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March 27, 2023

Via Electronic Submission

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Comments on File No. S7-32-22 (Regulation Best Execution)

Dear Secretary Countryman:

The Cornell Law Securities Clinic (“Clinic”) submits this comment on the Securities and Exchange Commission’s (“Commission” or “SEC”) rule proposal relating to a broker-dealer’s duty of best execution (“Proposal” or “Best Ex”). The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and provides public education regarding investment fraud to the largely rural “Southern Tier” region of upstate New York. For more information, please see: <http://securities.lawschool.cornell.edu>.

The Clinic supports the objectives of Best Ex because we believe that this Proposal protects investors like our clients. While trading platforms have made financial markets more accessible for retail investors without subjecting them to expensive fees and commissions, events like the “meme stock” frenzy highlight the importance of transparency and holding broker-dealers to a higher standard.

The Clinic agrees with Commission Chairperson Gary Gensler that it is important for the Commission to have its own best execution rule.¹ While the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB) have their respective best execution guidelines, they may be limited in their concern for retail investors due to their status as Self-Regulatory Organizations (SRO). The SRO structure poses a continual risk that industry members will subvert its processes to promote industry interests at the expense of the public.² We believe that the Commission, as a governmental agency, is in a better position to enforce such a standard and hold violators responsible for any transgressions.

¹ Gary Gensler, *Statement on Best Execution Proposal*, SEC (Dec. 14, 2022), <https://www.sec.gov/news/statement/gensler-best-execution-20221214>.

² Benjamin P. Edwards, *The Dark Side of Self-Regulation*, 85 U. Cin. L. Rev. 573, 573 (2017).

We discuss our support for specific rules below and urge the Commission to qualify the focus on best price, clarify the duty owed by executing broker-dealers, and provide a template to implement Best Ex. The Clinic expresses no opinion on the subsections of Best Ex that we do not address in this letter.

Finally, we support any retail investors who want the Commission to extend the deadline to submit comments. Although the Clinic does not need this extension, an extension may be beneficial to individual retail investors who need time to compare this Proposal to the three other proposals introduced by the Commission in December 2022.³

A. THE CLINIC SUPPORTS SECTION 1100 AND ITS IMPLEMENTATION OF BEST EXECUTION REQUIREMENTS FOR BROKER-DEALERS

The Clinic agrees with the Commission that the SEC should adopt its own rule requiring best execution from broker-dealers.

Although common law, FINRA, and MSRB rules already subject broker-dealers to a best execution standard, Best Ex would provide the SEC the ability to better enforce current standards by increasing the speed at which the Commission can react to market developments and innovations.⁴ For example, FINRA last updated its Best Execution standard in 2014, almost a decade ago,⁵ and MSRB's last update to its Best Execution standard was in 2015.⁶ The Clinic believes that retail investors will benefit from SEC guidance for broker-dealers to fulfill their best execution duties under Section 1100.

Additionally, Section 1100 subjects broker-dealers who engage in transactions involving crypto assets to the same best execution duties as other broker-dealers. As shown in a recent FINRA study of 2022 investment demographics, 27% of investors own crypto assets.⁷ Therefore, the Clinic believes that crypto assets make up a significant enough portion of the market to justify holding broker-dealers who engage in crypto-based transactions to the same standards as other broker-dealers.

B. THE CLINIC SUPPORTS SECTION 1101 AND ITS REQUIREMENT THAT BROKER-DEALERS HAVE WRITTEN POLICIES REGARDING HOW THEY COMPLY WITH THEIR BEST EXECUTION DUTIES

i. The Clinic Supports Section 1101(a) but asks that the Commission specify the types of information that would be considered necessary to comply with this section

³ SEC, SEC Proposals: Market Structure, <https://www.sec.gov/newsroom/market-structure-proposals-december-2022> (last visited Mar. 25, 2023).

⁴ See *supra* note 1.

⁵ FINRA, FINRA Rule 5310(a)(1), <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310>.

⁶ MSRB, Rule G-18, Best Execution and Interpositioning, <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-18.aspx>.

⁷ JUDY T. LIN ET AL., FINRA INV. EDUC. FOUND., THE CHANGING LANDSCAPE OF INVESTORS IN THE UNITED STATES: A REPORT OF THE NATIONAL FINANCIAL CAPABILITY STUDY 1, 7 (2022), <https://www.finrafoundation.org/sites/finrafoundation/files/NFCS-Investor-Report-Changing-Landscape.pdf>.

The Clinic agrees with the SEC that broker-dealers should have written policies describing how they comply with their best execution duties. Additionally, we agree that these policies should include certain factors deemed relevant by the Commission towards adequately fulfilling a broker-dealer's best execution duties.

Current factors deemed relevant to fulfilling best execution duties include best price listings, opportunities for price improvement, attributes of the order, and trading characteristics of the given security. The Clinic believes that these factors encompass relevant information a retail investor would desire their agent to consider when acting on their behalf. By requiring broker-dealers to expressly address how they consider these factors, more clarity will exist regarding whether a given broker-dealer is executing a client's orders in the manner most suited towards that client's needs. We believe that this clarity is necessary for the effective enforcement of Sections 1101(b) and 1101(c).

ii. The Clinic Supports Section 1101(b) but asks the SEC to tailor its scope as narrowly as possible to preserve access to commission-free trading for retail investors

The Clinic agrees with the SEC that the procedures required under Section 1101(b) should include additional considerations for when a broker-dealer executes a retail client's trade under a conflict of interest. Additionally, we support the conclusion that closer scrutiny over conflicted transactions will result in significant benefits for retail investors via increased price improvement and more transparency over transaction costs.

The rise of commission-free trading has correlated with a rise in transactions where the broker-dealer could financially benefit by breaching their duty of best execution. For example, a broker-dealer who engages in Payment for Order Flow (PFOF) transactions is incentivized to direct its clients' trades not to the market which offers that client the best price, but to the market-maker which offers that broker-dealer the largest payment for the right to execute that trade. Section 1101(b) helps to mitigate these risks by requiring broker-dealers engaging in conflicted transactions to document why they believe a given market achieves the best execution for their client despite the conflict. That said, due to the prevalence of conflicted transactions, the Clinic cautions the Commission to be extra diligent in ensuring that that Section 1101(b) contains no extraneous provisions that would burden broker-dealers for little to no gain.

Opponents of Section 1101(b) argue that restrictions on the use of PFOF for orders placed by retail investors, and thus a reduction in the revenue broker-dealers receive from such orders, will result in the elimination of commission-free trading.⁸ As commission-free trading is highly desired by retail investors, the Clinic further echoes these general concerns. Nonetheless, the Clinic believes that, if properly constructed, Section 1101(b) will not deprive retail investors of commission-free trading opportunities. As evidenced by its presence in countries like England and Singapore that have functionally banned PFOF, commission-free trading is not contingent upon PFOF.⁹ Furthermore, Fidelity Investments in the United States already profitably offers retail investors commission-free trading without relying on PFOF. For the above reasons, we believe that sufficient revenue streams—upselling complex financial products, time-based

⁸ See, e.g., Comment from Don Morris, Individual Retail Investor, SEC (Dec. 26, 2023), <https://www.sec.gov/comments/s7-32-22/s73222-320924.htm>.

⁹ Emilie Stevens, *What is commission-free trading?*, FREETRADE.IO (last visited Mar 8, 2023), <https://freetrade.io/learn/what-is-commission-free-trading>.

withdrawal fees, or acting both as a market maker and broker-dealer—already exist and ease any concerns that Section 1101(b) will deprive retail investors of commission-free trading.¹⁰

iii. The Clinic responds to the Commission’s requests for comment in relation to Section 1101:

The Commission has requested comments regarding whether the SEC should specify types of information that would be considered reasonably accessible for the purposes of Section 1101(a)(1)(i). The Clinic **supports** this objective. As some critics have expressed, an information gathering requirement which is too open ended creates the risk that all broker-dealers will connect with any and every trading venue or risk the possibility of future liability for failing to consider that venue.¹¹ This practice would be overly burdensome for little benefit. By specifying types of information which would be considered reasonably accessible, these risks of excessive compliance burdens are reduced while still retaining the benefits of 1101(a).

The Commission also requests comment as to whether broker-dealers should be required to evaluate markets outside of those deemed material potential liquidity sources when determining how to execute a conflicted transaction. The Clinic **does not support** this requirement. Echoing the concerns expressed by Commissioner Pierce, we find it neither sensible nor protective of retail investors to require firms to consider immaterial liquidity sources.¹² The determination as to whether a client’s order should be directed to an immaterial liquidity source occurs when a broker-dealer concludes that said source is material / immaterial. Asking broker-dealers to make and document this determination a second time is an inefficient source of resources that will only harm retail consumers by making those broker-dealers less efficient.

The Commission also requests comment as to whether documentation requirements should apply only to conflicted transactions or to all transactions. The Clinic **supports** documentation requirements only in cases of conflicted transactions. In cases of non-conflicted transactions, we believe that retail investors have no reason to think that their broker-dealer may not be acting in their best interests when executing orders. As a result, we believe additional documentation requirements for these orders would offer little benefit.

¹⁰ *Online Trading*, FIDELITY, <https://www.fidelity.com/trading/online-trading> (last visited Mar 25, 2023).

¹¹ Hester M. Pierce, *Is This The Best Execution We Can Get?*, SEC (Dec 14, 2022), <https://www.sec.gov/news/statement/peirce-best-execution-20221214>.

¹² *See id.*

C. THE COMMISSION'S FOCUS ON BEST PRICE IS BENEFICIAL FOR RETAIL INVESTORS BUT THE COMMISSION SHOULD QUALIFY THIS REQUIREMENT

Much like its counterpart regulations in the UK¹³ and EU¹⁴, Best Ex focuses on best price for US investors.¹⁵ It is argued that price is a leading indicator of best execution for retail investors.¹⁶

“[a]n informed trader will care about the speed of execution and concealing both the trader’s identity and the size of its order, in addition to the price. A large uninformed trader may seek a slower execution to signal to the market that the trades are being done by an uninformed trader. Finally, uninformed small traders will care above all else about the price they receive or pay.”¹⁷

While price is a primary concern for most retail investors, the Commission should provide a more flexible best execution benchmark for non-retail investors. As Commissioner Pierce points out, the rule makes it hard for brokers to tailor best execution according to their customer’s objectives.¹⁸ For institutional investors, the best execution of an order depends heavily on the parameters of each individual order, the profile and goals of the client issuing the order, and situation prevailing in the market at the time.¹⁹ Considering the Commission’s objective to protect both types of customers, the Commission could define best execution strictly in terms of best price only for retail investors while allowing broker-dealers to customize best execution for other types of investors based on their needs.

The Proposal does have exemptions for Best Ex compliance (and therefore, best price compliance) when an institutional customer is exercising independent judgment and executing its orders against a broker-dealer’s quotations;²⁰ when the broker-dealer receives an unsolicited instruction from a customer to route that customer’s orders to a particular market for execution;²¹ or if a customer provides the broker-dealer with other instructions regarding order-handling.²² However, all of these exemptions are customer-led and primarily unsolicited. The Commission does not clarify if broker-dealers could work with customers to devise a best execution standard based on the customer’s goals and the broker-dealer’s capacity and expertise to fulfill those goals, and if such a contract-based agreement would violate the Commission’s preference for unsolicited instructions.

¹³ UK FINANCIAL CONDUCT AUTHORITY, FCA Handbook, <https://www.handbook.fca.org.uk/handbook/COBS/11/2A.html>.

¹⁴ THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS, MiFID Supervisory Briefings Best Execution, https://www.esma.europa.eu/sites/default/files/library/2015/11/08_735.pdf.

¹⁵ Regulation Best Execution, 88 Fed. Reg. 5440, 5482 (proposed Dec. 14, 2022) (to be codified at 17 C.F.R. pt. 242.1100-1102) (defining most favorable terms as “best reasonably available price”) [hereinafter Best Ex].

¹⁶ Scott McCleskey, *Best Execution in a Cross-Market Environment: The Case for a Pan-European Policy*, 4 J. INT’L FIN. MKTS. 1 (2002).

¹⁷ Francis J. Facciolo, *A Broker’s Duty of Best Execution in the Nineteenth and Early Twentieth Centuries*, 26 PACE L. REV. 155, 156 (2005).

¹⁸ Peirce, *supra* note 10.

¹⁹ Stavros Gadinis, *Market Structure for Institutional Investors: Comparing the U.S. and E.U. Regimes*, 3 VA. L. & BUS. REV. 311, 346 (2008).

²⁰ Best Ex., *supra* note 14 at 5453.

²¹ *Id.*

²² *Id.*

Further, the Commission should consider narrowing the definition of “retail customer” under 1101(b)(4)(i) based on risk profile. Currently, the Commission defines a “retail customer” as a “natural person”.²³ However, this category could consist of a wide variety of individuals with varying levels of sophistication and personal net worth. A qualification of the current definition would further efforts to bifurcate the best execution standard based on a strict best price rule.

Allowing for a flexible best execution standard would ensure wider acceptance of this undoubtedly beneficial regulation amongst the investment community.

D. THE COMMISSION SHOULD CLARIFY THE DUTY OWED BY BROKER-DEALERS IF BEST EX IS ADOPTED

In the past, the Commission has refused to impose an explicit fiduciary duty on broker-dealers when they make recommendations to retail investors of any securities transactions or investment strategies, resorting to a “best interest” standard instead.²⁴

In this Proposal, the Commission states that the duty of best execution is rooted in the obligations of undivided loyalty and reasonable care that an agent owes to his principal.²⁵ Further, the Commission cites to a Special Study which states that a broker-dealer acting as an agent for a customer in the execution of a transaction assumes the obligations of a fiduciary.²⁶

The Commission should clarify the status of a broker-dealer based on these statements. Specifically, the Commission could clarify if Best Ex imposes a fiduciary duty on broker-dealers who are *executing transactions* as opposed to making recommendations. If the duty of best execution is different from a fiduciary duty, the Commission should explain how it differentiates between the two.

E. THE CLINIC ASKS THE SEC TO PROVIDE A TEMPLATE TO IMPLEMENT THE PROPOSAL

Based on our research on best execution policies in other countries, we conclude it is desirable that the Proposal adopt a basic template for uniformity. Firms could be required to fill in the information in the form provided by the SEC. Additionally, firms could be allowed to provide additional information that they cannot deliver through provided forms. Such uniformity will enhance the purpose of the Proposal by enabling easier usage of the information.

Best execution policies of other developed countries show how the lack of uniformity leads to ineffective policy outcomes. For example, EU’s Markets in Financial Instruments Directive II (MiFID II) requires investment firms including broker-dealers to equip themselves with best execution policies. Specifically, MiFID II requires firms to provide clients with an execution policy that explains their plans to comply with the best execution obligations. Also, the MiFID II framework sets out the obligation for firms to publish annual reports for the public and

²³ Best Ex., *supra* note 14 at 5464-65.

²⁴ See Regulation Best Interest, 84 Fed. Reg. 33318, 33319-35 (July 12, 2019).

²⁵ Best Ex., *supra* note 14 at 5482.

²⁶ *Id.* at 5482 n. 255.

investors to evaluate the quality of a firm's execution practices.²⁷ In 2022, the European Securities and Markets Authority published a report on the MiFID II framework on best execution policy.²⁸ The report highlighted that firms did comply with their duty to publish their best execution policy, however, the information had limited impact on end-users because the reports were too long and market participants used only small portions of the available information.²⁹

A possible solution to this issue can be found in the guidelines set by the Financial Conduct Authority (FCA) in the UK. The FCA requires broker-dealers to take measures to obtain the best possible result for their clients when executing their orders. FCA's Conduct of Business Sourcebook (COBS) also requires broker-dealers to publish their execution policies and to routinely review their execution practices. Under the guideline, firms are expected to review their execution policies at least annually pursuant to COBS 11.2A.20R. The order execution policy shall produce factors that affect their best execution policy, pursuant to COBS 11.2A.25, including but not limited to the following:

- (a) an account of the relative importance the firm assigns to various factors;
- (b) a list of the execution venues on which the firm places significant reliance in meeting its obligation to best execution policy;
- (c) a list of factors used to select an execution venue, including qualitative factors such as clearing schemes, circuit breakers;
- (d) how the execution factors of price costs, speed, likelihood of execution and other relevant factors are considered;

By requiring firms to provide information in a unified format, end users of the information will be able to easily locate the information they seek. For example, the American Bar Association's 509 report requires ABA accredited law schools to submit and disclose demographic, admission, and financial aid information which allows transparent comparison among law schools. Such uniform disclosure of information will strengthen the objectives of the proposed sections by the SEC.

F. THE CLINIC SUPPORTS REQUESTS TO THE COMMISSION TO EXTEND THE DEADLINE TO SUBMIT COMMENTS

Best Ex was only one among four proposals introduced on 14th December 2022.³⁰ The Clinic believes that these proposals would have a significant impact on market structure and the future of trading. We also agree with Commissioner Uyeda³¹ that in introducing these proposals, the Commission did not analyze the proposals' interactions with each other and left it to the

²⁷ Commission Delegated Regulation 2017/576, supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the annual publication by investment firms of information on the identity of execution venues and on the quality of execution, 2017 O.J. (L 87), 166-173, https://eur-lex.europa.eu/eli/reg_del/2017/576/oj.

²⁸ Review of the MiFID II framework on best execution reports by investment firms, EUROPEAN SECURITIES AND MARKETS AUTHORITY, https://www.esma.europa.eu/sites/default/files/library/esma35-43-3088_final_report_review_of_mifid_ii_framework_on_best_execution_reports.pdf, (May 16, 2022).

²⁹ *Id.* at 6.

³⁰ *See supra* note 3.

³¹ Mark Uyeda, Statement on Proposed Rule Regarding Best Execution, SEC (Dec. 14, 2022), <https://www.sec.gov/news/statement/uyeda-best-execution-20221214>.

public to deduce their interrelatedness. It is for these reasons that the Clinic supports any retail investor commentators who have requested for an extension of the deadline to comment on Best Ex and related proposals. The Clinic, alternatively, requests the SEC to analyze Best Ex with other proposals and publish a report that is easy to comprehend for retail investors whose trading activities these proposals would affect if taken together.

CONCLUSION

The Clinic believes that Best Ex would ensure that retail investors receive fair and equitable treatment when their orders are executed. By imposing stringent minimum standards for broker-dealers, the Commission could promote market efficiency and transparency.

The Clinic appreciates the opportunity to comment on Best Ex after a cursory reading of the proposal, and respectfully requests that the Commission take our comments into consideration while addressing Best Ex.

Respectfully submitted,

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