

***Panel Discussion Regarding Best Execution and its Role in post-NMS Market Structure***

**Prepared Remarks of Tyler Gellasch, Executive Director, Healthy Markets Association Before the Investor Advisory Committee of the Securities and Exchange Commission**

**June 10, 2021**

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Dear Chair Gensler, Commissioners, and Members of the Investor Advisory Committee, the Healthy Markets Association appreciates the opportunity to offer our views on the evolution of best execution in the modern capital markets.

HMA is a not-for-profit, member organization of public pension funds, investment advisers, broker-dealers, and market data firms focused on reducing conflicts of interest and improving the transparency, efficiency, and fairness of the capital markets.<sup>1</sup> In many ways, our overarching objectives are extremely similar to the Commission's mission to (1) protect investors, (2) promote fair, orderly and efficient markets, and (3) promote capital formation.

Importantly, HMA's primary area of focus is "market plumbing" -- how securities trade. While intermediaries and data providers are essential to making our markets work properly, there are also often significant risks that intermediaries may siphon off economic rents that can harm both investors and issuers. It is on these risks of waste created by intermediaries -- often borne of conflicts of interest -- that we predominantly focus.<sup>2</sup>

Perhaps the greatest opportunity for the SEC to improve the plumbing of the markets for investors lies in helping to answer one simple question:

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<sup>1</sup>To learn more about HMA or our members, please see our website at <http://healthymarkets.org/about>.

<sup>2</sup> In fact, HMA's very first public report called upon the SEC to propose and adopt significant reforms to Alternative Trading Systems (ATSs). When the SEC proposed reforms to just ATSs that trade NMS Stocks, HMA supported it, but we also recommended that the SEC go further, such as adopting enhanced ATS rules for those that trade government securities. Letter from, Healthy Markets Association, Brent J. Fields, Sec. and Exch. Comm'n, Feb. 26, 2016, available at <https://healthymarkets.wpengine.com/wp-content/uploads/2018/04/02-26-16-HM-letter-Regulation-of-NM-S-Stock-ATSs.pdf>. We were pleased the SEC has subsequently adopted reforms to NMS Stock ATSs, and look forward to the SEC potentially applying many of those reforms to venues trading other securities.



## ***Are my service providers getting me the best prices?***

In the pages that follow, we:

- 1) Offer a quick overview of Regulation NMS;
- 2) Examine what best execution means (and doesn't) for brokers;
- 3) Explore the clear conflicts of interest and costs to investors that arise from conflicted order routing incentives;
- 4) Examine the SEC's best execution obligations for investment advisers; and
- 5) Offer several recommendations for the Committee and Commission to materially reduce conflicts of interest and costs for investors.

## **Overview of Regulation NMS**

Regulation NMS was designed to provide both (1) disclosures of how covered securities trade, and (2) concrete backstops against particular customer abuses.

Although the SEC adopted Regulation NMS in 2005, it essentially updated and codified a number of pre-existing market structure rules such as the pre-existing rules 11Ac 1-5 and 11Ac 1-6 requiring the disclosure of order routing<sup>3</sup> and best execution information.<sup>4</sup> These rules were designed decades ago, as the world then-existed, and have not been materially improved since. Rules 605 and 606 are still woefully out of date, and inadequate for most market participants even with modest so called improvements to Rule 606. Worse, by failing to accurately incorporate essential information and relevant time horizons, these disclosures affirmatively provide inaccurate and misleading information to market participants and regulators. For example, the benchmark for "price improvement" is the national best bid and offer (NBBO) as that is determined from the best "protected quotations," which are generally only increments at or over 100 shares.<sup>5</sup> Internalizers subsequently use these unrealistic statistics to tout inflated price improvement statistics and brokers post these unrealistic statistics on their websites to their customers and potential customers. This creates a material misrepresentation of fact.

One of the cornerstones of Regulation NMS sought to provide additional protections to investors, including a cap on transaction fees for accessing liquidity on an exchange (at

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<sup>3</sup> 17 CFR § 242.606.

<sup>4</sup> 17 CFR § 242.605.

<sup>5</sup> We appreciate the Commission's modest revisions to the "round-lot" distinctions included in its December 2020 rules, but these revisions are woefully inadequate. See *Market Data Infrastructure*, Sec. and Exch. Comm'n, 86 Fed. Reg. 18596, Apr. 9, 2021, available at <https://www.govinfo.gov/content/pkg/FR-2021-04-09/pdf/2020-28370.pdf>.



30 cents per 100 shares for stocks over \$1 per share),<sup>6</sup> and the Order Protection Rule.<sup>7</sup> Notably, to this day, many exchanges charge the maximum allotted by rule, while non-exchange venues often charge significantly less. These relatively high fees create what is often a powerful incentive for brokers and other market participants to avoid routing to exchanges -- particularly if they are taking liquidity (and thus likely to incur the fee). Exchanges are also the only venues with protected quotations, which are used as benchmarks for the markets.

The Order Protection Rule is essentially a backstop to best execution. Generally speaking, the Order Protection Rule prohibits an exchange from executing an order at an inferior price to a “protected quotation” available on another exchange, and thus requires the exchange to route the order to its competitor.<sup>8</sup> As we explained to the Equity Market Structure Advisory Committee several years ago, the concept of preventing trade-throughs is valuable -- particularly to market participants without the resources or expertise to identify and prevent them -- but the mechanism adopted by Rule 611 makes little practical sense. Rather, best execution obligations should rest with the broker.

In recent years, the Commission and its Equity Market Structure Advisory Committee have considered, proposed, and even adopted some reforms to Regulation NMS. For example, the EMSAC considered potential changes to Rule 611 and the Commission itself adopted reforms to Rule 606 in 2018. Unfortunately, the Court of Appeals for the DC Circuit threw out the SEC’s potentially most impactful recent reform -- the ill-fated Transaction Fee Pilot.<sup>9</sup>

## Best Execution For Brokers

A broker’s best execution obligation “is based, in part, on the common law agency duty of loyalty, which obligates an agent to act exclusively in the principal’s best interest, and also has been incorporated explicitly in FINRA rules.”<sup>10</sup>

Specifically, FINRA Rule 5310 requires a broker to use reasonable diligence to ascertain the best market for the subject security.<sup>11</sup> This includes that the broker should consider the:

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<sup>6</sup> 17 CFR § 242.610.

<sup>7</sup> 17 CFR § 242.611.

<sup>8</sup> Memorandum from the Staff of the Division of Trading and Markets, Sec. and Exch. Comm’n, to the Equity Market Structure Advisory Cmte, Sec. and Exch. Comm’n, Rule 611 of Regulation NMS, Apr. 30, 2015, *available at* <https://www.sec.gov/spotlight/emsac/memo-rule-611-regulation-nms.pdf>.

<sup>9</sup> The Transaction Fee Pilot, which HMA supported strongly, was to be conducted pursuant to an Rule 610T.

<sup>10</sup> FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, Reg. Notice 15-46 (Nov. 2015), *available at* [https://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Notice\\_Regulatory\\_15-46.pdf](https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf).

<sup>11</sup> See FINRA, *Rule 5310: Best Execution and Interpositioning*. However, several other FINRA rules supplement this “Best Execution” rule, most notably Rule 2121, which governs commission rates and fees, including markups and markdowns. FINRA Rule 2121, *Fair Prices and Commissions*.



- character of the market for the security (e.g., price, liquidity, and volatility);
- size and type of transaction;
- number of markets checked;
- accessibility of the quotation; and
- terms and conditions of the order.<sup>12</sup>

In addition, regulators require brokers to review their execution quality and revise their practices accordingly. While order-by-order reviews are often the best for investors and was emphatically suggested in FINRA’s Notice to Members 15-46. To the contrary however, FINRA and regulators have historically allowed and seemingly continue to allow broker-dealers to evaluate execution quality on an aggregated basis pursuant to “regular and rigorous review” of its routing and execution arrangements, including what it could have received at other markets.<sup>13</sup> In laying out the standards for this “regular and rigorous review,” FINRA has stated that brokers should consider:

- price improvement opportunities (i.e., the difference between the execution price and the best quotes prevailing at the time the order is received by the market);
- differences in price disimprovement (i.e., situations in which a customer receives a worse price at execution than the best quotes prevailing at the time the order is received by the market);
- the likelihood of execution of limit orders;
- the speed of execution;
- the size of execution;
- transaction costs;
- customer needs and expectations; and
- the existence of internalization or payment for order flow arrangements.<sup>14</sup>

In recent years, FINRA and the SEC have brought a handful of enforcement cases against brokers and other third parties regarding best execution failures. For example, the SEC and FINRA have each recently brought cases against retail broker Robinhood. The SEC’s action stemmed from the brokers’ inaccurate marketing materials and website disclosures regarding its receipt of payment for order flow and claims that it was

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<sup>12</sup> See FINRA, *Rule 5310: Best Execution and Interpositioning*.

<sup>13</sup> FINRA, Supplemental Material 0.09 to Rule 5310, *Rule 5310: Best Execution and Interpositioning*.

<sup>14</sup> *Id.*



providing better executions than its competitors.<sup>15</sup> In particular, the SEC found that “Robinhood’s customers received inferior execution prices compared to what they would have received from Robinhood’s competitors.”<sup>16</sup> As discussed later, unfortunately, there is strong evidence to suggest that Robinhood’s customers -- and other retail investors -- are still getting inferior prices.

The SEC has also brought an action against a market maker who was paying for order flow. In January 2017, Citadel Securities settled with the SEC for inadequate disclosures around its execution practices.<sup>17</sup> Citadel paid its broker-dealer clients for access to “retail” orders. While claiming that it was executing these orders at (or within) the best displayed prices, in reality, Citadel was providing executions at the “best” prices, as measured by the Securities Information Processor (SIP). Citadel knew (because of its access to faster direct feeds from execution venues) that better prices were often available. When Citadel’s algorithms saw a better price for the customer was available outside of the SIP, the firm just locked in both sides for an instant profit. Interestingly, this was brought not as a failure to achieve “best execution,” but as a case for inadequate and misleading disclosures.

Going back still further, the SEC brought actions against several large banks and broker dealers regarding their order routing practices and ATS operations.<sup>18</sup> These cases were again largely framed as providing misleading disclosures and not as violations of the brokers’ best execution obligations -- even though the plain results of many of these cases was inferior executions (particularly prices) for their customers.

For example, in December 2016, Deutsche Bank settled a coordinated set of enforcement actions brought by the New York Attorney General,<sup>19</sup> SEC,<sup>20</sup> and FINRA. From 2012 to mid 2014, the bank was claiming to route orders one way, while really routing them another way. Because the order routing process of the bank’s “black box” was secret, customers weren’t able to readily evaluate the bank’s order routing processes. However, this was not a one-off problem. Deutsche Bank was far from the only major broker that ultimately settled actions with regulators over misleading claims about how it routed its customers’ orders.

More than two decades ago, the SEC expressly declared that “a broker-dealer must not allow a payment or an inducement for order flow to interfere with its efforts to obtain best

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<sup>15</sup> *In the Matter of Robinhood Financial, LLC*, Sec. Act Rel. No. 10906, Dec. 17, 2020, available at <https://www.sec.gov/litigation/admin/2020/33-10906.pdf>.

<sup>16</sup> *In the Matter of Robinhood Financial, LLC*, Sec. Act Rel. No. 92115, June 4, 2021, available at <https://www.sec.gov/litigation/admin/2021/34-92115.pdf>.

<sup>17</sup> *In the Matter of Citadel Securities*, Sec. Act Rel. No. 10280, Jan. 13, 2017, available at <https://www.sec.gov/litigation/admin/2017/33-10280.pdf>.

<sup>18</sup> See, e.g., Press Release, Barclays, Credit Suisse Charged With Dark Pool Violations, Sec. and Exch. Comm’n, Jan. 31, 2016, available at <https://www.sec.gov/news/pressrelease/2016-16.html>.

<sup>19</sup> *In the Matter of Deutsche Bank Securities, LLC*, (Dec. 16, 2016), available at [https://ag.ny.gov/sites/default/files/2016.12.15\\_db\\_settlement\\_agreement.pdf](https://ag.ny.gov/sites/default/files/2016.12.15_db_settlement_agreement.pdf).

<sup>20</sup> *In the Matter of Deutsche Bank Securities, LLC*, Sec. Act Rel. 10272 (Dec. 16, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10272.pdf>.



execution.”<sup>21</sup> Yet, the SEC has never undertaken to comprehensively examine or test to see if and how that might be occurring across brokers, or accurately quantify the harm to investors even in the rare instances when it becomes aware of that occurring.

Similarly, while FINRA has, over the past few years, highlighted conflicts of interest regarding order routing incentives, and even conducted targeted examinations,<sup>22</sup> FINRA has nevertheless continued to permit brokers to accept payments by market makers, exchanges, and other trading venues; has not required order-by-order reviews of execution quality for order (despite the reality that institutional brokers routinely provide that level of detail to their customers for similarly sized child orders);<sup>23</sup> and has permitted brokers to continue to avoid and inadequately consider the full range of alternative venues (e.g., exchanges, ATSS, and internalizers).<sup>24</sup>

## Conflicts Arising From Variable Order Routing Incentives

In the US, market venues -- including exchanges and market makers -- are permitted to provide brokers with order routing incentives. While both the SEC and FINRA have expressly declared that these incentives cannot unduly influence a routing decision, it is unclear to what extent these incentives may be driving up trading costs for both retail and institutional investors.

In the US, brokers and principal trades may face literally thousands of pricing tiers, depending upon who they are, their order types, their volumes, the securities they trade, and other factors. These tiers change frequently, and brokers and other market participants routing orders to these venues may not even know the rebate or fees that will apply to their orders, because the rates are typically not determined until the end of the month, when all of a month's volumes are known. This lack of clarity about trading costs also means that investors cannot know their brokers' incentives until well after a trade is completed. This may preclude even sophisticated investors from taking actions to protect themselves, such as by engaging their brokers on a “cost-plus” basis.

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<sup>21</sup> *Payment for Order Flow*, Sec. and Exch. Act, 59 Fed. Reg. 55006, 55009 n.28 (Nov. 2, 1994).

<sup>22</sup> *Targeted Examination Letter on Order Routing Conflicts*, FINRA, Nov. 2017, available at <https://www.finra.org/rules-guidance/guidance/targeted-exam-letters/order-routing-conflicts>; see also *Targeted Examination Letter on Zero Commissions*, FINRA, Feb. 2020, available at <https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/zero-commissions>.

<sup>23</sup> But see, *Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, FINRA, Notice to Members 15-46, Nov. 2015, available at [https://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Notice\\_Regulatory\\_15-46.pdf](https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf) (“FINRA believes that, given developments in order routing technology, order-by-order review of execution quality is increasingly possible for a range of orders in all equity securities and standardized options”).

<sup>24</sup> However, we note that FINRA has relatively recently taken enforcement action for failing to evaluate alternative execution venues. See, e.g., *Robinhood Financial, LLC, Letter of Acceptance, Waiver and Consent (AWC)*, FINRA, Case No. 2017056224001, Dec. 2019, available at <https://www.finra.org/sites/default/files/2019-12/robinhood-awc-121919.pdf>.



Put simply, the pricing tier system is too complex, a reality that is underscored by the recent revelation that Cboe was overcharging and undercharging some of its customers for years -- and nobody noticed.<sup>25</sup>

But that's not the only problem for brokers. Pricing tiers are also facially discriminatory, favoring larger volume traders over smaller volume traders. These tiers significantly impact the competition between brokers, again favoring the largest volume traders. And they are often customized to meet the trading practices of a single customer -- the opposite of "equitable." As a result, these pricing tiers are often inconsistent with the plain language of the Securities and Exchange Act.<sup>26</sup> We are not surprised by recent research demonstrating a material decrease in the number of exchange members at the leading US stock exchanges over just the past few years.<sup>27</sup>

Different pricing tiers may have profound impacts on investors' ultimate trading costs. These issues first hit "mainstream" discussions outside of very technical trading circles in 2014, with the publication of a best-selling book<sup>28</sup> and a high-profile hearing of the United States Senate Permanent Subcommittee on Investigations.<sup>29</sup>

Many institutional investors -- including the buy-side members of HMA -- are acutely aware of the risks created by conflicted order routing by their brokers, and many have turned to using complex due diligence questionnaires<sup>30</sup> and sought to engage in complex transaction cost analysis through third party providers. Some institutional investors have developed in-house technical expertise, while others have engaged third-party analysts, such as Babelfish Analytics or IHS Markit. Yet, to engage in these "self-help" strategies, investors needed the cooperation of their brokers. We are acutely aware that some brokers provided the data, while others have elected not to. Ultimately, what information investors receive -- and their ability to analyze it -- is often based on their level of interest, market power, and resources. In the end, even if an institutional investor engages a 3rd party, successful execution analysis is not guaranteed.

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<sup>25</sup> See *Notice of Filing and Immediate Effectiveness of a Proposal to Permit the Exchange to Look Back Only to July 2020 to Correct Certain Billing Errors which were Discovered in October 2020*, Sec. and Exch. Comm'n, Exch. Act Rel. No. 34-91239, (Mar. 2, 2021), available at <https://www.sec.gov/rules/sro/cboebzx/2021/34-91239.pdf>.

<sup>26</sup> 15 U.S. Code § 78f(b)(4), (b)(5), and (b)(8).

<sup>27</sup> John Ramsay, *The Rising Tide of Broker Costs, and the Shrinking Pool of Competitors*, June 8, 2021, available at <https://medium.com/boxes-and-lines/the-rising-tide-of-broker-costs-and-the-shrinking-pool-of-competitors-40d4d389e59a> (demonstrating that between 2012 and 2021, then number of exchange members decreased at NYSE by 26%, Arca by 69%, and Nasdaq by 44%).

<sup>28</sup> *Michael Lewis, Flash Boys*, (W.W. Norton & Company 2014).

<sup>29</sup> *Hearing on Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets before the Committee on Homeland Security and Government Affairs, Permanent Subcommittee on Investigations*, 113th Cong. (2014), available at <https://www.hsgac.senate.gov/subcommittees/investigations/hearings/conflicts-of-interest-investor-loss-of-confidence-and-high-speed-trading-in-us-stock-markets>.

<sup>30</sup> See, e.g., *Order Routing Questionnaire*, Healthy Markets Association, Nov. 14, 2016, available at <https://healthymarkets.wpengine.com/product/order-routing-questionnaire>.



For some institutional investors, the findings have proven to be disappointing. One large asset manager found that a very large percentage of its orders with one broker looked fine when measured against the prices on the SIPs, but were in reality trade-throughs, when compared to the exchanges' proprietary data feeds. Other times, investors found that some brokers' order routing behaviors seemed to change significantly at the end of month (ostensibly so that the broker could reach certain pricing tiers).

These anecdotal findings by institutional investors with the expertise, resources, and commitment to perform the analyses have also been supported by independent research by outside academics. For example, in early 2019, FINRA's Office of the Chief Economist released a paper finding that orders handled by brokers with high rates of routing to their affiliated ATSS generally had lower fill rates and lower execution quality.<sup>31</sup>

Order routing incentives seem to impact not just institutional investors, but retail investors' execution costs as well. While retail brokers and market makers often claim that they are providing customers with better prices than are available on the exchanges, this does not appear to be always true.

In fact, just this week, Professor Robert Bartlett, III at the University of California Berkeley School of Law published a paper that found "a sample of retail, non-exchange trades in two popular retail stocks—Amazon and GameStop—on January 27, 2021 reveals that 31-46% of odd lot trades would have received better pricing had the venue filled the order at the Nasdaq odd lot quote."<sup>32</sup> Put another way, brokers who were routing to market making internalizers could have often accessed better prices if their customers' orders had been sent to Nasdaq.

There are also other concerns. For example, are some brokers intentionally giving customers worse prices (e.g., lesser "price improvement") so as to maximize their own payments for order flow?

On March 11, 2021, the CEO of Virtu Financial gave an interview on CNBC in which he explained that his firm was trying to capture as much of the bid-ask spread as possible, and was willing to share some of that back to the brokers who provide it with orders in the form of a "profit share."<sup>33</sup> He then acknowledged that brokers decide how much of that "profit share" was kept by the brokers, versus how much would be shared with the brokers' customers in the form of price improvement. He claimed that his firm was "Switzerland" and had no role in determining how much a broker would keep for itself versus how much it would give back to its customers. In fact, he explicitly confirmed that because Fidelity doesn't accept payment for order flow for its retail customers' orders

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<sup>31</sup> Amber Anand, Mehrdad Samadi, Jonathan Sokobin, and Kumar Venkataraman, *Institutional Order Handling and Broker-Affiliated Trading Venues*, FINRA, Feb. 22, 2019, available at [https://www.finra.org/sites/default/files/OCE\\_WP\\_jan2019.pdf](https://www.finra.org/sites/default/files/OCE_WP_jan2019.pdf).

<sup>32</sup> Robert P. Bartlett, III, *Modernizing Odd Lot Trading*, June 8, 2021, available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3849763](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3849763).

<sup>33</sup> Remarks by Doug Cifu, CNBC, Mar. 11, 2021, video excerpts available at <https://twitter.com/SquawkCNBC/status/1369995291148050432>.





and Robinhood does, Fidelity's customers would "through the course of a month" receive better prices than Robinhood's customers. This admission suggests that Robinhood Financial, LLC -- and perhaps other brokers -- are electing to give their customers inferior prices or lower price improvements to their direct benefit. This behavior is in direct conflict with the adopted rules of Regulation NMS which states that [Broker-dealers] must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities<sup>34</sup>.

It seems like some brokers' claims that they are nevertheless providing best execution are based in part on their interpretation of Rule 605. Some order types and mid-point pricing schemes offered by the exchanges are excluded from the definition of "price improvement" for purposes of SEC Rule 605. In fact, "price improvement" -- as a statistic -- may have little relation to whether or not a customer actually received the best available price. Rule 605, which requires disclosure of statistics related to best execution, has not kept pace with the modern trading environment. Unfortunately, this allows firms to misleadingly claim "price improvement" (as defined in Rule 605) when they are, in fact, providing prices that are significantly inferior to those that may be available in the marketplace.<sup>35</sup>

For example, one significant way in which these statistics are misleading is due to the unique treatment of so-called "odd-lot" orders, which are generally orders for less than 100 shares. Historically, "odd-lot" orders and trades comprised a relatively small percentage of trades, and given their total share volumes, they were generally viewed as not material sources of liquidity nor necessarily essential for measuring market quality. As a result, "odd-lot" quotations have traditionally not been included on the SEC-mandated industry "tapes," also known as the Securities Information Processors ("SIPs"), nor are they considered "protected quotations" under Regulation NMS.<sup>36</sup>

Suppose a retail customer seeks to buy 25 shares of a stock through his online, retail brokerage account. Suppose further that 25 shares of that stock are available for sale on the New York Stock Exchange for \$10 and 100 shares are available on several exchanges at a price of \$10.01. The retail broker may sell the order to a market maker, who then may execute and give it to the customer at a price of \$10.0098, claiming that the order received "price improvement" at a rate of 2 cents per 100 shares. However, the customer actually received price dis-improvement. The best available price would have been on the New York Stock Exchange for a whopping 98 cents per 100 shares

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<sup>34</sup> Order Handling Rules, 61 FR at 48323.

<sup>35</sup> See, Letter from Tyler Gellasch, Healthy Markets Association, to Brent J. Fields, Sec. and Exch. Comm'n, Mar. 5, 2019, available at <https://www.sec.gov/comments/4-729/4729-5020185-182987.pdf>.

<sup>36</sup> Interestingly, while odd-lot trades have been reported in the SIPs for several years, odd-lot quotations have not. See *Order Approving the Eighteenth Substantive Amendment to the Second Restatement of the CTA Plan*, SEC, Exch. Act Rel. No. 34-70794, Oct. 31, 2013, available at <https://www.sec.gov/rules/sro/nms/2013/34-70794.pdf>. Odd-lot quotations are, however, included in the proprietary data feeds sold by exchanges because, not surprisingly, they are important sources of liquidity for investors of all sizes.



cheaper. Clearly, the customer didn't get the best available price. The customer did not get best execution. This should give rise to regulatory scrutiny and action.

Alternatively, suppose the market maker did execute the order at the best available price of \$10 (which is what we believe should be required by best execution). The broker could potentially claim (based on the current Rule 605 methodology) "price improvement" of a whopping \$1.00 per 100 shares, even though the retail customer's execution was not "improved" at all. Further, neither of these scenarios reflects what could well have been potential executions at the midpoint, or the reality that the spread themselves may be materially wider because of the diversion of orders away from the lit markets.

Lastly, we think it's worth noting that order routing incentives have played a significant part in segmenting order flow off exchanges, and have helped fuel the massive rise in off-exchange trading. So in addition to directly leading to higher costs for investors, the segmentation itself may be leading to wider spreads, more fragile prices, and greater institutional trading costs. For example, there is evidence to suggest that names that are more actively traded by retail investors tend to have higher transaction costs for institutional investors.<sup>37</sup>

## Best Execution For Investment Advisers

Investment advisers have a duty of best execution for when they are executing their clients' securities transactions.<sup>38</sup> Unlike broker-dealers, who are subject to FINRA's best execution rule<sup>39</sup> and guidance,<sup>40</sup> it is unclear how investment advisers should fulfill their best execution obligations.

Despite the urging of HMA,<sup>41</sup> the SEC has declined to adopt any "best execution" rule for investment advisers. That said, over the years, the SEC has relied upon its authority under the Advisers Act to adopt a number of substantive disclosure obligations that directly and indirectly impact advisers' best execution obligations.

For example, Item 12 of Form ADV Part 2A requires investment advisers to "[d]escribe the factors that you consider in selecting or recommending broker-dealers for client transactions and determining the reasonableness of their compensation (e.g.,

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<sup>37</sup> [Babelfish study]

<sup>38</sup> See 1986 Release ("an adviser, as a fiduciary, owes its clients a duty of obtaining the best execution on securities transactions.").

<sup>39</sup> *Rule 5310: Best Execution and Interpositioning*, FINRA, available at <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310>.

<sup>40</sup> *Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, FINRA, Notice to Members 15-46, (Nov. 2015), available at <https://www.finra.org/rules-guidance/notices/15-46>.

<sup>41</sup> Letter from Tyler Gellasch, Healthy Markets Association, to Brent J. Fields, Sec. and Exch. Comm'n, Aug. 7, 2018, available at <https://www.sec.gov/comments/s7-09-18/s70918-4182239-172535.pdf>.



commissions).<sup>42</sup> Many advisers also disclose their commitment to achieve best execution and the factors used by their advisers to select brokers to effectuate the funds' transactions. Further, registered investment companies include in their statements of additional information ("SAI") a description of the fund's brokerage allocation and other practices that may impact best execution.<sup>43</sup>

Advisers must also disclose and explain their actual and potential conflicts of interest with respect to their trading practices.<sup>44</sup> Trading conflicts that may impact best execution include the use of an affiliated broker on an agency or principal basis; research and/or brokerage obtained through soft-dollar arrangements; and interest in, or material business relationships with, broker dealers, including use of brokerage to recognize sales and distribution activities of broker-dealers and their affiliates for products offered advised by the adviser or its affiliates.

Investment advisers also typically disclose information about their broker selection and best execution practices in their investment advisory agreements, firm brochures, in response to due diligence requests, other regulatory filings, firm websites and marketing materials.<sup>45</sup>

For decades, the only clarity provided by the SEC regarding best execution is not about what best execution requires, but rather what is an exemption from it -- namely, reasonable payments for investment research.<sup>46</sup>

We have repeatedly asked the SEC to complement improvements to best execution for brokers by adopting clear expectations for what process investment advisers should be expected to undertake to fulfill their best execution obligations.<sup>47</sup>

Unfortunately, the SEC has instead opted to regulate investment advisers' best execution performance through its Divisions of Enforcement and Examinations. In April 2018, the SEC announced three cases against investment advisers related to their sales of higher-fee mutual fund share classes, which it has framed as, amongst other things, best execution failures.<sup>48</sup> Similarly, in July 2018 the then-Office of Compliance,

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<sup>42</sup> Item 12 of Form ADV Part 2A.

<sup>43</sup> See Form N-1A, Item 21.

<sup>44</sup> See Lori Richards, Director, Office of Compliance Inspections and Examinations, Sec. and Exch. Comm'n, Before the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), *available at* <https://www.sec.gov/news/speech/spch022706lar.htm>; See also: CFA Institute, Trade Management Guidelines (Nov. 2002), *available at* <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n3.4007>.

<sup>45</sup> 40 Act Lawyer, Best Execution; Legal and Practical Considerations for Investment Advisers and Funds, at 15, *available at* [https://www.40actlawyer.com/Articles/Best%20Execution%20\(Schnase%207-15-13\).pdf](https://www.40actlawyer.com/Articles/Best%20Execution%20(Schnase%207-15-13).pdf).

<sup>46</sup> See *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Sec. and Exch. Comm'n, Rel. No. 34- 23170, Apr. 28, 1986, *available at* <https://www.sec.gov/rules/interp/34-23170.pdf>.

<sup>47</sup> Letter from Tyler Gellasch, Healthy Markets Association, to Brent J. Fields, Sec. and Exch. Comm'n, Aug. 7, 2018, *available at* <https://www.sec.gov/comments/s7-09-18/s70918-4182239-172535.pdf>.

<sup>48</sup> Press Release, *SEC Orders Three Investment Advisers to Pay \$12 Million to Harmed Clients*, Sec. and Exch. Comm'n, Apr. 6, 2018, *available at* <https://www.sec.gov/news/press-release/2018-62> (referring to



Inspections, and Examinations released a Risk Alert finding that many investment advisers were not fulfilling their best execution obligations.<sup>49</sup> In particular, the Commission staff found that many investment advisers were:

- not performing best execution reviews;
- not considering materially relevant factors during best execution reviews;
- not seeking comparisons from other broker-dealers;
- not fully disclosing best execution practices;
- not disclosing soft-dollar arrangements;
- not properly administering mixed use allocations; and
- not following best execution policies and procedures, or simply didn't have adequate ones.<sup>50</sup>

Interestingly, while the Risk Alert notes that these are perceived “failures” by investment advisers, it is unclear what rule or guidance has clearly imposed an obligation on investment advisers to, for example, perform best execution reviews or consider relevant factors. To be clear, we believe that investment advisers should be required to engage in these activities to meet their best execution obligation -- and note that many, many investment advisers do so. But the SEC has never generally, unambiguously, and clearly obligated these firms to do so -- unlike FINRA's extensive rules and guidance for brokers.

Additionally, as markets have evolved over the past several years, and with the advent of MiFID II in Europe, investors have become increasingly focused on their trading costs, which may include both execution costs and payments for research. Again, in the US, it is unclear what the SEC expects from investment advisers regarding their identification, quantification, allocation, and disclosures of these costs.

Retail and institutional investors alike suffer because the SEC has not clearly established what processes investment advisers are expected to have, what substantive factors they are expected to consider, and what they are expected to disclose in order to fulfill their best execution obligations.

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settlements against PNC Investments LLC, Securities America Advisors Inc., and Geneos Wealth Management Inc.).

<sup>49</sup> As discussed below, we note here that the proposed Commission interpretation and the Commission staff's recent “Risk Alert” could collectively offer significant new contours for those expectations. *Compliance Issues Related to Best Execution by Investment Advisers*, Sec. and Exch. Comm'n, July 11, 2018, *available at* <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf> (2018 IA Best Ex Risk Alert).

<sup>50</sup> 2018 IA Best Ex Risk Alert.



## Recommended Improvements

HMA recommends that the SEC and FINRA take the following steps to better protect investors and ensure that brokers and investment advisers are fulfilling their fiduciary obligations of best execution:<sup>51</sup>

- 1) Enforce existing regulatory expectations for best execution for brokers, including that brokers (1) must review alternative trading venues and revise their routing accordingly, (2) should review orders on an order-by-order basis, and (3) cannot exercise their own discretion to provide investors with inferior prices (e.g., accept higher payments for order flow for themselves in return for reducing “price improvement” for their customers);
- 2) Eliminate conflict-creating order routing incentives that pit investors’ interests against their brokers’ profits;
- 3) With all due speed, add odd-lot quotations to the CTA/CQ and UTP Plans;
- 4) With all due speed, update Rule 605 to reflect modern trading time increments and trade sizes (e.g., the rise of odd-lots);
- 5) With all due speed, expand upon the 2018 revisions to Rule 606 so as to ensure that investors can receive order and trade information that can be used for transaction cost analysis, as well as provide a better understanding of their brokers’ incentives (e.g., rebates and fees);
- 6) Eliminate immediate effectiveness for implementing fee changes at exchanges so that market participants have enough time to review, comment and implement changes and so that market participants would know what a fee or rebate would be for a particular order at the time the order routing decision is being made;
- 7) Establish rules and guidance for best execution for investment advisers that would detail appropriate policies, procedures, practices, and disclosures, including the evaluation of both trading and research costs; and
- 8) Require disclosure of funds’ trading and research costs.

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<sup>51</sup> In May, HMA offered extensive recommendations to the SEC regarding a wide range of topics, many of which are repeated in summary fashion below. Letter from Tyler Gellasch, Healthy Markets Association, to Hon. Gary Gensler, Sec. and Exch. Comm’n, May 4, 2021, *available at* <https://healthymarkets.org/wp-content/uploads/2021/05/Gary-Gensler-Welcome-5-4-21-1.pdf>.



## Conclusion

Thank you for examining these important issues for investors, and we look forward to working with you to better protect investors and make the markets more fair, orderly, and efficient by modernizing and enforcing best execution.