

# **PROPOSED REGULATION BEST EXECUTION: SEC CONSIDERS MARKET STRUCTURE SHAKEUP**

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## PROPOSED REGULATION BEST EXECUTION: SEC CONSIDERS MARKET STRUCTURE SHAKEUP

The US Securities and Exchange Commission (SEC) [proposed Regulation Best Execution](#) (Proposal or Proposed Regulation Best Execution)<sup>1</sup> under the Securities and Exchange Act of 1934 (Exchange Act) to enhance the existing regulatory framework around best execution for brokers, dealers, government securities brokers, government securities dealers, and municipal securities dealers (collectively, Broker-Dealers). The Proposal was released December 14, 2022, alongside three other proposals covering a wide range of market structure issues in the equity markets (Equity Market Proposals).<sup>2</sup>

Although Proposed Regulation Best Execution would apply to a Broker-Dealer's execution of all types of securities—including digital asset securities—the data and additional requirements that would result from the Equity Market Proposals (if adopted) will factor heavily into how a Broker-Dealer will meet its best execution obligations under the Proposal with respect to equity transactions.

The comment period for Proposed Regulation Best Execution will remain open until the later of March 31, 2023, or 60 days after the applicable proposing release is published in the *Federal Register*. As of the date of this report, the Proposal has not been published in the *Federal Register*.

### KEY TAKEAWAYS

- Broker-Dealers would need policies and procedures that explicitly demonstrate how the Broker-Dealer will (1) obtain and assess reasonably accessible information concerning relevant markets; (2) identify material potential liquidity sources; and (3) incorporate these liquidity sources into their order handling practices and have access to them.
- Additional measures and documentation would be required for the following types of “conflicted” transactions: (1) principal (including riskless principal) transactions; (2) transactions with affiliates; and (3) transactions involving the receipt of payment for order flow.
- Broker-Dealers would need to review execution quality at least quarterly.
- Annual reviews and reports would have to be provided to the board of directors or equivalent.
- The SEC is placing a heavy emphasis on executions at the midpoint of the best bid and offer.
- Broker-Dealers would be expected to consider a wide variety of markets and data points when meeting their best execution obligations while simultaneously being mindful of price dis-improvement.
- The proposed rules include an exception for introducing brokers, but introducing brokers would still have significant obligations to oversee their clearing or executing brokers.

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<sup>1</sup> [Regulation Best Execution](#), Exchange Act Release No. 96496 (Dec. 14, 2022) (Proposing Release).

<sup>2</sup> [Order Competition Rule](#), Exchange Act Release No. 96495 (Dec. 14, 2022); Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, Exchange Act Release No. 96494 (Dec. 14, 2022); Disclosure of Order Execution Information, Exchange Act Release No. 96493 (Dec. 14, 2022).

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- The Proposal (along with the Equity Market Proposals) may ultimately spell the end of payment for order flow (PFOF) as we know it, and potentially impact the use of money market mutual funds in sweep programs.
- The SEC is proposing Regulation Best Execution pursuant to, among other provisions, the anti-fraud provisions of Section 15(c) of the Exchange Act.
- Broker-Dealers will be required to comply with the stricter best execution requirements of either Proposed Regulation Best Execution or those of an applicable self-regulatory organization (SRO): the Financial Industry Regulatory Authority (FINRA) or the Municipal Securities Rulemaking Board (MSRB).

## BACKGROUND

Proposed Regulation Best Execution is largely based on the FINRA<sup>3</sup> and MSRB<sup>4</sup> best execution rules but goes beyond the framework established by those SROs to make the framework more “effective.”<sup>5</sup> The Proposing Release provides a robust background on the best execution standard as articulated by those SRO rules and SEC statements over the years, generally highlighting the following:

1. The duty of best execution is derived from common law agency obligations of undivided loyalty and reasonable care that an agent owes to its principal.
2. The duty of best execution requires a Broker-Dealer to execute customers’ trades at the most favorable terms reasonably available under the circumstances, i.e., at the best reasonably available price.
3. Factors that historically go into a best execution analysis include the size of the order, speed of execution, clearing costs, trading characteristics of the security involved, availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information, and the cost and difficulty associated with achieving an execution in a particular market center.

Notwithstanding the factors that have historically gone into a best execution analysis, as discussed below, the Proposing Release appears to place a significant emphasis on price and execution at the midpoint of the best bid and offer.

In addition, we also note that the SEC is proposing Regulation Best Execution pursuant to, among other provisions, Sections 11A and 15 of the Exchange Act. With respect to the latter, the SEC specifically referenced the anti-fraud provisions of Section 15(c), noting that when a Broker-Dealer “violates its duty of best execution, it could be in violation of Section 15(c) of the Exchange Act.”

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<sup>3</sup> FINRA Rule 5310.

<sup>4</sup> MSRB Rule G-18.

<sup>5</sup> Proposing Release at 7.

## PROPOSED RULES

Proposed Regulation Best Execution consists of three rules:

- **Proposed Rule 1100:** This provision contains the best execution standard and three exceptions.
- **Proposed Rule 1101:** Consisting of four subparts, this is the operative provision of Proposed Regulation Best Execution, and would (i) outline the required policies and procedures that a Broker-Dealer must have to comply with the Proposal; (ii) include enhanced requirements for so-called “conflicted transactions”; (iii) require that Broker-Dealers regularly review the execution quality of their customer transactions; and (iv) provide an exemption from the requirements of the first three subparts for introducing brokers.
- **Proposed Rule 1102:** This provision would require that a Broker-Dealer conduct an annual review of policies and procedures and their effectiveness, and present this report to its board of directors (or equivalent governing body).

In addition, the Proposal would amend Rule 17a-4 under the Exchange Act to address a Broker-Dealer’s recordkeeping obligations under Proposed Regulation Best Execution.

## THE BEST EXECUTION STANDARD – PROPOSED RULE 1100

On its face, the best execution standard in Proposed Rule 1100 is deceptively simple. It requires a Broker-Dealer, and any natural person that is an associated person of a Broker-Dealer (Associated Persons), 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 (for purposes of Regulation Best Execution, the most favorable price) (the Best Execution Standard).

The Best Execution Standard applies in any transaction for or with a customer or a customer of another Broker-Dealer. It does not apply to a Broker-Dealer and Associated Persons when

1. another Broker-Dealer is executing a customer order against the Broker-Dealer’s quotation (Broker-to-Broker Exception)
2. an institutional customer, exercising independent judgment, executes its order against the Broker-Dealer’s quotation (Institutional Customer Exception); and
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 (Directed Order Exception).

## Observations

### *Markets*

Although not specified in the rule text, the SEC stated that a “market” for purposes of the Best Execution Standard would include Broker-Dealers (e.g., a Broker-Dealer’s principal trading desk), exchange markets, markets other than exchange markets, and any other venues that emerge as markets evolve.

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The term also includes the wide range of mechanisms operated by any given market that a Broker-Dealer may use to transact for or with customers, including different execution protocols, such as limit order books (some of which may provide for midpoint liquidity), floor auction facilities, or electronic auction mechanisms.

This broad definition vastly expands the types of venues and mechanisms that Broker-Dealers will have to consider when contemplating their obligations under the Proposal if adopted as is. It will require a dynamic evaluation of new trading mechanisms that could be captured by the concept of a market, such as new order exchange order types, auctions mechanisms if Proposed Rule 615 under Regulation NMS is adopted, or additional Broker-Dealers that are required to submit reports under the proposed amendments to Rule 605 under Regulation NMS.

## *Associated Persons of a Broker-Dealer*

In footnote 111 of the Proposing Release, the SEC stated that Proposed Rule 1100 would apply only to a natural person who is an associated person of a Broker-Dealer, in order to avoid capturing affiliated entities of a Broker-Dealer. However, it is unclear that this achieves the SEC's intended result.

As discussed in the Proposing Release, Section 3(a)(18) of the Exchange Act defines a "person associated with a broker or dealer" to mean "any partner, officer, director, or branch manager of the broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with the broker or dealer, or any employee of the broker or dealer." If the SEC intended to capture those persons licensed with Broker-Dealers as registered representatives, perhaps a narrower construct would have been to reference Rule 15b7-1 under the Exchange Act, which makes specific reference to the licensing requirements imposed by SROs on natural persons associated with Broker-Dealers.

## *Institutional Customer Exception*

The SEC did not provide a definition of an institutional customer, but it did request comment on whether it should use the standard outlined in the definition of "qualified institutional buyer" (QIB) as defined in Rule 144A under the Securities Act of 1933, or whether it should go broader and reference the entities included in the FINRA definition of "institutional account" under FINRA Rule 4512(c). The SEC also asked whether the exception should include sophisticated municipal market participants as in MSRB Rule G-48. The SEC's request for comments indicates that it might be considering placing limitations on the exception, potentially based on security or account types.

## *Investment Advisers and Dual Registrants*

Even though investment advisers have their own duty to seek best execution, the Proposing Release only addresses this obligation in its request for comments. Specifically, the SEC asks whether the Best Execution Standard poses any challenges or burdens for entities that are dually registered Broker-Dealers and investment advisers, and whether there are elements of an investment adviser's duty to seek best execution that are relevant in assessing the proposed Best Execution Standard for a Broker-Dealer.

## *Directed Order Exception*

The SEC did not elaborate on how a Broker-Dealer would evidence compliance with the Directed Order Exception, or whether a customer would have to provide this direction on an order-by-order basis. For instance, a Broker-Dealer operating a self-directed platform could conceivably have prepopulated order types and destinations in a menu format from which a customer can choose. If the customer chooses from these options, instead of just letting the Broker-Dealer order router decide, it is unclear whether the customer's order would be subject to the Directed Order Exception.

## REQUIRED POLICIES AND PROCEDURES – PROPOSED RULE 1101(A)

Proposed Rule 1101(a) requires that Broker-Dealers establish, maintain, and enforce written policies and procedures reasonably designed to comply with the Best Execution Standard (Policies and Procedures). The Policies and Procedures are required to address (1) compliance with the Best Execution Standard and (2) determination of the best market and making routing or execution decisions for customer orders (Best Market Determination).

### Compliance with the Best Execution Standard

In order to establish compliance with the Best Execution Standard, the Policies and Procedure must show how the Broker-Dealer will

- obtain and assess reasonably accessible information, including information about price, volume, and execution quality, concerning the markets trading the relevant securities;
- identify markets that may be reasonably likely to provide the most favorable prices for customer orders (material potential liquidity sources); and
- incorporate material potential liquidity sources into its order handling practices, ensuring that the broker or dealer can efficiently access each such material potential liquidity source.

The Proposing Release provided additional clarity and guidance regarding some of these elements.

#### *Execution Quality*

With respect to execution quality, the SEC stated:

- Competition levels should be considered when evaluating execution quality.<sup>6</sup>
- Broker-dealers should assess the features of options price improvement auctions, how those features might affect the level of competition and the execution quality offered by the auctions, and whether those features would allow an auction to provide the most favorable prices under prevailing market conditions.
- In considering RFQ systems as material potential liquidity sources for corporate and municipal bonds and government securities, a Broker-Dealer's Policies and Procedures could assess the filtering practices that may be applied by the RFQ system operator and the impact that those practices may have on the execution quality of those markets.<sup>7</sup>

#### *Material Potential Liquidity Sources*

In discussing material potential liquidity sources, the Proposing Release provides additional guidance based on the following security and market types:

- **NMS Stocks:** For National Market System (NMS) stock,<sup>8</sup> material potential liquidity sources could include (i) exchanges, (ii) alternative trading systems (ATSS), and (iii)

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<sup>6</sup> Proposing Release at 68.

<sup>7</sup> The SEC specifically states that if "an RFQ system applies an automatic filter that prevents a broker-dealer that initiates the RFQ from sending that request to all participants on the RFQ system, a broker-dealer could evaluate the potential impact that may have on that market's execution quality." Proposing Release at 70.

<sup>8</sup> "NMS stock" is defined in Rule 600(b)(55) as any NMS security other than an option, and "NMS security" is defined in Rule 600(b)(54) any security or class of securities for which transaction reports are collected, processed, and made

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Broker-Dealers, including market makers and wholesalers. With respect to the latter, the SEC stated that the concept of a market could also include trading protocols and auction mechanisms operated by these entities, including those that may provide price improvement opportunities, such as exchange limit order books, retail liquidity programs, midpoint liquidity, and wholesaler price improvement guarantees.<sup>9</sup>

- **OTC Equities Markets:** For the over-the-counter (OTC) equities market, potential material liquidity sources could include ATSS, wholesalers, and other OTC market makers.<sup>10</sup>
- **Options Markets:** In the options market, material potential liquidity sources could include the options exchanges and the range of trading protocols and auction mechanisms made available by them, such as (i) quotes from market makers resting on exchange limit order books; (ii) price improvement auctions; (iii) liquidity resting between the best bid and offer that may be available on exchange limit order books; and (iv) floor trading facilities that may provide a Broker-Dealer with the opportunity to seek competitive prices from floor participants for larger or complex options orders.<sup>11</sup>
- **Corporate and Municipal Bond Markets and Government Securities Markets:** For these securities, material potential liquidity sources could include (i) ATS and non-ATS electronic trading systems; (ii) RFQ systems and other auction mechanisms; (iii) interdealer brokers and other Broker-Dealers willing to be a counterparty upon request; and (iv) a Broker-Dealer's own principal trading desk.<sup>12</sup>

## *Potential Sources of Reasonable Accessible Information*

The SEC also provided clarity on potential sources of reasonable accessible information based on security and market type:

- **NMS Stock:** For NMS stock, these sources include (i) publicly available quotations; (ii) consolidated trade information; (iii) exchange proprietary data feeds; (iv) odd-lot market data; and (v) execution quality and order routing information contained in reports made pursuant to Rules 605 and 606 of Regulation NMS.<sup>13</sup>
- **OTC Equities Markets:** For the OTC equities markets, these sources include data from ATSS and OTC market makers and data concerning transaction prices in OTC equities made publicly available through the FINRA Over-the-Counter Reporting Facility (ORF).<sup>14</sup>

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available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.

<sup>9</sup> Proposing Release at 72.

<sup>10</sup> Proposing Release at 73.

<sup>11</sup> The SEC also stated that other Broker-Dealers in the options market could also represent a type of market that generally should be considered when assessing material potential liquidity sources given that some trades are arranged away from exchanges. Proposing Release at 73.

<sup>12</sup> Proposing Release at 74-75.

<sup>13</sup> Proposing Release at 72.

<sup>14</sup> Proposing Release at 73.

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- **Options Markets:** Data sources for options markets include proprietary data feeds, quarterly Rule 606 order routing reports, and consolidated trade and quotation data.<sup>15</sup>
- **Corporate and Municipal Bond Markets and Government Securities Markets:** Data sources for fixed-income securities include (i) data from ATSS and other trading platforms, such as RFQ systems, interdealer brokers, and dealers that handle and execute customer orders; (ii) trade data in the corporate bond and municipal bond markets made publicly available through FINRA's Trade Reporting and Compliance Engine (TRACE) and the MSRB's Real-time Transaction Reporting System (RTRS); and (iii) price aggregator services or evaluated pricing services.<sup>16</sup>

## Best Market Determination

In order to address its Best Market Determination obligations, a Broker-Dealer's Policies and Procedures will need to address how it will determine the best market and make routing or execution decisions for customer orders that it receives by

- 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;
- 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
- 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 a worse price.

As with compliance with the Best Execution Standard, the Proposing Release also recognizes that with the Best Market Determination, different securities and market types require different approaches.

### *NMS Stocks*

For retail Broker-Dealers in NMS stocks, the Proposing Release states that Policies and Procedures could include assessments of any "assurances from a wholesaler that certain orders routed by the retail Broker-Dealer to the wholesaler would be guaranteed midpoint executions by the wholesaler or otherwise exposed to opportunities for midpoint executions."<sup>17</sup> If the wholesaler is unable to provide such assurances, the Proposing Release states that the Broker-Dealer's Policies and Procedures could provide for an assessment as to whether other venues may provide opportunities for midpoint executions or other price improvement opportunities.

While the Proposing Release does not go as far as saying that assurances regarding midpoint executions are a requirement for wholesaling relationships, given the Proposing Release's overall emphasis on midpoint executions, it may be difficult for Broker-Dealers to defend any arrangement that does not include such assurances.

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<sup>15</sup> Proposing Release at 74.

<sup>16</sup> Proposing Release at 75.

<sup>17</sup> Proposing Release at 84.



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## *Listed Options*

For listed options, the Proposing Release states that the Policies and Procedures would be required to address how a Broker-Dealer will assess potential midpoint executions, including to the extent additional midpoint liquidity emerges, even though midpoint liquidity is not as commonly available on options exchanges. After that, Broker-Dealers should assess other price improvement opportunities, including (i) potential resting liquidity on exchange limit order books priced between the best bid and offer; (ii) exchange price improvement auctions; and (iii) an assessment of guarantees for price improvement that might be provided by wholesalers and the performance of the wholesalers.

## *Corporate and Municipal Bond Markets and Government Securities Markets*

For fixed-income markets, the Proposing Release states that a Broker-Dealer's Policies and Procedures will need to address how it will assess reasonably accessible and timely information with respect to the best displayed prices when such information may only be available through proprietary customer-facing systems that enable customers to transact at the displayed prices; on other venues such as ATSS, interdealer brokers, or otherwise; or in inventory held by the Broker-Dealer. Because the information available in the fixed-income markets is different than that available in the equity and options markets, the SEC noted that the Policies and Procedures may also need to account for exposure opportunities in RFQ platforms, and how counterparty filtering mechanisms on those platforms may impact Best Market Determination.

In addition, the SEC noted that some request-for-quote (RFQ) platforms have "last look" functionalities that "deter market participants that might otherwise vigorously compete to trade with the customer's order from submitting their most favorable prices, in light of the possibility that the Broker-Dealer is simply using the RFQ system for price discovery and ultimately intends to trade with its customer in a principal capacity."<sup>18</sup> The SEC stated that Broker-Dealers would need to assess how such a functionality would impact a Best Market Determination. In addition, the SEC stated that RFQ response time should also factor into a Best Market Determination analysis.

## *Other Factors Impacting Best Market Determinations*

In addition to the securities and market types identified above, the SEC noted that the following factors could also impact a Best Market Determination:

- Information leakage that may impact the handling and execution of large customer orders; a Best Market Determination should be designed to minimize the risk of information leakage and price impact concerns
- Whether the order is a market order or a limit order
- The likelihood of execution
- The trading characteristics of a security and the accessibility of a market (e.g., whether the security has readily available or accessible quotation data or trades in OTC markets)
- Market volatility
- Customer instructions
- Balancing the likelihood of obtaining better prices with the risk that delay could result in worse prices in determining the number and sequencing of markets to be assessed for customer orders

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<sup>18</sup> Proposing Release at 89.

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## Observations

### *Data, Data, Data*

What is clear from Proposed Rule 1101(a) is that Broker-Dealers are going to need data, and lots of it, to comply with the Best Execution Standard.

With respect to equity securities and NMS stocks in particular, the Equity Market Proposals will certainly produce plenty of data to assist Broker-Dealers in their Best Market Determinations. This abundance of NMS stock data, however, also comes with significant noise, and the challenge that Broker-Dealers will face is filtering the usable information from that noise.

While many of the large Broker-Dealers may have the technological infrastructure and budgets to build in-house analytical models to analyze best execution venues, many other Broker-Dealers will lack such in-house resources and have to rely on third-party service providers and software vendors. While the use of such providers (which have been used to evaluate venues for best execution under existing SRO rules) would be reasonable, Broker-Dealers would ultimately bear the responsibility for any deficiencies that result from reliance on those service providers. We note that Proposed Regulation Best Execution is being adopted in part under Exchange Act Section 15(c)'s anti-fraud provisions.

### *Challenges in Fixed-Income Markets*

While there may be an abundance of data for NMS stocks, and perhaps options and OTC equity trades, data for the fixed-income markets may still prove to be challenging. For instance, Broker-Dealers do not have universal access to all fixed-income ATSs and RFQ platforms, and it would be unreasonable for the SEC to expect Broker-Dealers to become subscribers to every ATS or platform. In addition, the SEC's focus on "last look" functionalities and counterparty filtering may further create a chilling effect on the use of RFQ platforms if Broker-Dealers believe that the SEC will discount such platforms in a Best Market Determination.

In addition, we note that the SEC has a pending rulemaking that would bring RFQ platforms within ATS registration requirements,<sup>19</sup> and an additional entry in its regulatory agenda<sup>20</sup> regarding ATSs. As such, this may ultimately add to the data sources that Broker-Dealers will have to consider.

### *Focus on Midpoint Executions*

Throughout the Proposing Release's discussion of Proposed Rule 1101(a), the SEC seems focused on midpoint execution as being the standard. In this regard, it appears that the SEC would expect Broker-Dealers to document the rationale for any deviation from a midpoint execution. While the SEC's focus on midpoint executions may be a further attempt at tightening spreads, it is unclear how realistic such an outcome might actually be in practice.

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<sup>19</sup> Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, Exchange Act Release No. 94062 (Jan. 26, 2022), 87 Fed. Reg. 15496 (Mar. 18, 2022).

<sup>20</sup> The SEC's Fall 2022 Unified Agenda of Regulatory and Deregulatory Actions, released on January 4, 2023, included an entry for a proposed rulemaking titled "Regulation ATS Modernization."

## CONFLICTED TRANSACTIONS – PROPOSED RULE 1101(B)

Proposed Rule 1101(b) would require a Broker-Dealer's Policies and Procedures to address additional considerations with respect to "conflicted transactions." Under this provision, a "conflicted transaction" would be any transaction for or with a retail customer<sup>21</sup> where the Broker-Dealer

- executes an order as principal, including riskless principal (Principal Transactions);
- routes an order to, or receives an order from, an affiliate for execution (Affiliate Transactions); or
- provides or receives PFOF.

Whenever a Broker-Dealer effects a Conflicted Transaction, Proposed Rule 1101(b) requires a Broker-Dealer's Policies and Procedures to go beyond what is required under Proposed Rule 1101(a) to

- 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;
- 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 than those identified as material potential liquidity sources; and
- document its compliance with the Best Execution Standard for conflicted transactions, including all efforts to enforce its best execution Policies and Procedures for conflicted transactions and the basis and information relied on for its determinations that such conflicted transactions would comply with the Best Execution Standard. Note:
  - This documentation has to be accordance with written procedures.
  - The Broker-Dealer also has to document any arrangement concerning PFOF, including the parties to the arrangement, all qualitative and quantitative terms concerning the arrangement, and the date and terms of any changes to the arrangement.

### *NMS Stocks and PFOF*

In the context of NMS stocks and conflicted transactions, the Proposing Release placed significant emphasis on PFOF. With respect to retail Broker-Dealers that receive PFOF from a wholesaler, the SEC stated that such a Broker-Dealer could need to

- establish, maintain, and enforce policies and procedures to address how it will evaluate additional liquidity sources that the Broker-Dealer would not otherwise need to evaluate if it did not receive PFOF, such as exchanges, ATSS, or other liquidity sources;

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<sup>21</sup> "Any transaction for or with a retail customer" means 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. For purposes of this definition, a "group of related family members" means a group of natural persons with any of the following relationships: child, stepchild, grandchild, great-grandchild, parent, stepparent, grandparent, great-grandparent, spouse, domestic partner, sibling, stepbrother, stepsister, niece, nephew, aunt, uncle, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive and foster relationships, and any other natural person (other than a tenant or employee) sharing a household with any of the foregoing natural persons.

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- document an effort to send orders to markets other than a wholesaler offering PFOF first at prices better than the NBBO; and
- document (for nonmarketable orders to exchanges that pay rebates) its assessment of fill rates and the likelihood of execution for nonmarketable orders at such markets as compared to other markets that do not provide such rebates.<sup>22</sup>

With respect to wholesalers, the SEC states that a wholesaler that executes customer orders in a principal capacity or pays a retail Broker-Dealer for order flow could also have to

- document its compliance with the Best Execution Standard for conflicted transaction by documenting the prices received from those markets that it checked pursuant to its policies and procedures;
- retain a record of the markets at which it attempted to execute customer orders at prices better than the NBBO; and
- retain records of market data feeds that the wholesaler uses when handling retail customer orders.<sup>23</sup>

Both wholesalers and retail Broker-Dealers would have to document any PFOF arrangements.

## *Options Markets*

The SEC indicates that PFOF, principal trading, and affiliated routing also present conflicts of interest in the execution of retail customer orders in the options market. As such, many of the concepts discussed above in the context of NMS stocks would apply. However, Broker-Dealers in options markets would need to evaluate whether any price improvement auctions may provide an opportunity to execute a customer order at a price that is better than the displayed best bid and offer.

In terms of documentation, the SEC outlined that a Broker-Dealer could document the prices received from those markets that it checked pursuant to its Policies and Procedures, such as by retaining records of market data feeds that the wholesaler uses when handling retail customer orders.<sup>24</sup>

## *Corporate and Municipal Bond Markets and Government Securities Markets*

The SEC recognizes that many fixed-income trades are effected on a principal basis and therefore would be conflicted transactions, and thus require that Broker-Dealers evaluate a broader range of ATSS, broker's brokers, RFQ systems, and other Broker-Dealers that trade on fixed-income markets than the markets the Broker-Dealer typically identifies. In terms of documentation, the SEC states that Broker-Dealers could retain records of any data feeds or other pricing information that the retail Broker-Dealer uses when handling retail customer orders, including ATS data feeds, responses to RFQs, transaction prices, and evaluated pricing information.<sup>25</sup>

In addition, the SEC outlined an expectation that Broker-Dealers will consider practices concerning the use of RFQ systems, including its filtering, response time, and last-look practices, and how those practices promote the execution of retail customer orders in a manner that complies with the Best

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<sup>22</sup> Proposing Release at 122.

<sup>23</sup> Proposing Release at 124. For nonmarketable orders, a wholesaler could use the processes that a retail Broker-Dealer uses.

<sup>24</sup> Proposing Release at 127-128.

<sup>25</sup> Proposing Release at 129.

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Execution Standard. Finally, the SEC expects that markup policies for principal trades will factor into this analysis.

## Observations

### *Family Offices*

As mentioned in the SEC's request for comments, a "transaction for or with a retail customer" would include a transaction with a "family office" as defined in Rule 202(a)(11)(G)-1(b) under the Investment Advisers Act of 1940. However, the SEC does ask whether this concept should be narrowed to effectively exclude institutional family offices; that is, a family office (as defined above) that (1) has one or more experienced securities or financial services professionals, (2) manages a threshold level of total assets (e.g., \$50 million or more) that are indicative of an institutional account, (3) has the capacity to evaluate independently the execution quality received from the Broker-Dealer, and (4) has professionals who are independent representatives of their family clients. Such an approach would be consistent with the approach taken under Regulation Best Interest via an SEC staff no-action letter.<sup>26</sup>

### *Chilling Effect on Receipt of PFOF*

Although the SEC did not explicitly ban PFOF, which was [widely reported as being in the works](#), the treatment of PFOF as a conflicted transaction (along with the qualified auction requirements in Proposed Rule 615 under the Equity Market Proposals<sup>27</sup>) may ultimately have the same impact. As discussed above, the SEC's expectation under the Proposing Release is that Broker-Dealers will effectively route orders to markets that do not provide PFOF before routing to those markets that do provide PFOF. When Broker-Dealers couple this expectation with their Best Market Determination obligations, potential order information leakage, worse prices associated with delays, and the requirements under Proposed Rule 615 under the Equity Market Proposals that Broker-Dealers route marketable retail customers orders to qualified auctions,<sup>28</sup> the SEC could succeed in banning PFOF in everything but name.

The Proposal would make it very difficult for a Broker-Dealer that accepts PFOF to comply with the Best Execution Standard, and by extension, place the Broker-Dealer at risk of violating the anti-fraud provisions of Exchange Act Section 15(c). Additionally, the indirect restrictions on PFOF and the qualified auction requirements could significantly undermine the economics that allow wholesalers to provide PFOF to other Broker-Dealers.

### *Fixed-Income*

Given that most fixed-income trading is effected on a principal basis, it is unclear whether classifying principal transactions as conflicted will have much of an impact on this market, other than requiring Broker-Dealers to further evaluate their markup policies. Perhaps one potential outcome of Proposed Regulation Best Execution could be the proliferation of additional fixed-income markets and trading venues that facilitate trading on an agency rather than principal basis.

### *Additional Markets*

It is unclear how requiring Broker-Dealers to identify and evaluate additional markets will provide any benefits or protections to customers. If a Broker-Dealer has already evaluated certain markets and determined that they are not material potential liquidity sources, the fact that the Broker-Dealer is

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<sup>26</sup> [Status of Institutional Family Offices for Purposes of Regulation Best Interest](#), SEC No-Action Letter (Dec. 23, 2020).

<sup>27</sup> Order Competition Rule, Exchange Act Release No. 96495 (Dec. 14, 2022).

<sup>28</sup> *Id.*

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engaging in conflicted transactions does not change the materiality of those markets. Requiring the Broker-Dealer to assess those markets would create additional work for the Broker-Dealer without any clear rationale for why those assessments would provide meaningful benefits.

## **REGULAR REVIEW OF EXECUTION QUALITY – PROPOSED RULE 1101(C)**

Under Proposed Rule 1101(c), a Broker-Dealer would be required to, at least quarterly,

- review the execution quality of its transactions for or with customers or customers of another Broker-Dealer, and how such execution quality compares with the execution quality the Broker-Dealer might have obtained from other markets; and
- revise its best execution Policies and Procedures, including its order handling practices, accordingly.

The Broker-Dealer is required to document the results of this review.

The SEC explained that in reviewing and comparing the execution quality of its customer transactions to the execution quality that might have been obtained from other markets, a Broker-Dealer could consider various factors, including

- price improvement opportunities;
- differences in price dis-improvement;
- likelihood of execution of limit orders;
- speed of execution;
- size of execution;
- transaction costs;
- customer needs and expectations; and
- the existence of internalization or payment for order flow arrangements.<sup>29</sup>

The SEC also stated that a Broker-Dealer that routinely routes customer orders to multiple trading centers, whether internal or external, could evaluate the latency impacts, fill rates, information leakage, and resulting execution quality harms.<sup>30</sup>

With respect to revisions to the Policies and Procedures and order handling practices, the SEC stated that it “preliminarily believes that revisions to the Broker-Dealer’s policies and procedures, including its order handling practices, would be appropriate if there were material differences in execution quality that were not otherwise justifiable.”<sup>31</sup>

### **Observations**

The SEC stated that the requirements of Proposed Rule 1101(c) are designed to be consistent with the requirements of FINRA Rule 5310.09. Indeed, the SEC made clear in the Proposing Release that Broker-Dealers are expected to still comply with the stricter requirements of either Proposed Regulation Best Execution or the FINRA and MSRB best execution rules. Thus, to the extent a Broker-Dealer engages in

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<sup>29</sup> Proposing Release at 133.

<sup>30</sup> Proposing Release at 134.

<sup>31</sup> Proposing Release at 136.

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execution reviews, it will likely do so under the FINRA standard, which itself can be changed through a less burdensome notice and comment process than an SEC rulemaking.

In this regard, it also brings up an interesting question as to whether the SEC will deem a violation of FINRA Rule 5310.09 to automatically include a violation of Proposed Rule 1101(c), especially where such a result could be viewed as SEC enforcement of SRO rules. While the SEC has the authority to amend SRO rules on its own,<sup>32</sup> it is unclear whether it has the authority to enforce SRO rules on its own.

## **INTRODUCING BROKERS – PROPOSED RULE 1101(D)**

Proposed Rule 1101(d) would permit a Broker-Dealer that qualifies as an introducing broker to rely on its executing broker to comply with Proposed Rules 1101(a), (b), and (c), subject to certain review requirements.

Under this provision, an “introducing broker” would be defined as a broker or dealer that

1. does not carry customer accounts and does not hold customer funds or securities;
2. has entered into an arrangement with an unaffiliated broker or dealer that has agreed to handle and execute on an agency basis all of the introducing broker’s customer orders (executing broker) (under this provision, principal trades by an executing broker with the introducing broker’s customer to fill fractional share orders in NMS stocks and riskless principal trades an executing broker in fixed-income securities will be considered to be handled on an agency basis); and
3. 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.

However, an introducing broker as defined above would still need to

- establish, maintain, and enforce policies and procedures that require the introducing broker to regularly review the execution quality obtained from such executing broker;
- compare that execution quality with the execution quality it might have obtained from other executing brokers;
- revise its order handling practices accordingly; and
- document the results of this review.

## **Observations**

### *Limited Relief*

The exception for introducing brokers does not appear to provide any significant relief. On the one hand, it does purportedly exclude introducing brokers from the Policies and Procedures requirement, direct compliance with the Best Execution Standard, and the Best Market Determination Requirement, but on the other hand it still requires that introducing brokers absorb the cost of evaluating the execution quality of their executing brokers, which, in reality, means their clearing brokers. In addition, introducing brokers

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<sup>32</sup> See Exchange Act Section 19(c).

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are supposed to evaluate the execution quality of their executing brokers against the execution quality of other execution brokers.

The SEC did not state how introducing brokers are supposed to obtain this information, other than stating that it

preliminarily believes that other executing brokers would have an incentive to provide the introducing broker with accurate and comparable execution quality information that the introducing broker could use to evaluate its existing arrangement due to their financial interest in potentially providing the introducing broker with order handling and execution services.<sup>33</sup>

While this is aspirational, absent a requirement for executing brokers to provide this information, it is unclear that market forces alone would be enough. An executing broker that expects to receive business from an introducing broker may be willing to provide the information, but there is little incentive for other executing brokers to provide the information to an introducing broker solely for comparison purposes. Further, while the expansion of the types of entities subject to Rule 605 reporting under Equity Market Proposals would provide introducing brokers with some information useful to evaluating the execution quality of other clearing brokers, it is not clear that the information available in such Rule 605 reports will easily translate to the determinations that introducing brokers will be required to make under Proposed Rule 1101(d).

Additionally, Rule 605 reports only cover equities, so introducing brokers may struggle to find useful data for other asset classes. The Proposal does not specify how frequently the introducing broker's regular review must be conducted, but the SEC included a request for comments asking whether a minimum frequency should be specified and what that frequency should be.

## *Impact to Clearing Relationships*

The Proposing Release seems to suggest that in evaluating the execution quality of their executing brokers (i.e., their clearing brokers), introducing brokers will somehow have the leverage to demand that their clearing brokers improve execution qualities lest they take their business elsewhere. This reflects a fundamental misunderstanding of the clearing/introducing model.

Overall, there is a small number of clearing brokers, and many introducing brokers, particularly smaller firms, have very little leverage in their relationships with their clearing brokers. Additionally, switching clearing brokers is an incredibly disruptive and time-consuming process for introducing brokers and their customers. It takes a significant amount of time for an introducing broker to (i) conduct due diligence, (ii) negotiate a new clearing agreement, (iii) obtain regulatory approvals, (iv) obtain customer consent for the transition (typically through a negative consent process with a 30-day minimum notice period), (v) establish connectivity with the new clearing broker, and (vi) transfer customer accounts. This process can take months, if not a year.

Further, the process often entails significant technological and operational transitions, and customers can be impacted by positions that are not supported by the new clearing broker. In the meantime, it is unclear if introducing brokers will be unable to avail themselves of the relief offered under Proposed Rule 1101(d).

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<sup>33</sup> Proposing Release at 152.



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## *Compensation Arrangements*

The relief granted in Proposed Rule 1101(d) is conditioned on an introducing broker not receiving any financial incentive for routing orders to the executing brokers. As a practical matter, to the extent that introducing brokers will now have to charge commissions and impose other direct charges for their services, clearing arrangements are often structured such that the clearing broker collects these charges on behalf of the introducing broker. The language in Proposed Rule 1101(d) makes it unclear as to whether this practice can continue in this manner.

## *Impact to Sweep Programs*

In addition, the remuneration prohibitions in Proposed Rule 1101(d) may have the unintended consequence of causing more Broker-Dealers to sweep customer-free credit balances into bank deposit programs rather than into money market mutual funds.

Over the years, as the industry has moved toward commission-free trading, Broker-Dealers have been forced to rely on other sources of revenue. In addition to PFOF, one important revenue source has been revenue generated from cash sweep programs operated pursuant to Rule 15c3-3(j) under the Exchange Act. Under that provision, customer-free credit balances can be swept into money market mutual funds or bank deposit programs, and often revenue models are structured such that clearing brokers and introducing brokers benefit financially from such programs.

Because money market mutual funds are securities, and thus the purchase of such instruments would involve customer orders routed through the clearing broker (i.e., the executing broker), it is unclear whether an introducing broker would be able to receive any financial benefit from such programs and rely on the relief in Proposed Rule 1101(d). Transfers to bank deposit programs, however, do not involve an order for the purchase or sale of a security. Bank deposit sweep programs also offer the opportunity for higher revenues than money market funds, as introducing and clearing brokers can earn significant revenue in the form of the spread between prevailing deposit account interest rates and the interest rate that is passed through to the customer. Particularly in a higher interest rate environment, this spread can be significantly greater than the revenue sharing payments that are paid by money market funds.

If PFOF is effectively eliminated (or significantly curtailed), Broker-Dealers may increasingly look to their sweep programs as an additional source of revenue.

## **ANNUAL REVIEW AND REPORT**

Under Proposed Rule 1102, Broker-Dealers would be required to, at least annually, review their best execution Policies and Procedures (including their order handling practices), with the results of this review (including any deficiencies and plans to address said deficiencies) being documented and presented in a written report to the board of directors (or an equivalent governing body).

In the Proposing Release, the SEC explains that this requirement is “designed to require Broker-Dealers to evaluate whether their best execution policies and procedures continue to work as designed and whether changes are needed to ensure their continued effectiveness.”<sup>34</sup>

This annual review differs from the review required by Proposed Rule 1101(c) because the annual review is meant to be a more holistic review that covers more than just execution quality. Both existing FINRA and MSRB rules have some variation of this review/reporting requirement, but the SEC explains that the proposed rule includes nuances that each of those rules is missing. According to the SEC, these annual

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<sup>34</sup> Proposing Release at 163.

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reviews should help regulators better understand a Broker-Dealer's compliance with the Best Execution Standard.

## Observations

This annual review requirement does place an onus on a Broker-Dealer's board of directors to carefully consider any reports regarding execution quality and changes that need to be made to the Broker-Dealer's routing practices. As such, persons occupying these roles should be mindful of their obligations and have a sufficient understanding of market execution practices.

## REVISIONS TO RULE 17A-4

Finally, the SEC is proposing amendments to Rule 17a-4 under the Exchange Act 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, with records in a readily accessible place in the first two years.

As explained in the Proposing Release, Proposed Regulation Best Execution would require Broker-Dealers to keep the following records:

- Policies and Procedures under Proposed Rules 1101(a), (b), and (d) and Proposed 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
- Annual report under Proposed Rule 1102

## Observations

While the recordkeeping obligations would appear straightforward, the obligations incumbent on Broker-Dealers to comply with various aspects of Proposed Regulation Best Execution require lots of data, lots of analysis, and snapshots in time. In this respect, the SEC's recently adopted [amendments to the electronic recordkeeping requirements](#), and in particular the new audit-trail requirement, may alleviate some of the burdens previously associated with needing to keep electronic records in a "write once, read many" format.

That said, it will be interesting to see how regulators expect firms to recreate the Best Market Determinations and whether third-party service providers will be a position to offer viable solutions to assist Broker-Dealers in meeting these and other obligations.

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## FINAL THOUGHTS

When coupled with the Equity Market Proposal, Proposed Regulation Best Execution stands to significantly increase the real-time market monitoring obligations that Broker-Dealers will have as they meet to satisfy customer orders.

Moreover, the focus on midpoint executions, along with the pressure on the receipt of PFOF, principal trading, and affiliate trading, may result in further pressure in the brokerage industry and reduced competition as Broker-Dealers have to consolidate, given the smaller pool of revenue sources.

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