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SEC Proposes Comprehensive Best Execution Framework for Broker-Dealers: Sidley

On December 14, 2022, the U.S. Securities and Exchange Commission (SEC) proposed rules that would establish SEC best execution rules and impose related obligations on firms subject to the standard (the Proposal).¹ The Proposal would generally require brokers, dealers, government securities brokers, government securities dealers, and municipal securities dealers (collectively, broker-dealers) to have detailed policies and procedures addressing how they achieve best execution for their customer orders, with heightened obligations for broker-dealers subject to certain conflicts of interest.²

Specifically, the SEC is proposing three rules — Proposed Rules 1100, 1101, and 1102 under the Securities Exchange Act of 1934, as amended (Exchange Act) — to implement its best execution framework for broker-dealers. The Proposal is broad in scope and would apply to customer transactions in all securities.³

The comment deadline is March 31, 2023, or 60 days after publication of the Proposal in the *Federal Register*, whichever is later. The Proposal was made concurrently with three other SEC proposals that are interrelated and could significantly change practices related to securities order handling and execution.⁴ The proposals collectively appear to advance the SEC's view that better prices for investors may result through encouraging competition among trading venues and increasing trading through certain exchanges or alternative trading systems (ATSS) that disseminate quotations rather than over-the-counter (OTC) market makers.⁵ The Proposal is unique among the four proposals in that it would apply to all securities transactions (e.g., equities, fixed income, private securities, digital assets), while the other three proposals apply only to national market system (NMS) stock.

Key Takeaways

If the Proposal is adopted, broker-dealers would need to undergo a thorough compliance review of their practices for handling customer orders to determine whether they have policies and procedures sufficiently detailed to satisfy the specified criteria. While broker-dealers may already have policies and procedures designed to comply with the Financial Industry Regulatory Authority, Inc. (FINRA) Rule 5310 and the Municipal Securities Rulemaking Board (MSRB) Rule G-18, many aspects of the Proposal extend beyond FINRA and MSRB requirements, such as provisions for conflicted transactions (as described in more detail below). Broker-dealers would also need to have an established process to conduct the required execution quality reviews and comparisons.

Broker-dealers, particularly those that engage in conflicted transactions, may also have to consider changes to their business models or current practices if necessary to satisfy the new obligations under the Proposal. For example, broker-dealers may need to incur the expense of incorporating access to additional markets into the broker-dealer's order handling practices. The SEC claims the policies- and procedures-based nature of the Proposal would provide broker-dealers "flexibility to exercise [their] expertise and judgment when executing customer orders";⁶ however, the prescriptive criteria established by the Proposal would effectively require broker-dealers to assess

and potentially modify existing practices to satisfy the policies and procedures they would be required to adopt.⁷

The Proposal would provide an alternative compliance mechanism for introducing brokers that meet certain conditions (as described in more detail below). Broker-dealers that seek to qualify as introducing brokers may similarly need to modify their business practices to satisfy the qualifying criteria under the Proposal, such as by no longer accepting payment for order flow. Even if a broker-dealer meets the introducing broker criteria, such broker-dealer would have to develop a process by which it can compare the execution quality of its executing brokers to other executing brokers.

In many ways, the Proposal would extend beyond the current FINRA and MSRB best execution rules. Key examples include that the Proposal

- explicitly requires a more detailed assessment of specified factors relevant to a best execution analysis to be included in a broker-dealer's policies and procedures
- imposes additional policies and procedures obligations and documentation requirements for conflicted transactions
- applies its execution quality review requirements to a broader range of broker-dealers
- requires a comparative analysis as part of its execution quality reviews (which is consistent with FINRA but broader than the MSRB)
- provides a narrower exception for introducing brokers with more strict qualification requirements

The SEC states that the Proposal would not alter broker-dealers' existing obligations to comply with the FINRA and MSRB Rules and that broker-dealers should comply with any additional or more specific requirements in each rule, as applicable. Nevertheless, it remains unclear whether FINRA or the MSRB would amend their best execution rules if the Proposal is adopted.

Overall, many questions remain about whether the proposal is necessary and how, if at all, it may be reasonably justified to address regulatory gaps. Much of what the SEC proposes, excepting its not-so-subtle attempt to eliminate payment for order flow practices, is not new and would be consistent with the guidance, examination, and enforcement activity conducted by FINRA in this area.⁸

Background

The duty of best execution, which predates the federal securities laws, generally requires that a broker-dealer execute a customer's trades at the most favorable terms reasonably available under the circumstances. Today, FINRA has a rule detailing the best execution obligations of its member broker-dealers and has, through enforcement actions and regulatory notices, issued guidance to its members on those obligations.⁹ The MSRB has a comparable best execution rule applicable to municipal securities dealers for transactions in municipal securities.¹⁰ However, there is currently no SEC rule or standard governing best execution for broker-dealers' customer orders.

According to the SEC, the impetus for the Proposal is its belief that the existing regulatory framework can be made more effective. The SEC is concerned that current best execution policies and procedures may vary and alleges that customers would benefit from "consistently robust best execution practices" with "heightened attention" by broker-dealers that have certain order handling conflicts of interest.¹¹ The SEC also states that the Proposal would enable it to exercise additional enforcement capabilities.

Regulation Best Execution

Best Execution Standard

The Proposal would establish a best execution standard for broker-dealers, requiring a broker-dealer to use reasonable diligence to ascertain the best market for a 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 (referred to as the “most favorable price”).¹²

Policies and Procedures

The Proposal would require broker-dealers to establish, maintain, and enforce written policies and procedures addressing how the broker-dealer will comply with the best execution standard and make routing or execution decisions for customer orders, including by

- obtaining and assessing reasonably accessible price, volume, and execution quality information concerning markets trading the relevant securities
- identifying markets reasonably likely to provide the most favorable prices
- incorporating those markets into the broker-dealer’s order handling practices and ensuring it can efficiently access each of them
- assessing reasonably accessible and timely information with respect to displayed prices, price improvement opportunities, and order exposure opportunities
- assessing customer order attributes and securities trading characteristics
- balancing the likelihood of obtaining better prices in assessing additional markets with the risk that a delay in executing a customer order could result in a worse price

Conflicted Transactions

A broker-dealer transacting with a retail customer¹³ that engages in a principal trade or routes to or from an affiliate or provides or receives payment for order flow¹⁴ (each a “conflicted transaction”) would be subject to additional obligations under the Proposal. In particular, these broker-dealers’ best execution policies and procedures must address how the broker-dealer will obtain and assess additional information and evaluate a broader range of markets beyond what is required for nonconflicted transactions. In addition, these broker-dealers would have to document the details of any payment for order flow arrangement and their compliance with the best execution standard for conflicted transactions, including their efforts to enforce their policies and procedures and the basis and information relied on for their determination that the conflicted transaction was consistent with the best execution standard.

Other than a questionable requirement for the broker-dealer to assess and consider immaterial market centers, the Proposal is largely consistent with current FINRA guidance and application. Moreover, the SEC admits that compliance with this aspect of the Proposal would be more expensive than what is received through payment for order flow so that a significant number of broker-dealers would elect to stop receiving payment for order flow.¹⁵

Regular Review of Execution Quality

The Proposal would require broker-dealers to, at least quarterly, review the execution quality of their customer transactions, compare such execution quality with the execution quality that might have been obtained from other markets, and revise their best execution policies and procedures and order handling practices accordingly.¹⁶

Introducing Brokers

The Proposal would provide an alternative compliance mechanism for a broker-dealer that routes its customer orders to another broker-dealer for execution and meets certain conditions¹⁷ (referred to

as an “introducing broker”). Rather than comply with the policies and procedures and execution quality review requirements described above, an introducing broker would need to have policies and procedures that require it to regularly review the execution quality obtained from its executing broker, compare such execution quality with what it might have obtained from other executing brokers, and revise its order handling practices accordingly. This aspect of the Proposal regarding introducing brokers takes aim at the use of payment for order flow. Many introducing brokers route order flow to wholesalers that pay for order flow and execute orders in a principal capacity. Such arrangements may effectively be eliminated by the Proposal.

Annual Report

The Proposal would require broker-dealers (including introducing brokers) to, at least annually, conduct a review of their best execution policies and procedures and order handling practices and prepare a written report presented to the broker-dealer’s board of directors.

1 Exchange Act Release No. 96496 (December 14, 2022), <https://www.sec.gov/rules/proposed/2022/34-96496.pdf>.

2 While the proposed rules apply to broker-dealers, investment advisers should pay close attention to the Proposal.

The SEC was careful to note in the Proposal that investment advisers have a similar duty to seek best execution of a client’s transactions where the adviser has responsibility to select broker-dealers to execute client trades. See Proposal at 11 n.11.

3 The SEC specifically emphasized that the Proposal would also apply to any digital asset that is a security. Proposal at 37 (referring to a “digital asset” as “an asset that is issued and/or transferred using distributed ledger or blockchain technology ..., including, but not limited to, so-called ‘virtual currencies,’ ‘coins,’ and ‘tokens’ ”).

4 See Sidley updates: [SEC Proposes Rule to Enhance Competition for Certain Individual Investor Orders; SEC Proposed Amendments to Modernize Disclosure of Order Execution Information; and SEC Proposes Rules Related to Minimum Pricing Increments, Access Fee Caps, and Transparency of Better Priced Orders](#).

5 See Chair Gary Gensler, Competition and the Two SECs, address before the SIFMA Annual Meeting (October 24, 2022), <https://www.sec.gov/news/speech/gensler-sifma-speech-102422>.

6 Proposal at 9.

7 For example, because broker-dealers engaging in conflicted transactions would be required to have policies and procedures that address how the broker-dealer will obtain and assess additional information and evaluate a broader range of markets beyond those identified as material potential liquidity sources, they may ultimately need to seek additional market information or connect to new trading venues.

8 “The release is thinner when it comes to assessing how the rule alone, or in combination with the other rules on today’s dockets, will change markets and affect investors.” Commissioner Hester M. Peirce, Is This the Best Execution We Can Get? (December 14, 2022), <https://www.sec.gov/news/statement/peirce-best-execution-20221214>.

9 See FINRA Rule 5310. See also, for example, FINRA Regulatory Notice 15-46, Best Execution:

Guidance on Best Execution Obligations in Equity, Options, and Fixed Income Markets (November 2015),

https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.

10 See MSRB Rule G-18. See also MSRB Implementation Guidance on MSRB Rule G-18, on Best Execution (last updated February 7, 2019), <https://msrb.org/Implementation-Guidance-MSRB-Rule-G-18-Best-Execution>.

11 Proposal at 7.

12 The Proposal sets forth certain exemptions for a broker-dealer where (i) another broker-dealer is executing a customer order against the broker-dealer's quote, (ii) an institutional customer exercising independent judgment executes an order against the broker-dealer's quote, or (iii) the broker-dealer receives an unsolicited instruction from a customer to route its order to a particular market. This is consistent with existing FINRA guidance and application. The Proposal would not include an exemption for transactions with a "Sophisticated Municipal Market Professional" that is currently in place under MSRB Rules. See MSRB Rules G-48(e) and D-15.

13 A "transaction for or with a retail customer" would be defined as "any transaction for or with the account of a natural person or held in legal form on behalf of a natural person or group of related family members." Proposed Rule 1101(b)(4)(i).

14 See 17 CFR 240.10b-10(d)(8) (defining "payment for order flow").

15 See Proposal at 344-45, 357-58.

16 The SEC states that while comparable to existing FINRA and MSRB requirements this review obligation would apply to more broker-dealers than FINRA Rule 5310 and be more frequent than under MSRB Rule G-18. See Proposal at 134-37.

17 These conditions include that the broker-dealer (i) does not carry customer accounts or hold customer funds or securities, (ii) has entered into an arrangement with an unaffiliated broker-dealer to handle and execute all of its customer orders on an agency basis, and (iii) has not accepted any payment for order flow from the executing broker. Proposed Rule 1101(d)(1)-(3).

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