading centers and national securities exchanges. To the extent consistent with their best execution responsibilities, broker-dealers would be permitted to route segmented orders directly to any national securities exchange without first routing the order to a qualified

auction. In the Proposal, the SEC gives the example of a broker-dealer operating in a market in which prices are moving rapidly away from a segmented order and the broker-dealer believes that obtaining a better price in a qualified auction is unlikely. The SEC explains that, in that situation, the broker-dealer could route a segmented order directly to execute against the best available price available at a national securities exchange.[\[8\]](#)

## **Specific Rules Under the Proposal**

The Proposal would also impose specific rules on national securities exchanges, NMS Stock ATSs, originating brokers, and broker-dealers more generally.

### **National Securities Exchanges and NMS Stock ATSs**

Proposed Rule 615(d)(1) would prohibit a national securities exchange or an NMS Stock ATS from operating a qualified auction for segmented orders unless it complied with the provisions of Rule 615 and met the definition of "open competition trading center." Further, national securities exchanges, pursuant to proposed Rule 615(g), and open competition trading centers, pursuant to proposed Rule 615(d)(2), would be prohibited from operating a system, other than a qualified auction, that is limited, either in whole or in part, to the execution of segmented orders. Each prohibition contains an exception for systems limited to executing segmented orders that fit within one of the five proposed exceptions to Rule 615 discussed above. These proposed prohibitions are intended to prevent national securities exchanges and open competition trading centers from operating venues that would siphon segmented order flow away from qualified auctions.

### **Originating Brokers and Broker-Dealers Generally**

Proposed Rule 615(e) would require originating brokers to:

1. Establish, maintain, and enforce written policies and procedures reasonably designed to identify the orders of customers as segmented orders;
2. Not route a customer order identified as a segmented order without identifying the order as segmented to the routing destination; and
3. If the originating broker made a certification to prevent disclosure of its name in an auction message, the broker must establish, maintain, and enforce written policies and procedures reasonably designed to assure that the identity of the originating broker will not be disclosed, directly or indirectly, to any person that could participate in the qualified auction or otherwise trade with the segmented order.

Proposed Rule 615(f) would impose the following requirements on all brokers-dealers:

1. In receiving an order identified as a segmented order, the broker or dealer may not route the segmented order without identifying it as such to the routing destination; and
2. If the broker-dealer knows where the segmented order will be routed, the broker-dealer would not be allowed to submit an order to the continuous order book of an open competition trading center or national securities exchange that could have priority to trade with the segmented order.

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## Notes

[1] Order Competition Rule, Exchange Act Release No. 34-96495 (Dec. 14, 2022) ("Proposing Release"), available at <https://www.sec.gov/rules/proposed/2022/34-96495.pdf>.

[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>; Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, Exchange Act Release No. 34-96494 (Dec. 14, 2022) ("Tick Size Proposal"), available at <https://www.sec.gov/rules/proposed/2022/34-96494.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] The SEC proposes to define "restricted competition trading center" in Rule 600(b)(87) as any trading center that is not an open competition trading center or national securities exchange.

[4] The SEC proposes to define a "segmented order" in Rule 600(b)(91), as an order for an NMS stock that is 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 in which the average daily number of trades executed in NMS stocks was less than forty in each of the six preceding months.

[5] The SEC proposes to define a "qualified auction" in Rule 600(b)(81), as an auction operated by an open competition trading center pursuant to Rule 615(c).

[6] The SEC proposes to define "open competition trading center" in Rule 600(b)(64), as one of two entities. First, a national securities exchange that: (i) operates a self-regulatory organization (SRO) trading facility that is an automated trading center and displays automated quotations that are disseminated in consolidated market data; (ii) provides transaction reports disseminated in consolidated market data identifying the national securities exchange as the venue of execution; (iii) has an average daily share volume of 1.0 percent or more of the aggregate average daily share volume for all NMS stocks as reported by an effective transaction reporting plan during at least four of the preceding six calendar months; and (iv) has internal rules governing a "qualified auction" including compliance with proposed Rule 615(c). Second, an open competition trading center would include an NMS Stock ATS that: (i) displays quotations through an SRO display-only facility (currently, the only such facility is FINRA's ADF); (ii) operates as an automated trading center and displays automated quotations that are disseminated in consolidated market data; (iii) provides transaction reports identifying the NMS Stock ATS as the venue of execution that are disseminated in consolidated market data; (iv) allows any registered broker-dealer to become a subscriber, subject to narrow exceptions; (v) provides equal access among all subscribers of the NMS Stock ATS and the registered broker-dealer of the NMS Stock ATS to all services that are related to a "qualified auction" and to any continuous

order book; (vi) has an average daily share volume of 1.0 percent or more of the aggregate average daily share volume for NMS stocks as reported by an effective transaction reporting plan during at least four of the preceding six calendar months; and (vii) operates pursuant to an effective Form ATS-N and, with regard to any "qualified auction," the Form ATS-N sets forth the operations of its "qualified auction" and compliance with the requirements of proposed Rule 615(c), as well as the requirements above.

[\[7\]](#) The SEC proposes to define "originating broker" in Rule 600(b)(69) as "any broker with responsibility for handling a customer account, including, but not limited to, opening and monitoring the customer account and accepting and transmitting orders for the customer account."

[\[8\]](#) Proposing Release at 76.

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