
The SEC Proposes Regulation Best Execution

February 22, 2023

I. Introduction

On December 14, 2022, the Securities and Exchange Commission (the SEC or Commission) proposed Regulation Best Execution (Proposed Reg Best Ex),¹ which would establish through Commission rules a federal best execution regulatory framework for brokers, dealers, government securities brokers, government securities dealers and municipal securities dealers. As proposed, Proposed Reg Best Ex consists of three rules: (1) Rule 1100, which sets forth “the best execution standard”; (2) Rule 1101, which requires policies and procedures; and (3) Rule 1102, which requires an annual report.

This alert discusses the requirements of Proposed Reg Best Ex and the significant impact the proposal may have on the industry, if adopted. Proposed Reg Best Ex goes beyond the existing best execution regulatory regime set forth by the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB).² The implementation of Proposed Reg Best Ex exactly as proposed could lead to complexities in areas that do not align with existing FINRA and MSRB best execution rules, and create substantial regulatory uncertainty for (not to mention burden on) broker-dealers subject to the various rules. At the same time, certain aspects of Proposed Reg Best Ex are highly complex and trend toward micromanagement of broker-dealers’ decision-making processes and best judgment for where and how to execute their customers’ orders. Moreover, Proposed Reg Best Ex would require broker-dealers that engage in what the SEC refers to as “conflicted transactions” to have *even more* robust procedures specific to

¹ Regulation Best Execution, Securities Exchange Act of 1934 Release No. 96496 (Dec. 14, 2022); 88 Fed. Reg. 5440 (Jan. 27, 2023) (“Proposed Reg Best Ex”), <https://www.govinfo.gov/content/pkg/FR-2023-01-27/pdf/2022-27644.pdf>.

² See Proposed Reg Best Ex at 5441 (the Commission noting that “while FINRA and the MSRB have established best execution rules . . . and generally require broker-dealers to have procedures for compliance with relevant laws and rules, the Commission believes it is appropriate to propose its own comprehensive and detailed best execution requirements.”). It is possible that FINRA and MSRB would amend or possibly revoke their rules if and when the Proposed Reg Best Ex is adopted, but the SEC rulemaking does not mandate that outcome.

those transactions. While the proposal asserts that these additional requirements would help mitigate the potential for incentives to negatively impact a broker-dealer's best execution determinations, it is not clear what the SEC's expectation is for broker-dealers and execution-related outcomes under this "better than normal best execution" standard. In various places throughout the proposing release, the Commission highlighted its belief that Proposed Reg Best Ex would enhance investor protection by facilitating the Commission's and self-regulatory organization's (SRO) examination and enforcement capabilities.³ Comments on Proposed Reg Best Ex are due on March 31, 2023.

II. The Best Execution Standard – Rule 1100

Proposed Rule 1100 would require broker-dealers to use reasonable diligence to ascertain the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.⁴

The proposed best execution standard would apply broadly to any transaction for or with a customer or a customer of another broker-dealer, with very limited exceptions. The exceptions include when (1) the broker-dealer is quoting a price for a security where another broker-dealer routes a customer order for execution against that quote; (2) an institutional customer, exercising independent judgment, executes its order against the broker-dealer's quotation; or (3) the broker-dealer receives an unsolicited instruction from a customer to route its order to a particular market for execution and the broker-dealer processes that customer's order promptly and in accordance with the terms of the order.⁵ These exclusions are consistent with preexisting exclusions from SRO best execution rules.

III. Best Execution Policies and Procedures – Rule 1101

Like the current FINRA and MSRB best execution rules, proposed Rule 1101 requires a broker-dealer to establish and maintain written policies and procedures reasonably designed to comply with the proposed standard.⁶ Yet the requirements in the proposed rule, which we set forth below, go well beyond current SRO rules and frequently prescribe specific assessments a broker-dealer must make in order to comply with its obligation with unprecedented granularity, both with regard to substance and, in some cases, the sequencing of considerations. There is a concern that this level of granularity effectively substitutes the judgment of SEC staff for the judgment of the industry professionals responsible for the broker-dealer's compliance with this highly technical rule.⁷ There is also a concern that the prescriptive nature of the rule proposal would hinder broker-dealers from

³ *Id.* at 5523–24.

⁴ *Id.* at 5451.

⁵ The SEC notes that the exemptions distinguish between a broker-dealer that is acting solely as the buyer or seller of securities and one that is accepting order flow from another broker-dealer. *Id.* at 5451–52.

⁶ *Id.*

⁷ Commissioner Hester M. Peirce, "Is This the Best Execution We Can Get?" (Dec. 14, 2022), <https://www.sec.gov/news/statement/peirce-best-execution-20221214>.

adjusting their policies and procedures in accordance with the unique facts and circumstances presented by different markets as they evolve.

A. Framework for Compliance with the Best Execution Standard

Under proposed Rule 1101(a), these procedures must address how the broker-dealer will (1) comply with the best execution standard and (2) determine the best market for the customer order that it receives.⁸ In particular, such policies and procedures must show how the broker-dealer will:

- obtain and assess reasonably accessible information, including information about price, volume and execution quality, concerning the markets trading the relevant securities;
- identify markets that may be reasonably likely to provide the most favorable prices for customer orders (material potential liquidity sources); and
- incorporate material potential liquidity sources into its order handling practices and ensure that it can efficiently access each such material potential liquidity source.⁹

The Commission provides the following examples of liquidity sources for National Market System (NMS) stocks, over-the-counter (OTC) equity markets, options markets, and corporate and municipal bond markets and government securities markets.

- **NMS Stocks:** Material potential liquidity sources could include exchanges, alternative trading systems (ATs) and broker-dealers, including market makers and wholesalers.¹⁰ The Commission notes that it could also include trading protocols and auction mechanisms operated by these entities, such as those that provide price improvement opportunities and wholesaler price improvement guarantees.¹¹ Sources of reasonably accessible information for NMS stock include (1) publicly available quotation data, (2) consolidated trade information, (3) exchange proprietary data feeds, (4) odd lot market data, and (5) execution quality and order routing information contained in reports made pursuant to Rules 605 and 606 of Regulation NMS.¹²

⁸ Proposed Reg Best Ex at 5454–55.

⁹ The proposed rule highlights the importance of market information to the broker-dealer’s best execution analysis and that execution quality is a relevant factor to that analysis. In discussing execution quality, the Commission makes several observations. First, the Commission states that broker-dealers should consider including competition levels of a market as an element of its best execution policies and procedures. Second, in their policies and procedures, broker-dealers should address how they would assess the features of options price improvement auctions, how those features might affect the level of competition and the execution quality offered by the auctions, and whether those features would allow an auction to provide the most favorable prices under prevailing market conditions. Third, in considering request for quote (RFQ) systems as material potential liquidity sources for corporate and municipal bonds, the broker-dealer’s policies and procedures could assess the filtering practices that may be applied by the RFQ system operator and the impact that those practices may have on the execution quality of those markets. *Id.* at 5454–56.

¹⁰ *Id.* at 5457.

¹¹ *Id.*

¹² *Id.*

- **OTC Equities:** Broker-dealers could consider ATSS, wholesalers and other OTC market makers as potential material liquidity sources.¹³ A broker-dealer could also consider obtaining data from ATSS and OTC market makers as a source for reasonably accessible information, in addition to the data publicly available through the FINRA OTC Reporting Facility.¹⁴
- **Options:** Material potential liquidity sources could include the options exchanges and the range of trading protocols and auction mechanisms made available by them. This may include: (1) quotes from market makers resting on exchange limit order books, (2) price movement auctions, (3) liquidity resting between the best bid and offer that may be available on exchange limit order books, and (4) floor trading facilities that may provide a broker-dealer with the opportunity to seek competitive prices from floor participants for larger or complex options orders.¹⁵ The Commission adds that a broker-dealer would also need to consider whether other broker-dealers may represent material potential liquidity sources for its customers' options orders.
- **Corporate, Municipal and Government Bonds:** Material potential liquidity sources could include ATS and non-ATS electronic trading systems, RFQ systems and other auction mechanisms, interdealer brokers and other broker-dealers willing to be a counterparty upon request, and a broker-dealer's own principal trading desk.¹⁶ In obtaining reasonable sources of information, a broker-dealer could obtain data from: (1) ATSS and other trading platforms, such as RFQ systems, interdealer brokers, and dealers that handle and execute customer orders; (2) trade data in the corporate bond and municipal bond markets made publicly available through FINRA's Trade Reporting and Compliance Engine (TRACE) and the MSRB's Real-time Transaction Reporting System (RTRS); and (3) price aggregator services or evaluated pricing services.¹⁷

B. Best Market Determination

Under proposed Rule 1101(a)(2), a broker-dealer's best execution policies and procedures would be required to address how it will determine the best market and make routing or execution decisions for customers by:

- assessing reasonably accessible and timely information with respect to the best displayed prices, opportunities for price improvement, including a specific requirement to address opportunities for midpoint executions, and order exposure opportunities that may result in the most favorable price;

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

- assessing the attributes of customer orders and considering the trading characteristics of the security, the size of the order, the likelihood of execution, the accessibility of the market and any customer instructions in selecting the market most likely to provide the most favorable price; and
- in determining the number and sequencing of markets to be assessed, reasonably balancing the likelihood of obtaining better prices with the risk that delay could result in a worse price.¹⁸

In the proposing release, the Commission acknowledges that the methods for determining the best market for customer orders will vary depending on the trading characteristics of the securities and provides a detailed list of potential assessments by security type.¹⁹

For example, the policies and procedures of a broker-dealer in NMS stocks could include assessments of any “assurances from a wholesaler that certain orders routed by the retail broker-dealer to the wholesaler would be guaranteed midpoint executions by the wholesaler or otherwise exposed to opportunities for midpoint executions.”²⁰ In the event the wholesaler cannot provide such assurances, the Commission notes that the policies and procedures may provide for an assessment as to whether customer orders would best be executed with midpoint liquidity that may be available on an exchange, ATS or other market.²¹ Upon assessment of the opportunities for midpoint executions, a broker-dealer’s policies and procedures could provide for an assessment of whether there are other price improvement opportunities that might be available.²²

With regard to listed options, the Commission acknowledges that midpoint liquidity is not commonly available on options exchanges. Nonetheless, broker-dealer policies and procedures would be required to address how the broker-dealer will assess potential midpoint executions, including to the extent additional midpoint liquidity emerges.²³ After the assessment of potential opportunities for midpoint executions, the broker-dealers could assess other available price improvement opportunities, including: (1) potential resting liquidity on exchange limit order books priced between the best bid and offer, (2) exchange price improvement auctions, and (3) an assessment of

¹⁸ *Id.* at 5459.

¹⁹ *Id.*

²⁰ Whether these statements about midpoint execution could reflect an evolving standard for measuring execution quality against the midpoint is unclear under Proposed Reg Best Ex. For example, in the Commission’s Order Competition Rule proposal, the Commission would provide an exception to wholesalers from having to route orders to a qualified auction if they have a limit price that is equal to or more favorable than the National Best Bid and Offer midpoint. To the extent the proposal implies that best execution should be measured based on midpoint, that may be problematic. The focus on midpoint executions also may not be practical for large orders in equity securities or illiquid securities. *Id.* at 5460; *see* Order Competition Rule Proposal, 88 Fed. Reg. 128 (Jan. 3, 2023).

²¹ *Id.*

²² *Id.*

²³ *Id.*

guarantees for price improvement that may be provided by wholesalers and the performance of the wholesalers.²⁴

Unlike the equities and options markets, information about consolidated market prices is not readily obtainable in the corporate and municipal bond markets and government securities markets. Therefore, the Commission notes only that the broker-dealer's policies and procedures should include assessments of best displayed price information that is "reasonably accessible and timely" in the corporate and municipal bond markets and government securities markets.²⁵ This could include RFQ mechanisms or, in the absence of reliable pricing information, a competitive auction mechanism.

Given that customer orders vary in attributes and size, the Commission provides additional factors that could affect a broker-dealer's best market determination and that the broker-dealer would be required to address in its policies and procedures, including:

- information leakage when handling large orders and the price impact that could harm execution quality;
- whether or not the order is a market order or limit order;
- the likelihood of execution;
- the trading characteristics of a security and the accessibility of a market;
- extreme market conditions that result in heightened volatility or impact the liquidity of a security;
- customer instructions; and
- how the broker-dealer will reasonably balance the likelihood of obtaining better prices with the risk that delay could result in worse prices in determining the number and sequencing of markets to be assessed for customer orders.²⁶

IV. Additional Policies and Procedures and Documentation for Conflicted Transactions with Retail Customers – Rule 1101(b)

If a transaction with a retail customer meets the SEC's definition of "conflicted transaction," proposed Rule 1101(b) would require broker-dealers to have even more robust policies and procedures and documentation—beyond what is required for non-conflicted transactions.²⁷ Of note, the proposal would require a broker-dealer to document any arrangement concerning payment for order flow.²⁸ A "conflicted transaction" would be defined as any "transaction for or with a retail

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.* at 5462–63.

²⁷ *Id.* at 5471.

²⁸ *Id.*

customer” where a broker dealer: (1) executes an order as principal (which would include orders executed on a riskless principal basis); (2) routes an order to, or receives an order from, an affiliate²⁹ for execution; or (3) provides or receives payment for order flow as defined under Rule 10b-10(d)(8) under the Securities Exchange Act (Exchange Act).³⁰

Treating riskless principal trades as conflicted transactions does not make sense as a practical matter (because these trades are the economic equivalent of agency trades) and is inconsistent with treatment of riskless principal stock trades in other contexts, for example, FINRA stock trade reporting rules and Section 28(e) of the Exchange Act. And notably, the additional requirements applicable to conflicted transactions are particularly problematic for certain types of securities. For example, in the proposing release, the Commission acknowledges that many broker-dealers in the corporate and municipal bond markets and government securities markets trade with retail customers on a principal basis. As such, these broker-dealers would be engaged in conflicted transactions for virtually all fixed income trades. Such broker-dealers would be required to evaluate a broader range of ATSs, broker’s brokers, RFQ systems and other broker-dealers that trade on these markets that the broker-dealer identifies under proposed Rule 1101(b).³¹ Complying with such a standard will be particularly difficult in instances where there are limited sources, for example, with highly illiquid bonds.

A. Policies and Procedures for Conflicted Transactions

Under proposed Rules 1101(b)(1) and 1101(b)(2), a broker-dealer’s best execution policies and procedures would be required to address the following with respect to conflicted transactions:

- How the broker-dealer will obtain and assess information beyond that required by proposed Rule 1101(a)(1)(i), including additional information about price, volume and execution quality in identifying a broader range of markets beyond those identified as material potential liquidity sources; and
- How the broker-dealer will evaluate a broader range of markets, beyond those identified as material potential liquidity sources, that might provide the most favorable price for customer orders, including a broader range of order exposure opportunities and markets that may be smaller or less accessible.

The Commission notes that while proposed Rule 1101(b) does not ban conflicted transactions, such transactions should be subject to more robust policies and procedures to help mitigate the

²⁹ “Affiliate” would be defined by proposed Rule 1101(b)(4)(iii) as with respect to a specified person, any person that, directly or indirectly, controls, is under common control with, or is controlled by, the specified person. “Control” would be defined for purposes of the proposed definition of “affiliate” by proposed Rule 1101(b)(4)(iii) as the power, directly or indirectly, to direct the management or policies of the broker-dealer whether through ownership of securities, by contract or otherwise. *Id.*

³⁰ *Id.*

³¹ *Id.* at 5471.

potential negative effects on a broker-dealer's best execution determinations.³² We anticipate that firms may find it challenging to delineate specifically how the policies and procedures for conflicted transactions should be different from the policies and procedures for the non-conflicted transactions, especially across different markets. In this regard, the Commission also noted that broker-dealers may adopt a single set of policies and procedures covering both conflicted and non-conflicted transactions to comply with proposed Rules 1101(a) and 1101(b), as long as these policies and procedures meet the "beyond" standard.³³

B. Documentation of Compliance with Best Execution Standard for Conflicted Transactions

Proposed Rule 1101(b)(3) would require a broker-dealer to document its compliance with the best execution standard for conflicted transactions.³⁴ Such documentation would include all the broker-dealer's efforts to enforce its policies and procedures for conflicted transactions and the basis and information relied on for its determination that it has met the best execution standard with regard to conflicted transactions.³⁵ The Commission also acknowledges that the way a broker-dealer documents its compliance may vary based on considerations specific to the broker-dealer. Therefore, the rule does not prescribe the manner in which a broker-dealer would need to document its compliance with the proposed best execution standard.

As part of its documentation required under this subpart, however, broker-dealers receiving payment for order flow would be required to document any arrangement, whether written or oral, concerning payment for order flow.³⁶ Such documentation would include, but is not limited to, the parties to the arrangement, all qualitative and quantitative terms concerning the arrangement, and the date and terms of any changes to the arrangement.³⁷ Wholesalers that execute customer

³² *Id.* at 5467.

³³ *Id.* at 5466–67, n. 191.

³⁴ The Commission states that a broker-dealer could do so by: (1) retaining records of any data feeds or other pricing information that it uses when handling retail customer orders; (2) documenting its order handling practices that can impact whether customer orders are executed in compliance with the best execution standard, such as the broker-dealer's practices concerning the use of RFQ systems (e.g., filtering, response time and last look practices); and (3) documenting its markup policies for principal trades, including how the broker-dealer assesses markups for trades with customers and any variations depending on the nature of the transaction (e.g., riskless principal trades versus trades with the broker-dealer's inventory). *Id.*

³⁵ *Id.* at 5468.

³⁶ Rule 606 of Regulation NMS currently requires broker-dealers to disclose information regarding the handling of their customers' orders in NMS stocks and listed options, including payment for order flow arrangements. Rule 607 of Regulation NMS and Securities and Exchange Act Rule 10b-10 also require payment for order flow disclosures. Further, Regulation Best Interest requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations to retail customers. It seems that this requirement may be duplicative from the information required to be disclosed under Rule 606 and the conflict of interest disclosures under Regulation Best Interest. *Id.*; 17 C.F.R. § 242.606; 17 C.F.R. § 240.151-1.

³⁷ Qualitative and quantitative terms would include any terms that impact the variability or establish a condition concerning payment for order flow. For example, any terms based on the characteristics of an order (e.g., size, marketability, held or not held, special order handling instructions, whether the order is a complex options order) and the type of security involved (e.g., whether the security is in the S&P 500 Index, exchange-traded fund) or the price of a security. This requirement is intended to capture payment for order

orders in a principal capacity and pay a retail broker-dealer for order flow would also be required to document their payment for order flow arrangements.³⁸ The proposal does not clarify whether receipt of exchange rebates constitutes receipt of payment for order flow for purposes of determining whether an execution is a conflicted transaction under the proposal. Without clear guidance from the Commission, the proposal may result in a large number of orders falling under this heightened standard.

The Commission notes that a failure to have and enforce the policies and procedures applicable to conflicted transactions would be a violation of Proposed Reg Best Ex. This would mean that the SEC could charge a broker-dealer for violating the rule even if the broker-dealer obtains best execution for all of its transactions.

V. Regular Review of Execution Quality – Rule 1101(c)

Under proposed Rule 1101(c), a broker-dealer would be required to, no less frequently than quarterly,³⁹ review the execution quality of its transactions for or with its customers or customers of another broker-dealer, and how such execution quality compares with the execution quality the broker-dealer might have obtained from other markets, and to revise its best execution policies and procedures, including their order handling and routing practices, accordingly.⁴⁰ A broker-dealer also would be required to document the results of this review.⁴¹

The Commission has noted that a broker-dealer would not satisfy the requirements of proposed Rule 1101(c) if it solely conducts the review based on the markets to which it currently routes orders to customers without considering other markets or trading venues.⁴² Instead, a broker-dealer would be required to consider the potential execution quality at trading venues that it does not currently use to execute customer orders, including new markets to the extent they become

flow arrangements between broker-dealers, and between broker-dealers and other markets, regardless of whether there is any contractual obligation associated with the payment for order flow arrangement.

³⁸ The proposal provides that a wholesaler could document its compliance with the best execution standard for conflicted transactions by: (1) documenting the prices received from those markets that it checked pursuant to its policies and procedures, (2) retaining a record of the markets at which it attempted to execute customer orders at prices better than the National Best Bid and Offer, (3) retaining records of market data feeds that the wholesaler uses when handling retail customer orders, and (4) 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 does pay for order flow. *Id.* at 5470.

³⁹ While proposed Rule 1101(c) would require broker-dealers to review execution on at least a quarterly basis, the Commission believes that, in many cases, broker-dealers may determine that a review of execution quality more frequently than quarterly is appropriate. *Id.*

⁴⁰ A broker-dealer would be required to compare the execution quality for or with its customers or customers of another broker-dealer to the execution quality the broker-dealer might have obtained from other markets. However, the proposal does not fully address how a broker-dealer would be able to compare the execution quality it receives to execution quality it might hypothetically receive from another market center. It may also be difficult for firms to assess hypothetical execution quality. *Id.*

⁴¹ *Id.*

⁴² *Id.* at 5472.

available, and consider whether it needs to access such markets to attain best execution for customer orders.⁴³

A broker-dealer also would be required to revise its best execution policies and procedures, including order handling practices, after it has conducted its execution quality review, where warranted. While not explicitly stated in the proposed rule, the Commission noted that revisions to the broker-dealer's policies and procedures, including its order handling practices, would be appropriate if there were material differences in execution quality that were not otherwise justifiable.⁴⁴ While Proposed Reg Best Ex would generally align with FINRA's quarterly execution quality reviews, the Commission has stated that it may be more appropriate for a broker-dealer to perform execution quality reviews more frequently than quarterly. The proposal provides that a broker-dealer should determine the appropriate frequency of review by considering, for example, the nature of its business; the asset class transacted; new pools of liquidity, trading protocols or sources of data that have emerged; the availability of technology needed to conduct execution quality reviews; and the level of transparency in a particular market.⁴⁵

VI. Introducing Broker's Reliance on an Executing Broker's Review of Execution Quality – Rule 1101

An introducing broker that routes customer orders to an executing broker would not need to separately comply with proposed Rules 1101(a), 1101(b) and 1101(c) so long as the introducing broker: (1) meets the SEC's limited definition of "introducing broker" and (2) establishes, maintains and enforces policies and procedures that require the introducing broker to regularly review the execution quality obtained from such executing broker,⁴⁶ compare it with the execution quality it

⁴³ The Commission noted that a broker-dealer could consider various factors, including price improvement opportunities, differences in price disimprovement, likelihood of execution of limit orders, speed of execution, size of execution, transaction costs, customer needs and expectations, and the existence of internalization or payment for order flow arrangements. Additionally, a broker-dealer that routinely routes customer orders to multiple trading centers, whether internal or external, could evaluate the latency impacts, fill rates, information leakage and resulting execution quality harms. And, when conducting these reviews, a broker-dealer could consider the procedures it uses or would use for executing the same or similar transactions for its own accounts. *Id.*

⁴⁴ The Commission has noted that this requirement is consistent with FINRA Rule 5310.09, which requires a broker-dealer to determine whether any material differences in execution quality exist among the markets trading the security and, if so, modify its routing arrangements or justify why it is not modifying its routing arrangements. *Id.* at 5473.

⁴⁵ The Commission noted, for example, that a broker-dealer could evaluate the execution quality statistics that market participants are required to disclose on a monthly basis pursuant to Rule 605 of Regulation NMS. Conversely, a broker-dealer may determine to review the execution quality of customer transactions in non-NMS stocks less frequently due to the characteristics of those other markets. *Id.*

⁴⁶ As part of an introducing broker's agreement with the executing broker, the Commission noted that an introducing broker may wish to consider requiring the executing broker to fully disclose its execution quality reviews of the introducing broker's customer orders to the introducing broker in lieu of conducting its own independent analysis of the execution quality ultimately received from the executing broker. *Id.* at 5477.

might have obtained from other executing brokers,⁴⁷ and revise its order handling practices,⁴⁸ accordingly. The introducing broker would also be required to document the results of this review.⁴⁹

An “introducing broker” would be defined narrowly as a broker-dealer that: (1) does not carry customer accounts and does not hold customer funds or securities⁵⁰; (2) has entered into an arrangement with an unaffiliated broker-dealer that has agreed to handle and execute on an agency basis all of the introducing broker’s customer orders (“executing broker”)⁵¹ and (3) has not accepted any monetary payment, service, property or other benefit that results in remuneration, compensation or consideration from the executing broker in return for the routing of the introducing broker’s customer orders to the executing broker.⁵²

With respect to the second prong, the Commission noted that there are two principal trading scenarios that would be considered to be trading on an agency basis solely for the purposes of proposed Rule 1101(d)(2): (1) fractional share trading in NMS stocks and (2) riskless principal

⁴⁷ While an introducing broker would be afforded discretion in how it evaluates the execution quality that could be provided by other executing brokers, the Commission noted that an introducing broker could consider the execution quality and order routing disclosures of these executing brokers along with the information that these executing brokers might provide to the introducing broker directly in connection with this obligation. *Id.*

⁴⁸ An introducing broker may consider it appropriate to change its routing practices to the extent a material difference exists between the execution quality provided by its existing executing broker and the execution quality that might have been obtained from other executing brokers. Alternatively, the Commission noted that an introducing broker could discuss the results of its review with its executing broker and whether it is appropriate for the executing broker to modify its order handling and execution practices in order to provide better execution quality for the introducing broker’s customers. If the executing broker were to either provide a reasonable explanation for the execution quality disparity identified by the introducing broker or agree to modify its order handling and execution practices in order to provide better execution quality, it could be appropriate for the introducing broker to continue to retain the services of its executing broker. Should the introducing broker’s regular review demonstrate persistent execution quality issues that are not justifiable by the executing broker, the introducing broker should consider retaining the services of another executing broker. *Id.* at 5477.

⁴⁹ The Commission believes the documentation would enable the introducing broker to better evaluate the effectiveness of its executing broker on an ongoing basis, as well as help ensure that regulators have access to information to effectively oversee the introducing broker’s efforts to satisfy its obligations under proposed Rule 1101(d). *Id.* at 5478.

⁵⁰ The first requirement is designed to identify those broker-dealers that do not handle or execute customer orders and therefore need to enter into arrangements with other broker-dealers to provide those services. *Id.*

⁵¹ The Commission noted that the second requirement contains several elements. First, the proposed requirement that an arrangement be in place for the handling and execution of all customer orders by another broker-dealer is designed so that the introducing broker does not exercise discretion concerning the routing and execution of customer orders in a manner that would otherwise require the application of all of the provisions of Proposed Reg Best Ex. Second, because the introducing broker would be permitted to rely on the executing broker rather than having policies and procedures that address independently many of the operative provisions of Proposed Reg Best Ex (including the additional obligations for conflicts of interest with retail customers), the introducing broker should not be permitted to be subject to a conflict of interest by selecting an affiliated executing broker. Third, the executing broker would be required to agree to handle all of the introducing broker’s customer orders on an agency basis rather than in a principal capacity; otherwise, the introducing broker would effectively be making a determination concerning how its customer order should be executed, and thus the introducing broker would be subject to the full requirements of Proposed Reg Best Ex. *Id.* at 5475–76.

⁵² The third prong is similar to the second prong in that the introducing broker, which would be exempt from many of the operative provisions of Proposed Reg Best Ex, should not be subject to a conflict of interest that could influence its selection of a broker-dealer that will handle and execute its customers’ orders.

trading⁵³ in corporate and municipal bonds and government securities. With respect to fractional shares, an executing broker, for example, would fill fractional share orders of an introducing broker's customer buy orders by buying a whole share into its inventory and allocating a portion of that share to fill the customer's fractional share order. The Commission acknowledged that an executing broker filling the fractional share components of an introducing broker's customer orders in this manner should not disqualify the introducing broker from relying on the executing broker-dealer's compliance with proposed Rules 1101(a), 1101(b), and 1101(c) because the executing broker is filling the fractional share components on a principal basis solely for the purpose of completing transactions that otherwise would be executed on an agency basis.⁵⁴ With respect to the corporate and municipal bond markets and government securities markets, the Commission recognized that the executing broker does not fill a customer order out of its own inventory, but rather finds a counterparty for the customer order prior to executing the customer order and that the bond simply flows through the executing broker's account for transaction processing before ultimately being transferred to the appropriate customer.⁵⁵

With respect to the second scenario, the proposal is not clear as to the reasons why stocks are not included within the definition of riskless principal, particularly if broker-dealers comply with FINRA trade reporting rules for riskless principal trades. It is also not clear why these two principal scenarios are not carved out from the definition of "conflicted transaction."

VII. Annual Reports – Rule 1102

Proposed Reg Best Ex imposes an "annual report" requirement, which is similar to the annual report requirement in SEC Rule 15c3-5 but represents a deviation from the current FINRA and MSRB best execution framework. Under this requirement, a broker-dealer that effects any transaction for or with a customer or a customer of another broker-dealer would be required to, no less frequently than annually, review and assess the design and overall effectiveness of its best execution policies and procedures, including its order handling practices under proposed Rule 1102.⁵⁶ The review and assessment would be required to be conducted in accordance with written procedures and would be required to be documented.⁵⁷ In addition, the broker-dealer would be required to prepare a written report detailing the results of such review and assessment, including a description of all deficiencies found and any plan to address such deficiencies. The report would

⁵³ A broker or dealer executes an order as "riskless principal" under proposed Rule 1101(b)(4)(ii) if, after having received an order to buy from a customer, the broker or dealer purchases the security from another person to offset a contemporaneous sale to the customer or, after having received an order to sell, the broker or dealer sells the security to another person to offset a contemporaneous purchase from the customer. *Id.* at 5476.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.* at 5479.

⁵⁷ *Id.*

then need to be presented to the board of directors (or equivalent governing body) of the broker-dealer.⁵⁸

The Commission noted that a broker-dealer should assess its best execution policies and procedures holistically when assessing the overall effectiveness of those policies and procedures.⁵⁹ A broker-dealer may also utilize its execution quality reviews and any documentation with respect to conflicted transactions prepared during the course of the review period. Unlike the execution quality review that broker-dealers would be required to perform at least quarterly, the annual review requirement in proposed Rule 1102 would be a broader, more holistic review of the broker-dealer's policies and procedures not focused solely on execution quality.⁶⁰

It is unclear why the SEC believes that an annual report requirement is necessary or why preparing such a report is the best use of a compliance officer's time. Broker-dealers already conduct "regular and rigorous reviews" of execution quality under FINRA guidance and Proposed Reg Best Ex Rule 1101(c) would mandate regular reviews (at least quarterly) of execution quality with documented results of the review. Given this quarterly review and documentation requirement, the justification and cost-benefit basis for an additional annual report requirement is not clear.

VIII. Recordkeeping Requirements

The Commission proposes to amend Rule 17a-4 by adding new paragraph (b)(17). The proposed rule would require broker-dealers to preserve all records made pursuant to proposed Rules 1101 and 1102 for a period of not less than three years, the first two years in a readily accessible place.⁶¹ The proposed rule would require broker-dealers to make records of the following:

- Policies and procedures under proposed Rules 1101(a), 1101(b) and 1101(d) and Rule 1102;
- Documentation of compliance with the best execution standard for conflicted transactions under proposed Rule 1101(b);
- Documentation of payment for order flow arrangements under proposed Rule 1101(b);

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ The Commission noted that a broker-dealer may review the results of its execution quality reviews in conjunction with its overall review of its policies and procedures, to the extent it would assist the broker-dealer in identifying any inadequacies and supporting any revisions to its best execution policies and procedures, including its order handling practices, as appropriate. The Commission also noted that ongoing changes in order handling technology and differing broker-dealer trading models and practices may require a broker-dealer to reconsider its best execution policies and procedures in a way that is not identified during the course of a broker-dealer's regular execution quality reviews conducted pursuant to proposed Rule 1101(c). For instance, the proposed annual review process may encourage the broker-dealer to consider investments in new technologies to improve its overall best execution process despite the fact that the broker-dealer has not identified any issues with its existing execution quality. *Id.* at 5480.

⁶¹ *Id.* at 5481.

- Documentation of the results of the regular review of execution quality under proposed Rule 1101(c);
- Documentation of the results of the regular review of execution quality by introducing brokers under proposed Rule 1101(d);
- Documentation of the annual review under proposed Rule 1102; and
- An annual report under proposed Rule 1102.⁶²

IX. Application to Crypto Asset Securities

Proposed Reg Best Ex would apply to all securities, including any digital asset that is a security under federal securities law (i.e., crypto asset securities).⁶³ While the Commission acknowledged that it “has limited information about the order handling and best execution practices of broker-dealers that engage in transactions for or with customers in crypto asset securities,”⁶⁴ it nonetheless proposes to subject transactions in these assets to the rules so that customers could receive certain protections to ensure that they receive the most favorable price.⁶⁵ Indeed, the Commission notes that the duty of best execution is “of fundamental importance to investors and the markets, including investors in, and the market for, crypto asset securities.”⁶⁶ Broker-dealers should thus take steps to ensure they are evaluating the range of markets that trade crypto asset securities and appropriately identify those markets that may likely provide customers with the most favorable prices.

Notably, Proposed Reg Best Ex does not provide guidance on how to determine whether a crypto asset meets the definition of security under the federal securities laws, despite continued industry requests for additional guidance and acknowledgment by a Commissioner that clarity is needed.⁶⁷

⁶² *Id.*

⁶³ Footnote 94 of the release provides, “To the extent digital assets rely on cryptographic protocols, these types of assets also are commonly referred to as ‘crypto assets’ and ‘digital asset securities’ [and] can be referred to as ‘crypto asset securities.’” The Commission further notes that for purposes of the release, the Commission does not distinguish between the terms “digital asset securities” and “crypto asset securities.” “Digital asset” refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology (“distributed ledger technology”), including, but not limited to, so-called “virtual currencies,” “coins” and “tokens.” *Id.* at 5448.

⁶⁴ The Commission noted that it had limited information about order handling and execution practices, in part “due to the fact that only a small portion of crypto asset security trading activity is occurring within entities that are registered with the Commission and any of the SROs.” *Id.*

⁶⁵ The Commission noted that a customer transacting in crypto asset securities should receive the protections afforded by the requirement that broker-dealers exercise reasonable diligence to ascertain the best market for the crypto asset securities and buy and sell in such market so that the price to the customer is as favorable as possible under prevailing market conditions. As a result, broker-dealers should take steps to ensure that they are evaluating the range of markets on which crypto asset securities trade and appropriately identifying those markets that may be likely to provide customers with the most favorable prices. *Id.* at 5448–49.

⁶⁶ *Id.* at 5449.

⁶⁷ In Commissioner Peirce’s statement regarding the Spring 2022 Regulatory Flexibility Agenda, she noted that although the agenda included rules that might regulate crypto protocols or platforms, it does not include rules primarily intended to grapple with the main questions that have arisen around these assets, such as when a crypto asset is a security. *See* Commissioner Hester M. Peirce, “Rip Current Rulemakings:

Because the Commission is admittedly proposing rules for a market where it “has limited information” about the relevant order handling practices, it is unclear how the rules—if adopted—would impact the crypto securities industry. The Commission does seek certain information about its characterization of the retail order handling and execution practices for crypto asset securities, but in light of the continued uncertainty about when a crypto asset is a security under the federal securities laws, it is unclear whether this information will be provided to the Commission and, if so, how reflective it will be of industry practices broadly.

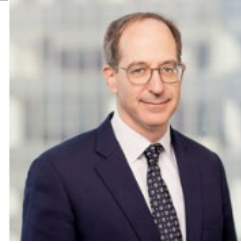
Statement on the Regulatory Flexibility Agenda” (Jun. 22, 2022),
<https://www.sec.gov/news/statement/peirce-statement-regulatory-flexibility-agenda-062222>.

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