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SEC Must Weigh Thorny Questions to Expand Exchange Framework

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In 2022, the Securities and Exchange Commission issued a proposal to significantly expand what constitutes an "exchange." If finalized, it would have the practical effect of subjecting a wider universe of the technologies that support the securities markets to the SEC's regulatory program for "alternative trading systems," a form of exchange-light regulation.

The proposal garnered renewed attention earlier this year when the SEC reopened the comment period to gather input on the proposal's application to crypto asset securities and decentralized finance technologies, or DeFi. The reopening occurred during—and contributed to—prominent policy debates concerning the SEC's approach to cryptocurrencies and DeFi.

But the SEC's original focus for the rulemaking initiative shouldn't be overlooked: fixed income markets, and the agency's desire to redraw the ATS regulatory perimeter as it applies to the platforms, technologies, and systems that help facilitate trading of credit and rates products.

Securities and Trading

"Fixed income" encompasses a broad range of products, with different features and trading mechanisms: corporate bonds, securitized products, public finance securities, and government bonds, among others.

Broadly speaking, and with certain exceptions, fixed income securities are less standardized and interchangeable than equities. They also trade less frequently.

Trading of these products therefore historically developed, and still operates to a large extent, through dealer-centric practices: A buyer or seller calls or messages multiple dealers to ascertain interest in an instrument and conducts manual, bilateral negotiations to transact.

That said, portions of these markets have become more electronified over the past two decades. Technologies and innovations—including various communication networks, request for quote protocols, stream axes, "click-to-trade" functionalities, and all-to-all trading protocols, among others—have fostered more efficient and lower-cost trading environments.

From a regulatory perspective, some fixed income platforms operate as ATSs. But other systems and technologies have operated legally outside the exchange/ATS regulatory paradigms—as part of registered broker-dealers or without registration.

This is due to the nature of fixed income trading practices, coupled with the SEC's existing "exchange" definition, developed in 1998. The definition generally contemplates the order-driven equity markets: It focuses on the bringing together of firm, actionable orders for matching and trading.

The SEC's proposal would change this. In addition to eliminating an exemption from the regulatory framework for government securities-only trading platforms, the proposal would broaden the "exchange" definition—and thus the ATS regulatory ambit—across all securities types. It would do this in two ways:

The existing "exchange" definition requires the bringing together of firm orders. The proposal would relax this limitation by replacing "orders" with "trading interest," which includes orders and non-firm indications of a willingness to trade.

The proposal would add "communication protocols" as a form of an established, non-discretionary method that triggers exchange status.

Key Decision Points

If the SEC seeks to adopt the proposal, it will need to carefully navigate many complexities and challenges. For credit markets, these four issues will be near the top of that list.

Slowing Electronification and Maturation of Markets. A fundamental question for the SEC is whether its contemplated expansion of ATS regulation would dampen the trend towards more automated and efficient fixed income markets.

New tools and technologies have created efficiencies, increased competition, and lowered costs —to the benefit of investors and issuers.

Regulation ATS and other corresponding requirements would introduce costs, complexities, and regulatory risks. Emerging companies and established institutions take these considerations into account when deciding whether to develop and launch—or continue operating—platforms, systems, and technologies.

The SEC will need to think carefully about this dynamic—and how to minimize stifling further progress in these markets. One potential approach would be to exempt, or limit costs imposed on, emerging systems and technologies.

"Communication Protocol." The SEC's proposal doesn't explicitly define the term "communication protocol system," a broad category of technology that it proposes including within the expanded regulatory ambit. Instead, the proposal describes the category in general terms and through examples.

But a vague and imprecise regulatory boundary creates the risk of a "we know it when we see it" form of regulation. This would raise fairness questions and make administering the program challenging for agency staff.

Therefore, if the SEC seeks to adopt this concept, it will need to carefully craft the definition and guidance so that market participants—and, importantly, different SEC personnel across the agency's divisions and offices—have a clear and consistent understanding of where regulatory lines begin and end.

SEC Resources and Planning. The SEC estimates the proposal could result in 35 to 46 newly designated ATSs. The agency will need to confirm that it has sufficient resources across its regulatory and examination functions to effectively administer the ATS program.

Notably, an expansion of the ATS program could conceivably occur when resources across the SEC may be facing significant new strains due to many other pending SEC initiatives.

Compliance Timing. The SEC's proposal contemplates short timelines for compliance. The proposal would require a newly designated fixed income ATS to file a Form ATS with the SEC no later than 30 days after the final rule's effective date.

An institution could conceivably be required to submit a filing with the SEC and have a compliance infrastructure in place within three to four months of the vote to finalize the rulemaking.

Striking the right balance on compliance timelines—for example, 18 to 24 months—would demonstrate that the agency understands that the development and implementation of an effective compliance program is a complex and time-intensive process.

It would also send an important message to the industry concerning the level of care and rigor that the SEC expects institutions to invest in compliance. An unrealistically short timeframe would send the opposite message.

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