

## SEC Promotes Order Competition—by Limiting It?

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

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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 attempt to dissect each of these Market Structure Proposals. Our first in the series on Regulation Best Execution Proposal can be found [here](#). In this Client Alert, we provide an overview, insights, and key takeaways for the Order Competition Rule Proposal

### Order Competition Rule Proposal Overview

Proposed Rule 615 (the "Order Competition Rule") is comprised of two key requirements: (1) the order competition requirement; and (2) qualified auction requirements. The Proposal also sets forth other mandates specific to various market participants, which we will discuss in context.

While the order competition requirement is relatively simple at a high level, its impacts would be far reaching and would drastically alter how retail investor orders in NMS stocks are handled. Further, other requirements of the Proposal would place additional, new obligations on retail broker-dealers, clearing firms, wholesalers, alternative trading systems ("ATS") and national securities exchanges. The SEC argues that these new obligations are needed to improve fair competition and investor protection. However, beneath the surface and in practice, the Proposal seems more likely to curtail free market competition and increase market uncertainty in the name of claimed investor benefits that the SEC struggles to define.

### Order Competition Requirement

Subject to certain exceptions, Proposed Rule 615(a) would prohibit a "restricted competition trading center" from executing internally a "segmented order" for an NMS stock until after a broker-dealer has exposed such an order to competition at a "specified limit price" in a "qualified auction" that meets certain qualified auction requirements (discussed below).

According to the Proposal, the purpose of this requirement is to expose segmented orders to competition thus providing the best prices on an order-by-order basis and thereby minimizing transaction costs incurred by individual orders for marketable orders.

## Definitions

Before diving into the Proposal, we need to lay out a few new expressly defined terms:

- **Segmented Order** means an order for an NMS stock that is for the account:
  - (1) of a natural person (including an account held in legal form on that person's behalf or group of related family members); and
  - (2) in which the average daily number of trades executed in NMS stocks was less than 40 in **each** of the preceding 6 calendar months.
- **Open Trading Competition Center ("OTCR")** means either a national securities exchange or an NMS Stock ATS that meets a number of specific conditions discussed below.
- **Restricted Trading Competition Center ("RCTR")** means any trading center other than an OTCR or a national securities exchange.
- **Qualified Auction** means an auction operated by an OTCR that meets the "qualified auction requirements" discussed below.
- **Originating Broker** means any broker responsible for handling a customer account, including, but not limited to, opening and monitoring the customer account and accepting and transmitting orders for the customer account.

## Applicability and Segmented Order Exceptions

As referenced above, the order competition requirement would apply only to **segmented orders**, but it would not apply to:

- (1) a segmented order received and executed by an RCTR when no OTCR is operating a qualified auction for the segmented order; or
- (2) any of the following, if at the time the segmented order is received by the RCTR:
  - a. the segmented order has a market value of at least \$200,000 based on the NBBO midpoint;
  - b. the segmented order is executed by the RCTR at a price equal to or more favorable than the NBBO midpoint for that segmented order; or
  - c. the segmented order is a limit order with a limit price set by the customer equal to or more favorable for the segmented order than the NBBO midpoint; or
- (3) the fractional share component of a segmented order that is received and executed by a RCTR when no OTCR is operating a qualified auction for the segmented order that:
  - a. accepts fractional share orders; and
  - b. the customer placed the order resulting in a fractional share component.

The first exception is intended to recognize the fact that an RCTR may receive a segmented order during a time period in which an OTCR is not operating a qualified auction. For instance, a qualified auction could not be operated during time periods in which the facilities for disseminating consolidated market data (securities information processors or "SIPs") are not operating. Currently, that time period is any time other than 4 a.m. to 8 p.m. Eastern time on equity market trading days.

With respect to the fractional share component exception, it should be noted that the exception is limited solely to the fractional share. If a segmented order involves a whole share and a fractional share component, only the fractional share component is excepted—the whole share would be subject to the order competition requirement. The primary reason for this exception is that most trading centers, and all

national securities exchanges, accept only whole share orders. Applying the Proposed Rule to fractional shares would be impractical and potentially end many fractional share trading programs.

### *Identifying Segmented Orders and Originating Brokers*

The effectiveness of the order competition requirement hinges largely on originating brokers properly identifying customer orders as segmented orders. To that end, Proposed Rule 615(e) sets forth three requirements for originating brokers that would:

- (1) require originating brokers to establish, maintain and enforce written policies and procedures reasonably designed to identify customer orders as segmented orders;
- (2) prohibit originating brokers from routing segmented orders without also identifying the order as such to the routing destination; and
- (3) if an originating broker does not want its identity disclosed in an auction message (discussed below), the originating broker must:
  - a. certify that it has established, maintains and enforces written policies and procedures reasonably designed to assure that the originating broker's identity will not be disclosed to any person that could participate in the qualified auction or otherwise trade with the segmented order ("Anonymity Certification"); and
  - b. establish, maintain and enforce such written policies and procedures.

To the extent that multiple brokers have responsibility for handling a customer account (such as in an introducing/carrying broker relationship), each such broker would be an "originating broker." However, consistent with [FINRA Rule 4311](#) (Carrying Agreements), the brokers would be permitted to allocate in a written carrying agreement the responsibilities for handling a customer account, including the broker responsible for opening and approving accounts and acceptance and transmission of orders for execution.

Similar to the requirement for originating brokers, Proposed Rule 615(f) requires all broker-dealers that receive an identified segmented order to also identify the order as such to the routing destination. These analogous requirements are intended to ensure that no segmented order reaches an RCTR without being properly identified as such thereby triggering the order competition requirement for the RCTR receiving the segmented order.

### *Qualifying as OCTRs*

The definitions of OCTR and RCTR effectively determine (1) those trading centers that would be authorized to operate qualified auctions, and (2) the RCTRs that would be subject to the order competition requirement.

Notably, based on the definitions for OCTRs and RCTRs as proposed, some national securities exchanges will not qualify as either type of trading center. Further, due to the OCTR conditions required for an NMS Stock ATS, no such NMS Stock ATS would currently be able to qualify as an OCTR. So where's the competition?

- **National Securities Exchanges**

As noted above, not even all national securities exchanges would qualify as an OCTR as a result of the requirement for a national securities exchange to meet all of the following four conditions:

- (1) the exchange must operate an SRO trading facility that is an automated trading center and display automated quotations disseminated in consolidated market data pursuant to Rule 603 of Reg NMS;
- (2) the exchange must provide transaction reports identifying it as the venue of execution disseminated in consolidated market data pursuant to Rule 603 of Reg NMS;

- (3) the exchange must have had an average daily share volume of at least 1% of the aggregate average daily share volume for all NMS stocks as reported by an effective transaction reporting plan during at least 4 of the preceding 6 calendar months; and
- (4) the exchange would be required to operate pursuant to its own rules, which shall provide that the exchange will comply with the qualified auction requirements.

The Proposal notes that as of the end of September 2022, 6 of the 16 national securities exchanges would not qualify as an OCTR because they would not meet the 1% volume threshold. In other words, only 10 national securities exchanges currently would qualify as an OCTR under the Proposed Rule.

- **NMS Stock ATs**

In an effort to place national securities exchanges and NMS Stock ATs on what the SEC views to be equal regulatory footing, an NMS Stock ATS must meet each of the following seven conditions to qualify as an OCTR:

- (1) the ATS must display quotations through an SRO display-only facility in compliance with Rule 610 of Reg NMS;
- (2) the ATS must operate as an automated trading center and display automated quotations disseminated in consolidated market data pursuant to Rule 603 of Reg NMS;
- (3) the ATS must provide transaction reports identifying the ATS as the venue of execution disseminated in consolidated market data pursuant to Rule 603 of Reg NMS;
- (4) the ATS must permit any registered broker-dealer to become a subscriber of the ATS, provided that the broker-dealer is not subject to a statutory disqualification;
- (5) the ATS must provide equal access among all of its subscribers and the registered broker-dealers of the ATS to all services related to (i) a qualified auction operated by the ATS, and (ii) any continuous order book operated by the ATS;
- (6) the ATS must have had an average daily share volume of at least 1% of the aggregate average daily share volume for all NMS stocks as reported by an effective transaction reporting plan during at least 4 of the preceding 6 calendar months; and
- (7) the ATS must operate pursuant to an effective Form ATS-N that evidences compliance by the ATS with the qualified auction requirements and the above conditions.

While at least 10 national securities exchanges currently would qualify as an OCTR, no NMS Stock ATS would currently meet all of the required conditions.

In particular, the only existing "SRO display-facility," FINRA's alternative display facility ("ADF"), does not have any participating members, and FINRA's ADF has not been used to actively display quotes since 2015. Moreover, in order for FINRA to add a new ADF participant, FINRA would need to file a proposed rule change with the SEC. To that end, shortly after the Proposal was released, FINRA **filed** a proposed rule change seeking to add a new ADF participant which, if approved, would establish the only NMS Stock ATS that could meet the first condition for an NMS Stock ATS to qualify as an OCTR. **Commenters** have generally opposed addition of the new participant to FINRA's ADF, and the proposed rule change awaits action by the SEC as of date of this Client Alert.

However, even if the SEC approved the new ADF participant, the requirement of the third condition that the NMS Stock ATS's transaction reports identify the ATS as the venue of execution in consolidated market data is not currently possible. The transaction reports that FINRA currently provides for dissemination in consolidated market data do not identify the particular FINRA member (including both NMS Stock ATS's and broker-dealers) that reported the trade. As a result, even ADF participating NMS Stock ATS still

currently could not qualify as an OCTR unless the effective NMS plans for NMS stocks were conformed to provide such information.

Thus, of the currently existing 16 national securities exchanges and 33 NMS Stock ATS's, only 10 national securities exchanges would qualify as OCTRs under the Proposed Rule and all NMS Stock ATSs would be RCTRs. For a Proposal that claims to be intended to increase competition, it is unclear how requiring NMS stock orders to be funnelled to just 25% of the available venues meets that objective.

### *OCTRs that Intend to Operate Qualified Auctions*

Proposed Rule 615(d) sets forth requirements for national securities exchanges and NMS Stock ATSs that intend to act as OCTRs and operate qualified auctions.

First, the national securities exchange or NMS Stock ATS must meet the definition of an OCTR. As discussed above, only 10 national securities exchanges currently meet that definition. Accordingly, all other national securities exchanges and all NMS Stock ATSs would currently be prohibited from operating a qualified auction. Increasing the number of OCTRs will be no simple task. As noted above, NMS Stock ATSs will need SEC approval of FINRA Rule changes and conforming changes to the effective NMS plans, and they would be required to take on new regulatory obligations, all while fighting over artificially capped fees (see below).

Second, any system operated by an OCTR for the execution of segmented orders must be a qualified auction unless the segmented order meets the Segmented Order Exceptions discussed above. For example, during time periods in which a SIP is not operating (any time other than 4 p.m. to 8 p.m. Eastern on US equity market trading days), an OCTR may operate a system for the execution of segmented orders is not a qualified auction.

### **Qualified Auction Requirements**

Prior to an RCTR internally executing a segmented order, a broker-dealer must have exposed the order to competition at a specified limit price in a qualified auction that meets the qualified auction requirements. By definition, the auction must be operated by an OCTR to be deemed a qualified auction. Thus, as noted above, only the 10 national securities exchanges that can currently qualify as OCTRs could operate a qualified auction, provided that they adhere the following qualified auction requirements pertaining to:

- (1) Auction messages;
- (2) Auction responses;
- (3) Pricing increments;
- (4) Fees and rebates; and
- (5) Execution priorities of auction responses and resting orders.

### *Auction Messages*

An OCTR that receives a segmented order must provide a message for dissemination in consolidated market data pursuant to Reg NMS Rule 603 that announces initiation of a qualified auction for the order. The auction message must invite auction responses for the order and include the following:

- (1) identify of the OCTR;
- (2) symbol, side (buy or sell), size, limit price; and
- (3) identity of the originating broker (unless the originating broker provides the Anonymity Certification).

In 2020, the SEC adopted a new rule and amended existing rules to establish a new infrastructure for consolidated market data and to update and significantly expand the content of consolidated market data, including expanded disclosure of "auction information" ("MDI Rules"). However, the MDI Rules have yet to

be implemented and the SEC disapproved the last proposed implementation plan of the MDI Rules in September 2022. Accordingly, if the Proposed Rule is adopted, the effective NMS Plans for NMS stocks would need to be conformed to provide for dissemination of auction messages. The MDI Rules would need to incorporate auction messages when implemented.

### *Auction Responses*

Assuming the industry gets through the hurdle of figuring out how to disseminate an auction message in consolidated market data, once the auction message is disseminated, OCTRs must hold the qualified auction open for a period of at least 100 milliseconds to no more than 300 milliseconds. During this time period, the OCTR must accept auction responses. However, the auction responses must be undisplayed during the qualified auction—and must not be disseminated thereafter.

The purpose of this requirement is to eliminate the potential advantage of market participants with faster systems that could observe other auction responses and then time their auction responses near the end of the qualified auction. In addition, the requirement would prevent information leakage about the trading interest of market participants.

### *Pricing Increments*

OCTRs must price segmented orders and auction responses in the following manner:

- increments of at least \$0.001, if the security price is \$1 or more per share;
- increments of at least \$0.0001, if the security price is less than \$1 per share; or
- at the NBBO midpoint.

The proposed increments are intended to balance the objectives of allowing for frequent price improvement while preventing market participants from attempting to gain execution priority by pricing auction responses in very small increments.

### *Fees and Rebates*

The Proposal limits OCTRs on both charging fees and providing rebates that the SEC intends will provide "sufficient" financial incentives for OCTRs to operate qualified auctions while promoting the SEC's primary objectives of (i) promoting better prices for individual investors, and (ii) enhancing opportunities for investors to interact directly with segmented orders. Whatever that fluff means, the reality is that the SEC would place fee and rebate caps set slightly above the current average fees charged and rebates paid, and the uniform rate restriction would effectively hamstring the practice of payment for order flow ("PFOF").

### **Fee and Rebate Caps**

Proposed Rule 615 prohibits or caps fees and rebates for the submission and execution of segmented orders and auction responses based on price per share:

		<b><i>Submission</i></b>	<b><i>Execution</i></b>
<b>Fees</b>	<b>Segmented Order</b>	Not permitted	Not permitted
	<b>Auction Response</b>	Not permitted	Must not exceed: <ul style="list-style-type: none"> <li>• \$0.0005 per share for securities priced at \$1 per share or higher; and</li> <li>• 0.05% of the price per share for securities priced at less than \$1 per share</li> </ul>

<b>Rebates</b>	<b>Segmented Order</b>	Must not exceed: <ul style="list-style-type: none"> <li>• \$0.0005 per share for securities priced at \$1 per share or higher; and</li> <li>• 0.05% of the price per share for securities priced at less than \$1 per share</li> </ul>
	<b>Auction Response</b>	

### Uniform Rates

In addition to the above limitations, whatever permitted fee is charged or rebate provided, it must be the same for all segmented orders and all auction responses, as applicable, in an OCTR's qualified auctions. In other words, an OCTR would not be permitted to charge different fees for auctions of different securities, or to different market participants or for different classes of market participants. For example, the uniform rate requirement would prohibit volume discounts or differential fees or rebates for increased order flow.

### *Auction Execution Priority Rules*

The final qualified auction requirement establishes five rules for determining auction execution priority:

- (1) **Price Priority:** Highest priced auction response to buy, and lowest priced auction response to sell.
- (2) **Customer Priority:** Customer account auction responses over broker-dealer account auction responses.
- (3) **No Time Priority:** If received during the qualified auction, the timing of the auction response must have no impact on execution priority.
- (4) **No Favoritism:** OCTRs may not favor the routing broker-dealer, originating broker, OCTR operating the auction, or any affiliate of the foregoing.
- (5) **Resting Orders vs. Auction Responses:** For segmented orders resting on the continuous book of the OCTR operating the qualified auction at the conclusion of an auction period ("Resting Orders"), priority with respect to auction responses is determined as follows:

Scenario	Priority
Auction response has less favorable price than a resting order	Resting Order
Auction response at the same price of a displayed Resting Order	Resting Order
Auction response at the same price of a undisplayed Resting Order	Auction Response

### Duty of Best Execution

Peppered throughout the Proposal, the SEC makes clear that broker-dealers' performance of their obligations under Proposed Rule 615 also must be consistent with their duty of best execution. Of course, despite acknowledging the simultaneous release of its Regulation Best Execution Proposal, the SEC makes virtually no effort to assess the potential impact that either proposal might have on the other.

Nevertheless, the Proposal reminds broker-dealers of their existing duty of best execution, and that each broker-dealer within the order routing chain must ensure its routing decisions are consistent with that duty. For example, as the Proposal notes in its "Overview of Order Competition Requirement" section, upon receipt of a customer's segmented order, a broker-dealer must decide, consistent with its duty of best execution, whether to route the segmented order directly to a qualified auction, to a national securities exchange or to an OCTR. Somewhat ironically, in explaining the purpose for the Proposal, the SEC seems to discount the fact the broker-dealer choosing to route segmented orders to a wholesaler over a national securities exchange is dependent on the broker-dealer assessing each wholesalers' execution quality, consistent with the broker-dealer's duty of best execution.

The Proposal notes that the Proposed Rule is designed to give broker-dealers "sufficient flexibility to obtain best execution of [segmented orders] in the full range of market conditions." However, given the complexity of the proposed requirements, prescribed constraints on OCTR competition, fees and rebates, and disincentives for continued technological innovation, "minimal" flexibility may be a more accurate description. Further, the Proposal is full of complicated requirements for broker-dealers (including wholesalers, retail brokers, and clearing firms) at which they are likely to fail, and keep SEC enforcement and exam staff quite busy.

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## Key Takeaways: Show Your Work

The SEC bases much of the Proposal on addressing its perception that certain individual investor orders result in lower adverse selection costs on liquidity providers than other orders routed to national securities exchanges (*i.e.*, the Proposal's so-called "segmented order"). According to the SEC's data analysis, broker-dealers route more than 90% of marketable orders of individual investors in NMS stocks to six off-exchange dealers ("wholesalers"), with two of those wholesalers capturing approximately 66% executed share volume among those six wholesalers.

The release states that these types of orders are attractive to wholesalers because they have lower adverse selection costs (*i.e.*, lower risk that the price of the stock will move against the wholesaler when executing the order). Further, investors typically benefit from having such orders routed to wholesalers by receiving better execution prices generally than orders routed to nationally securities exchanges. To attract these types of orders, wholesalers also may offer rebates to the routing broker-dealers in the form of PFOF. Thus, wholesalers benefit by more consistently capturing the spread on such orders, the customers benefit by receiving some price improvement over the prices on national securities exchanges, and routing broker-dealers can benefit if the wholesaler provides PFOF.

Despite the seemingly mutually beneficial market structure among broker-dealers and the individual investors, it is this structure that seems to be at the heart of the Order Competition Rule Proposal, as well as the other Market Structure Proposals. The SEC suggests that the Proposal would lead to "significantly" better prices for these investors, and estimates that the current market structure results in an annual "competitive shortfall" of about \$1.5 billion. However, the SEC relies on limited data from the past year (sometimes just single quarters) to justify its analysis.

Under the cloak of "promoting a level playing field" for all market participants who may want to trade with segmented orders, the Proposal would effectively cut off NMS Stock ATs in their current form from being OCTRs. Moreover, if those ATs wanted to compete with national securities exchanges, they must turn to a FINRA system that hasn't been actively used in nearly a decade, and would need additional SEC approval to even participate. Further, to increase "order competition," the SEC would remove free market pricing by setting fee and rebate caps, and based on an average of past revenue capture by the exchanges that the SEC views as "sufficient" revenue for OCTRs to support the operations that would be required under the Proposal.

For what would amount to a massive overhaul of the current market structure for individual trades in NMS stocks, the SEC relies on a very limited amount of data and information. The market volatility in early 2021

and the fact that there has been a spike in retail investor interest in the stock market seems like a pretty scant basis to completely overhaul the U.S. equity markets. Review it? Sure. But a Proposal of this magnitude surely necessitates more careful study with data from periods that cover more than just the past year or two, particularly where the basis for the Proposal cites no major market event other than a spike in retail investor interest in stocks. Not to mention that the race to zero commissions has led to virtually free trading for the retail investors, better prices for those retail investors than they were getting from the national securities exchanges.

When the SEC adopted Reg NMS in 2005, the staff understood that changes to the operation of equity markets entail many moving parts and widespread impact. To that end, the SEC spent **five years** studying and reviewing equity market structure, collecting and analyzing data, and meeting with and listen to public input before proposing Reg NMS. This Proposal reflects a rushed rulemaking approach with insufficient data on the potential impacts of pushing segmented order flow to national securities exchanges.

Indeed, just a few weeks ago, a manual error on certain national securities exchanges (the only ones that would currently qualify as OCTRs) led to massive market swings, and is now being touted as a very recent real world example that the SEC's push to have more trading on exchanges has not been sufficiently tested.

As we mention in our other Market Structure Proposal Alerts, even if adopted, we expect implementation of the proposals to be delayed for some time, as the SEC evaluates comments, and then manages highly anticipated litigation. This Proposal is highly technical, and interested persons (particularly broker-dealers and NMS Stock ATSS) should consider an all-hands on deck review. **The comment deadline currently is March 31, 2023.**

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