

**MEMO# 34805**

January 13, 2023

## **SEC Proposes Regulation Best Execution**

[34805]

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TO: Closed-End Investment Company Committee

Equity Markets Advisory Committee

ETF (Exchange-Traded Funds) Committee

Fixed-Income Advisory Committee

Municipal Securities Advisory Committee

SEC Rules Committee

Security Valuation Operations Committee RE: SEC Proposes Regulation Best Execution

On December 14, 2022, the Securities and Exchange Commission (SEC or "Commission") proposed Regulation Best Execution ("Proposal"), which would establish a new Commission standard regarding a broker-dealer's duty of best execution.[\[1\]](#) While the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB) already have rules and guidance directly addressing the duty of best execution, the SEC believes that an additional regulatory regime at the SEC level governing best execution would result in better execution quality and otherwise be beneficial, particularly for enforcement purposes.[\[2\]](#) While a large portion of the rule aligns with the FINRA and MSRB best execution standards, there are important distinctions between the Proposal and existing FINRA and MSRB regimes, including additional compliance and recordkeeping obligations for broker-dealers. As discussed in more detail below, Regulation Best Execution would add additional obligations for retail customer transactions that present conflicts of interest, such as payment for order flow[\[3\]](#) or internalization.

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 Regulation NMS in 2005.[\[4\]](#) Given the breadth and complexity of the four proposals, we have prepared a separate member memorandum on each proposal. This memorandum summarizes Regulation Best Execution. 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, the comment deadlines for the Proposal and the Rule 605 Proposal will remain open until March 31, 2023, or 60 days after the date of publication of the proposing release in the Federal Register, whichever is later. Comments on the Tick Size Proposal and the Auction Proposal are due on March 31.

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 costs and burdens associated with the Proposal will directly impact broker-dealers, there likely would be secondary impacts to asset managers. For example, asset managers' orders would need to be routed in accordance with this best execution standard. Do members believe that this more prescriptive approach may impact order execution quality as compared to the current FINRA and MSRB standards? Additionally, what level of due diligence do asset managers believe may be required of them in reviewing broker-dealer best execution reports, assuming asset managers are able to obtain such best execution reports from broker-dealers? Regarding costs, the SEC estimates that the Proposal would cost the broker-dealer community approximately \$300 million to comply for the first year and \$150 million each year thereafter. Do members have concerns that these costs would be indirectly borne by asset managers (through increased commissions or otherwise), and potentially by retail investors through increased fees or expenses? We are interested in members' feedback on these and other issues raised by the Proposal. A summary of the Proposal is below.

## **The Best Execution Standard**

Proposed Rule 1100 would set forth the best execution standard for broker-dealers. Specifically, proposed Rule 1100 states that, in any transaction for or with a customer, or a customer of another broker-dealer, a broker-dealer,<sup>[5]</sup> or a natural person who is an associated person of a broker-dealer, must use reasonable diligence to ascertain the best market for the security,<sup>[6]</sup> and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.<sup>[7]</sup> The proposed Rule 1100 best execution standard would apply to securities transactions for or with a broker-dealer's own customers, as well as securities transactions for or with customers of another broker-dealer. The proposed best execution standard would apply to transactions for or with a customer, regardless of whether the broker-dealer is transacting for or with the customer on an agency basis or in a principal capacity.<sup>[8]</sup> Further, the proposed best execution standard would apply to both retail and institutional customer orders.

While the proposed best execution standard is consistent with FINRA's and MSRB's best execution standards,<sup>[9]</sup> the prescriptive, detailed compliance requirements, as well as the interpretive scope, certain exemptions, and applicability of proposed Regulation Best Execution differ from that of the FINRA and MSRB standards, as they have been interpreted. For example, while the MSRB exempts transactions with sophisticated municipal market participants (SMMPs)<sup>[10]</sup> from its best execution rule, the SEC proposes no similar exemption from Regulation Best Execution.<sup>[11]</sup> The SEC asks whether it should provide a broader exemption from the proposed best execution standard under Rule 1100 for a broker-dealer when it engages in any transaction for or with institutional customers, similar to MSRB's exemption for broker-dealers and municipal securities dealers transacting with SMMPs.<sup>[12]</sup>

Rule 1100, and the associated rules proposed under Regulation Best Execution, would not supplant FINRA or MSRB's best execution rules and requirements. Thus, a broker-dealer would be required to comply with proposed Regulation Best Execution in addition to its existing obligations under FINRA and MSRB's best execution regimes, as applicable.

Proposed Rule 1100 would provide three exemptions from the best execution standard. A broker-dealer would not be subject to the best execution standard when: (i) another broker-dealer is executing a customer order against the broker-dealer's quotation (i.e., the broker-dealer is acting in a market-maker, specialist, or other similar liquidity provider capacity); (ii) an institutional customer, exercising independent judgment, executes its order against the broker-dealer's quotation;[\[13\]](#) or (iii) the broker-dealer receives an unsolicited instruction from a customer to route that customer's 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 (i.e., directed orders).[\[14\]](#)

## **The Best Execution Policies and Procedures**

While both FINRA's and MSRB's rules require broker-dealers to have policies and procedures to comply with, respectively, FINRA and MSRB rules, as well as with the federal securities laws and applicable regulations, FINRA's and MSRB's requirements regarding policies and procedures are not as specific as Regulation Best Execution's proposed requirements.[\[15\]](#) For example, neither FINRA nor MSRB require broker-dealers' best execution policies and procedures to include specific elements. The SEC notes that while broker-dealers may currently have policies and procedures in place to ascertain the best market for a security, such policies and procedures may need to be updated to specifically address the elements specified in proposed Rule 1101.[\[16\]](#)

Proposed Rule 1101(a)(1) would require a broker-dealer's best execution policies and procedures to address how it will comply with the proposed best execution standard by: (i) obtaining and assessing reasonably accessible information, including information about price, volume, and execution quality, concerning the markets trading the relevant securities; (ii) identifying markets that may be reasonably likely to provide the most favorable prices for customer orders ("material potential liquidity sources"); and (iii) incorporating material potential liquidity sources into the broker-dealer's order handling practices and ensuring that it can efficiently access each such material potential liquidity source.

While the SEC does not explicitly state that a market providing auction-style price improvement will be the market most favorable for customer orders, it strongly suggests that it believes that would be the case.[\[17\]](#) Further, the SEC notes that when a broker-dealer is identifying potential liquidity sources, there is no requirement to set a minimum number of markets but rather a broker-dealer should follow its policies and procedures in assessing reasonably accessible information to determine material potential liquidity sources that would allow for best execution. The SEC explicitly states that quotation data made publicly available must be considered when seeking best execution of customer orders, but that broker-dealers should consider whether consolidated trade information, exchange proprietary data feeds, odd lot market data, and broker and exchange reports are needed to make best execution determinations.[\[18\]](#) In making best execution determinations, the broker-dealer may take into consideration the handling and execution of the size of the order, whether institutional or retail, as well as fees charged for connectivity, market data, and executing.

Proposed Rule 1101(a)(2) would require a broker-dealer's best execution policies and

procedures to address how it will determine the best market and make routing or execution decisions for customer orders that it receives by: (i) assessing reasonably accessible and timely information with respect to the best displayed prices, opportunities for price improvement, including midpoint executions, and order exposure opportunities that may result in the most favorable price; (ii) assessing the attributes of customer orders and considering the trading characteristics of the security, the size of the order, the likelihood of execution, the accessibility of the market, and any customer instructions in selecting the market most likely to provide the most favorable price; and (iii) in determining the number and sequencing of markets to be assessed, reasonably balancing the likelihood of obtaining better prices with the risk that delay could result in worse prices.

The SEC notes that in determining the best market for customer orders, the assessment of reasonably accessible and timely information with respect to the best displayed prices and opportunities for price improvement would vary depending on the trading characteristics of particular securities. Further, with regard to order handling, the SEC acknowledges that not all customer orders have the same attributes or size and that a broker-dealer's best market determination will be affected by such attributes. The SEC provides the specific example of a broker-dealer handling and executing large orders and how sensitivity to information leakage and price impact may be paramount and, therefore, any "best market determination" may be designed to minimize those risks.[\[19\]](#) The SEC further notes that a broker-dealer's policies and procedures should address how the broker-dealer will implement handling and execution instructions given by customers.

## **Policies and Procedures and Documentation for Conflicted Transactions**

Proposed Rule 1101(b) would impose a new regulatory requirement that is not part of either FINRA's or MSRB's best execution regimes. Proposed Rule 1101(b) would require a broker-dealer's best execution policies and procedures to address additional considerations with respect to "conflicted transactions." A "conflicted transaction" would be defined as any "transaction for or with a retail customer"[\[20\]](#) where a broker-dealer: (i) executes an order as principal, including riskless principal; (ii) routes an order to, or receives an order from, an affiliate for execution; or (iii) provides or receives "payment for order flow."[\[21\]](#)

If a broker-dealer engages or intends to engage in "conflicted transactions," proposed Rule 1101(b) would require a broker-dealer's best execution policies and procedures to address: (i) how the broker-dealer will obtain and assess information beyond that required by proposed Rule 1101(a), including additional information about price, volume, and execution quality, in identifying a broader range of markets beyond those identified as material potential liquidity sources; and (ii) how the broker-dealer will evaluate a broader range of markets, beyond those identified as material potential liquidity sources, that might provide the most favorable price for customer orders, including a broader range of order exposure opportunities and markets that may be smaller or less accessible. While the intent of proposed Rule 1101(b) is to require a broker-dealer to consider a broader range of markets for conflicted transactions than it otherwise would, the SEC notes that it is possible that a broker-dealer may obtain and assess information beyond what is needed to identify material potential liquidity sources for non-conflicted transactions and may not have additional information or markets to assess.[\[22\]](#)

Beyond policy and procedure requirements, proposed Rule 1101(b) would also require a broker-dealer to document its compliance with the best execution standard for conflicted transactions, including all efforts taken to enforce its policies and procedures for conflicted

transactions and the basis and information relied on for its determination that the conflicted transactions would comply with the best execution standard. This documentation would need to be done in accordance with written procedures. The SEC believes that, in connection with documenting its compliance, the broker-dealer could document the prices received from those markets that it checked pursuant to its policies and procedures. Finally, proposed Rule 1101(b) would require a broker-dealer to document any arrangement, whether written or oral, concerning payment for order flow including, but not limited to, the parties to the arrangement, all qualitative and quantitative terms concerning the arrangement, and the date and terms of any changes to the arrangement.

## **Introducing Broker Exception**

Proposed Rule 1101(d) would permit a broker-dealer that qualifies as an "introducing broker"[\[23\]](#) to rely on its executing broker to comply with proposed Rule 1101, subject to certain requirements. Because introducing brokers do not handle or execute customer orders in a manner that would warrant the application of proposed Rule 1101, the Commission proposes to permit introducing brokers to rely on their executing brokers for purposes of complying with proposed Rule 1101. An introducing broker would need to establish, maintain, and enforce policies and procedures that provide for regular review of the execution quality obtained from its executing broker. Further, the introducing broker's policies and procedures would need to provide for comparisons of the executing broker's execution quality with the execution quality it might have obtained from other executing brokers as well as require revision of its order handling practices if its execution quality comparison shows that a change is warranted. This execution quality review, and its results, must be documented, which the SEC believes would assist the introducing broker and regulators by helping to ensure that the introducing broker maintains and retains a robust record of execution quality.

While executing brokers are not required to share their execution quality reviews or annual reports (which are discussed in the next section below), the SEC believes that executing brokers are likely to share or provide those documents to introducing brokers. The SEC believes, without support, that executing brokers would have an incentive to provide introducing brokers with accurate and comparable execution quality information due to their financial interest in potentially providing such introducing brokers with order handling and execution services.[\[24\]](#) The SEC therefore suggests that an introducing broker may want to consider requiring the executing broker to fully disclose its execution quality reviews to the introducing broker as well as obtain execution quality information from other executing brokers that could have handled and executed the introducing broker's customer orders.[\[25\]](#)

## **Review and Recordkeeping Requirements**

### **Regular Review of Execution Quality**

Proposed Rule 1101(c) would require a broker-dealer that engages in any transaction for or with a customer or a customer of another broker-dealer to, no less frequently than quarterly, review the execution quality of its transactions, and how such execution quality compares with the execution quality the broker-dealer might have obtained from other markets. Broker-dealers would need to revise their best execution policies and procedures accordingly, including order handling and routing practices, as well as document the results of the review.

## **Annual Report Requirement**

Proposed Rule 1102 would require a broker-dealer that effects any transaction for or with a customer or a customer of another broker-dealer to, no less frequently than annually, review and assess the design and overall effectiveness of its best execution policies and procedures, including its order handling practices. Although proposed Rule 1101(c) would require a broker-dealer to implement minimum quarterly reviews of execution quality, the annual review requirement in proposed Rule 1102 would be a broader, more holistic review of the broker-dealer's policies and procedures, not focused solely on execution quality. The annual Rule 1102 review and assessment would be required to be conducted in accordance with written procedures, documented, and would result in a written report detailing the results of such review and assessment, including a description of all deficiencies found and any plan to address such deficiencies. This report would be required to be presented to the board of directors (or equivalent governing body) of the broker-dealer.

## **Recordkeeping Requirements**

Proposed Regulation Best Execution would require broker-dealers to make the following records:

- Policies and procedures under proposed Rules 1101(a), (b), and (d) and Rule 1102;
- Documentation of compliance with the best execution standard for conflicted transactions under proposed Rule 1101(b);
- Documentation of payment for order flow arrangements under proposed Rule 1101(b);
- Documentation of the results of the regular review of execution quality under proposed Rule 1101(c);
- Documentation of the results of the regular review of execution quality by introducing brokers under proposed Rule 1101(d);
- Documentation of the annual review under proposed Rule 1102; and
- Annual report under proposed Rule 1102.

Current Rule 17a-4(e)(7) would apply to the policies and procedures required by proposed Regulation Best Execution. The SEC also proposes to amend Rule 17a-4 to add new paragraph (b)(17) to require broker-dealers to preserve all other records made pursuant to proposed Rules 1101 and 1102 for a period of not less than three years, the first two years in a readily accessible place.

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## **Notes**

[1] Regulation Best Execution, Exchange Act Release No. 34-96496 (Dec. 14, 2022) ("Proposing Release"), available at <https://www.sec.gov/rules/proposed/2022/34-96496.pdf>.

[2] Proposing Release at 305.



[3] It is important to note that "payment for order flow" would also include rebates from exchanges in addition to standard payments for order flow.

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

[5] "Broker-dealer" includes a broker, dealer, government securities broker, government securities dealer, or municipal securities dealer.

[6] This includes all securities (other than exempted securities (exclusive of government and municipal securities) or commercial paper, bankers' acceptances, or commercial bills). The Proposal specifically mentions equities, SEC-regulated options, fixed income securities, government securities, municipal securities, and crypto asset securities. "Crypto asset securities" would be any digital asset that is issued and/or transferred using distributed ledger or blockchain technology meeting the definition of "security."

[7] The SEC notes that investment advisers, as part of their fiduciary duty, have a duty to seek best execution of a client's transactions where the adviser has responsibility to select broker-dealers to execute client trades. Proposing Release at n.11. The Commission asks: (i) whether the proposed best execution standard would pose any challenges or burdens for entities that are dually-registered broker-dealers and investment advisers; and (ii) what effect, if any, the proposed best execution standard would have on investment advisers and their duty to seek best execution. Proposing Release at 57 (Question 10).

[8] This means that if a wholesaler is executing as principal against a customer order routed to the wholesaler for execution, it would still need to ascertain that the retail customer order was receiving best execution.

[9] FINRA Rule 5310(a)(1) provides that, in any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject 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. MSRB Rule G-18(a) provides that, in any transaction in a municipal security for or with a customer or a customer of another broker, dealer, or municipal securities dealer, a broker-dealer must use reasonable diligence to ascertain the best market for the subject security and buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.

[10] MSRB Rule D-15 defines an SMMP by three requirements: the nature of the customer; a determination of sophistication by the dealer; and an affirmation by the customer. Specifically, the MSRB rule states that the customer must be: (i) a bank, savings and loan association, insurance company, or registered investment company; (ii) an investment adviser registered either with the Commission under section 203 of the Investment Advisers Act of 1940 or with a state securities commission; or (iii) any other person or entity with total assets of at least \$50 million. To achieve a determination of customer sophistication, the broker-dealer must have a reasonable basis to believe that the customer is capable of evaluating investment risks and market value independently, both in general and with

regard to particular transactions and investment strategies in municipal securities. Finally, the customer must affirmatively indicate that it is exercising independent judgment in evaluating: (a) the recommendations of the broker-dealer; (b) the quality of execution of the customer's transactions by the broker-dealer; and (c) the transaction price for non-recommended secondary market agency transactions as to which (i) the broker-dealer's services have been explicitly limited to providing anonymity, communication, order matching, and/or clearance function and (ii) the broker-dealer does not exercise discretion as to how or when the transactions are executed. The affirmation may be given orally or in writing and may be given on a transaction-by-transaction basis, a type-of-municipal security basis, or an account-wide basis.

[\[11\]](#) See MSRB Rule G-48(e).

[\[12\]](#) Proposing Release at 60 (Question 21).

[\[13\]](#) Regarding the second exemption, the SEC notes that in the corporate and municipal bond and government securities markets, institutional customers often handle and execute their own orders and commonly request prices from broker-dealers for particular securities. In these instances, the broker-dealer is simply responding to the institutional customer's request (e.g., through widely known request for quote (RFQ) mechanisms) and the institutional customer is exercising independent discretion over the handling and execution of its orders. Accordingly, the SEC believes that the broker-dealer in these circumstances should be exempted from the best execution standard under proposed Rule 1100.

[\[14\]](#) The SEC also requests comment on whether it should provide an exemption from the proposed best execution standard for transactions in municipal fund securities (such as interests in 529 college savings plans) or mutual fund securities. Proposing Release at 62 (Questions 27-28).

[\[15\]](#) Proposing Release at 64-65.

[\[16\]](#) Proposing Release at 83.

[\[17\]](#) Proposing Release at 24, 67-68 and n.136.

[\[18\]](#) Proposing Release at 72-73.

[\[19\]](#) Proposing Release at 91. The SEC notes that when an institutional customer gives a large order to be executed on behalf of one account (e.g., a single mutual fund or pension fund), it expects the broker-dealer that handles and executes such large order to do so in a manner that ensures best execution is provided to the "parent" order. In other words, to the extent that a parent order is split into smaller "child" orders, the institutional customer expects the best execution analysis to evaluate whether the parent order was executed at the most favorable price possible under prevailing market conditions according to customer instructions.

[\[20\]](#) The Commission would define "transaction for or with a retail customer" as any transaction for or with the account of a natural person or held in legal form on behalf of a natural person or group of related family members.

[\[21\]](#) The Commission considers "payment for order flow," consistent with Rule 10b-10(d)(8), as any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker-dealer from any broker-dealer, national



securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker-dealer to any broker-dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker-dealer's unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker-dealer routing a customer order that exceeds that fee, expense or financial obligation. This would include wholesalers paying for order flow as well as exchange rebates.

[\[22\]](#) Proposing Release at n.191.

[\[23\]](#) Proposed Rule 1101(d) would define "introducing broker" as a broker-dealer that: (i) does not carry customer accounts and does not hold customer funds or securities; (ii) has entered into an arrangement with an unaffiliated broker-dealer that has agreed to handle and execute on an agency basis all of the introducing broker's customer orders (an "executing broker"); and (iii) has not accepted any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration from the executing broker in return for the routing of the introducing broker's customer orders to the executing broker. Fractional share trading in NMS stocks and riskless principal trading in corporate and municipal bonds and government securities may be executed as principal by the executing broker without affecting a broker-dealer's compliance with the "introducing broker" definition.

[\[24\]](#) Proposing Release at n.238.

[\[25\]](#) Proposing Release at 151-52.