CITADEL | Securities

March 31, 2023

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: Regulation Best Execution (File No. S7-32-22)

We appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on its proposal to override longstanding protective best execution rules with extremely onerous, arbitrary, and impractical requirements that will not benefit investors (the "Proposal").[1]

Retail investors in the U.S. equities market currently benefit from rigorous best execution rules that are issued by FINRA,[2] approved by the Commission,[3] and overseen jointly by FINRA and the Commission.[4] These rules, and related interpretative guidance, have been updated and refined over decades to account for technological changes and industry best practices. Without identifying any specific deficiency in the current best execution framework, the Commission now suddenly proposes to replace it with an entirely new rule that will worsen retail execution quality.

Remarkably, the Proposal's economic analysis does not dispute the lack of investor benefit. Much of the Proposal's "economic baseline" is simply copy-and-pasted from the Commission's separate Order Competition proposal.[5] The actual analysis of this Proposal's economic effects on efficiency, competition, and capital formation is extremely limited and fails to consider the extensive information regarding broker-dealer order routing practices and best execution compliance programs that is already available to the Commission under current FINRA rules.[6] Instead, the Commission inaccurately asserts that it "lacks detailed data on broker-dealers' current

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[1] "Regulation Best Execution," 88 FR 5440 (Jan. 27, 2023) at 5493, available at: https://www.govinfo.gov/content/pkg/FR-2023-01-27/pdf/2022-27644.pdf (the "Proposal").

[2] FINRA is a self-regulatory organization that is "under the supervision of the Securities and Exchange Commission." *See* https://www.finra.org/about/what-we-do.

[3] Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of Proposed Rule Change to Adopt NASD Rule 2320 (Best Execution and Interpositioning) and Interpretive Material ("IM") 2320 as FINRA Rule 5310 in the Consolidated Rulebook Exch. Act Rel. No. 65895 (Dec. 5. 2011).

[4] For example, the Commission regularly examines compliance with existing best execution standards and has brought enforcement actions against broker-dealers relating to best execution practices.

[5] *See infra* note 70.

[6] We note that FINRA and the Commission have undertaken comprehensive reviews of order handling and best execution for retail equities transactions. *See generally* 2023 Report on FINRA's Examination and Risk Monitoring Program (Jan. 2023) (requesting information regarding how member firms comply with FINRA Rule 5310 and documentation of best execution reviews); 2022 Report on FINRA's Examination and Risk Monitoring Program (Feb. 2022) ("Assessing firms' compliance with their best execution obligations under FINRA Rule 5310 is one of the cornerstones of FINRA's oversight activities. This oversight has evolved with changes in firms' business models, for example the advent of the 'zero commission' model").

order handling practices and documentation practices that would allow it to predict the extent of changes as a result of this proposal"[7] and ultimately concludes that it "cannot ascertain the extent to which [any purported] benefits would be realized."[8] As a result, the Commission has not met the prevailing legal standard that agency rules "must be based on some logic and evidence, not sheer speculation."[9] The glaring inability to substantiate a single tangible benefit for retail investors is a fatal flaw that requires the Proposal to be withdrawn in its entirety.

Any objective review of retail execution quality clearly demonstrates the extent to which current best execution rules benefit and protect retail investors. According to the Proposal, wholesale broker-dealers fill over 44% of retail marketable shares at midpoint or better.[10] On average, retail investors now only pay approximately 45% of the quoted half-spread (i.e. the spread between the midpoint and the NBBO). In aggregate, wholesale broker-dealers delivered approximately $3 billion in savings to retail investors during 2022 via price improvement according to the statistics published pursuant to Commission Rule 605. This reported amount will significantly increase once the Commission implements its Rule 605 Proposal to enhance the accuracy of execution quality statistics.[11] This exceptional execution quality goes hand-in-hand with the significant reduction – and, in many instances, the complete elimination – of transaction-based commissions.

Rather than protecting and enhancing retail execution quality, the Proposal appears to be motivated by the overarching objective of preventing wholesale broker-dealers from handling retail orders without offering a credible, data-based market or economic justification. To achieve this outcome, the Commission specifically targets those transactions that are handled by wholesale broker-dealers by arbitrarily designating virtually all retail equities and options transactions as "conflicted transactions" that are subject to new vague, costly, and impractical requirements, including mandating that broker-dealers evaluate markets that are not "material liquidity sources."

To the extent the Commission believes that mandating these new order routing practices for "conflicted transactions" will result in more favorable execution outcomes for retail investors, then they should be equally applied to *all* customers owed a duty of best execution, and not just retail investors. Instead, these requirements appear designed to eliminate wholesale broker-dealers by encouraging retail broker-dealers "to execute customer orders prior to sending them to a wholesaler" in order to "de-conflict."[12] In seeking to extinguish wholesale broker-dealers through the "conflicted transaction" requirements, the Commission is actively undermining the ability of

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[7] Proposal at 5523-24, including fn. 535.

[8] *Id.*

[9] *Sorenson Commc'ns Inc. v. FCC*, 755 F.3d 702, 708 (D.C. Cir. 2014) (internal quotation marks omitted).

[10] Proposal at 5500. The Commission finds that 44.57% of retail marketable shares are filled at midpoint or better, with 31.69% filled at midpoint and 12.88% filled at better than midpoint.

[11] Battalio, Robert H. and Jennings, Robert H., Why Do Brokers Who Do Not Charge Payment for Order Flow Route Marketable Orders to Wholesalers? (Dec. 14, 2022) available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4304124 ("Battalio study") (finding that addressing shortcomings in current Rule 605 data may increase reported price improvement statistics for retail orders by up to 5 times, which would equate to approximately $15 billion in 2022).

[12] Proposal at 5469.

retail broker-dealers to comply with their own best execution requirements.

Bypassing wholesale broker-dealers will not benefit retail investors, as wholesale broker-dealers provide significantly better execution quality than other market centers, as well as important client services that other market centers do not offer, such as bearing the costs associated with resolving trade errors and making trade adjustments so that retail broker-dealers can maintain a high level of customer satisfaction. In addition, to the extent wholesale broker-dealers were bypassed, each of the hundreds of retail broker-dealers would then be responsible for maintaining connections to nearly 50 individual markets, and would have to develop sophisticated order routing systems, build the required market access controls, and bear the associated operational risk and complexity. Retail broker-dealers would also have to cover the costs associated with exchange trading fees, venue memberships, and market data subscriptions. As evidence of the significance of these costs, we estimate that retail broker-dealers would have incurred approximately $2.2 billion in exchange access fees alone during 2022 if marketable retail orders were required to be directly routed to exchanges. All in search of a benefit that the Commission admits it cannot "ascertain."

We urge the Commission to withdraw the Proposal and more fully review available information regarding current order routing practices and retail execution quality before considering new rules that would effectively supersede existing FINRA rules.

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I. <u>The Proposed Requirements for "Conflicted Transactions" are Arbitrary and Impractical</u>

The Proposal arbitrarily establishes a new category of transactions – "conflicted transactions" – that are subject to costly and impractical requirements that will almost certainly result in worse execution quality for retail investors. The definition of a "conflicted transaction" solely targets retail investors and is drafted to ensure that virtually all retail orders will be captured.[13] New order routing requirements for "conflicted transactions" are then applied to both retail broker-dealers and wholesale broker-dealers, requiring that markets that are not material potential liquidity sources must nonetheless be considered. Given these impractical requirements, it is clear that the Proposal is specifically designed to fundamentally change the manner in which retail orders are handled, irrespective of the negative impacts for retail investors.

As detailed below, the Commission should eliminate the misguided "conflicted transactions" concept from the Proposal. Establishing a two-tiered standard is inconsistent with the core principle of best execution. Furthermore, the Commission fails to identify a retail-specific market structure deficiency that would warrant exclusively targeting retail investors with these vague and impractical requirements. Nor do the criteria used to identify "conflicted transactions" explain the Commission's exclusive focus on retail investors, as these expansive criteria would equally capture many other types of orders, absent the Commission proposing to arbitrarily exclude non-retail investors. Ultimately, this Proposal will increase costs and complexity – and worsen execution quality, for retail investors – reversing decades of undeniably significant improvements delivered by wholesale broker-dealers.

A. A Two-Tiered Standard Is Inconsistent with the Concept of Best Execution

The Commission proposes to dramatically depart from decades of precedent to create a separate best execution standard for retail orders that establishes more costly and impractical order routing requirements than the general best execution obligation (including broadening the universe of markets that must be considered beyond material potential liquidity sources). The Commission asserts, without evidence, that these more onerous requirements "*could* [emphasis added] lead to improved prices for retail customers."[14] However, to the extent the Commission truly believes these order routing practices will result in more favorable execution outcomes, they should then be applied to *all customers* that are subject to best execution requirements – not just a select subset.

Under the Proposal, a broker-dealer handling a customer order that is subject to the general best execution obligation must identify "material potential liquidity sources" and assess "reasonably accessible" information about price, volume, and execution quality as part of its order

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[13] The Proposal defines a "conflicted transaction" as "any transaction for or with a retail investor, where the broker or dealer executes an order as principal, including riskless principal; routes an order to, or receives an order from, an affiliate for execution; or provides or receives payment for order flow as defined in Exchange Act Rule 10b-10(d)(8)." Exchange Act Rule 10b-10(d)(8) broadly defines PFOF to include exchange rebates and other forms of express payments in return for the routing of customer orders.

[14] Proposal at 5524.

routing practices.[15] However, for "conflicted transactions," a broker-dealer must do even more and "identify a broader range of markets beyond those identified as material potential liquidity sources" and assess information beyond that required under the general best execution standard.[16] While the precise expectations are unclear, the Commission appears to suggest that information that is not "reasonably accessible" and markets that are not "material liquidity sources" would need to be included as part of order routing decisions.[17] The Commission has provided no evidence or logic as to why these requirements should be expected to result in more favorable execution outcomes for retail investors (particularly when taking into account factors such as access fees, latency, and fill rates) or how they address or mitigate any perceived conflict.

More fundamentally, best execution has always been a binary consideration. To the extent the Commission (or FINRA) conclude that an order routing practice or other requirement leads to a more favorable execution outcome, then it is equally applied to all customers subject to best execution. Therefore, if the Commission believes evaluating markets that are not "material liquidity sources" will improve execution outcomes, this order routing practice should be applied to all customers, including retail investors, professional traders, and institutional investors (e.g. pension plans, insurance companies, and other asset managers). The Commission has failed to explain why establishing a two-tiered standard is consistent with the core principle of best execution.

B. The Proposal Arbitrarily Targets Retail Investors

The Commission fails to justify selectively applying the "conflicted transaction" requirements to retail investors. As described in more detail below, the Commission does not identify a retail-specific market structure deficiency or acknowledge the comprehensive regulatory framework (including best execution standards) that already governs retail transactions. Nor do the criteria used to identify "conflicted transactions" explain the Commission's exclusive focus on retail investors, as these expansive criteria would equally capture many other types of orders, absent the Commission proposing to arbitrarily exclude non-retail investors.

(i) The Proposal Fails to Identify a Market-Wide Harm That Justifies Solely Targeting Retail Investors

The Commission makes several unsubstantiated allegations regarding retail execution quality in an attempt to justify solely targeting retail investors with the "conflicted transaction" requirements. None of these allegations withstand scrutiny.

[15] Proposal at 5455.

[16] Proposal at 5467.

[17] *See id.* at 5467, fn. 192 and surrounding text ("For conflicted transactions, the broker-dealer, in accordance with its policies and procedures for conflicted transactions, would additionally evaluate some of the markets that it did not identify as material potential liquidity sources for non-conflicted transactions.").

1. Retail Investors Have Access to Comprehensive Execution Quality Data

The Commission claims that "retail customers generally would benefit more than non-retail customers from the more robust conflicted transactions requirements because retail customers are likely to have fewer resources for evaluating the best execution practices of their broker-dealers than non-retail customers."[18] However, this claim is directly contradicted by the Commission in its Rule 605 Proposal.[19]

First, the Commission acknowledges in the Rule 605 Proposal that retail investors have access to a significant amount of execution quality data published pursuant to Commission rules and that "independent analysts, consultants, broker-dealers, the financial-press, and market centers" all assist retail investors by "analyzing the disclosures and producing more digestible information using the data."[20] In addition, the Commission states that it is often *easier* for retail investors to use this available information to hold their brokers accountable as switching costs are low and "retail brokers will compensate new customers for transfer fees that their outgoing broker-dealer may charge them."[21]

Second, retail broker-dealers actively monitor execution quality metrics on their customers' behalf. Academic research has found that "retail brokers appear to be controlling execution quality by routing to wholesalers who require lower compensation for liquidity generation."[22] The millions of retail orders submitted each day in the U.S. equities market provide retail broker-dealers with extremely robust datasets that enable them to make informed order routing decisions. The Commission is unable to dispute the exceptional execution quality delivered by retail broker-dealers and wholesale broker-dealers.

Third, the Rule 605 Proposal is designed to significantly increase the amount of information available to retail investors. In the Rule 605 Proposal, the Commission asserts that this additional information will increase transparency and enable retail investors "to compare execution quality across broker-dealers to alleviate the principal-agent problem that exists between broker-dealers and their customers."[23]

Fourth, the Commission acknowledges in the Rule 605 Proposal that it can be difficult for non-retail investors to compare execution quality across broker-dealers. Specifically, the Commission notes that institutional order handling reports are "highly individualized," making it difficult to compare execution quality across broker-dealers, or to examine the execution quality of a market

[18] Proposal at 5465.

[19] "Disclosure of Order Execution Information," 88 FR 3786 (Jan. 20, 2023), available at: https://www.govinfo.gov/content/pkg/FR-2023-01-20/pdf/2022-27614.pdf ("Rule 605 Proposal").

[20] Rule 605 Proposal at 3796.

[21] Rule 605 Proposal at 3877.

[22] Dyhrberg, Anne Haubo and Shkilko, Andriy and Werner, Ingrid M., The Retail Execution Quality Landscape at 6 (Mar. 14, 2023) at 6, available at: https://ssrn.com/abstract=4313095 ("Dyhrberg study").

[23] Rule 605 Proposal at 3863.

center to which their broker-dealers do not currently route orders.[24] This appears to directly conflict with the Commission's assertion in this Proposal that institutional customers "are more readily able to evaluate the impact of their broker-dealers' conflicted transactions."[25]

Based on the Commission's Rule 605 Proposal, the amount of execution quality information available to retail investors does not provide a justification for solely applying the "conflicted transaction" requirements to retail investors. If anything, once the amendments to Rule 605 are finalized, retail investors will arguably have more detailed and informative execution quality data than other investors. At the very least, to minimize the effect of what will likely be inconsistent, destabilizing, and counter-productive best execution rules, the Commission should only consider any potential changes to best execution after the Rule 605 proposal is implemented.

2. Retail Investors Receive Exceptional Execution Quality

The Commission also insinuates that the "conflicted transactions" requirements are necessary for retail investors because wholesale broker-dealers fail to deliver superior execution quality. Specifically, the Commission asserts that "for stocks priced higher than $30, it appears that between 60-93% of the shares executed by the wholesale broker-dealer in a principal capacity at a price less favorable than the NBBO midpoint had liquidity available at the NBBO midpoint on an exchange or ATS."[26] This remarkable assertion has no basis in fact.

First, the Commission's methodology for determining available midpoint liquidity appears deeply flawed. Although the Commission provides very little detail regarding how it arrived at these numbers, such as the specific venues where midpoint liquidity was purportedly available,[27] it appears that the Commission does not take order size into account. This means the Commission does not consider the all-in price when evaluating current order routing practices.

As an example, consider a retail order for 1000 shares that is routed to a wholesale broker-dealer, with 100 shares of midpoint liquidity available on an exchange. If the wholesale broker-dealer decides to internalize this order, any comparison of execution quality must assess the all-in execution price for the entire 1000 share order. Specifically, the relevant comparison is whether the wholesale broker-dealer provides a better all-in price than would have been achieved on-exchange (since, in our example, after executing the 100 shares at midpoint, the remaining 900 shares would still have to be executed at other less competitive price levels). Importantly, when comparing execution quality, it is not accurate to assume that any midpoint liquidity available on exchanges and ATSs is purely additive, and that a wholesale broker-dealer would necessarily provide the same all-in price to an order that it partially fills on another venue compared to an

[24] Rule 605 Proposal at 3834.

[25] Proposal at 5465.

[26] Proposal at 5445, fn. 55.

[27] The Commission does not consider, for example, whether the relevant venues permit wholesale broker-dealers to send retail orders (since ATSs are not typically subject to fair access requirements) or whether the purported midpoint quotes are conditional (i.e. may be cancelled before accessed) or require a minimum quantity in order to be accessed.

order that is completely internalized. Once an order is routed to the market, and there is insufficient interest to fill such order at specific price levels, any market participant will take that into account (as well as the information leakage that has occurred) when determining whether (and at what price) to fill the balance of the order. At the core of the Commission's methodology seems to be the misguided notion that a wholesale broker-dealer will be able to provide the same level of principal liquidity and price improvement it does today on any *remaining* shares that were *not* able to obtain midpoint liquidity on external markets.

Second, the Commission also fails to consider other data that is relevant to assessing retail investor execution quality and wholesale broker-dealer order routing practices. For example, the Commission does not consider the impact of exchange and ATS fees on all-in prices delivered to retail investors. Nor does the Commission analyze how often wholesale broker-dealers provide midpoint or better prices when no midpoint liquidity was available on exchanges or ATSs.

Third, the Commission conveniently ignores the wealth of data showing the exceptional execution quality delivered by wholesale broker-dealers. In particular, this Proposal finds that wholesale broker-dealers fill over 44% of retail marketable shares at midpoint or better.[28] In aggregate, wholesale broker-dealers delivered approximately $3 billion in savings to retail investors during 2022 via price improvement according to the statistics published pursuant to Commission Rule 605, a reported amount which will significantly increase once the Commission implements its Rule 605 Proposal to enhance the accuracy of execution quality statistics.[29] In the past decade, the average E/Q delivered by wholesale broker-dealers for market orders has improved (i.e. declined) by nearly 60%. On average, retail investors now only pay approximately 45% of the quoted half-spread (*see Appendix A*).

Fourth, the Commission appears to be suggesting that, as a general matter for many stocks, nearly every retail order could receive an execution at midpoint. If this were true, we would expect to see exchange retail liquidity programs attract significant liquidity. In reality, midpoint liquidity that is accessible by retail-sized orders is not often available on exchanges and ATSs.[30] Academic research has found that on-exchange midpoint trading volume "represents less than 5% of total trading volume."[31] The Commission's misguided assertions cannot obscure the exceptional execution quality delivered by wholesale broker-dealers, with a remarkable 44% of all retail marketable shares receiving the midpoint price or better according to Commission data.

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[28] *Supra* note 10. We note wholesale broker-dealers do not simply internalize and also access available midpoint liquidity on other market centers.

[29] *See* Battalio study (finding that addressing shortcomings in current Rule 605 data may increase reported price improvement statistics for retail orders by up to 5 times, which would equate to approximately $15 billion in 2022).

[30] For example, our data suggests that the IEX Retail Midpoint Program has available liquidity less than 2.5% of the time for marketable orders that we receive.

[31] Ernst, Thomas and Spatt, Chester S. and Sun, Jian, Would Order-by-Order Auctions Be Competitive? (Dec. 13, 2022) at 18, available at: https://ssrn.com/abstract=4300505 ("Ernst study").

3. Payment for Order Flow is a Distraction

Finally, the Commission asserts that the "conflicted transaction" requirements are warranted because payment for order flow ("PFOF") may adversely affect retail investors.[32] In doing so, the Commission ignores prevailing academic research[33] and its conclusion in the Rule 605 Proposal that differences in the nature of the order flow (i.e. adverse selection) are a principal driver of observed differences in execution quality across retail broker-dealers.[34] For example, a broker-dealer that often handles larger orders would be unlikely to receive the same execution quality as a broker-dealer that typically only handles smaller, odd lot orders. In addition, academic research has shown that retail broker-dealers route to wholesale broker-dealers, regardless of whether PFOF is present, because of "the superior execution quality provided to these orders, which is commercially advantageous to retail brokers and is consistent with a retail brokers [*sic*] best execution obligations."[35]

More broadly, to the extent the Commission believes that further regulatory action is necessary with respect to PFOF, the Commission should consider more targeted alternatives, such as establishing a payment cap that equally applies to both on-exchange and off-exchange PFOF. As acknowledged in the Proposal, PFOF "includes any exchange rebates paid to a broker-dealer in return for sending orders to the exchange."[36] Since exchange rebates can be paid for orders submitted by all types of market participants (and not just retail investors), any purported concerns about PFOF do not justify solely targeting retail investors with the "conflicted transaction" requirements. Indeed, cost differentials across trading venues (e.g. between a maker-taker and taker-maker venue) are more economically meaningful than the average off-exchange PFOF rate of less than 1/10 of a cent per share for retail marketable orders.

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[32] Proposal at 5507.

[33] *See, e.g.,* Schwarz, Christopher and Barber, Brad M. and Huang, Xing and Jorion, Philippe and Odean, Terrance, The 'Actual Retail Price' of Equity Trades (Sept. 13, 2022) at 27, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4189239; and Battalio study at 38. In asserting the opposite view in the Proposal, the Commission does not provide any data regarding the economic significance of any purported "negative relationship" between off-exchange PFOF and price improvement. Proposal at 5510, fn. 466.

[34] Rule 605 Proposal at 3839.

[35] Battalio study at 8.

[36] Proposal at 5507.

(ii) A Comprehensive Regulatory Framework Already Protects Retail Investors

A comprehensive regulatory framework already successfully protects retail transactions. Retail investors receive detailed disclosures regarding broker-dealer routing practices. These include Rule 606[37] and Rule 607[38] reports, trade confirmations under Rule 10b-10,[39] and additional disclosures pursuant to Regulation Best Interest[40] and Form CRS, as applicable.[41] In particular, these disclosures contain information regarding potential conflicts and inducements, such as PFOF. Although these reports and disclosures contain detailed information, the Commission recognizes that "independent analysts, consultants, broker-dealers, the financial-press, and market centers" assist retail investors by producing "more digestible information using the data."[42]

In addition, retail investors benefit from current FINRA best execution rules and guidance. This best execution framework is approved, and overseen, by the Commission. In approving the FINRA best execution rule, the Commission found that the rule "clarifies the existing best execution requirements, and [. . .] enhance[s] investor protection and promote[s] just and equitable principles of trade."[43] Importantly, the Commission also regularly examines compliance with existing best execution standards[44] and has brought enforcement actions against broker-dealers

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[37] Rule 606 of Regulation NMS requires broker-dealers to provide public quarterly reports that disclose, among other things, the identity of the top ten venues to which they routed orders for execution and the material aspects of their relationship with each of those venues, including any arrangement for payment for order flow or profit sharing.

[38] Rule 607 of Regulation NMS requires broker-dealers to disclose upon opening a new customer account and on an annual basis thereafter: (i) their policies regarding payment for order flow, including a statement as to whether any payment for order flow is received for routing customer orders and a detailed description of the nature of the compensation received, and (ii) their policies for determining, in the absence of specific customer instructions, where to route customer orders that are the subject of payment for order flow, including a description of the extent to which orders can be executed at prices superior to the NBBO.

[39] For any NMS stock, Rule 10b-10 requires that a broker-dealer indicate on a customer's confirmation statement when payment for order flow has been received on a transaction and also indicate that the source and nature of the compensation received in connection with the particular transaction will be furnished upon the customer's written request.

[40] *See* 15l-1(a)(2)(iii) (requiring a broker-dealer to identify and disclose "all conflicts of interest" associated with securities recommendations to clients). As part of these disclosures, broker-dealers disclose to retail investors conflicts of interest related to payment for order flow, order routing and rebates. *See e.g.,* Best Interest Disclosure Statement, Merrill Lynch (Jan. 2023) available at: https://olui2.fs.ml.com/publish/content/application/pdf/GWMOL/Regulation-Best-Interest-Disclosure-Statement_RBIDISC.pdf.

[41] *See* Form CRS Instructions (requiring broker-dealers to disclose the principal fees and costs that retail investors will incur for brokerage services, including how they are assessed and the conflicts they create; and provide examples of a firm's conflicts of interest) available at: https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf. Retail broker-dealers disclose conflicts of interest relating to payment for order flow in their Form CRS.

[42] Rule 605 Proposal at 3796.

[43] Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of Proposed Rule Change to Adopt NASD Rule 2320 (Best Execution and Interpositioning) and Interpretive Material ("IM") 2320 as FINRA Rule 5310 in the Consolidated Rulebook Exch. Act Rel. No. 65895 (Dec. 5. 2011).

[44] *See, e.g.,* 2022 National Examination Priorities available at https://www.sec.gov/files/2022-exam-priorities.pdf.

relating to best execution practices. The Commission does not – and could not – explain why the existing regulatory regime is not sufficient to protect investors. Indeed, the current FINRA rules require retail broker-dealers to regularly assess the execution quality provided by wholesale broker-dealers – an assessment that drives competition between wholesale broker-dealers to provide efficient, high-quality executions. This is supported by academic research, which has found that "retail brokers appear to be controlling execution quality by routing to wholesalers who require lower compensation for liquidity generation"[45] and that retail broker-dealers route to wholesale broker-dealers because of "the superior execution quality provided to these orders, which is commercially advantageous to retail brokers and is consistent with a retail brokers [*sic*] best execution obligations."[46]

Given the comprehensive regulatory framework that already exists, and the Commission's failure to identify specific shortcomings with the current regime, there is no rational and justifiable basis for a duplicative, inconsistent version of best execution that solely targets retail investors with more onerous and impractical "conflicted transaction" requirements.

(iii) The Criteria Used to Identify a "Conflicted Transaction" Do Not Justify Solely Targeting Retail Investors

Finally, the criteria used to identify a "conflicted transaction" do not explain why the Commission decided to solely target retail investors.[47] Under the proposed criteria, virtually all retail transactions in U.S. equities and options would be deemed "conflicted transactions." However, these expansive criteria would equally capture many other types of orders, absent the Commission proposing to arbitrarily exclude non-retail investors.

For example, if the presence of an exchange rebate is sufficient to designate a transaction as "conflicted," then that should be the case for all customer orders subject to best execution requirements that receive a rebate. The Commission does not explain why the receipt of an exchange rebate for a retail investor order creates more concern than the receipt of the same exchange rebate for an order from another type of investor.[48] Similarly, the Commission fails to explain why only exchange rebates create a particular concern, rather than any fee differential that exists between two market centers. For example, instead of providing a rebate, one venue may adopt a no-fee model and another may charge an access fee. This type of economic differential

[45] Dyhrberg study at 6.

[46] Battalio study at 8.

[47] The Proposal sets forth the following extremely broad criteria to identify a "conflicted transaction": (a) any transaction involving PFOF (including an exchange rebate), (b) any transaction executed in a principal capacity (including riskless principal), or (c) any transaction where the broker-dealer routes an order to, or receives an order from, an affiliate for execution.

[48] Indeed, such a rebate may be far more impactful for a larger non-retail order. In addition, the Commission does not explain how the "conflicted transaction" requirements address or mitigate any perceived conflict resulting from PFOF, including exchange rebates.

between two market centers would appear to give rise to similar potential concerns as an exchange rebate.[49]

The other criteria that are used to identify a "conflicted transaction" raise similar questions. There is no explanation as to why it is more problematic for retail orders to be executed on a principal basis (including riskless principal transactions that are actually executed on exchanges or ATSs) compared to other types of orders. Indeed, the Commission's explanation for including riskless principal transactions is "because of the variability of markups and markdowns,"[50] which appears more applicable to non-equities asset classes, as we are not aware of wholesale broker-dealers applying "markups" or "markdowns" to retail equities or options "held" orders executed on exchanges or ATSs via riskless principal transactions. In addition, the only explanation for the criteria addressing the routing of customer orders to affiliates cites academic studies relating to the routing of *institutional* orders to broker-affiliated ATSs.[51] And yet, confusingly, these institutional orders are then exempted from the definition of a "conflicted transaction" entirely.

Based on the above, it is clear that the criteria selected to identify "conflicted transactions" fail to provide the Commission with a rational justification to solely target retail investors with more onerous requirements, especially given the increased costs and complexity, and worse execution quality, that are likely to result.

C. The Proposal Inappropriately Restricts Market Competition

By arbitrarily designating virtually all retail (and only retail) equities and options transactions as "conflicted transactions," and applying the associated costly and impractical requirements to both retail broker-dealers and wholesale broker-dealers, the Commission specifically targets those transactions that are handled by wholesale broker-dealers. In particular, the Proposal appears designed to eliminate wholesale broker-dealers, irrespective of the negative impact on retail investors.

(i) The Proposal's Vague and Impractical "Conflicted Transaction" Requirements Are Designed to Eliminate Wholesale Broker-Dealers

Notwithstanding the Commission's statutory obligation to promote fair competition among market centers, the Commission provides several vague and impractical "suggestions" regarding how retail broker-dealers could comply with the requirements for "conflicted transactions."[52]

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[49] The Proposal also does not acknowledge that exchange fees and rebates are set pursuant to rules filed with, and approved by, the Commission and are not "optional" for market participants. Subjecting certain orders to more onerous requirements based on the receipt of a rebate, or the presence of a cost differential, introduces significant complexity and uncertainty. For example, whether best execution now requires routing to the best price or the lowest access fee.

[50] Proposal at 5464, fn. 182.

[51] Proposal 5448 (citing a study titled "*Institutional Order Handling and Broker-Affiliated Trading Venues*").

[52] In addition, the Commission suggests that a wholesale broker-dealer could comply with the "conflicted transaction" requirements by documenting that "it provides the same price improvement to the customers of retail broker-dealers to which it does not pay for order flow that it provides to the customers of broker-dealers to which it

These "suggestions" appear designed to achieve the arbitrary objective of eliminating wholesale broker-dealers, including:

- Suggesting that retail broker-dealers should solicit "price improvement commitments" from wholesale broker-dealers.[53] It is unclear what the Commission means by price improvement commitments, given that the execution quality of individual orders cannot be guaranteed in advance and will depend on, among others, the specific characteristics of an order and overall market conditions.

- Suggesting that retail broker-dealers attempt "to execute customer orders prior to sending them to a wholesaler."[54] This notion of entirely bypassing wholesale broker-dealers appears throughout the Proposal, as the Commission acknowledges that some retail broker-dealers will do so in order to "de-conflict" and not be subject to the "conflicted transaction" requirements.[55]

Notably, the proffered solution of a retail broker-dealer "de-conflicting" requires dismantling any PFOF arrangements with wholesale broker-dealers[56] and routing retail orders in a pure agency capacity. This envisaged outcome is not designed to result in better execution quality for retail investors. Rather, the Commission concludes that the Proposal is "likely to reduce the share of retail customer order flow that is internalized."[57] This admission reflects the true objective of the Proposal, which is to attempt to eliminate wholesale broker-dealers, irrespective of the negative impact on retail investors (such as the loss of price improvement)[58] and the extensive costs that would be incurred by retail broker-dealers (such as incurring an estimated $2.2 billion in exchange access fees alone during 2022 if marketable retail orders were required to be directly routed to

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pays for order flow." However, as the Commission explained in its Rule 605 Proposal, differences in the nature of the order flow (i.e. adverse selection) are a principal driver of observed differences in execution quality across retail broker-dealers. Rule 605 Proposal at 3839. Following from the Commission's own explanation, wholesale broker-dealers should not be willing to offer identical execution quality to all retail broker-dealers.

[53] Proposal at 5470.

[54] Proposal at 5469.

[55] Proposal at 5530, fn. 577.

[56] We note that, if this is the overarching objective of the Commission, it is unclear why more narrowly-tailored alternatives were not pursued. For example, the Commission could establish a payment cap that equally applies to both on-exchange and off-exchange PFOF.

[57] Proposal at 5530.

[58] One retail broker-dealer found that the execution quality provided by wholesale broker-dealers saved their retail clients alone at least $3.4 billion in 2021. U.S. Equity Market Structure: Order Routing Practices, Considerations, and Opportunities, Charles Schwab (Q2 2022) at page 13, available at: https://content.schwab.com/web/retail/public/about-schwab/Schwab-2022-order-routing-whitepaper.pdf. In addition, the Commission's Rule 605 execution quality data shows that retail orders routed to exchanges are consistently executed at all-in prices that are worse than the quoted spread, perhaps due to the fact that the size of order may be larger than available liquidity at the NBBO. Irrespective of order size, the differential between the average E/Q delivered by wholesale broker-dealers and exchanges is vast, exceeding 50% for even the smallest orders.

exchanges[59]). As a result, in seeking to eliminate wholesale broker-dealers through the "conflicted transaction" requirements, the Commission is actively undermining the ability of retail broker-dealers to comply with their own best execution requirements.

The Commission's apparent aim of extinguishing wholesale broker-dealers while promoting exchanges violates Section 11A of the Securities Exchange Act of 1934 (the "Exchange Act"). In exercising its authority to "facilitate the establishment of a national market system for securities," the Commission must "assure . . . fair competition . . . between exchange markets and markets other than exchange markets" and "assure equal regulation of all markets for qualified securities."[60] Those express statutory objectives "necessarily constrain[ ]" the Commission's regulatory authority.[61]

Here, the Commission does not subject exchange-owned routing brokers to the same best execution requirements as other broker-dealers when handling retail orders, which raises concerns of an uneven playing field. And even setting that problem to one side, the Commission's efforts to hamstring wholesale broker-dealers for the benefit of exchanges run headlong into the Exchange Act's "fair competition" and "equal regulation" requirements. Exchanges already enjoy a number of competitive advantages unavailable to off-exchange market centers – largely due to exchanges' status as self-regulatory organizations. Those advantages will only be magnified by the Proposal's attempt to eliminate wholesale broker-dealers' ability to handle retail orders.

First, as self-regulatory organizations, exchanges enjoy judicially-created absolute immunity from private damages suits under a wide variety of circumstances.[62] Courts have held that self-regulatory organizations and their officers "are entitled to absolute immunity when they are, in effect, 'acting under the aegis' of their regulatory duties."[63] And while the doctrine of absolute immunity is premised on the exchange's performance of regulatory functions, exchanges have claimed immunity from liability even in connection with activities that are primarily commercial in substance.[64] Off-exchange market centers, by contrast, are subject to private liability for their actions.

Second, to the extent exchanges' activities are not protected by absolute immunity, they are frequently insulated by their own rules, which strictly limit exchanges' liability to their members.[65] Those rules are given legal effect through the Commission's approval process and through the

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[59] We estimate total retail marketable shares using Rule 605 data and our internal data and apply the access fee cap to this figure.

[60] 15 U.S.C. § 78k-1(a)(1)(C)(ii), (c)(1)(F).

[61] *Bus. Roundtable v. SEC*, 905 F.2d 406, 416 (D.C. Cir. 1990).

[62] *See*, *e.g.*, *Standard Inv. Chartered, Inc. v. NASD, Inc.*, 637 F.3d 112, 115–16 (2d Cir. 2011) (per curiam).

[63] *DL Cap. Grp., LLC v. Nasdaq Stock Market, Inc.*, 409 F.3d 93, 97 (2d Cir. 2005).

[64] *See*, *e.g.*, Exchange Act Release No. 67507 (July 26, 2012) (Nasdaq asserting that Facebook IPO malfunctions and consequent member losses resulted from its exercise of regulatory authority).

[65] *See*, *e.g.*, NASDAQ Equity 2 § 17(b)(2) (limiting liability to $3 million per month in aggregate or available insurance); NYSE Rule 18(c)(i) (limiting liability to $500,000 per month in aggregate).

statutory obligation that exchanges comply with their own rules.[66] Unlike absolute immunity, rule-based liability limitations stretch beyond exchanges' regulatory functions and cover purely commercial activity of the same kind engaged in by off-exchange market centers. By contrast, if off-exchange market centers want to enjoy limitations on liability for their commercial activities, they must negotiate with their customers to do so.

Third, as self-regulatory organizations, exchanges have an inherent competitive advantage in their ability to design and implement market structure initiatives. For example, in Rule 613, the Commission delegated to self-regulatory organizations the authority to develop a national market system plan to create, implement, and maintain a comprehensive consolidated audit trail that would allow regulators to track activity throughout U.S. markets in national market system securities.[67] The Commission ultimately approved the consolidated audit trail plan that was developed by the self-regulatory organizations.[68] With respect to this critical regulation affecting the environment in which both exchanges and off-exchange market centers compete for business, exchanges' status as self-regulatory organizations allowed them to shape the legal terrain in ways that off-exchange market centers could not.

Exchanges enjoy numerous competitive advantages compared to off-exchange market centers. By designing the Proposal to competitively disadvantage wholesale broker-dealers in their ability to handle retail orders, the Commission would create a competitive imbalance that is inconsistent with its Exchange Act obligations to assure "fair competition" and "equal regulation" among markets.[69]

(ii) The Proposal Cannot Substantiate Any Tangible Benefits to Retail Investors Resulting from the "Conflicted Transaction" Requirements

The Proposal's economic analysis does not substantiate *any* tangible benefits that would accrue to retail investors as a result of the "conflicted transaction" requirements. Notably, much of the "economic baseline" section is copy-and-pasted from the Commission's separate Order Competition proposal.[70] Moreover, the economic baseline section does not appear to be

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[66] *See* 15 U.S.C. § 78s(b), (g)(1).

[67] "Consolidated Audit Trail," 77 FR 45722 (Aug. 1, 2012).

[68] "Joint Industry Plan; Order Approving the National Market System Plan Governing the Consolidated Audit Trail," 81 FR 84696 (Nov. 23, 2016).

[69] 15 U.S.C. § 78k-1(a)(1)(C)(ii), (c)(1)(F).

[70] For example, we note that (i) nearly half of the data tables presented in this Proposal's economic analysis are essentially identical to tables presented in the Order Competition proposal; (ii) pages 5488-5503 of the Proposal – constituting approximately 25% of the Proposal's economic analysis – are largely copy-and-pasted from the Order Competition proposal *(compare to 88 FR 180-211)*; and (iii) perhaps most egregiously, in analyzing the impact of the Proposal on market competition, the Commission largely copy-and-pasted certain paragraphs of the Order Competition proposal's economic analysis and replaced "lower-volume exchanges" with "smaller brokers." In relation to this copy-and-pasted economic analysis, we incorporate herein our critique of the use of the "realized spread" metric that is set forth in our separate comment letter on the Order Competition proposal (including Appendix C thereto).

referenced or otherwise incorporated into the Commission's actual analysis of the economic effects of this Proposal, including with respect to efficiency, competition, and capital formation.[71]

The Commission's actual economic analysis of this Proposal is extremely limited and vague, as it frequently uses the word "could" and asserts that it "lacks detailed data on broker-dealers' current order handling practices and documentation practices that would allow it to predict the extent of changes as a result of this proposal."[72] As a result, the Commission admits that it "cannot ascertain the extent to which these [purported] benefits would be realized."[73] This admission is striking as best execution is regularly listed as an examination priority for the Commission, and both FINRA and Commission staff have engaged in exhaustive reviews of broker-dealer order handling practices. There is absolutely no justification for the Commission to propose a best execution rule without first reviewing information that is available pursuant to existing Commission and FINRA requirements. Given the Commission's own admission that any purported benefits of the Proposal cannot be substantiated, the Proposal should be withdrawn in its entirety.

Given the Commission's inability to connect the Proposal to any tangible benefits for retail investors, adopting the Proposal would be arbitrary and capricious in violation of Section 25(b)(4) of the Exchange Act.[74] The Commission's acknowledgment that it does not know whether the Proposal will result in better execution quality for retail investors reflects a fundamental failure to consider "an important aspect of the problem" – how, or if, the Proposal would work in practice.[75] The most important "aspect of the problem" framed by the Commission is whether the new requirements imposed by the Proposal will actually further the duty of best execution and "result in better execution quality for retail customer orders."[76] The Commission's speculation about ways in which broker-dealers "could" comply with the Proposal and the effects such changes "could" have on execution quality demonstrates that the Commission has not remotely considered the likely real world effects of the Proposal on broker-dealers and retail investors.[77]

Moreover, an agency's predictive judgments about the likely effects of a rule "must be based on some logic and evidence, not sheer speculation."[78] The Commission has offered no logic or evidence to support its conjecture that the Proposal "could result in better execution quality for

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[71] Proposal at 5523-37.

[72] Proposal at 5523-24, including fn. 535.

[73] Proposal at 5523-24.

[74] 15 U.S.C. § 78y(b)(4).

[75] *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983); *see also id.* (arbitrary and capricious for an agency to "offer[ ] an explanation for its decision that runs counter to the evidence before it").

[76] Proposal at 5523.

[77] See *Cigar Ass'n of Am. v. FDA*, 964 F.3d 56, 62–63 (D.C. Cir. 2020) (regulations requiring health warning labels on tobacco products were arbitrary and capricious because the FDA failed to adequately address whether the labels would likely increase or decrease the number of tobacco users).

[78] *Sorenson Commc'ns Inc. v. FCC*, 755 F.3d 702, 708 (D.C. Cir. 2014) (internal quotation marks omitted).

retail customer orders."[79] Indeed, the Commission's speculation about how the rule "could" work in practice suggests that it would be improperly implementing the Proposal to "determine whether there *might* be a problem worthy of regulation," rather than to address existing problems.[80] Rules that are not "designed to address identified problems" are per se arbitrary and capricious.[81]

(iii) The "Conflicted Transaction" Requirements Will Harm Retail Investors

The Proposal fails to adequately assess the impact on retail investors if retail broker-dealers are compelled to "de-conflict" and bypass wholesale broker-dealers as a result of the costly "conflicted transaction" requirements that are applied to both retail broker-dealers and wholesale broker-dealers.[82]

First, execution quality is likely to significantly decline, as wholesale broker-dealers demonstrably provide significantly better execution quality for retail orders than other market centers.[83] In addition to offering better prices, wholesale broker-dealers frequently fill orders for more shares than are publicly displayed and guarantee execution. Wholesale broker-dealers also develop sophisticated order routing systems to locate the best available liquidity across market centers, and academic research has found that wholesale broker-dealers often "adjust the execution prices on externalized trades to provide better prices to the customer than the wholesaler(s) obtains directly from external venues when routing an order away."[84] The major wholesale broker-dealers are able to leverage their trading expertise to provide a tighter spread to retail investors (via price improvement).

Second, wholesale broker-dealers often provide important client services that other market centers do not, including offering a high level of operational resilience, bearing the costs associated with trade adjustments, and resolving trade errors. In contrast, exchanges are protected by strict limitation of liability provisions that often cap damages at an aggregate of $500,000 per month.[85] These caps bear no relation to the substantial costs that can result from an exchange error or system outage, in which case retail investors are unlikely to be fully reimbursed if a wholesale broker-dealer is not involved.

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[79] Proposal at 5527.

[80] *NYSE LLC v. SEC*, 962 F.3d 541, 545 (D.C. Cir. 2020)

[81] *Id.* at 556; *see also id.* at 556–57 ("Rules are not adopted in search of regulatory problems to solve; they are adopted to correct problems with existing regulatory requirements that an agency has delegated authority to address.").

[82] We note the Commission acknowledges there may be other significant costs associated with the "conflicted transactions" requirements. *See* Proposal at 5533-34.

[83] One retail broker-dealer found that the execution quality provided by wholesale broker-dealers saved their retail clients alone at least $3.4 billion in 2021. *Supra* note 58.

[84] Battalio study at 5.

[85] *See, e.g.,* BATS Exchange, Inc. Rule 11.16 (limiting liability to an aggregate of $500,000 per month); EDGX Exchange Rule 11.12 (limiting liability to an aggregate of $500,000 per month).

Third, bypassing wholesale broker-dealers will significantly increase costs for retail broker-dealers (which may be passed on to retail investors). In particular, each retail broker-dealer will be required to maintain connections with nearly fifty market centers, and will have to develop specialized and sophisticated order routing systems, build the required market access controls, and bear the associated operational risk and complexity. Furthermore, retail broker-dealers will have to cover the costs associated with exchange trading fees, venue memberships, and low latency market data subscriptions.

As evidence of the significance of these costs, we estimate that retail broker-dealers would have incurred approximately $2.2 billion in exchange access fees alone during 2022 if marketable retail orders were required to be directly routed to exchanges.[86] In addition, the Commission finds that wholesale broker-dealers paid $940 million in PFOF for NMS stocks to retail broker-dealers during 2022.[87] In aggregate, bypassing wholesale broker-dealers would lead to well over $3 billion in annual costs for retail broker-dealers that may be passed on to retail investors. The Proposal's economic analysis neither considers these costs nor the associated market-wide operational risks of requiring this many new connections.[88] In addition, the barriers to entry for a new retail broker-dealer will significantly increase.

For all of these reasons, academic research has conclusively found that "retail brokers route orders to wholesalers even when they do not choose to charge wholesalers to interact with their marketable order flow because of the superior execution quality provided to these orders, which is commercially advantageous to retail brokers and is consistent with a retail brokers [*sic*] best execution obligations."[89] In seeking to disadvantage wholesale broker-dealers through the "conflicted transaction" requirements, with no credible data-based analysis or justification, the Commission is actively undermining best execution. We urge the Commission to eliminate the misguided "conflicted transactions" concept if it does not withdraw the Proposal in its entirety.

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[86] *Supra* note 59.

[87] Order Competition Proposal, 88 FR 128 (Jan. 3, 2023) at 206.

[88] Proposal at 5531. We note the Commission was more willing to acknowledge the costs associated with prohibiting PFOF entirely, but failed to consider whether the "conflicted transaction" requirements would, in practice, largely prohibit PFOF and thus result in similar costs to retail investors. Proposal at 5539.

[89] Battalio study at 8.

II. The General Best Execution Standard is Ambiguous and Unnecessary

As detailed above, FINRA rules already establish a robust best execution framework and broker-dealers are subject to examinations by the Commission (and FINRA) regarding these requirements. As a result, it is unclear why an entirely new best execution rule is warranted, even if the "conflicted transactions" concept were to be removed. Jettisoning decades of market practice under current FINRA rules, and attempting to adopt a single new rule that covers a wide range of asset classes, will lead to unnecessary costs and confusion for broker-dealers and investors.

A. The Proposal Creates Significant Ambiguity Regarding Whether It Is Consistent With Current FINRA Rules

The Commission claims that the newly proposed general best execution standard is consistent with current FINRA rules.[90] However, the Proposal creates significant uncertainty regarding whether this is accurate in practice.

(i) The Preamble to the Proposal Contains Problematic "Suggestions" For Retail Orders in Equities

The preamble of the Proposal contains many problematic "suggestions" regarding how broker-dealers "could" comply with best execution requirements for retail orders in equities in the event the "conflicted transaction" requirements do not apply. These suggestions are inconsistent with current FINRA rules and do not improve execution outcomes for retail investors.

For example, the Proposal suggests that wholesale broker-dealers *could* provide assurances that certain orders "would be guaranteed midpoint executions by the wholesaler or otherwise exposed to opportunities for midpoint executions."[91] If wholesale broker-dealers do not guarantee midpoint execution, the Proposal surmises that retail broker-dealers *could* consider routing retail orders themselves to attempt to obtain midpoint liquidity on exchanges and ATSs before then considering whether to route the order to a wholesale broker-dealer.[92]

These suggestions suffer from similar flaws as those made by the Commission for "conflicted transactions." No market participant (including a wholesale broker-dealer) is in a position to guarantee midpoint executions of individual orders in advance, given that execution outcomes will depend on the specific characteristics of an order (including size and direction) and overall market conditions. In addition, midpoint liquidity is hidden, meaning that it requires significant sophistication to be able to accurately predict when and where it will be available. Routing and unsuccessfully attempting to locate midpoint liquidity on exchanges or ATSs has significant negative consequences, as any market participant will take that into account (as well as the

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[90] Proposal at 5441, fn. 3.

[91] Proposal at 5460.

[92] *Id*.

information leakage that has occurred)[93] when determining whether (and at what price) to fill an order.

None of the suggestions provided by the Commission accurately reflect how smart order routers operate in practice, or how they are used by wholesale broker-dealers to improve overall execution outcomes for retail investors. In fact, according to Commission data, wholesale broker-dealers already deliver midpoint or better prices to a remarkable 44% of retail marketable shares.[94] Instead, many of the suggestions contained in the Proposal appear to be directly inconsistent with the objective of delivering best execution. As such, we urge the Commission to more accurately reflect broker-dealer order routing practices in the Proposal.

More generally, the Commission's many suggestions regarding how the Proposal "could" (as opposed to "shall") be interpreted in practice limits the ability of market participants to provide meaningful comments. Under the Administrative Procedure Act, "[n]otice of a proposed rule must include sufficient detail on its content and basis in law and evidence to allow for meaningful and informed comment."[95] The Proposal "is too general to be adequate" because it fails to describe how the Proposal will operate in practice "with reasonable specificity," thereby depriving interested parties of the ability to comment on the Proposal's effects.[96] The "[f]ailure to provide the required notice . . . is a fundamental flaw that normally requires vacatur of the rule."[97] Additionally, as noted above, adopting the Proposal would be arbitrary and capricious in violation of the Exchange Act because the agency has failed to adequately consider the most important aspect of the problem – whether the Proposal would actually further the duty of best execution and improve execution outcomes for retail investors.[98]

(ii) The Proposal Creates Ambiguity Regarding the Executing Broker Exception

The Proposal specifies that a broker-dealer is not subject to best execution when "[a]nother broker or dealer is executing a customer order against the broker or dealer's quotation."[99] While the Commission asserts that this proposed exemption "is consistent with FINRA Rule 5310.04,"[100] the Proposal introduces unnecessary uncertainty by failing to copy all of FINRA Rule 5310.04.

In particular, FINRA Rule 5310.04 is clear that the duty to provide best execution only arises when an order is routed to a broker-dealer "for the purpose of order handling and execution." This provides important clarification that best execution does not apply when a broker-dealer is acting

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[93] The Commission cursorily acknowledges that "[p]inging for midpoint liquidity at multiple venues could increase the risk of information leakage or that prices may move, possibly resulting in some market participants canceling midpoint orders they posted." Proposal at 5502, fn. 429.

[94] *Supra* note 10.

[95] *Am. Med. Ass'n v. Reno*, 97 F.3d 1129, 1132 (D.C. Cir. 1995); *see* 5 U.S.C. § 553(b); 15 U.S.C. § 78y(b)(4).

[96] *Small Refiner Lead Phase-Down Task Force v. EPA*, 705 F.2d 506, 549 (D.C. Cir. 1983).

[97] *Heartland Reg'l Med. Ctr. v. Sebelius*, 566 F.3d 193, 199 (D.C. Cir. 2009) (internal quotation marks omitted).

[98] *State Farm*, 463 U.S. at 43; *see Cigar Ass'n of Am.*, 964 F.3d at 62–63. See Proposal at 5523.

[99] Proposed §242.1100(a).

[100] Proposal at 5452, fn. 114.

solely as buyer and seller in the transaction for its own account.[101] While it may appear self-evident that best execution does not apply if a broker-dealer is not "handling" an order, we urge the Commission to avoid introducing unnecessary uncertainty and to copy all of FINRA Rule 5310.04 in any final rule.

B. An Entirely New Best Execution Requirement Is Unnecessary

Regardless of whether the Commission's general best execution standard is intended to be consistent with current FINRA rules, the Proposal is a misguided effort that will lead to unnecessary costs and confusion for broker-dealers and investors. By creating a new rule, instead of revising or adopting current FINRA rules, the Commission is jettisoning decades of market practice and interpretative guidance. As acknowledged by the Commission, the implementation and review of best execution involves facts and circumstances determinations based on firm-specific data and processes.[102] Even though FINRA has committed to adjusting its rules to maintain consistency with the Commission's ultimate approach,[103] it is unnecessarily disruptive to override decades of market practice and results in completely new rulemaking.

C. The Commission Lacks Statutory Authority to Adopt the Proposal

The Proposal is promulgated under Sections 11A and 15(c) of the Exchange Act,[104] but neither section authorizes the Proposal. Section 11A is not, as the Commission incorrectly assumes, an open-ended source of authority to regulate the national market. To be sure, Section 11A lists various "policy objectives," but an agency action cannot "rest merely on the 'policy objectives of the Act.'"[105] Section 11A explicitly authorizes the Commission to "use its authority under [the Exchange Act]"[106] and then, pursuant to the Exchange Act, delegates to the Commission specific powers – for example, to make "rules and regulations" assuring the accurate publication of information "with respect to *quotations*."[107] Section 11A does not authorize the Commission to set a best-execution rule for *all retail orders*. Best execution is – and has long been – governed

[101] For example, if a broker-dealer elects to route to a single dealer platform ("SDP"), the SDP does not receive orders for purposes of order handling, but allows persons to enter orders for execution against the dealer's proprietary account. In this case, the SDP is not vested with the discretion or authority, nor does it have the ability (*e.g.,* by using a smart order router), to handle such orders by considering or sourcing external liquidity on competing markets.

[102] For example, "[a] broker-dealer's assessment of the accessibility of a market could vary depending on the cost of maintaining connectivity, receiving market data, and transacting on the market." Proposal at 5462, fn. 172.

[103] *See* Letter from FINRA and MSRB (Feb. 7, 2023), available at: https://www.sec.gov/comments/s7-32-22/s73222-20156788-324933.pdf.

[104] *See* Proposal at 5442.

[105] *Georgia v. President of U.S.*, 46 F.4th 1283, 1298 (11th Cir. 2022).

[106] 15 U.S.C. § 78k-1(a)(2).

[107] *Id.* § 78k-1(c)(1)(B) (emphasis added).

by rules of the self-regulatory organizations.[108] And while the Commission has a role to play in supervising *those* rules,[109] it does not have the authority to unilaterally redo them in its own name.

Section 15(c) does not authorize the Proposal either. Section 15(c) provides the Commission with the authority to prevent fraudulent, deceptive, or manipulative acts or practices.[110] The Commission suggests that "[w]hen a broker-dealer violates its duty of best execution, it could be in violation of section 15(c) of the Exchange Act."[111] But the Commission offers only speculation that the Proposal will actually further the duty of best execution.[112] A Proposal that even the Commission does not say will improve execution cannot be justified as a measure to root out fraud, deception, or manipulation. Nor does the Commission offer an explanation for why the Proposal – if it is intended as an anti-fraud measure – creates a two-tier best execution standard depending on whether a "conflicted" transaction comes from a retail or a non-retail investor. If "conflicted" transactions resulted in fraudulent denials of best execution (and the Commission offers no evidence that they do), then that would remain true regardless of investor type. Given the Commission's failure to demonstrate that the Proposal will prevent fraud, deception, or manipulation, adopting the Proposal would exceed the Commission's statutory antifraud authority.[113]

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[108] *See id.* § 78o-3(b)(6) ("The rules of the association are designed to … promote just and equitable principles of trade ….").

[109] *See id.* (requiring Commission review of SRO rules); *id.* § 78s(c) (authorizing the Commission to amend SRO rules).

[110] *Id.* § 78*o*(c)(2)(D).

[111] *Id.*

[112] Proposal at 5523.

[113] *See* 15 U.S.C. § 78y(b)(4).

III. The Commission Failed to Consider the Impact of the Other Proposals Issued Simultaneously

In addition to the current Proposal, the Commission simultaneously issued three other proposals that address U.S. equity market structure. These proposals significantly overlap with the Proposal, and materially impact the economic analysis contained therein as detailed below. However, the Commission entirely fails to consider the impact of these other proposals, and instead repeatedly "encourages commenters to review [the other proposals] to determine whether it might affect their comments on this proposing release."[114] This results in a clearly insufficient economic analysis, as well as a conflicting and confusing bundle of proposals that fail to give the public notice of the actual, ultimate regulatory requirements the Commission is proposing, and that make it impossible for the public to fully, meaningfully comment. With the Commission's ultimate proposal so unclear, the public cannot reliably discern upon what it is commenting. For this and other reasons, none of these four proposals can be properly finalized without re-proposal and full harmonization with any other proposed Commission rule on equity market structure.

A. Order Competition

This Proposal appears to be patently contradictory with the Order Competition proposal.[115] For example, the Order Competition proposal appears to require nearly all retail marketable orders to be routed to an auction mechanism (or an exchange) even if the routing broker-dealer does not agree that it is likely to deliver a more favorable outcome for the order. In addition, since exchanges are permitted to provide rebates in the new retail auctions under the Order Competition proposal, these retail transactions would be considered "conflicted transactions," thereby seemingly requiring broker-dealers to consider other liquidity sources beyond material potential liquidity sources (including in advance of sending the retail order to an auction).[116]

As a result of these patent inconsistencies, broker-dealers would be faced with having to choose between complying with their best execution obligations under this Proposal and violating the requirements arising from the Commission's Order Competition proposal, or *vice versa*.[117]

B. Disclosure of Order Execution Information (Rule 605)

In the Rule 605 proposal, the Commission acknowledges that there are several material shortcomings in current execution quality data that must be addressed. Indeed, recent academic research has found that addressing all these shortcomings in the Rule 605 data may increase reported price improvement statistics for retail orders by 5 times.[118] This means that, in aggregate,

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[114] *See, e.g.,* Proposal at 5537, fn. 610.

[115] "Order Competition Rule," 88 FR 128 (Jan. 3, 2023) at 129, available at: https://www.govinfo.gov/content/pkg/FR-2023-01-03/pdf/2022-27617.pdf.

[116] Proposal at 5467.

[117] Notably, no one involved in the actual auction (including the exchange and the auction bidders) will be subject to best execution obligations.

[118] Battalio study at 1.

there are billions of dollars per year in price improvement from wholesale broker-dealers that is currently not factored into the analysis in this Proposal, since the Commission is relying on current 605 data. Before insinuating that wholesale broker-dealers do not deliver exceptional execution quality to retail investors, the Commission has the duty to update Rule 605 to produce accurate and comprehensive execution quality data.

More generally, the Rule 605 proposal focuses on the importance of providing more transparency to retail investors in order to allow them to make informed decisions. In addition, market participants and regulators would be able to compare execution quality more easily across retail broker-dealers. This Proposal, however, seeks to restrict investor choice and dictate market structure outcomes by arbitrarily targeting retail investors with more onerous requirements that are likely to reduce execution quality and overall market competition.

C. Minimum Pricing Increments and Access Fees

In the Minimum Pricing Increments and Access Fees proposal, the Commission attempts to restrict the prices at which trading can occur in the hope that it will reduce off-exchange retail trading.[119] For example, with respect to stocks with a minimum quoting increment of 1/2 of a cent or 1 cent, trading would no longer be permitted to occur at 1/10 of a cent increments, in contrast to how exchange retail programs and wholesale broker-dealers currently operate. This appears directly inconsistent with best execution requirements under this Proposal, as the impact would likely be borne by retail investors through worse execution quality. Indeed, the Minimum Pricing Increments and Access Fees proposal suggests that approximately $3 billion per year of retail price improvement may be at risk.[120]

Separately, the Commission has not considered how reducing the minimum quoting increment for tick-constrained symbols may impact the availability of midpoint liquidity on external venues, thereby further obviating purported concerns discussed in this Proposal.[121]

[119] "Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders," 87 FR 80266 (Dec. 29, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-12-29/pdf/2022-27616.pdf

[120] *Id.* at 80307.

[121] Citadel Securities has consistently advocated in favor of reducing the minimum quoting increment to 1/2 of a cent for tick-constrained symbols (taking into account quoted spread and available liquidity). *See* our comment letter on the Minimum Pricing Increments and Access Fees proposal.

IV. The Commission Must Adequately Consider Reasonable, Less Burdensome Alternatives

As detailed above, FINRA rules already establish a robust best execution framework, with decades of market practice and interpretative guidance. The Commission should continue to operate within this framework by making any revisions to best execution obligations directly through proposed changes to existing FINRA rules.

The Commission's only stated justification for not pursuing this alternative is that it would not include the arbitrary and onerous "conflicted transactions" requirements, which the Commission argues address "the trade-off between payment for order flow and price improvement for equities" and "the less than fully competitive price improvement auction mechanisms for options."[122] However, to the extent the Commission believes that further regulatory action is necessary with respect to PFOF specifically, the Commission should consider more targeted alternatives, such as establishing a payment cap that equally applies to both on-exchange and off-exchange PFOF. Furthermore, the Proposal does not specifically require any modification to the price improvement auction mechanisms that are operated by various exchanges for options. Thus, the only tangible effect of the "conflicted transactions" requirements will be to harm retail investor execution quality as detailed above.

We recommend the Commission more fully review available information regarding current order routing practices and retail investor execution quality before considering any revisions to existing FINRA rules. In addition, the Commission should focus on identifying whether specific gaps exist under current FINRA rules, such as ensuring that exchange-owned routing brokers that handle retail orders are subject to equivalent best execution requirements.[123]

For the reasons above, the Commission should withdraw the Proposal.

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We thank the Commission for considering our comments.

Please feel free to call the undersigned with any questions regarding these comments.

Respectfully,

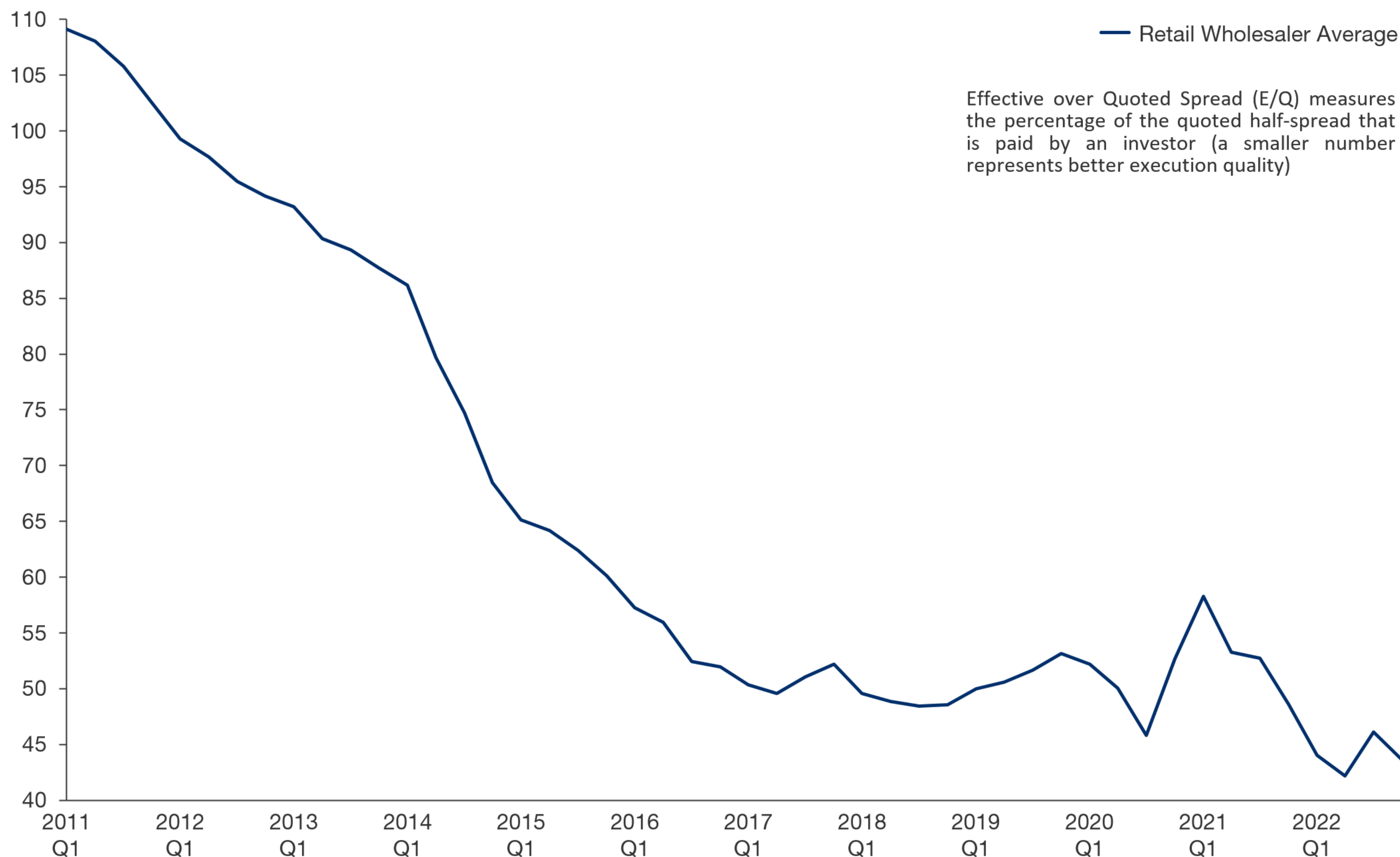
/s/ Stephen John Berger

Managing Director

Global Head of Government & Regulatory Policy

[122] Proposal at 5537, fn. 606.

[123] In addition, asset classes other than equities and options likely deserve priority in terms of improving overall market transparency and investor outcomes.


Retail Effective/Quoted Results (2011 – 2022)
Retail Wholesaler Average
Effective over Quoted Spread (E/Q) measures the percentage of the quoted half-spread that is paid by an investor (a smaller number represents better execution quality)
110
105
100
95
90
85
80
75
70
65
60
55
50
45
40
2011 Q1
2012 Q1
2013 Q1
2014 Q1
2015 Q1
2016 Q1
2017 Q1
2018 Q1
2019 Q1
2020 Q1
2021 Q1
2022 Q1
Data is from SEC Rule 605 filings and covers market orders in NMS securities (100-9,999 shares)