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IN FOCUS

March 1, 2023

SEC-Proposed Regulations to Reform Stock Trading

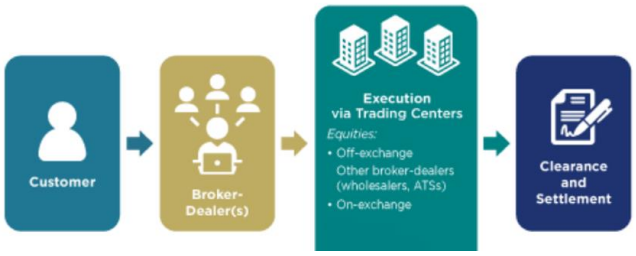
The Securities and Exchange Commission (SEC), which regulates capital markets, announced four proposed rules on December 14, 2022, to reform the market structure for trading. The proposed regulation affects how stock trading orders are executed, priced, and disclosed. If finalized, these SEC proposals could constitute the most significant changes to the regulation governing stock trading since 2005, when Regulation National Market System (Reg NMS) was introduced. This In Focus provides background on the market structure for equity (stock) trading and discusses the four proposed rules on best execution, order competition, order execution disclosure, and order pricing.

Equity Market Structure

A trading center that brings together multiple securities buyers and sellers generally has to (1) register with the SEC as a national securities exchange or (2) operate as an alternative trading system (ATS) and register as a broker-dealer. A national securities exchange is a securities exchange that has registered with the SEC under Section 6 of the Securities Exchange Act of 1934 (P.L. 73-291). ATSs are SEC-regulated electronic trading systems that match securities orders for buyers and sellers. Some ATSs are referred to as "dark pools" because, unlike national securities exchanges, they do not publicly display the size and price of their orders. A broker is any person engaged in securities buying and selling for others, while a dealer is any person engaged in securities transactions from the person's own account. Because most securities firms act as both brokers and dealers, they are called broker-dealers.

Figure 1 illustrates the typical equity market structure for a stock trade. When an investor goes through a broker-dealer to place a trade, the broker-dealer could route the customer order to one of several execution venues (trading centers). Execution refers to the process of fulfilling a buy or sell order. These venues include national securities exchanges and off-exchange venues such as ATSs, single-dealer platforms, and wholesalers (also referred to as market makers). Transactions also go through a clearance and settlement process, whereby transaction details are verified and money and shares are transferred between the accounts of the buyer and seller.

Figure 1. Equity Market Structure



Source: SEC.

Many regulatory requirements promulgated by the SEC and the industry self-regulatory organization—the Financial Industry Regulatory Authority (FINRA)—govern securities trading and market structure. These requirements include rules designed to promote market transparency (e.g., publicly displayed quotations and other disclosure and reporting requirements), ensure fair access and fair representation (e.g., standards of care for customer transactions to mitigate conflicts of interest and other risks), pricing restrictions, and market data distribution.

SEC Proposed Rules

According to the SEC, the benefits of the proposed reform include (1) leveling the playing field for different segments of equity markets, such as national securities exchanges, wholesalers, and dark pools, where trading activities take place; (2) increasing transparency on execution quality and facilitating investors' ability to compare trading venues and increase market competition; and (3) promoting competition through fair and open auctions.

Some industry participants pushed back on the SEC's rulemaking. For example, a senior official from zero-commission retail brokerage firm Robinhood said, "I've never seen a rulemaking effort of this size and complexity and interconnectedness being done all at the same time, this quickly, with so little advance study and discussion."

A NASDAQ study shows that about 40% of U.S. stock trading volume takes place off-exchange. The SEC's market structure reform proposals may increase competition and transparency and drive trading volume from off-exchange venues to national securities exchanges. In anticipation of this shift, share prices at several wholesalers decreased sharply at the announcement of the SEC's proposals, potentially reflecting investors' views on the proposals' potential adverse impact on the wholesalers.

Two of the four proposed rules are more controversial. The SEC commissioners advanced the proposals on best execution and order competition in a split vote. Two other proposals relating to order execution disclosure and order pricing were advanced unanimously.

Best Execution

The duty of best execution requires a broker-dealer to execute customers' stock and other securities trades at the most favorable terms under prevailing market conditions. The SEC has no existing regulation on best execution, while FINRA already has a best execution rule (Rule 5310), which was first established in 1968 by its predecessor, the National Association of Securities Dealers. Because of best execution's importance to investor protection by fostering the best broker-dealer conduct, the SEC believes it would be important to set its own standards. The SEC's proposed rule establishes best execution standards that aim to ensure

that broker-dealers have completed reasonable due diligence to provide an execution price for a customer order that is the best possible under reasonable circumstances, subject to certain exemptions. Additional requirements would apply when the broker-dealer has a conflict of interest. It also requires broker-dealers to develop written policies and procedures for such standards. In addition, the proposed rule establishes time intervals for broker-dealers to review the execution quality of customer transactions (at least quarterly) and their best execution policies and procedures (at least annually). The SEC estimates aggregate one-time compliance costs of $165.4 million and ongoing annual costs of $128.9 million for broker-dealers.

While broker-dealers already have some procedures in place to meet FINRA's existing best execution requirements, many aspects of the SEC proposal extend beyond FINRA's current requirements. Critics believe the proposal is unduly detailed and prescriptive and may force firms to modify existing business practices to meet these obligations, making the proposal expensive and difficult to comply with. For example, under certain conditions, broker-dealers must go beyond "material potential liquidity sources" to seek the most favorable prices for customer orders. SEC Commissioner Hester Peirce, who voted against the proposal, believes such prescriptive requirements are not as sensible as allowing more discretion for broker-dealers to mitigate conflicts of interest through greater due diligence.

Order Competition

The SEC proposed a new rule on order competition that requires certain retail orders to be put up for auction before they could be executed internally by any trading venues that restrict order-by-order competition. The proposal aims to address a concern associated with retail investor orders that are currently largely routed to wholesalers (90%) instead of being exposed to competition from a broad range of market participants. The SEC estimates this "competitive shortfall" to be $1.5 billion per year, or 1.08 basis points (0.0108%) per dollar traded by wholesalers, for investors.

The proposed rule generally prohibits a wholesaler from internally executing (i.e., fulfilling the orders themselves) certain orders, called "segmented orders," unless the orders are exposed to competition in qualified auctions operated by qualified trading centers (i.e., open competition trading center), subject to some exemptions. The proposed new approach could enable more market participants—such as hedge funds and pension funds—to compete for trade orders and potentially achieve more favorable execution prices. Such open competition is generally nonexistent for the 90% or so retail orders processed by wholesalers.

Critics argue that multiple academic studies have shown that retail investors are *not* receiving worse price execution under the current system. Financial reporters at Barron's and others have challenged the SEC's calculations in the proposed rule, saying its estimates were overstated and uncertain. Critics believe the replacement of a functional system with a highly complex, costly, and unproven new process may or may not increase competition, but it would likely introduce new risks such as potential execution challenges, operational uncertainties, and adverse effects on retail investor participation in investment activities.

Order Execution Disclosure

The SEC proposed to expand the scope of Rule 605 of Reg NMS, which governs the disclosure requirements for trading order executions. The agency emphasizes that trading practices have changed significantly since Rule 605's adoption in 2000, yet the rule has not been updated for two decades. The proposed amendments aim to help improve data availability for understanding trading order execution quality across broker-dealers and trading centers (e.g., national securities exchanges, market makers, and ATSs), thus enhancing transparency and competition.

The proposed amendments include (1) expanding the monthly execution quality reporting requirements to large broker-dealers, single-dealer platforms, and entities that would operate qualified auctions as proposed in the order competition rule; (2) expanding the orders covered for reporting to include certain irregular orders submitted outside of regular trading hours, non-exempt short sale orders, and others; (3) amending the information required by re-categorizing order sizes and types and adding new reporting items; and (4) subjecting all reporting entities to summary reports that are formatted as Extensible Markup Language and PDF for standardization.

Order Pricing

The SEC proposed a new rule to amend the minimum price increments (tick size), reduce access fee caps for certain quotations, and accelerate the compliance with price transparency requirements for certain data feeds (e.g., information for trade orders of less than standard units, referred to as "odd lot").

Currently, national securities exchanges face restrictions on certain pricing increments, which are limited to $0.01, as opposed to increments produced by market conditions that sometimes favor narrower than $0.01 increments, especially for stocks with low per-share prices. Because Rule 612 under Reg NMS constrains *quoting*, but not *trading*, under certain conditions, wholesalers can execute sub-penny increments, while national securities exchanges are unable to do so (because their trades are often generated from the ranking of quotes). This has led to a years-long policy push from national securities exchanges regarding their ability to attract trade orders through sub-penny increments that are perceived as more reflective of market conditions.

The SEC's new proposal, among other things, would allow the exchanges to quote some tick size in less than one-penny increments. The proposal would amend tick size requirements under Rule 612 to establish a variable minimum pricing increment for both the *quoting* and *trading* of Reg NMS stocks for all on-exchange and off-exchange trading venues, subject to certain exceptions. As such, it would level the playing field for exchanges and wholesalers with regard to pricing increments.

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IF12336

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