Peeling Back The Layers Of SEC's Equity Trading Reforms

By **Charles Sommers, Andrew Blake and Thomas Archer** (October 22, 2024)

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On Sept. 18, in a unanimous vote, the U.S. Securities and Exchange Commission adopted rules amending the minimum pricing increments, or tick sizes,[1] for the quoting and trading of national market system stocks under Rule 612 of Regulation NMS.

NMS stocks are exchange-listed equities and exchange-traded funds. It also reduced access fee caps[2] for trading against a protected quotation under Rule 610 of Regulation NMS.[3]

The final rules accelerate the modified "round lot" definition and inclusion of odd-lot[4] information into consolidated market data to increase the transparency of better-priced orders in the market given delays in the implementation of the SEC's December 2020 Market Data Infrastructure Rules, or MDI Rules.[5]

The final rules also amend the "odd-lot information" definition adopted under the MDI Rules to require the identification of the best odd-lot order.

The final rules will become effective 60 days after publication of the adopting release in the Federal Register. The compliance date for the final rules will be Nov. 3, 2025, except for the dissemination of odd-lot information — including the best odd lot orders — which will have a compliance date of the first business day of May 2026.

Assuming the final rules can survive a judicial challenge, the SEC believes that it will result in reduced transaction costs for investors and allow stocks to be priced more competitively and efficiently.

Background

Regulation NMS Rules 610 and 612 were adopted in 2005 to establish, among other things, a minimum tick size of $0.01 for NMS stocks priced at or above $1, and a corresponding cap on access fees of $0.003 per share for such stocks.

Since Rules 610 and 612 were adopted, the SEC believes that a number of NMS stocks have become "tick constrained," meaning that the pricing of such stocks is being artificially constrained by the current tick size, and the stock would otherwise trade with a spread less than the tick size in the course of normal trading.

The final rules will reduce tick sizes for NMS stocks that the SEC believes are tick-constrained, and also reduce the access fees caps so that the current access fee caps do not become too large in relation to tick sizes.

In December 2020, the SEC adopted the MDI Rules, which included: (1) changes to round lots depending on the price of the security, rather than today's uniform 100 share round lots; and (2) adding to consolidated market data all odd-lot quotations priced greater than or equal to the national best bid, and less than or equal to the national best offer, aggregated at each price level at each exchange, in addition to odd-lot transaction data.

Given delays in the implementation of the MDI Rules, the SEC proposed to accelerate adoption of the round lots and odd-lot order information as part of consolidated market data sooner.

Summary of the Changes

Minimum Tick Sizes and Access Fees

Under the final rules, the SEC amended Rule 612 of Regulation NMS to reduce the minimum pricing increments for quotes and orders in NMS stocks priced at, or greater than, $1 per share based on a stock's time-weighted average quoted spread[6] over a designated evaluation period, as follows:

Time-Weighted Average Quoted Spread	Minimum Tick Size
> $0.015	No smaller than $0.01
≤ $0.015	No smaller than $0.005

If the quotation is priced below $1 per share, the minimum tick size will be $0.0001. If a security becomes an NMS stock during the evaluation period — such as in the case of an IPO — then a minimum pricing increment of $0.01 will be assigned for quotations equal to or greater than $1 per share, and the stock will have a round lot of 100 shares.

Under the final rules, the time-weighted average quoted spread for all NMS stocks must be evaluated by the primary listing exchange over an evaluation period to determine the appropriate minimum tick size. The evaluation period will last for three months, twice per year.

The first evaluation period will run from January through March — quarter one —and the minimum pricing increment calculated during the evaluation period will be effective beginning on the first business day in May and continue through the last business day in October.

The second evaluation period will run from July through September — quarter three — and will yield a minimum pricing increment that will be effective beginning on the first business day in November and continue through the last business day in April of the following calendar year.

Thus, stocks will have a minimum pricing increment of either $0.005 or $0.01, depending on their time-weighted average quoted spread during the evaluation period, for six months before being reevaluated.

Access Fee Caps

In light of the changes to tick sizes, the final rules also reduce the access fee caps that limit what a trading center may charge for the execution of orders against a protected quotation. The final rules retain the current uniform access fee cap structure, which designates access fee caps based on the price of the protected quotation.

Under the final rules, NMS stocks quoted at $1 or more will have an access fee cap of $0.001 per share, and NMS stocks quoted at less than $1 will have an access fee cap of 0.1% of the quotation price per share.

In addition, the final rules prohibit a national securities exchange from charging fees or providing rebates — or other remuneration, such as discounted fees, other credits or forms of linked pricing — for the execution of an order in an NMS stock unless the fee, rebate or other remuneration can be determined at the time of execution.

Consequently, any national securities exchange that facilitates trading in NMS stock and that (1) imposes a fee or provides a rebate that is based on a volume threshold, e.g., volume-based discounts; or (2) establishes tier requirements or tiered rates based on minimum volume thresholds, must base such fees or rebates on volume achieved during a stated period prior to the assessment of the fee or rebate.

Today, most, if not all, such fee structures are forward-looking — i.e., the discounted fees apply to the next month's fees.

Order Price Transparency — Round Lots and Odd Lot Order Information

As noted above, because implementation of the MDI Rules has been delayed, the final rules accelerated the adoption of the round lot provisions and odd-lot order information.

The final rules also amended the definition of odd-lot information under current Rule 600(b)(59) to include a new data element that would identify the best odd-lot orders to buy and sell.

Specifically, the best odd-lot order to buy means the highest-priced odd-lot order to buy that is priced higher than the national best bid, and the best odd-lot order to sell means the lowest-priced odd-lot order to sell that is priced lower than the national best offer.

If two or more national securities exchanges or associations provide odd-lot orders at the same price, the disseminator of consolidated market data — i.e., a securities information processor — will be required to determine the best odd-lot order by ranking all such identical odd-lot buy orders or odd-lot sell orders, as the case may be, first by size and then by time.

We note that the final rules do not affect the requirement that a protected quotation must be a round lot.

The final rules also amend the evaluation period used to determine the size of a round lot for an NMS stock to align with the evaluation period for tick sizes.[6] Under the final rules, the evaluation period is defined to mean all trading days in March for the round lot assigned on the first business day of May and all trading days in September for the round lot assigned on the first business day of November. The new round lots tiers are as follows:

Average Closing Price (per share)	Round Lot Size
$250 or less	100 shares
$250.01 – $1,000.00	40 shares
$1,000.01 – $10,000.01	10 shares
$10,000.01 or more	1 share

Round lots will be effective beginning on the first business day of May for the March evaluation period and continue through the last business day of October.

For the September evaluation period, round lot assignments will be effective beginning on the first business day of November and continue through the last business day of April of the next calendar year.

Notably, these amendments align the evaluation period for round lot assignments with the evaluation period for minimum pricing increment determinations under Rule 612.

SEC Study

As part of the final rules, the SEC committed to conducting a study by May 2029 to review and study the effects of the final rules.

This study may include an investigation of: (1) general market quality and trading activity in reaction to the implementation of the variable tick size; (2) the reaction of quoted spreads to the implementation of the amended access fee cap; and (3) changes to where market participants direct order flow, e.g., to exchange versus off-exchange venues, following the implementation of the final rules.

Key Takeaways

Quoting in More Granular Price Increments

Once implemented, the changes to minimum tick size will cause a majority of stocks — approximately 74.3%, based on the SEC's estimate using 2023 data — to be quoted in more granular half-penny (i.e., $0.005) increments, rather than the $0.01 minimum tick most prevalent today.

This will likely necessitate systems changes for a large number of market participants, including broker-dealers and exchanges, to allow for the submission, ranking and display of orders at more granular pricing increments.

Moreover, the applicable minimum tick sizes will vary by stock and may change for each stock on a biannual basis, which will require broker-dealer systems be able to accommodate such changes, and inform their customers.

Reduced Access Fee Caps for Stock Exchanges

The changes to access fees caps — setting a uniform cap on such fees of $0.001 per share (i.e., 10 mils) for all stocks price above $1 — will have significant implications for the pricing structure for exchanges.

The "maker-taker" pricing model, offering a rebate to liquidity providers and a fee for liquidity takers — and the inverted "taker-maker" model — currently key off of today's access fee cap of $0.003 per share (i.e., 30 mils), with the exchange's profiting from the difference between the taker fee and the maker rebate, known as the "net capture."

While the SEC states that exchanges will be able to maintain their current net capture rate, the exchanges appear poised to challenge the reduced access fee caps.

Judicial Challenges

On Oct. 8, We the Investors and Urvin Finance Inc. filed a petition for review of the final rules in the U.S. Court of Appeals for the District of Columbia Circuit, arguing that the commission's adoption of the final rules violated the Administrative Procedure Act and the Securities Exchange Act. It is not yet clear on what basis the petitioners allege the SEC to have violated the law.

Additionally, comment letters at the proposal stage of the final rules from national securities exchanges suggested that they may also challenge the final rules in court, primarily because of concerns over the narrowed access fee caps.

Notably, the SEC stated that it views the separate components of the final rules "to be severable to the fullest extent permitted by law," perhaps anticipating the forthcoming battle in court.

However, a number of market participants expressed the view during the comment process that tick sizes should only be lowered to the extent access fees are lowered in tandem, primarily to prevent an access fee from representing too high a percentage of the minimum quoting increment.

As a result, judicial challenges to the reduced access fees caps might also bring about challenges to the more granular tick sizes.

No Harmonization of Trading and Quoting Increments

The SEC declined to adopt its proposal to harmonize trading and quoting increments, a contentious component of the proposed rules.

Specifically, the SEC had proposed to only permit trades to be executed in the permissible quoting increment for the stock, which many commenters argued would deny investors subpenny price improvements that they receive on their orders today.

Broader Implications

Once implemented, the lower tick sizes should allow trading to better reflect the underlying economics of the security and reduce transaction costs for investors by narrowing bid-ask spreads — i.e., the difference between the best bid for the security and the best offer to buy.

For example, if the best bid and offer quotation for a stock are $10.03 x $10.04 — a spread of $0.01 — there may be a market participant that would be willing to sell at $10.035, but who cannot under current rules. Once implemented, the final rules would allow this market participant to offer the stock at $10.035. In turn, a buyer could now buy that stock for a half-penny less per share than they can today, i.e., $10.035 rather than $10.04.

However, the final rules must first survive a judicial challenge from a retail investor advocacy group, and very likely a separate challenge from national securities exchanges. It may therefore be some time before investors can enjoy any benefits arising from the final rules.

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[1] A "tick" is the minimum pricing increment that can be used to quote and trade securities. An appropriate tick size can help reduce trading costs for market participants.

[2] Access fees are fees charged for the execution of an order that exchanges frequently use to fund rebates to broker-dealers that provide liquidity on the exchange.

[3] Securities Exchange Act Release No. 101070, 89 FR 81620 (Oct. 8, 2024).

[4] A round lot typically means 100 shares, although Rule 600(b)(82) of Regulation NMS, as amended by the MDI Rules, would vary this amount depending on a NMS stock's average closing price in the prior calendar month. An odd-lot order is an order for the purchase or sale of an NMS stock in an amount less than a round lot.

[5] For more information on the MDI Rules, please see Sidley's client alert here:https://www.sidley.com/en/insights/newsupdates/2021/01/sec-adopts-rules-to-modernize-equity-market-data-content-and-infrastructure.

[6] The time-weighted average quoted spread was defined by the final rules to mean "the average dollar value difference between the NBB and NBO during regular trading hours where each instance of a unique NBB and NBO is weighted by the length of time that the quote prevailed as the NBB or NBO." See 17 CFR 242.612(a)(2).

[7] See 17 CFR 242.600(b)(93)(iii)-(iv).