KPMG

Regulatory Alert

Regulatory Insights

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Market structure: SEC proposals addressing transparency, competition, and investor protections

KPMG Insights: *The SEC took unprecedented action in promulgating a series of rules proposals and amendments geared toward trade execution, order flow and transparency. Taken holistically, these proposals represent significant changes to the retail trading market structure. The proposals are meant to help "shine a light" on trades, particularly those within dark venues/pools and wholesalers. However, the extent of these changes is anticipated to impact all entities involved in retail investment. The proposals are meant to help further protect investors through such means as: Best Execution standards, increasing transparency in pricing and order execution, and driving "quality" in terms of disclosures in such areas as fractional share orders, odd-lot orders and larger-size orders. These proposals come as a result of what regulators felt to be both conflicts of interest and the potential for market manipulation/distortion in the retail trading market at large. Companies should assess both direct and indirect impacts and risks from these proposals (including business lines and third-party strategy, products, service and feature impacts, and technology and system readiness).*

Following through on Chair Gensler's speech in June 2022, where he outlined potential updates to rules governing the national market system (NMS) (see KPMG regulatory alert here), the Securities and Exchange Commission (SEC) issued four proposals, including both amendments and new rules, under the Securities Exchange Act of 1934 related to:

1. Best Execution
2. Disclosure of Order Execution Information
3. Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders
4. Order Competition

According to the SEC, these proposals will "promote a more competitive, transparent, and efficient market structure for NMS stocks, with resulting benefits to investors".

Key highlights of each proposed rule are outlined below.

1. Best Execution

The SEC is proposing a new rule series, Regulation Best Execution (Rules 1100, 1101, and 1102), which would set forth a best execution regulatory framework that would apply to broker-dealers (inclusive of brokers, dealers, government securities brokers, government securities dealers, and municipal securities dealers). The rule would:

— Establish a best execution standard for broker-dealers that would require them to use "reasonable diligence" to execute customers' trades at the most favorable terms reasonably available under the circumstances. Some exemptions to the standard would apply.

— Require broker-dealers to establish, maintain, and enforce written policies and procedures "reasonably designed" to comply with the best execution standard.

— Require broker-dealers that engage in certain "conflicted transactions" (as defined in the rule) for or with a retail customer to implement more robust policies and procedures.

— Require broker-dealers to review, at least quarterly, the execution quality of their customer transactions.

— Exempt “introducing brokers” from complying with certain requirements if they establish, maintain, and enforce policies and procedures that require them to regularly review the execution quality obtained from their executing broker.

— Require broker-dealers to review, at least annually, their best execution policies and procedures, including order handling practices, and present a report detailing the results of such reviews to their boards of directors or equivalent governing bodies.

2. Disclosure of Order Execution Information

The SEC’s proposed amendments to Rule 605 under Regulation NMS are intended to update required disclosures for order execution of stocks listed on a national securities exchange. As proposed, the amendments would expand the scope of Rule 605 to include:

— Broker-dealers who introduce or carry 100,000 or more customer accounts.

— Single-dealer platforms.

— Entities operating qualified auctions (as proposed separately under the Order Competition rule).

Additionally, the proposed amendments would:

— Require the expanded entities subject to Rule 605 to make publicly available monthly execution quality reports.

— Update the definition of a “covered order” to include certain orders submitted outside of regular trading hours, certain orders submitted with stop prices, and non-exempt short sale orders.

— Modify the existing order size categories to base them on round lots and add order size categories for fractional share orders, odd-lot orders, and larger-sized orders.

— Create a new order type category for marketable immediate-or-cancel orders and replace three existing categories of non-marketable order types with three new categories of order types (beyond-the-midpoint limit orders, executable non-marketable limit orders, and executable orders with stop prices).

— Eliminate time-to-execution categories in favor of average, median, and 99th percentile time to execution statistics.

— Change the realized spread statistics (to be calculated after 15 seconds and one minute) and require new statistical measures of execution quality.

— Require all subjected entities to make a summary report available in accordance with the SEC’s formatting requirements.

3. Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders

This proposal would make additional amendments to Regulation NMS in the following three areas:

— **Minimum Pricing Increments (Tick Size):** The SEC proposes to amend the minimum pricing increments under Rule 612 to establish a four-tier variable minimum pricing increment model that would apply to quotes and trades on exchanges, alternative trading systems, and over-the-counter (some exceptions apply). The minimum pricing increments would pertain to quotations, orders, indications of interest, and trades in NMS stocks equal to or greater than $1.00 per share.

— **Access Fees:** Proposed changes to Rule 610 are intended to reduce the level of access fee caps for quotations in NMS stocks to align with the proposed variable minimum pricing increments. NMS stocks priced at $1.00 or more would be subject to an access fee based on the minimum pricing increment (under Rule 612). NMS stocks priced less than $1.00 would be subject to access fees equal to 0.05 percent of the quotation price.

  - A national securities exchange would be prohibited from “imposing or permitting to impose, any fee(s), or providing, or permitting to be provided, any rebate or other remuneration (e.g., discounted fees, other credits, or forms of linked pricing) for the execution of an NMS stock unless such fee, rebate, or remuneration can be determined at the time of execution.”

— **Transparency of Better Priced Orders:** In order to improve the transparency of better priced orders, proposed amendments to Rules 603(b) and 600(b) would:

— Accelerate the implementation date of the round lot and odd-lot information definitions adopted under the Market Data Infrastructure Rules.

— Require existing exclusive securities information processors (exclusive SIPs) to collect, consolidate, and disseminate odd-lot information.

— Require national securities exchanges and associations to provide the data necessary to generate odd-lot information to the exclusive SIPs.

— Modify the definition of odd-lot information to include a new data element that identifies the best odd-lot orders to buy and sell across all national securities exchanges and national securities associations.

4. Order Competition

The SEC summarizes that, in an effort to enhance competition for the execution of marketable orders of individual investors, it is proposing a new rule, the Order Competition Rule, which would require certain orders of individual investors to be exposed to competition in a qualified auction (a fair and open auction) before they could be executed internally by any trading center that restricts order-by-order competition.

— The rule would apply to "segmented orders", which would be defined (and subject to exceptions detailed in the rule) as NMS stocks made for an account:
  - Of a natural person or an account held in legal form on behalf of a natural person or group of related family members
  - In which the average daily number of trades executed in NMS stocks was less than 40 in each of the six preceding calendar months.

— Proposed requirements for qualified auctions would include:
  - Dissemination of auction messages in consolidated market data.
  - An auction duration between 100 and 300 milliseconds.
  - Adherence to minimum pricing increments that are no less than $0.001 for segmented orders and auction responses with prices of $1.00 or more per share.
  - Prohibitions against charging fees for submission of a segmented order (permissible fees will be capped).
  - Prohibitions against execution priority requirements that give priority to the fastest auction response or to the auction response submitted by the broker-dealer that routed the segmented order to auction.

The SEC invites public commentary on each of the rule proposals and listed questions therein. Comments are requested on or before March 31, 2023, or 60 days after the date of publication the Federal Register, whichever is later.

Relevant KPMG Thought Leadership

— Regulatory Alert | Market structure: SEC remarks on potential updates

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— Regulatory Insights POV | Ten Key Regulatory Challenges of 2023

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