

Regulatory Alert

Regulatory Insights for Financial Services

June 2022

Market structure: SEC remarks on potential updates

KPMG Insights. SEC's recent speech on "Market Structure and the Retail Investor" offers broker-dealers and other market participants a preview of the potentially expansive changes that may be proposed across the SEC's stock-trading rules this year. The speech highlights perceived inefficiencies in the U.S. national market system that may disproportionately impact retail investors. The SEC's concerns are partly influenced by the 2021 events surrounding the trading of meme stocks, which brought out potential issues and impacts related to current payment for order flow practices, best execution, market competition, and conflicts of interest. Select Capital Markets industry participants have already begun to respond to the outlined considerations with some suggesting that the market is functioning well for ordinary investors and that the scope of the potential changes as outlined could potentially inhibit new retail investors' entry into the markets.

Securities and Exchange Commission (SEC) Chair Gensler has outlined six areas where he believes the SEC's rules governing the national market system could be updated to drive greater efficiencies and improve fairness and competition for retail investors. Referencing a recent Staff Report on "last year's meme stock event" that cites considerations to protect investors and maintain fair, orderly, and efficient markets, Chair Gensler stated that he had asked SEC staff to consider and make recommendations regarding:

1. Minimum Pricing Increment
2. National Best Bid and Offer
3. Disclosure of Order Execution Quality
4. Best Execution
5. Order-by-Order Competition
6. Payment for Order Flow, Exchange Rebates, and Related Access Fees

Highlights of relevant concerns and areas of staff focus/consideration are outlined below.

1. Minimum pricing increments

At present, in "lit markets", investors see prices in one-penny increments while wholesalers can fill orders at sub-penny prices and without open competition. To address questions as to whether this disparity is "fair and best promotes competition,"

- SEC staff has been asked to consider:
 - Harmonizing tick sizes across market centers so that all trading occurs at minimum increments
 - Reducing the minimum tick size to "better align with off-exchange activity"

2. National Best Bid and Offer (NBBO)

Limitations to the NBBO suggest it "may not be a precise measuring rod for assessing whether retail investors are receiving fully competitive prices." At present, only round lots (defined as quote for 100 shares or more) are included such that many retail investors, who are more likely to buy or sell at odd lot prices, are unable to see the NBBO quotes. In addition, despite a significant increase in odd lots, a new rule to redefining round lots to capture lots of less than 100

shares in certain instances is several years away from implementation.

- SEC staff is considering:
 - Accelerating implementation of the new round lot definition as included in the Market Infrastructure Rule
 - Accelerating implementation of enhanced transparency for quotation information also within the Market Infrastructure Rule
 - Potentially establishing an odd-lot best bid offer to enable retail investors to see “better prices” regardless of share quantity

3. Disclosure of Order Execution Quality

Retail investors cannot compare execution across brokers while “market centers,” such as dark pools, wholesalers, and exchanges provide these disclosures in regular reports pursuant to Rule 605.

- SEC staff is considering updates to Rule 605 to require:
 - Order execution quality disclosures for investors, potentially including reporting requirements for broker-dealers
 - All reporters to provide summary statistics of execution quality, such as the price improvement as a percentage of the spread

4. Best Execution

Although regulators such as FINRA and the MSRB (Municipal Securities Rulemaking Board) have rules on best execution, the SEC does not currently have rules pertaining to broker-dealer’s best execution duty to customers.

- SEC staff is considering whether to propose a best execution rule for equities and other securities that would:
 - Require broker-dealers to exercise reasonable diligence to execute customer orders in the best market

- Detail procedural standards for handling and executing customer orders

5. Order-by-Order Competition

Chair Gensler states the “vast majority” of retail marketable orders are flowing to wholesalers that pay for this order flow. He added that although it is suggested retail investors receive “slightly better prices compared to NBBO” in these instances, they may not receive the fully competitive “best price”.

- SEC staff is considering how to enhance order-by-order competition, including through potentially open and transparent auctions or other means

6. Payment for Order Flow, Exchange Rebates, and Related Access Fees

Chair Gensler stated that payment for order flow can increase conflicts of interest risks, including the potential for distorting routing decisions and incentivizing broker-dealers to use digital engagement practices to increase customer trading. Similarly, exchange rebates may also pose conflicts of interest risks regarding the routing of customer limit orders.

- SEC staff is considering:
 - How to mitigate risks aligned to payment for order flow and exchange rebates
 - Improving transparency of exchange fees and rebates for investors
 - Changes to access fees in the event that tick sizes are reduced (e.g., if minimum pricing increments are reduced, access fee caps may also have to be reduced in order to be proportionate)

For additional information, please contact [Amy Matsuo](#) or [Mike Sullivan](#).

Contact the author:



Amy Matsuo
Principal and Leader
Regulatory and ESG Insights
amatsuo@kpmg.com

kpmg.com/socialmedia



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