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FINRA
1700 K Street, NW
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Re: Modernizing FINRA's Best Execution Guidance
Reg Notice 26-15

Dear FINRA:

Non-AI Summary

- The best execution rule should cover all orders handled by FINRA members, not just orders in "securities."
- The proper benchmark for best execution in cash equities should be the Effective Best Bid or Offer based on displayed liquidity in the lit markets, including odd lots, for the particular size of the order.
- Brokers that pass through access fees should include them in determining where to route orders.

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else. I am very grateful to Georgetown University for financial support. Over the years I have served as a Visiting Academic Fellow at the NASD (predecessor to FINRA), served on the boards of the EDGX and EDGA stock exchanges, served as Chair of the Nasdaq Economic Advisory Board, and performed consulting work for brokerage firms, stock exchanges, other self-regulatory organizations, government agencies, market makers, industry associations, and law firms. I am the academic director for the FINRA Certified Regulatory and Compliance Professional (CRCP®) program at Georgetown University. I've also visited over 100 licensed stock and derivative exchanges around the world. As a finance professor, I practice what I preach in terms of diversification and own modest and well-diversified holdings in most public companies, including brokers, asset managers, market makers, and exchanges.

Background

FINRA is asking for comment on modernizing its principles-based Rule 5310 on best execution. This is very timely given the changes going on in the markets. The pending demise of SEC Rule 611, the "trade-through rule," makes Rule 5310 even more important.[2] The concept of "best execution" is complicated by the competitive and sometimes opaque nature of our markets, as well as the advent of tokenized trading of securities and other bright shiny objects. In addition, many broker-dealers now handle customer orders not only in "securities" but also in futures, crypto assets, meme coins, prediction markets, and other bright shiny objects.

Unlike many US rules, this principles-based approach to best execution is one that has been copied by many other jurisdictions.[3] This implies that the basic principles-based approach is a sound one that has withstood the test of time. The basic principle – that brokers have a job to get the best results for their customers – is one that is invariant across asset classes and products. However, changes in market structure and technology do call for modernization of the interpretations for particular asset classes.

The best execution rule should apply to all orders, not just "securities."

The U.S. is unique in establishing an extremely fragmented financial regulatory structure for "commodities" versus "securities." This is an absurd structure that no other country has been dumb enough to copy.[4] While other countries have copied our principles-based best execution rules, they apply them to "orders," not just orders in "securities." FINRA should do the same and apply the best execution rule to all customer orders, not just orders in "securities." High standards of

[2] The comment letter can be read at https://www.sec.gov/comments/4-862/4862-646547-1937314.pdf.
[3] For example, see the UK FCA version at https://handbook.fca.org.uk/handbook/cobs11/cobs11s9, the EU MiFID Article 27(1) version at https://www.esma.europa.eu/publications-and-data/interactive-single-rulebook/mifid-ii/article-27-obligation-execute-orders, and the Canadian version at https://www.asc.ca/-/media/ASC-Documents-part-1/Rule-Review/2024/01/Rule-Consolidation-Project-Phase-2-01-11-2024.pdf.
[4] The separation between securities and commodities regulation came about because, at the time in the early 1970s when Congress was deciding what to do about financial futures, then SEC Chairman Ray Garrett did not want the job of policing futures exchanges and he actively lobbied Congress not to give the job to the SEC.

commercial honor dictate that brokers apply the same standards to orders in non-security instruments as they do for "securities."

Traditionally, FINRA-registered brokers only dealt with "securities," so a securities-only rule was fine back in the day. If a broker wanted to offer futures trading to customers, it would then register with the CFTC as a futures commission merchant (FCM) and maintain separate accounts for the futures distinct from securities. Given the centralized nature of futures exchanges, there was little need for the CFTC or the NFA to have a best execution rule for futures orders: There was only one way to execute a futures order in soybeans, and that was to send it to the CBOT.[5]

With the evolution of our financial markets, broker-dealers are now or will be offering not just trades in "securities" but also trades in crypto markets, meme coins, futures, and prediction markets. This creates regulatory gaps that are exacerbated by our fragmented regulatory system.

Recent years have seen significant activity in the never-ending turf battles between the SEC and CFTC. Under previous regimes, SEC officials opined that (almost) every crypto asset was a "security" under SEC jurisdiction. CFTC officials, relying upon the Commodity Exchange Act's broad definition of "commodity" as including anything "in which contracts for future delivery are presently or in the future dealt in," opined that everything that was not clearly delineated as a security was a commodity within CFTC jurisdiction.[6]

There is currently a spirit of détente between the SEC and the lone CFTC commissioner, and they seem to be working on a truce that demarcates the boundaries over who regulates what. For now. A different regime at either the SEC or CFTC may well move in different directions. History shows that is likely to be the case in the future. Just ask the survivors of any statutorily-required joint rulemakings how easy it is for different agencies to cooperate on rulemakings.

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[5] The NFA does have a best execution interpretation of its rules for security futures, but most of the reliance is on the "high standards of commercial honor" rule. See NFA Compliance Rule 2-4 https://www.nfa.futures.org/rulebooksql/rules.aspx?RuleID=9048&Section=9

[6] 7 U.S.C. § 1a. There are two exceptions to the CEA definition of commodity: Onion futures and box office receipts. Onion futures were banned following manipulation scandals in the 1950s. The motion picture industry successfully lobbied against box office receipts because they did not want a futures market that might create negative publicity about a future movie indicating it could be a flop.

Part of the current zeitgeist at the SEC is to recognize that investment contracts can expire, and that a financial thingy can start out as an investment contract and thus a "security" under the Howey Test™, but eventually stop being one when the founders of a crypto project stop doing work on the project.[7] The canonical example is bitcoin. Now that Satoshi Nakamoto has apparently ascended into heaven and is no longer working on bitcoin, it is no longer a "security" if it ever was one. There is no issuer raising cash and speculators are not buying it because they are counting on management to pay dividends.

There is a certain logic that once a project has permanently ceased its promised managerial efforts, it is no longer raising capital and there is no need for the investor protections of the Securities Act of 1933.

However, there is still secondary market trading in those assets on venues that look and smell like traditional financial markets. Financial intermediaries participate in those markets. There is still a need for the protections for which the Securities Exchange Act of 1934 was designed. There is a need to protect investors from market manipulation, intermediary failures, insider trading, and abusive sales practices.

There is a big public policy question here: If this 34-Act-style protection is not provided by the SEC, then by whom? The CFTC? Even though, in the eyes of some, everything is a "commodity" under CFTC jurisdiction, the CFTC generally only has authority over derivative markets, not spot markets. This creates a huge regulatory gap in investor protection that invites bad actors. Would it fall to whatever is left of the CFPB? The FTC?[8] The states? The plaintiff bar? The beauty of the SRO model provides authority for the brokerage industry to regulate itself through FINRA. FINRA's rulemaking and enforcement authority over its members is not constrained to activities involving "securities."

FINRA should expand Rule 5310 to cover all orders handled by FINRA members, not just orders in "securities." The brokerage industry has worked hard to earn the

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[7] See, for example, https://www.sec.gov/newsroom/speeches-statements/moloney-statement-book-of-howey-031726 along with the proposed Regulation Crypto Assets at https://www.sec.gov/files/rules/proposed/2026/33-11434.pdf.

[8] One of my favorite bits of regulation trivia is that the FTC was the agency originally in charge of implementing the Securities Act of 1933 as the SEC was not created until the Securities Exchange Act of 1934.

trust of its customers. Investors expect the same level of protection that they receive in securities markets. If even just a few sleazy brokers are allowed to <bleep> customers who trade cryptos or whatevers just because those products do not check the “securities” box, it will harm the reputation of the entire brokerage industry.

Consistent rules across financial products will reduce compliance costs.

Having different standards for different products increases the complexity of markets. This complexity increases the likelihood that honest firms intending to comply make unintentional yet costly compliance mistakes. The subtle differences between MSRB rules for municipal bonds and the relevant FINRA rules for other bonds are cases in point. For example, MSRB Rule G-18 only requires annual reviews, while FINRA Rule 5310 requires at least quarterly “regular and rigorous” reviews.[9]

Having the same principles-based standard for all orders handled by FINRA-member firms will reduce confusion and thus compliance costs in the industry. Failure to modernize the rule to go beyond securities will result in much costly confusion as the industry seeks to figure out what rules apply and where. If another entity comes up with rules for things that are not “securities” it will create compliance traps that will inevitably ensnare FINRA members, even those that are trying to do the right thing.

FINRA action can forestall incoherent action from other regulators.

If FINRA does not act, other regulators may well step in, providing additional standards that add additional complexity and compliance risk for FINRA members. FINRA action here will save its members much future regulatory grief.

[9] For another example, MSRB Rule G-15 has a minimum denomination rule forbidding brokers from effecting transactions in muni bonds in less than the minimum denomination size. There is no comparable FINRA rule, nor should there be. Such a rule may incentivize an investor to purchase more of a bond than otherwise desired, decreasing their diversification and increasing their risk.

<u>The benchmark for best execution should be based on the lit market volume, including odd-lots, for a particular order at the time of order placement.</u>

The traditional measure for execution quality has been to compare execution prices with the National Best Bid or Offer (NBBO). An order that gets a better price than the NBBO is seen as getting "price improvement" over the quote. However, the NBBO is a flawed benchmark for execution quality as it is based on quotes for at least a "round lot," typically 100 shares.[10] For a $2 stock, a round lot represents $200, which means that an order for only $200 could set the quote. For a $200 stock, it would take $20,000 to set the quote.

With stock splits falling out of favor, we now have a much larger number of high-priced stocks. Consequently, we now have many more odd lot and fractional share trades. Indeed, nearly half of trades on our exchanges are now odd lot trades. As the NBBO is only based on quotes for one or more round lots, there is a lot of semi-transparent liquidity inside the NBBO. There are often many odd-lot orders at prices inside the NBBO.

The SEC has dealt with this through a clumsy kludge by requiring the SIPs to disseminate a Best Odd Lot Order or BOLO in addition to the NBBO. However, the BOLO is still not widely displayed to investors. BOLO also has serious shortcomings as a benchmark for execution quality. For example, if the BOLO is only good for 10 shares, it provides an unrealistic benchmark for a 15-share order.

The appropriate benchmark for best execution of a cash equity market order is the price that is currently displayed in the lit market for an order of that size. It is now trivial for a computer to examine the displayed depths of book and calculate what the price would be to trade a given dollar amount against the displayed orders. Brokers should use the Effective Best Bid and Offer (EBBO) as a benchmark for measuring execution quality.

[10] The SEC recently made a half-hearted attempt to address this problem by tinkering with the size of the round lot for shares priced over $250. From $250 to $1,000 the round lot is 40 shares, from $1,000 to $10,000 10 shares, and 1 share above $10,000.

For example, suppose that a consolidation of the displayed liquidity in the market shows the following selling interest:[11]

Price	Shares
$10.03	10,000
$10.02	500
$10.01	100
$10.00	10

The execution benchmark for any particular order should be the number of displayed shares available at a given price, the Effective Best Bid or Offer. In the current example, National Best Offer is $10.01 and the BOLO is $10.00. For a five-share order, the Effective Best Offer (EBO) for a 5-share order is $10.00. For a 50-share order the EBO would be based on 10 shares at $10.00 and 40 shares at $10.01, for an EBO of $10.008

For a 100-share order, it would be, not $10.01, but the price obtained by sweeping the book and buying all 10 shares displayed at $10.00 and then 90 more at $10.01, for an EBO of $10.009.

Here is a table showing the EBO for various size orders:

Order Size	Effective Best Offer (EBO)
5	$10.00
50	$10.008
100	$10.009
500	$10.0176
1,000	$10.0227

The EBBO shows the prices that a broker can achieve instantly in the lit market without finding any hidden liquidity. That is the bare minimum that should be

[11] Please note that I am NOT advocating for a Consolidated Limit Order Book (CLOB). That discussion is really a debate on priority rules that allocate ties when different investors are quoting the same price. Here, I am advocating that brokers use publicly displayed data and calculate what a particular trade would cost if it were executed at the displayed prices.

expected from a broker. Basing execution quality measurement on highly flawed NBBO numbers makes little sense when it is so easy to calculate the lit liquidity available.

This would also require that the SIPs provide at least some depth of book information within and near the NBBO. Until that happens, the interpretation should require that brokers use the best data they have, but not force them to buy expensive prop feeds from every platform with an exchange medallion. However, if they subscribe to prop feeds for other uses, they should use that data to measure best ex.

Brokers that pass through access fees should include them in routing orders.

Brokers have three general choices for dealing with the access fees and rebates charged/paid by exchanges and other platforms: They can 1) appear to absorb them and thus indirectly pass them through to customers, or 2) explicitly pass both fees and rebates directly through to customers, or 3) explicitly pass through only the fees while pocketing the rebates.

This is basically a commercial decision best left to the broker and the competitive marketplace, as long as it is clearly communicated to clients. Notice that I use the word "communicated" here instead of "disclosed." It is only "communicated" if the bulk of clients understand the communication. A "disclosure" that is nothing but a glob of fine-print legaldygook is not an example of communication.

It stands to reason that some brokers will want to pass through exchange fees and rebates, while others will choose to absorb them. Brokers offer complex packages of services, including information feeds, software, order handling flexibility, analytical tools, cute Super Bowl baby ads, and more. When choosing brokers, customers decide which packages of services best serve their needs. In the current environment, some brokers receive payment-for-order flow (PFOF), and others do not.

Brokers should continue to have the freedom to offer whatever bundle of services and charges they think appropriate. What matters to the client is the total cost of trade execution, including commissions, fees, market impact, information leakage, and settlement costs. In addition to the costs of a specific trade, there are the overhead costs of connecting to and dealing with brokers, including the hassles of dealing with customer service when there is an issue. Been there, done that, got the infinite hold music.

A broker that chooses to pass through the costs and benefits of accessing a particular platform should rightly be looking at the total net cost, net of access fees and rebates, for the trade. It should then rightly take those into consideration when routing orders. With brokers thus paying more attention to access fees, competitive pressure will keep exchanges from overcharging, eliminating the need for the SEC to impose price controls on access fees.

Respectfully submitted,

James J. Angel,

Georgetown University

As an added bonus, here is a ChatGPT illustration of my comments: