

SEC New Year's Resolution? Market Restructuring for All!

In brief

On December 14, 2022, the Securities and Exchange Commission ("SEC") proposed four separate rulemakings under the Securities Exchange Act of 1934 ("Exchange Act") that would create a federally defined best execution standard for broker-dealers and overhaul the US equities market structure (collectively, the "Market Structure Proposals").

If adopted in their current form, these proposals would meaningfully impact market participants and practices. Given the nearly 1,700 pages of combined rules proposals, firms may need to devote significant resources just to digest their potential impact on particular business models.

In a series of Client Alerts, we will attempt to dissect each of these Market Structure Proposals. In this Client Alert, we provide an overview, insights, and key takeaways for the Regulation Best Execution (Reg Best Ex) Proposal.

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Reg Best Ex Proposal Overview

Regulation Best Execution would create a federally defined best execution standard for broker-dealers that is generally consistent with the existing best execution standards codified in **FINRA Rule 5310** and **MSRB Rule G-18** (collectively, SRO Rules). Despite this general consistency with SRO Rules, the proposed Reg Best Ex standard can be distinguished in ways that should be assessed by market participants to determine the impact on their particular business models. Moreover, Reg Best Ex would impose new policies and procedures requirements. These new requirements include elements that must be addressed by all broker-dealers in order to comply with the standard, as well as new supervision expectations, and additional compliance and documentation mandates related to certain conflicted transactions.

Proposed Rule 1100 — The Best Execution Standard

As drafted, Reg Best Ex provides that "[i]n any transaction for or with a customer, or a customer of another [broker-dealer], a [broker-dealer], or a natural person who is an associated person of a [broker-dealer], shall 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 Reg Best Ex, "broker-dealer" includes a broker, dealer, government securities broker, government securities dealer, or municipal securities dealer.

Reg Best Ex would not apply to a broker-dealer or its associated persons when:

- (1) another broker-dealer executes a customer order against the broker-dealer's quotation;

- (2) an institutional customer, exercising independent judgment, executes its order against the broker-dealer's quotation; or
- (3) the broker-dealer receives an unsolicited directed customer order and the broker-dealer executes the order promptly in accordance with the customer's instructions.

Save for the proposed exemption involving institutional customers, which does not currently exist under the SRO Rules, the Reg Best Ex standard, including its applicability scope, is generally consistent with SRO rules. However, the SEC views this proposed new exemption as appropriate in instances where institutional customers handle their own orders directly with their broker-dealers, and the broker-dealer is acting solely as a buyer or seller of securities. The SEC did not define "institutional customer" in the proposal, instead requesting comments from the public on the appropriate definition.

As a practical matter, the duty of best execution codified in the Reg Best Ex standard presents no substantive difference from the best execution standard codified in SRO Rules and, like the SRO Rules, codifies the longstanding duty of best execution that has been developed through case law.

Not Surprisingly, Reg Best Ex Would Also Apply to Crypto Asset Securities

Of interest, the proposal contains a brief discussion on the applicability of Reg Best Ex to transactions involving "crypto asset securities," which the SEC indirectly defines as any "digital asset" that is a security or government security under the federal securities laws. The proposed rule release further describes a "digital asset" as an asset that is issued and/or transferred using distributed ledger or blockchain technology.

In the rule release, the SEC stated that it has limited information about order handling and best execution practices of broker-dealers that engage in transactions involving crypto asset securities, leading the agency to conclude that:

- only a small portion of crypto asset security trading activity is occurring within entities that are registered with the SEC and any SRO;
- only a limited amount of crypto asset security volume is executed on trading venues under the SEC's Regulation ATS framework; and
- significant trading activity in crypto asset securities may be occurring in non-compliance with the federal securities laws.

The SEC did not take any unexpected positions on this basis but the rule release concluded that Reg Best Ex would apply to a broker-dealer with respect to a customer transaction in a crypto asset "security." In this regard, SEC makes clear its view that the bedrock duty of best execution is equally fundamental and important to investors in, and the market for, crypto asset securities. The SEC also warned that broker-dealers should ensure that they are evaluating the range of markets that trade crypto asset securities to appropriately identify those markets that may be likely to provide customers with the most favorable prices.

The inclusion of a discussion of best execution in the context of crypto asset securities builds upon the SEC's other statements and guidance involving market participants (particularly broker-dealers) engaging in the digital assets business. In any future enforcement actions against a market participant trading digital assets that the SEC views as "securities," these statements will surely be referenced. Further, these comments are of particular interest because the duty of best execution has been found to subject broker-dealers to fraud liability under Exchange Act Section 10(b) and Rule 10b-5 which, in addition to SEC enforcement authority, may provide investors with a potential private right of action. Given the frequency and substance of recent **statements** by Chairman Gensler and SEC Enforcement staff on exercising SEC enforcement authority in the crypto space, and the turmoil in the current digital assets markets generally,

this may prove to be an area to watch, apart from substantive rulemaking or legislative activity related to the crypto industry.

Proposed Rule 1101 — Reg Best Ex Policies and Procedures and Related Obligations

Best Execution Compliance Framework and Best Market Determination

As proposed, Reg Best Ex would preserve the reasonable diligence requirement under SRO Rules to comply with the best execution standard, and require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to comply with the standard. This requirement aligns with the similar general supervisory requirements under the SRO Rules, such as FINRA Rule 3110. However, Reg Best Ex would go beyond SRO Rules by mandating particular elements every broker-dealer would be required to include in their policies and procedures. The SEC views the prescriptive procedures requirement as necessary to provide for "consistently robust best execution practices" to benefit customers, rather than the current varying practices that have been observed by the SEC.

In particular, Reg Best Ex would require broker-dealers' policies and procedures to address:

- (1) **how the broker-dealer will comply with the proposed standard of best execution**, including by identifying markets that may be reasonably likely to provide the most favorable prices for customer orders ("material potential liquidity sources"); incorporating these liquidity sources into order handling practices, and ensuring that the broker-dealer can efficiently access each source; and
- (2) **how the broker-dealer will determine the best market for customer orders received**, including by assessing reasonably accessible and timely pricing information and opportunities for price improvement.

While these proposed elements touch on familiar concepts and factors provided in past [SEC](#) and [FINRA](#) guidance on the duty of best execution, broker-dealers would need to review existing policies and procedures to ensure alignment with the proposed requirements.

New Conflicted Transactions Requirements

With respect to retail customers, broker-dealers also would be required to implement additional policies and procedures to address certain "conflicted transactions" where the broker-dealer:

- (1) executes an order as principal (including riskless principal);
- (2) routes to, or receives from, an affiliate an order for execution; or
- (3) provides or receives payment for order flow (PFOF).

In such circumstances, broker-dealers would be required to document compliance with additional conflicted transaction requirements, including all efforts to enforce its specific conflicted transaction best execution policies and procedures, as well as the basis for its determination that the conflicted transactions would comply with the Reg Best Ex best execution standard. Further, broker-dealers providing or receiving PFOF would be required to document any such arrangements (whether written or oral), including certain material terms of the arrangements.

In June 2021, FINRA issued [guidance](#) reminding broker-dealers of their best execution obligations in the context of PFOF, as well as other forms of economic inducement, such as executing transactions as principal and internalizing a firm's own customer orders. In that guidance, FINRA reiterated the SEC's longstanding position that "a broker-dealer must not allow a payment or an inducement for order flow to interfere with its efforts to obtain best execution." FINRA Rule 5310.09 incorporates these principles by requiring that firms:

- (1) ensure that they direct customer orders to markets that provide the most beneficial terms for such orders; and
- (2) compare any material differences in execution quality their customers will receive at competing markets—including markets they may have existing routing arrangements with, as well as those they do not.

Reg Best Ex would further enshrine these obligations and provide more fertile ground for enforcement actions with respect to the new conflicted transactions requirements, adding inadequate policies and procedures to the list of potential bases for violations. Firms with PFOF arrangements and principal internalization practices should consider how these more prescriptive obligations may impact their existing programs.

Since it does not appear that great efforts were made to harmonize the four Market Structure Proposals, it will be important for firms to weigh this proposal along with the others, to consider impacts and effects on their business model, particularly with respect to PFOF practices, internalization, and fractional share programs.

Broader Applicability of Requirements for Regular Review of Execution Quality

Reg Best Ex also would require broker-dealers subject to the rule to review the execution quality of their customer orders **at least quarterly**, compare it with the execution quality that might have been obtained from other markets, document this review, and revise their best execution policies and procedures accordingly. The SEC stated that this execution quality review requirement would be consistent with the regular and rigorous execution quality review requirement of FINRA Rule 5310.09, except that Reg Best Ex would expand the scope of the requirement to all broker-dealers subject to Reg Best Ex.

FINRA Rule 5310.09 currently requires an at least quarterly rigorous review of execution quality if the broker-dealer does not conduct an order-by-order review and it either (a) routes customer orders to other broker-dealers for execution on an automated, non-discretionary basis; or (b) internalizes customer order flow. Reg Best Ex would not limit the execution quality review to the circumstances provided in Rule 5310.09. Thus, broker-dealers not previously subject to the execution quality review in Rule 5310.09 would now need to implement new policies and procedures to address this requirement.

Introducing Broker Exemption Directly Aimed at PFOF

Reg Best Ex would provide an exemption for "introducing brokers" that route customer orders to an executing broker, provided that the introducing broker:

- (1) establishes, maintains, and enforces policies and procedures that require it to:
 - a. regularly review the execution quality obtained from its executing broker;
 - b. documents the review;
 - c. compares the execution quality to that of other executing brokers;
 - d. revises its order handling practices accordingly;
- (2) does not carry customer accounts or hold customer funds or securities;
- (3) has a clearing agreement with an unaffiliated executing broker that has agreed to execute trades on an agency basis; and
- (4) does not accept any benefit from the executing broker in return for routing the customer orders (e.g., PFOF).

While the exemption contains other conditions, the primary impact likely would be providing a strong incentive to introducing brokers to avoid receiving PFOF. Introducing brokers will need to weigh the costs of compliance with the expanded policies and procedures requirements, particularly with respect to conflicted transactions and execution quality reviews, against the economic benefits of PFOF and internalization. If adopted, we expect many introducing brokers currently receiving PFOF that would otherwise be able to rely on the exemption likely would end their PFOF practices.

Proposed Rule 1102 — Annual Report

Reg Best Ex as proposed also would require broker-dealers subject to the rule to review and assess the overall effectiveness of their best execution policies and procedures, including their order handling practices, on **at least an annual basis**, and prepare a report detailing the results of such review and assessment that would be presented to the broker-dealer's board of directors, or an equivalent governing body.

Key Takeaways: A Rule in Search of a Problem?

The SEC's newly proposed Reg Best Ex would provide a more prescriptive approach for how broker-dealers meet their best execution obligation, and expand the requirements and scope of existing best execution requirements currently in place under SRO Rules. The SEC's proposed step-by-step approach to achieving best execution is a departure from the generally principles-based nature of the longstanding broker-dealer best execution obligation. The rule proposal release, however, offers little factual or evidentiary support to substantiate the SEC's claim that the proposal would benefit customers.

As Chairman Gensler acknowledged in his [statement](#), this proposed rule is largely a response to the volatility of early 2021, in which markets experienced a spike in retail investor interest in investing and the related meme stock events. Further, Gensler's primary expressed concerns, bolstering his support for the proposal, appear to relate to the fact that the SEC does not have an explicit best execution rule, and Reg Best Ex would provide the SEC with additional enforcement capabilities.

As the Reg Best Ex standard does not create a new duty and would adopt the same standard already applicable to broker-dealers through the SRO Rules, it begs the question who really benefits from requiring prescriptive policies and procedures.

No independent study was conducted by the SEC on how the additional measures required under proposed Reg Best Ex, either on their own or in combination with the effects of the other Market Structure Proposals, would provide investors with better prices or execution quality, and these proposals leave little room for investors that prioritize speed or other factors over nominal price improvement. Moreover, the SEC tacitly acknowledges in the proposal release that any benefits are largely speculative because the SEC lacks sufficient data on either current broker-dealer order handling and routing practices or execution quality reviews.

Further, the SEC also acknowledges that due to its lack of data, the new requirements may lead to better prices for some retail investors and worse prices for others. Notwithstanding the lack of data on which the SEC bases this new rule proposal and its inability to reasonably predict the proposal's impacts, the rule release does herald that the requirements would at least facilitate enforcement inquiries and broker-dealer exams. But to what end? Where it is unclear what additional protection is being provided to investors, or what harm currently being incurred, more exams and enforcement seems like busy work.

As noted above, one area on which we can agree with the SEC is that the practice of PFOF under the proposed Reg Best Ex likely would be significantly curtailed, even as the attendant benefits - or costs - to investors remain largely speculative. In this regard, the potential increased costs to both wholesalers

providing PFOF and introducing brokers receiving it, as well as their customers, could take the brunt of that impact.

The industry already has **signaled** strong opposition to Reg Best Ex as well as the other Market Structure Proposals, while the early proposal **comments** and **reddit boards** popular with the retail investors behind the 2021 meme stock reflect a grassroots effort supporting the proposals. We will discuss the other Market Structure Proposals in forthcoming Client Alerts, but even if adopted, we expect implementation of the proposals to be delayed for some time, as the SEC evaluates comments, and then manages anticipated litigation. The comment deadline for the Reg Best Ex Proposal is March 31, 2023 or 60 days after the proposal is published in the Federal Register, whichever is later.

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