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Via Electronic Comment Submission

U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549
Attention: Vanessa Countryman, Secretary

Re: Proposed Regulation Best Execution; Release No. 34-96496; File No. S7-32-22

Dear Secretary Countryman:

I appreciate the opportunity to comment on new Regulation Best Execution proposed by the U.S. Securities and Exchange Commission ("Commission"). If adopted, Regulation Best Execution would codify for the first time the federal-level best execution standard for broker-dealers and related obligations, requiring broker-dealers to achieve the "most favorable price" for their customers. This means that broker-dealers would be required to use reasonable diligence to ascertain the best market for the 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. Regulation Best Execution would also require broker-dealers to establish related robust policies and procedures, particularly for firms engaging in "conflicted transactions" for or with retail customers.[1]

Brokers' best execution obligations are not new. In fact, the operative words in the proposed best execution standard are identical to those in Financial Industry Regulatory Authority ("FINRA") Rule 5310. Nevertheless, key aspects of the proposed obligation and related requirements depart from the current best execution regulatory regime, will require significant industry adjustments, and will reshape the landscape for order routing, execution, and broker economics.

[1] As proposed, a "conflicted transaction" would be any transaction for or with a retail customer where a broker-dealer (1) executes an order as principal, including riskless principal, (2) routes an order to or receives an order from an affiliate for execution, or (3) provides or receives payment for order flow ("PFOF"). The Commission notes in the proposal that "[r]etail broker-dealers receiving cash payments from wholesale market makers in return for routing their customers' orders to the market maker for execution is a common example of [PFOF]." However, the scope of what counts as PFOF is vast and includes "any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker or dealer's unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation." See Rule 10b-10(d)(8) under the Securities Exchange Act of 1934 ("Exchange Act").

Below are several observations from our review of the proposal. We encourage the Commission to consider these prior to adopting the proposal.

1. The Commission noted in the proposal that "a broker-dealer's failure to achieve the most favorable price for customer orders would not necessarily be a violation of the proposed best execution standard." However, Regulation Best Execution appears to focus on price as the alpha and omega considerations for firms. The Commission devotes significant discussion in the proposal to broker-dealers' obligations to scour so-called "material potential liquidity sources" for the best available price, yet substantially less time helping broker-dealers understand how to identify and weigh other best execution factors (like trading characteristics of the security, size of orders, likelihood of execution, access to and utilization of data feeds (including the use of proprietary exchange feeds versus the SIPs), exchange and ATS access fees, and the speed and means of access to quotes and related latency considerations). It is critically important for the Commission to enhance its focus on and explanation of these non-price factors, ideally in the form of flexible guidance to the industry. This is particularly the case regarding determining what is "reasonably accessible information" and whether brokers can "efficiently access each material potential liquidity source."

2. Sticking with price, it seems like the Commission expects firms to achieve executions for their customers at the midpoint of the national best bid and offer ("NBBO"). By way of example, the proposal mentions midpoint 173 times and the Commission notes its belief "that customers would benefit from robust considerations by retail broker-dealers regarding, for example, the possibility of available liquidity priced at the midpoint of the NBBO at other markets." The Commission does not, however, explicitly say that firms should route orders to exchanges to hit midpoint liquidity prior to routing for execution by wholesalers. Nevertheless, the proposal feels skewed in that direction (especially when read in tandem with the retail order auction exposure rulemaking proposed by the Commission on the same day in December 2022). Additional clarity from the Commission in this area is critical.

3. Brokers engaged in conflicted transactions for or with retail investors may need to scour small, opaque markets with thin and unreliable liquidity to achieve what we are calling *super best execution*. The Commission noted in the proposal "that customers would benefit from considerations by these retail broker-dealers of whether other markets may provide customer orders, or a portion of those orders, with potentially better executions than wholesalers." The Commission should enhance its explanation of the proverbial line between regular and super best execution price checks. We wonder, for example, whether the Commission has in mind a specific number or sequencing of markets to be assessed and, even if those super best executions are possible, at what cost to investors (both literally and figuratively). The Commission itself even refers to "reasonably balancing the likelihood of obtaining better prices with the risk that delay could result in a worse price." Additional consideration and guidance from the Commission in this area is critical, particularly because the Commission seems to

acknowledge that brokers' practices will likely be all over the map and could be challenging for less-liquid asset classes and certain thinly traded securities.[2]

4. On the one hand, the Commission acknowledged "the importance of providing a broker-dealer flexibility to exercise its expertise and judgment when executing customer orders, and proposed Regulation Best Execution primarily would be a policies and procedures-based rule." However, proposed Regulation Best Execution could result in a pivot from what has been a principles-based approach to achieving and regulating best execution, to a prescriptive, rules-based system that heavily emphasizes brokers' policies and procedures. We are also concerned about the likelihood of different and converging requirements and expectations between Regulation Best Execution, if adopted, and existing FINRA Rule 5310 and the guidance FINRA has provided to the industry over the course of several years. We urge the Commission to fully consider these concerns before it adopts Regulation Best Execution.

5. The conflicted transaction regime would only apply to "retail customers," which the SEC defines more broadly than under existing FINRA rules and even compared to Regulation Best *Interest.* In particular, and unlike Regulation Best Interest, retail customers for best *execution* purposes would encompass accounts held in legal form on behalf of a natural person or a "group of related family members," which the SEC intends to cover the "types of arrangements that may be set up to benefit family groups, including individual retirement accounts, corporations, and limited liability companies for the benefit of related family members." The Commission explains its rationale for the diverging best *interest* and best *execution* scopes, stating that "[p]roposed Rule 1101(b) does not incorporate all of the definition of 'retail customer' in Regulation Best Interest because that definition is limited to scenarios where a person receives and uses a recommendation. In contrast, proposed Rule 1101(b) and the proposed standard of best execution are not limited to scenarios where a person receives and uses a recommendation."

   The Commission also cites to certain existing Commission, exchange, and FINRA rules for identifying orders for the accounts of natural persons, or for related accounts, with which broker-dealers "would already be familiar." However, we think it is a flawed approach to compare Regulation Best Interest and proposed Regulation Best Execution, which are essentially sales practice rules, to trade reporting and exchange-based liquidity programs, particularly when the Commission spent significant time and effort carefully crafting the "retail" definition in Regulation Best Interest. Under the approach the Commission presently contemplates, small and medium-sized introducing brokers that are not accustomed to coding customer account types in the way the Commission referenced in the proposal will face

[2] The Commission notes its belief that what we are calling the super best execution obligation "may be interpreted very differently by different broker-dealers, and may prove challenging in markets for some asset classes where the number of potential markets is limited and broker-dealers may effectively be checking all reasonably available prices in current practice."

unnecessary and onerous complexity and costs, which those firms may ultimately pass on to customers.

The Commission should instead use a single core definition of retail customer that focuses on natural persons and scope it to apply to recommended transactions for best *interest* and more broadly for best *execution* purposes. The Commission should also incorporate relief its staff has provided in the best interest context for institutional family office customers of brokers.

6. Proposed Regulation Best Execution does not define the term "institutional customer," but asks commenters if a definition is appropriate. As with our observation above regarding the retail customer definition, the Commission should adopt a definition or express a view that is consistent with existing industry practice. That could mean using the definition for "institutional account" in FINRA Rule 4512, including applying a threshold of $50 million in assets, above which even natural persons would qualify as institutional. Alternatively, it could mean inherently considering every customer that is not a natural person to be institutional. Either way, the scope of "institutional customer" should include institutional family offices, as noted above.

7. It was only a few years ago that the SEC was encouraging innovation to improve secondary market quality for thinly traded securities, which we understand is retail-heavy.[3] Instead, we understand that the market for thinly traded securities has contracted significantly since September 2020, when the Commission amended Exchange Act Rule 15c2-11 by limiting the ability for brokers to quote and publish on these names. The Regulation Best Execution proposal is lean on discussion around OTC trading. Nevertheless, the potential intersection of these rules would make it increasingly challenging for brokers to satisfy the regular best execution standard, let alone achieve super best execution for conflicted retail transactions, which the Commission seems to acknowledge.[4] This will likely result in a chilling effect on brokers' willingness to provide retail investors with access beyond the top several thousand names. Additional analysis from the Commission is critical in this area, particularly regarding potential detrimental effects on the ability of small private issuers to raise capital.[5]

8. Regulation Best Execution would impose new requirements on introducing brokers that, until now, have complied with their best execution obligations by performing "regular and rigorous" reviews of execution quality ("EQ") reports and other statistics from executing and clearing brokers with which they have contracted. The Rule 605 amendments proposed by the

[3] See Commission Statement on Market Structure Innovation for Thinly Traded Securities, Exchange Act Release No. 87327 (Oct. 17, 2019), 84 FR 56956 (Oct. 24, 2019) (File No. S7-18-19), available at https://www.sec.gov/rules/policy/2019/34-87327.pdf.
[4] The Commission notes in the proposal "that liquidity provision in thinly traded and unlisted securities may decrease."
[5] The Commission seems to acknowledge this concern, noting that "[t]o the extent that broker-dealers' willingness to make markets in these securities decreases overall, this may increase trading costs for these securities and make it more difficult for companies to go public before they are eligible to be listed on registered exchanges."

Commission on the same day as Regulation Best Execution should, if approved, enhance broker disclosure of order execution information and seem designed to help in this regard. However, given the requirement to rigorously review EQ and adjust order-handling practices based on those reviews, it is not clear why the Commission proposed a narrow definition of introducing broker that excludes firms that execute through an affiliated broker. If those introducing brokers' EQ reviews indicate that they can obtain better executions from a non-affiliated broker, they would implicitly be required to route to the non-affiliated broker. Accordingly, the Commission should reconsider this approach to scoping the introducing broker definition.

9. The Regulation Best Execution proposal is one of three other significant market structure proposals announced on the same day in December 2022.[6] Each of these four proposals warrants careful consideration without effects from exogenous factors, like the adoption of the other three. For example, beyond the proposed new retail order auction proposal, what does the Commission expect from brokers regarding "order exposure opportunities that may result in the most favorable price"? Similarly, how will the anticipated new minimum tick sizes affect brokers' consideration of pricing when making their order routing decisions? Likewise, will the enhanced 605 reports actually yield the information the SEC anticipates and will firms be expected to ingest and factor those into their routing decisions immediately?

   Similar concerns exist related to the baseline in the Commission's cost/benefit analysis ("CBA"), in which the Commission noted that it "assesse[d] the economic effects of the proposed amendments in NMS stocks relative to a regulatory baseline in NMS stocks that includes the implementation of the [Market Data Infrastructure 'MDI Rules'] … including potentially countervailing or confounding economic effects from the MDI Rules in NMS stocks." The Commission further noted that, "given that the MDI Rules have not yet been implemented, they have not affected market practice and therefore data that would be required for a comprehensive quantitative analysis of the economic effects in NMS stocks that includes the effects of the MDI Rules is not available. It is possible that the economic effects in NMS stocks relative to the baseline could be different once the MDI Rules are implemented."

   These factors lead one to wonder how the Commission could ever reasonably analyze the proposal's effects after implementation, when there are so many other significant changes likely happening at or around the same time as a prospective implementation of Regulation Best Execution. The Commission should strongly reconsider the prudence of adopting any of these four proposals contemporaneously with the others and, likewise, consider postponing the

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[6] These include an "Order Competition Rule" (proposed new Exchange Act Rule 616, requiring certain retail equity orders to be exposed in auctions before being internalized), proposed amendments to Exchange Act Rule 605 (enhancing broker disclosure of order execution information), and proposed amendments to Exchange Act Rules 610 and 612 (amending minimum pricing increments and exchange access fee caps and enhancing the transparency of better-priced orders).

implementation of Regulation Best Execution until after the industry has adjusted to the implementation of the MDI Rules. If the Commission does adopt one or more of these proposals, it is critically important that the Commission stagger the implementation dates by a minimum of six months (and not implement Regulation Best Execution until at least six months after implementation of the MDI Rules).

10. Sticking with the CBA, it seems to not fully consider several very important factors that are critical to the functioning of the securities markets, particularly for retail investors and many of the small retail-focused brokers that support them.

    Return of Trading Fees and Loss of Ancillary Services

    Retail investors have mostly traded for free for the past several years. We understand that many small brokers have relied on PFOF (both cash and non-cash forms) to enable them to provide commission-free trading and other services to investors. The proposal *may* lead to potential better execution prices and greater opportunities for price improvement for retail investors. Some investors *may* also be better off if their brokers cease accepting PFOF as a result of fewer conflicts of interest involved in their trades. However, the proposal may also lead to increased trading fees and loss of investor access to ancillary products and services. Imposition of trading fees, if firms choose to adjust their revenue models in this way, will add to investors' costs, erode their gains, and may even cause some investors to exit the markets (or decrease their activity) simply because of the fees. Some brokers may also decrease or discontinue other services offered to retail investors, or charge investors for access, including for research, broader educational resources, and real-time quotes. These negative outcomes could completely undermine the perceived benefits of the proposal.

    The Commission notes that it "preliminarily believes that it is unlikely that the proposal would significantly increase the prevalence of retail commissions because the market to provide retail broker-dealer services is competitive and many of the broker-dealers that the Commission believes will remove their conflicts receive relatively small payments for their order flow." The Commission also states that "[t]o the extent that these firms do experience a major reduction in their PFOF revenue, they may face pressure to develop other lines of revenue, including the addition of commissions and/or fees for trading and advisory services, although broker dealers that have heavily promoted their commission-free business model would be more reticent to add commissions and/or fees, despite the loss of PFOF." The Commission should gather additional data to support these views before adopting the proposal and further explain how it arrived at these conclusions, particularly in light of what appear to be contradictory statements in the proposal.

    In that regard, the Commission "acknowledges that some retail customers could pay more for their transactions when in reducing its conflicted transactions, a broker-dealer changes order handling practices to route to destinations, which may not always provide the same price

improvement that was previously realized for conflicted transactions." The Commission also notes that "broker-dealers that reduce their reliance on PFOF arrangements would also be likely to see commensurate decreases in their revenue. This increase in costs to execute customer orders may be passed on to retail investors as additional fees to trade, or in the form of commissions." The Commission did seem to consider a total ban or overt restriction on PFOF, noting that such a step "would increase the likelihood of higher commissions for retail investors or an increase in the cost of other services offered by retail broker-dealers compared to the proposal. It may also further reduce competition between broker-dealers compared to the proposal. Larger broker-dealers with more diversified business models may be more likely to expand their market share and smaller broker-dealers who are more dependent on PFOF revenue streams may be more likely to exit the market." The Commission should further consider and explain how the various statements in this and the previous paragraph are consistent with each other, particularly when, from a practical standpoint, many small retail brokers will likely consider the proposal to be a de facto ban on accepting PFOF (unless fully "deconflicted" by passing 100% of the proceeds on to customers).

Higher Barriers to Entry and Less Competition

The Commission acknowledges that the proposal "could also result in higher barriers to entry and potential exit of small broker-dealers." One must query whether it is better for investors to have fewer choices for the firms they use. Lack of competition typically results in the opposite outcome. The Commission even acknowledges that "[s]ome services may no longer be offered by any competitors if a specialized broker-dealer exits the market, although the Commission preliminarily believes that if there is sufficient demand for such a service, a broker-dealer may make it available to customers when demand is sufficient, as may be the case after one or more broker-dealers exit the market." However, one must wonder whether this will promote the ability of larger firms to garner greater share of the market, potentially to the detriment of small retail investors who will have fewer choices. In this regard, the Commission itself even notes:

> "[t]o the extent that some retail brokers do resume charging commissions, they may be constrained by competitive pressures in the commission rates they can charge. Larger retail brokers that do not accept equity PFOF could continue to provide commission-free trading. This, in turn, would put competitive pressure on the extent to which retail broker-dealers could charge commissions and still retain customers. If the ability of smaller retail brokers to charge commissions is constrained by competition, it could increase the competitive advantage of larger retail brokers, which could raise the barriers to entry for new brokers and cause some smaller retail brokers to exit the market."

The Commission further notes that it:

> "preliminarily believes that the proposal may increase barriers to entry and disadvantage smaller broker-dealers because of the increased compliance costs and resulting economies

> of scale that would result under the proposal. Furthermore, the proposal could result in consolidation among smaller broker-dealers or these broker-dealers being absorbed (via merger) by larger broker-dealers to take advantage of the economies of scale. Such a change to the competitive landscape could also reduce competition in the market for trading services."

More Onerous Compliance for Small Firms vs. Larg Competitors

The Commission noted that it "preliminarily believes that larger broker-dealers that are likely to continue engaging in conflicted transaction if the proposed rules are adopted are likely to already connect to a broader range of venues than would be represented by SIP data." This seems to suggest that it would be more difficult (and therefore more costly) for small brokers to comply with the proposed conflicted transaction requirements compared to their larger competitors. The Commission further notes that it "cannot predict how many broker-dealers that elect to engage in conflicted transactions would increase the range of venues to which they connect and what costs they would incur to do so because broker-dealers are diverse in business models and practices and each broker-dealer would need to evaluate its own operational procedures to make such a determination." The Commission further notes that it "lacks detailed information on broker-dealers' current policies and procedures with respect to best execution standards and order handling practices to determine how many broker-dealers would be required to change their order handling practices under the proposal." The Commission should further explore and explain these important considerations and potential outcomes before adopting Regulation Best Execution, particularly regarding the likely effects on retail investors who currently send their orders to small independent brokers.

Others

The Commission includes a statement regarding the perceived benefits of the proposal leading to "better investor protection" based on the notion that "the proposed documentation requirement would help promote broker-dealer compliance and facilitate enforcement and examination." The Commission should further explain what it means by this statement.

The Commission also notes that it "preliminarily believes the proposed documentation requirement with respect to conflicted transactions could result in benefits in the NMS stock and options markets. However, a significant amount of information that would help reconstruct market conditions (e.g., NBBO, size at NBBO, trade prices, volume, order level information in CAT) around the time of conflicted transactions is currently available through public and regulatory data sources (e.g., SIP, CAT, OPRA), so those benefits may be small." The Commission should further explain what it means by this statement.

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Thank you for your consideration of these observations.

Respectfully submitted,

/s/ Nicholas J. Losurdo

Partner
Goodwin Procter LLP

cc: The Honorable Gary Gensler, U.S. Securities and Exchange Commission, Chairman
The Honorable Hester M. Peirce, U.S. Securities and Exchange Commission, Commissioner
The Honorable Caroline A. Crenshaw, U.S. Securities and Exchange Commission, Commissioner
The Honorable Jaime Lizárraga, U.S. Securities and Exchange Commission, Commissioner
The Honorable Mark T. Uyeda, U.S. Securities and Exchange Commission, Commissioner
Haoxiang Zhu, U.S. Securities and Exchange Commission, Director, Division of Trading and Markets