

The price you pay: Chair Gensler previews potential market structure changes

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SEC Chair Gensler has directed SEC staff to consider significant changes to the pricing and execution of securities orders, including possible auction requirements for retail stock orders.

In a June 8, 2022 [speech](#), [SEC Chair Gary Gensler announced](#) that he has asked SEC staff to consider proposing significant changes to pricing and execution practices, particularly for retail securities trades. Though only a high-level preview of potential rulemaking, several of the proposed changes will undoubtedly be controversial and could fundamentally change business models for retail brokerage firms and wholesale market makers if adopted. Chair Gensler did not provide a timeline for publishing any proposals for public comment, but given the recent pace of SEC rulemaking, we could see proposals later this year.

Proposed changes to market structure tend to trigger significant debate among market participants. At present, retail investors tend to trade stocks commission-free, and receive executions at prices at least marginally better than the National Best Bid and Offer (NBBO)—benefits not typically enjoyed by other investor classes. While there is likely room for further improvement, many market participants have established their business around the current structure, and changes—particularly around requiring auctions or limiting payment for order flow—could change these firms' economic models, potentially impacting the benefits that accrue to investors. If changes are proposed, we expect significant debate around whether the purported benefits would outweigh the risk of costs being borne by investors in other ways.

Order-by-order competition

Among the most significant proposals, Chair Gensler has asked SEC staff to make recommendations to enhance order-by-order competition for retail equity transactions. This could include requiring retail brokers to send investor stock orders to auctions, where trading firms and other investors could compete to fill the order at the best price instead of these orders flowing directly to wholesalers. The devil will be in the details of any proposed rules—including whether the auctions could occur through ATSS or would be required to occur on exchanges—but the auction proposal would represent a significant restructuring of the current market practice for retail order execution. Auction mechanisms could also impact the business models and economic and other existing arrangements between retail brokers and market makers.

Payment for order flow, exchange rebates, and related access fees

Chair Gensler continues to be focused on the potential conflicts of interest presented by payment for order flow and exchange rebate practices, and he has asked SEC staff to make recommendations on how to mitigate such conflicts. While he did not offer any details on the types of rules the SEC could propose here, Chair Gensler noted that several other jurisdictions have, or are considering, prohibiting payment for order flow, implying the staff may consider something similar. While payment for order flow is generally viewed as the revenue source that permits brokers to offer retail investors commission-free trading, Chair Gensler indicated that the SEC would analyze the economic impact of any

proposal.

In addition, Chair Gensler has asked SEC staff to consider improving transparency of exchange fees and changes to access fees in light of potentially lower minimum tick sizes, as discussed below.

National best bid and offer

Chair Gensler has asked SEC staff to consider improvements to the way the NBBO is calculated. SEC rules generally require that brokers and exchanges execute orders at prices no worse than the NBBO—i.e., buy orders must be executed at no higher than the lowest offer, and sell orders at no lower than the highest bid, displayed across all available exchanges. The NBBO is also used as the measuring stick for determining “price improvement”—the extent to which an execution is achieved at a price *better* than the NBBO. The current NBBO includes only round lots, which are quotes for 100 shares or more. The SEC adopted new market infrastructure rules in 2020 that will implement a broader definition of round lots and enhance the transparency of quotation information for odd lots, subject to lengthy implementation and transition periods. Chair Gensler has asked SEC staff to consider accelerating the implementation of some of these rules. Further, SEC staff will consider whether there should also be an odd-lot best bid and offer, providing transparency into the best prices regardless of size, given that retail investors are more likely to buy or sell at odd-lot prices.

Disclosure of order execution quality

Chair Gensler also suggested that an expansion of Rule 605 reporting requirements might enhance retail investors’ ability to compare execution quality by their brokers. He has asked SEC staff to make recommendations on possible updates to Rule 605, which generally applies such disclosure requirements to market centers but not retail brokers, such as mandating broker-dealers to file monthly Rule 605 reports, which would provide more disclosure to investors on order execution quality. SEC staff will also consider whether reporting parties should be required to provide summary statistics of execution quality, including a monthly summary of price improvements and other statistics. These disclosures would be in addition to those required under Rule 606, which requires brokers to provide quarterly reports on order routing practices and provide certain execution quality information upon customer request.

Best execution

The Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB) have rules on best execution, which require broker-dealers to exercise reasonable diligence to execute customer orders in the best market so that their customers receive the most favorable terms under prevailing market conditions. Further, the SEC has enforced broker-dealers’ best execution obligations as an anti-fraud matter under the federal securities laws and its rules.

Notwithstanding the existing sources of best execution obligations, Chair Gensler has asked SEC staff to consider recommending that the SEC adopt its own best execution rule, which could include more detail around the procedural standards brokers must meet when handling and executing customer orders that might benefit broker-dealers and investors. It is unclear what such a proposal would look like or how it would differ from the existing FINRA and MSRB rules, or the similar standards that the SEC has enforced under its anti-fraud authority.

Minimum pricing increment

Finally, Chair Gensler noted the disparity in tick size—minimum increments at which securities are priced—between lit markets and off-exchange venues. For most stocks, stock exchanges generally can only execute stocks priced at their displayed full-penny pricing increments, while off-exchange wholesale market makers are able to fill orders at sub-penny prices. SEC staff have been asked to consider recommendations to (1) harmonize tick size across trading venues so that all trading occurs in the minimum increment and (2) shrink the minimum tick size to better align with off-exchange activity.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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