Davis Polk

Reg NMS resized: SEC adjusts tick sizes, lowers access fees and accelerates lot size amendments

September 26, 2024 | Client Update | 9-minute read

The SEC finalized a package of amendments to Regulation National Market System (Reg NMS) to reduce minimum pricing increments (or "ticks") for certain stocks to half-penny increments, lower exchange access fee caps, and accelerate implementation of pending rules on order price transparency.

Last week the SEC adopted the second of its four equity market structure proposals, initially released as a package in late 2022. Like the component adopted in March of this year, these amendments were among the less controversial of the initial proposals and, consistent with public comments, were significantly pared back from the proposal. The Reg NMS Amendments include:

- **Rule 612**: Adjusting the tick sizes at which certain NMS stocks (i.e., exchange-listed stocks and ETFs) can be accepted, ranked or displayed from a penny ($0.01) to a half penny ($0.005).
- **Rule 610**: Lowering access fee caps applicable to national securities exchanges and requiring national securities exchanges to make the amounts of all fees and rebates determinable at the time of execution.
- **MDI Rules:** Accelerating the implementation date of aspects of the Market Data Infrastructure Rules (MDI Rules) (themselves amendments to Reg NMS) that define round lots and odd lots and require certain information dissemination about best odd-lot orders.

The SEC made a number of adjustments to the proposed rule in response to public comments, key among them:

- Tick sizes would be reduced to, at the smallest, half-penny increments (i.e., $0.005) for certain NMS stocks, rather than adopting the proposed additional smaller tick tiers (i.e., $0.002, $0.001).
- The tick size for particular stocks could potentially change every six months based on three months' worth of data, instead of quarterly based on one month of data.
- The SEC dropped a proposed requirement that would have prohibited trades from being *executed* at prices smaller than the minimum tick sizes, in addition to requiring trades to be *quoted* using the minimum tick sizes.

The Reg NMS Amendments will become effective 60 days after the date of publication of the adopting release in the Federal Register. However, as detailed below, compliance is not required for some period after the Reg NMS Amendments become effective.

Key provisions of the Reg NMS Amendments

We provide below a summary of the Reg NMS Amendments, including key market structure policy considerations behind the amendments and notable changes relative to the proposed rule.

Minimum pricing increments: amendments to Rule 612

Currently, under Rule 612, the minimum pricing increment, or tick size, at which orders can be accepted, ranked or displayed, is $0.01 for stocks priced at or greater than $1.00 and $0.0001 for stocks priced below $1.00. Importantly, the rule did not prohibit *executing* trades at smaller price increments than the minimum for accepting, ranking or displaying orders. Transactions that are executed at sub-penny prices typically involve midpoint executions on national securities exchanges or executions by OTC market makers providing price improvement from the national best bid and offer (NBBO).

The SEC's original policy rationale for constraining quoting (but not trading) to penny increments was to limit the ability of a market participant to gain priority over competing orders ("jump the queue") by offering an economically trivial better price, which if unchecked, could discourage participants from displaying liquidity. This rationale did not require prohibiting *trading* in sub-pennies, because if those prices were not being accepted, ranked or displayed, they merely provided a better execution price without potentially undermining displayed quotes. But in the years since the rule was adopted, many highly-liquid stocks have typically been quoted at a penny spread—indicating that Rule 612 may have been limiting competition and market forces from further reducing the spread, and thus investor costs.

As amended, Rule 612 requires tick sizes to be regularly adjusted between a penny and half-penny, for NMS stocks priced at or greater than $1.00 per share. The assignment of the applicable tick size for each NMS stock would depend on the liquidity profile of the stock, determined by its Time Weighted Average Quoted Spread (or TWACS), with the half-penny tick size applying to the most liquid and actively traded stocks. The determination of the tick size will be calculated by the stock's primary listing exchange, adjusting (i) in May, based on the TWACS between the prior January and March, and (ii) in November, based on the TWACS during the prior July through September. The TWACS would be calculated as the average dollar value difference between the national best bid (NBB) and the national best offer (NBO) during regular trading hours, where each instance of a unique NBB and NBO is weighted by the length of time that the quote prevailed as the NBB or NBO. The SEC estimated that the new half-penny tick size would apply to almost 1,800 stocks, accounting for approximately 66% of share volume, and 43% of dollar volume of trading.

As amended, Rule 612 will apply the following tick sizes, based on the price per share and the TWACS:

Minimum pricing increment	**Price per share**	**Time Weighted Average Quoted S during evaluation period**
$0.01	Equal to or greater than $1.00	Greater than $0.015
$0.005	Equal to or greater than $1.00	$0.015 or less
$0.0001	Less than $1.00	N/A

Access fee caps: amendments to Rule 610

Reg NMS generally prohibits "trade throughs," where an order is executed on Exchange A, even though Exchange B was displaying a better price (a protected quote). To avoid a situation where the better price on Exchange B is illusory in light of Exchange B having a much higher fee to access the quote than Exchange A, Rule 610 imposes an "access fee" cap, currently limiting exchange fees on accessing protected quotes to no more than (i) 30 cents per 100 shares ($0.003/share, or 30 mils) for stocks priced at or greater than $1.00 and (ii) 0.3% of the quotation price for stocks priced less than $1.00. While many exchanges charge the highest permissible access fee, much of that fee is actually rebated to the other side of the trade as a reward for providing liquidity, rather than being fully retained by the exchange.

Although the SEC has not banned access fees and rebates, it has asserted that they have caused distortions in the securities markets. According to the SEC:

– The predominant exchange fee structure of paying rebates to liquidity-making orders and charging access fees to liquidity-taking orders (the maker-taker model) to attract order flow can create a discrepancy between displayed prices and net prices.

- Access fees and rebates could create conflicts of interest for broker-dealers, such as by encouraging broker-dealers to route customer orders to an exchange to avoid fees or to receive the highest rebate.

Under the Reg NMS Amendments, the SEC lowered the exchange fees on accessing protected quotes to no more than (i) 10 cents per 100 shares ($0.001/share, or 10 mils) for stocks priced at or greater than $1.00 and (ii) 0.1% of the quotation price for stocks priced less than $1.00. To align with the final revisions to Rule 612, which dropped proposals for $0.002 and $0.001 tick size tiers, as adopted, amended Rule 610 streamlined the access fee caps into two categories: stocks priced equal to or greater than $1.00 and stocks priced less than $1.00.

The SEC claims that lowering access fee caps will reduce market distortions and align with the minimum pricing increment amendments under the revised Rule 612. First, reduced access fee caps would necessarily lower rebate levels that are used to incentivize order flow. Second, reduced access fee caps will prevent possible market distortions that could arise when combined with the new half-penny tick—by setting the fee cap ($0.001) sufficiently below the half-penny tick size ($0.005). Finally, the SEC claims that the reduced access fee cap reflects the market reality that trading costs have diminished over time due to electronic trading and other market structure changes.

The chart below shows the access fee caps that apply, based on the minimum pricing increment, which itself is based on the TWACS and price per share:

Access fee cap	Minimum pricing increment	Time Weighted Average Quoted Spread during evaluation period	Price per share
$0.001	$0.01	Greater than $0.015	Equal to or greater t
$0.001	$0.005	$0.015 or less	Equal to or greater t
0.1% of quote	$0.0001	N/A	Less than $1.00

As described above, the amendments to Rule 610 lower access fee caps for NMS stocks of all prices. But the SEC opted to adopt a higher access fee cap than proposed (i.e., 0.1% instead of 0.05% of the quotation price per share) for stocks priced under $1.00.

Finally, the Reg NMS Amendments further revise Rule 610 to prohibit exchanges from imposing fees or rebates that are not determinable at the time of execution. Many exchange fee structures offer volume-based fee or rebate tiers calculated on a *look back* basis at the end of each month based on that month's volume. As a result, at the time of execution, a member may not know what tier they qualify for, and thus what their fee or rebate will be.

Odd-lot price transparency: amendments to MDI Rules

In 2020, the SEC adopted the MDI Rules, amending Reg NMS to expand the content of core market data that is made available to market participants and adopt a new model for collection, consolidation and dissemination of consolidated market data. Despite being adopted, the MDI Rules have not yet been implemented because of various contingencies applicable to the implementation dates. Rather than materially revise the substance of the MDI Rules, last week's Reg NMS Amendments accelerate the implementation of previously finalized provisions of the MDI Rules.

The accelerated MDI Rules include (i) a new definition of "round lot"[1] to deem smaller share orders in higher priced stocks to be round lots, rather than fixed at 100 shares and (ii) the addition of information about odd- lot executions and better-than NBBO-priced odd-lot orders to the category of core market data that must be made widely available by national securities exchanges via the consolidated tape. In response to comments about the proposed timeline for compliance with the new definitions, as adopted, the compliance date for the amendments to the MDI Rules is later than initially proposed.

Compliance dates

Rule amendment	Topic	Compliance date: first business day of…
Rule 612	Tick sizes	November 2025
Rule 610	Access fee caps	November 2025
Rule 600	Definition of round lot	November 2025
Rule 600	Definition of odd lot	May 2026

Next steps

- Market participants impacted by the Reg NMS Amendments (including national securities exchanges, ATSs, broker-dealers, and market data providers) will need to turn their attention to implementation. Significant efforts may be needed, on a relatively short time frame, to build out and revise their systems and operations to support the changes effected by the Reg NMS Amendments by the applicable compliance dates.
- Although it is unclear whether anyone will challenge the Reg NMS Amendments in court, some commenters questioned the SEC's authority to impose certain provisions of the amendments, such as the access fee caps, without more explicit statutory authority. Because many of the aspects of the Reg NMS Amendments were designed to work in tandem, challenges to some provisions could impact even unchallenged requirements.
- With the issuance of the Reg NMS Amendments, the SEC has now finalized two of the less controversial components of the 2022 equity market structure reform proposals. The SEC has not clearly indicated when or whether it plans to proceed with the remaining proposals (i.e., the proposed Order Competition Rule and Regulation Best Execution). But if adopted without significant changes, the combined effects would significantly impact existing business models and are likely to face broader industry resistance.

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.

Robert A. Cohen
+1 202 962 7047
robert.cohen@davispolk.com

Gabriel D. Rosenberg
+1 212 450 4537
gabriel.rosenberg@davispolk.com

Zachary J. Zweihorn
+1 202 962 7136
zachary.zweihorn@davispolk.com

Carl Emigholz
+1 202 962 7044
carl.emigholz@davispolk.com

Tyler X. Senackerib
+1 212 450 3419
tyler.senackerib@davispolk.com

Mary Jane Dumankaya
+1 212 450 3654
maryjane.dumankaya@davispolk.com

[1] The definition of "round lot" is important because various other SEC rules rely on the concept of round lots. A round lot is a standard unit of trading for stocks under SEC rules and was historically 100 shares, regardless of the stock. For example, the definition of "bid" or "offer" under Reg NMS is the price at which parties are willing to buy or sell one or more round lots. Changing the definition of a round lot will thus have an impact on what constitutes a bid or offer.