

# SEC's Order Competition Rule Is Regulation by Speculation

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In December, the U.S. Securities and Exchange Commission issued four rule proposals that would fundamentally transform our nation's equity markets.

The comment period ends March 31, and while the final rules may take another year, followed by implementation periods, if you want to comment, now is the time.

The proposals, if they become final rules, would constitute a significant restructuring of our equity markets.

Three of the proposals fall under the Regulation National Market System rule set. The most significant of these would be a new rule – Rule 615 under the Securities Exchange Act of 1934, the proposed order competition rule – that would transform the way most retail orders are routed. It is generating the most criticism.

The two other NMS rule proposals involve amendments to Rule 605 under the Exchange Act, expanding disclosure obligations, and amendments to Rule 612 under the Exchange Act, amending tick size.

The fourth proposal is an entirely new regulation, "Regulation Best Execution," that basically takes the Financial Industry Regulatory Authority's best execution rule as the SEC's own, then expands upon it. These would become new Exchange Act Rules 1100, 1101, and 1102.

This article focuses on the SEC's most controversial proposal, the order competition rule.

## **Rule 615 – The Order Competition Rule**

The SEC has said it seeks to increase competition for the execution of marketable orders of individual investors.

It proposes to do this by requiring certain orders of individual investors to be exposed to competition in fair and open, qualified auctions at a specified limit price before they can be executed internally by any trading center that restricts order-by-order competition.

This means that wholesalers who receive retail orders from broker-dealers, before executing the orders internally, would first have to determine at what price they would be willing to execute the order, then route the order as a limit order at that specific price to an auction run by an exchange or by an alternative trading system to expose it to competition.

If the order is not executed fully in the auction within a very brief period of time, about 300 milliseconds, then, and only then, would the wholesaler be permitted to execute the order internally.

This requirement would apply to segmented orders, which are defined as orders for NMS stocks from individual investors who have traded less than 40 times a month in each of the preceding six months. There are exceptions for large orders, where the wholesaler executes the order at a better price than the national best bid and offer midpoint, or when the customer provides a limit price that is equal to or more favorable than the NBBO midpoint.

### **Where Does this Come From?**

SEC Chairman Gary Gensler has stated his concerns with equity market structure for years. His main target appears to be payment for order flow, where retail broker-dealers route order flow to wholesale market makers and, in return, receive some payment back from the wholesaler.

As compared to exchanges, wholesalers receive a great deal of retail order flow that is considered uninformed and therefore somewhat balanced in volume between buy and sell orders. This allows wholesalers to provide tighter spreads and better prices to retail investors because there is less risk of adverse selection.

Exchanges, on the other hand, typically receive order flow from institutional clients or high-frequency traders, which is often informed flow and unbalanced in volume, requiring greater spreads to cover the greater risk of adverse selection, ultimately resulting in less advantageous prices to the customer.

Wholesalers also benefit from knowing what the NBBO is on the exchanges, but they are not bound to it when executing internally.

According to the wholesalers, the price improvement they provide in the form of payment for order flow, as measured against orders executed at the NBBO on the exchanges, is significant and typically split around 80-20 between the customer and the broker-dealer.

In other words, most of the price improvement goes to the retail investors. This payment for order flow is largely responsible for zero-commission trading and, along with the advent of popular trading apps, has prompted an explosion in trading by the young and diverse.

But Gensler has stated he is concerned with segmentation in the equity market because there is no competition on an order-by-order basis between the wholesalers and the exchanges – there are two systems, really, plus the dark pools. And, he’s noted, there is little transparency into the wholesalers or the dark pools themselves.

Gensler has also stated his concern with concentration in the wholesale market maker segment because it is dominated by just a few players.

He has also previously pointed to the aggregation of data by market makers. The concentration of trading at certain market makers has allowed those market makers to aggregate data, which, according to Gensler, provides a further competitive advantage over other market makers with less order flow and over the exchanges, which see only their own data.

Finally, he has also warned that payment for order flow presents a potential conflict of interest to retail broker-dealers who may choose to maximize their payments rather than seek the best prices for their customers.

### **What Does the Proposed Rule Do?**

The proposed order competition rule would provide the exchanges, via the proposed auctions, the opportunity to compete for the retail order flow that is now going only to the wholesalers.

This would, in part, address Gensler’s concerns about market segmentation. It also would likely shift more order flow to the exchanges, which reduces his issues about the concentration of order flow presently going to a few wholesalers, and it also could result in the effective sharing of trading data, via the auctions, between the wholesalers and the exchanges, promoting transparency.

Additionally, it would lessen concerns about conflicts of interest because payment for order flow would likely be reduced as a result of more order flow being routed to the exchanges, with commensurately less incentive for retail broker-dealers to route order flow to wholesalers.

Sounds like a win-win, right?

## If It Ain't Broke, Don't Fix It

First, and foremost, as many critics have said, “if it ain't broke, don't fix it” because investors, with zero-commission trading and price improvement, have never had it better.

Second, the huge costs associated with creating the proposed new infrastructure – the auction markets and the technology to integrate them into existing order routing systems – and then sustain that infrastructure, must ultimately be borne by investors. That would reduce or potentially eliminate any cost-savings to the customers from the proposal.

Third, the present system keeps separate the balanced order flow of retail investors from the more toxic order flow going to the exchanges.

Segmentation means, in effect, that retail order flow to wholesalers, with tighter spreads and lower adverse selection costs, generally receives better prices than the more toxic flow to exchanges. Indeed, the SEC has recognized these benefits of segmentation in the proposed rule itself:

“Because liquidity providers can profitably offer better prices to segmented orders of individual investors with low adverse selection costs as compared to the prices they can offer other types of order flow, trading mechanisms that offer such segmentation, as would a qualified auction, *are quite likely to obtain better prices for segmented orders* than other trading mechanisms, such as the continuous order book of an open competition trading center or national securities exchange, that commingle all types of order flow.”

SEC Proposed “Order Competition Rule,” Exchange Act Release No. 96495, p. 76 (Dec. 14, 2022) (emphasis added).

The SEC is proposing the auctions as an intermediary of sorts between wholesalers and exchanges to level the playing field and provide competition between the two segments.

Retail order flow would be sent by wholesalers and others to the auctions, where the order flow would be exposed, to some extent, to more toxic order flow from institutional investors and high-frequency traders.

Under these circumstances, auctions might provide tighter spreads and improved prices compared to those available on the exchanges, but they also might provide wider spreads and worse prices compared to those presently available from wholesalers.

In other words, it is a zero-sum game: If the order flow to auctions effectively mixes the two order flows, then the spread and prices available at the auctions would fall somewhere between what was

available from the exchanges and what was available from wholesalers.

In the end, institutional investors and high-frequency traders would benefit from narrower spreads and better prices, but retail investors would have wider spreads *and* higher prices. And if the two order flows don't interact or mix at all because the prices are consistently better on the wholesaler side, then the extra expense – and the built-in delay for investors – is pointless.

Fourth, under the proposed rule, broker-dealers would not receive as much payment for order flow as they do now, or any at all.

This creates the real possibility that zero-commission trading would end and, along with it, the trading by the young and diverse. Again, retail investors would pay more to trade.

Finally, the SEC's lack of hard data, economic analysis, or a pilot program to support the proposal means the proposed rule should more properly be labeled "regulation by speculation," one that's more a creature of politics than economics.

Notably, no significant market participants or groups of market participants are complaining about the current system. And while it may satisfy Gensler's stated aim to level the playing field between wholesalers and the exchanges, it will be the retail investor who pays for it, through worse prices passed through from implementation costs and the loss of commission-free trading.

## **Conclusion**

Criticism is rightly focused on the order competition rule which, if adopted, could result in higher costs for retail investors and, perhaps, the loss of zero-commission trading.

Gensler may dream of a single, perfectly competitive and transparent equity market, but the current system has evolved organically and it works.

Retail investors have never had it better, no significant market participants are complaining about the current system and the SEC has not backed the new proposals with academic research, case studies, or pilot programs. It bears repeating: "if it ain't broke, don't fix it!"

Retail broker-dealers and wholesalers, and their retail customers, should consider submitting a comment – by March 31 – to let the SEC know how they feel about the proposed Order Competition Rule.

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# Authored By

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Justin L. Chretien

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