Professional Perspective

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October 11, 2023

Bloomberg Law

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Fixed Income & ATS Regulation: Key Decision Points for the SEC

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In January 2022, the Securities and Exchange Commission (SEC or Commission) issued a high-profile proposal to expand its definition of "exchange." If finalized, the rulemaking would have the practical effect of subjecting a wider universe of the systems and technologies that support the securities markets to the SEC's system of regulation for "alternative trading systems" (ATSs), a form of "exchange-light" regulation.

Earlier this year, the rulemaking proposal garnered renewed attention when the Commission reopened the comment period to solicit input concerning the proposal's application to crypto asset securities and decentralized finance technologies (DeFi). The comment reopening occurred during the midst of, and also contributed to, prominent policy debates regarding the US government's approach to cryptocurrencies and DeFi.

But what should not be overlooked is the SEC's original focus for the rulemaking initiative: *fixed income markets*—and the agency's desire to redraw the ATS regulatory perimeter as it applies to platforms and systems that help facilitate trading of various credit and rates products. Over the years, many of these technologies—which have contributed to the ongoing electronification and maturation of fixed income markets—have been able to legally operate outside of the ATS regulatory framework. The SEC's proposal seeks to change this.

This article provides context and historical perspective on the SEC's approach to this area of market regulation. Working from this lens, the article then outlines four key issues that the Commission will need to carefully navigate if it seeks to finalize the rulemaking.

Basic Regulatory Framework

Any entity that meets the definition of an "exchange" must either register with the SEC as a national securities exchange or operate as an ATS in compliance with **Regulation ATS**. The vast majority of entities that meet the exchange definition elect to operate under the less onerous ATS regulatory scheme.

The existing definitions of "exchange" apply—in concept—with respect to all types of securities:

- The **Exchange Act** states that the term "exchange" means an entity or system that "provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing . . . the functions commonly performed by a stock exchange as that term is generally understood . . . ."

- Through Rule 3b-16, the SEC has further defined the term "exchange" to mean an entity or system that: (1) brings together the orders for securities of multiple buyers and sellers and (2) uses established, non-discretionary methods—whether by providing a trading facility or by setting rules—under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade. The rule contains certain exclusions, including for when orders are entered for execution against the bids and offers of a single dealer.

But even though the exchange definition applies in respect of all "securities"—and certain substantive provisions of Regulation ATS apply specifically to fixed income— some platforms, systems and technologies that support fixed income trading have been able to operate outside of the exchange and ATS regulatory paradigms, either as part of registered broker-dealers or without SEC registration. This state of affairs does not necessarily reflect an attempt to evade ATS regulation, but instead reflects the characteristics of fixed income trading practices and the architecture and application of the SEC's current definition of "exchange."

Fixed Income Trading Practices & SEC Regulation

"Fixed income" is a catch-all term that refers to a broad and diverse range of credit and rates products, with different features and trading mechanisms: corporate bonds, securitized products, public finance securities, US Treasuries and other government and agency bonds, among others. Broadly speaking, and with the general exception of US Treasuries, fixed income securities are less standardized and interchangeable than equity securities—and trade less frequently.

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A corporate issuer's stock, for instance, may trade through a single primary equity listing. But that same issuer may have hundreds of outstanding bond issuances—with different features—which trade far less frequently than the issuer's stock. This heterogeneity hampers the matching of buying and selling interest for a given security, and has historically made it more difficult to form centralized electronic trading markets for fixed income. Trading of fixed income therefore developed, and still operates to a large extent, through manual, dealer-centric practices: A buyer or seller calls, emails or messages sales professionals at multiple dealers to ascertain interest in a given instrument —including price and quantity—and then conducts manual, bilateral negotiations to ultimately transact.

Over the last few decades, the growing use of new trading technologies and tools has, to varying degrees, "electronified" certain portions of the fixed income markets, resulting in more efficient, liquid and lower-cost trading environments. These technologies and tools—which have been developed and deployed by electronic trading platform providers, broker-dealers, institutional investors and data vendors—include various types of communication networks, request for quote (RFQ) protocols, stream axes, "click-to-trade" functionalities and all-to-all trading protocols, to name a few.

The SEC established its "exchange" definition in the late 1990s—with equity markets front of mind. Market regulation at that time was focused primarily on the emergence of electronic communications networks that were functioning as alternative markets to stock exchanges. The technologies that have facilitated greater electronic trading in fixed income were also beginning to emerge in the late 1990s, but did not receive the same regulatory focus as equities during that period. Consequently, the "exchange" definition that the SEC adopted in 1998—when the agency created the ATS regulatory program—largely reflected equity trading practices: the bringing together of firm, actionable orders for matching and trading, within the context of liquid, listed equities.

When these two factors—the nature of fixed income securities and trading practices and the details of the SEC's existing "exchange" definition—are viewed together, it becomes clear why some fixed income technologies have been able to operate outside of the exchange/ATS perimeter.

Take a disclosed RFQ protocol, which resembles a multilateral, electronified version of over-the-counter, dealer-centric trading: It enables institutional investors to simultaneously query multiple dealers for prices on a particular bond and at a given size. As highlighted in comment letters filed with the SEC, many RFQ protocols have over the years been able to take the position that they fall outside of the "exchange" definition. For example, an RFQ protocol facilitates parties' communications and negotiations that may (or may not) lead to transactions—whereas the exchange definition requires the *bringing together* of "*orders*." Additionally, an RFQ requester typically has discretion whether or not to trade against any quote provided in response to its request for a quote. Thus, the system does not necessarily meet another element of the existing exchange definition, the use of "established, non-discretionary methods" under which orders interact.

SEC Proposal to Expand "Exchange" Definition

The roots of the SEC's 2022 proposal to expand the "exchange" definition can be traced to a 2018 recommendation from the SEC's Fixed Income Market Structure Advisory Committee. The Committee recommended, among other things, that the SEC work with other regulators to review and consider whether the regulatory framework governing fixed income electronic trading platforms should be updated to "account for differences in protocols and market structures commonly used to trade fixed income securities as compared to equities."

Motivated in part by this recommendation, the Commission in 2020—then under Chairman Jay Clayton—proposed to eliminate a long-standing exemption from the regulatory framework for government securities-only trading platforms. The SEC's 2020 release also solicited comment on the regulatory framework for electronic platforms that trade corporate debt and municipal securities.

Then in early 2022, the Commission—then and now under Chairman Gary Gensler—issued an expanded proposal, which not only re-proposed to eliminate the exemption for government securities-only markets, but also proposed to expand the scope of the "exchange" definition—and thus the ATS regulatory ambit—across all securities types.

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The proposal would broaden the definition of "exchange" in two important ways:

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

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

Applying the proposal to the earlier example of a disclosed RFQ protocol is instructive. The proposal would appear to eliminate the aforementioned bases for the position that the technology does not meet the exchange definition: A system that brings together non-firm indications of interest and facilitates communications and negotiations that lead to a trade would appear to satisfy the proposed definition of exchange.

Key SEC Decision Points

If the Commission seeks to move forward with adopting the proposal—as is anticipated—then it will need to carefully navigate numerous complexities and challenges. In the context of fixed income—particularly credit products—the following four issues will be near the top of that list.

Slowing Electronification & Maturation of Fixed Income Markets

In deciding whether to adopt the proposal, the Commission will have to grapple with the fundamental and perennial question: How do the anticipated benefits of the contemplated rule change stack up against the anticipated costs?

This question is particularly important in this context because, as explained above, technological advancements have driven the development of more efficient, competitive and lower-cost fixed income markets—to the benefit of investors and issuers. In its 2022 proposal, the SEC cited a report that found that technological advancements in the municipal securities market and the movement from voice trading towards greater electronic trading in that market helped reduce transaction costs for dealer customer trades by 51% between 2005 and 2018. Indeed, the electronification of communications and workflows has reduced search costs, provided market participants with a greater view of liquidity, increased competition and created trading and operational efficiencies across fixed income markets.

The imposition of Regulation ATS and other requirements triggered by ATS status would impose costs, complexities and risks that would materially affect the cost-benefit analyses—and ultimately, the decision-making processes—of developers and operators of trading-related technologies and platforms. These considerations apply both to emerging companies seeking to introduce new technologies, as well as established institutions, where individual business units must justify their investments and tools against their individual profit/loss statements and ultimately convince senior management that the relevant costs and risks associated with a given technology or trading system are justified.

Congress gave the SEC authority to exempt emerging systems from exchange registration—and therefore the need to operate as an ATS. This exemptive authority is available where the Commission finds that "by reason of the limited volume of transactions effected on such exchange," exchange registration is neither necessary nor appropriate. The Commission has rarely used this exemptive authority, and did not acknowledge its existence in the 2022 proposal. That said, a robust exemptive pathway for new and emerging technologies and systems could help mitigate the challenges associated with the imposition of regulatory costs on emerging systems and technologies.

'Communication Protocol' Concept

One of the most controversial aspects of the SEC's proposal is the contemplated addition of "communication protocols" as one of the functions by which an exchange makes available "established, non-discretionary methods under which buyers and sellers can interact and agree to the terms of a trade."

As an initial matter, the Commission will need to assure itself that the "communication protocol" concept is consistent with Congressional intent regarding what constitutes an exchange. Heretofore, an exchange has traditionally been understood to be an entity or system that not only brings together orders, but also serves as *the venue or system* where the resulting transaction occurs. Certain statutory text arguably suggests that Congress believed that the exchange concept would be so limited. For example, the statutory authority for the aforementioned "limited volume" exemption from exchange

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registration states that the exemption is only available where by "reason of the limited volume of transactions *effected on such exchange*" (emphasis added), such exemption is appropriate. This implies that an exchange is *the venue* where the relevant transaction occurs. The statutory exemptive authority does not refer to a system, such as what appears to be the Commission's proposed concept of a "communication protocol," that facilitates communications or interactions that may ultimately lead to transactions effected outside the system.

The Commission will also have to decide how to define the communication protocol concept with sufficient clarity. The proposal does not explicitly define the term "communication protocol." Instead, it describes the concept in general terms and through examples. The proposal states, for example, that a communication protocol system may not necessarily match counterparties' trading interests, but buyers and sellers using such systems can be brought together to interact, either on a bilateral or multilateral basis.

A vague and imprecise regulatory boundary creates the risk of a "we know it when we see it" form of regulation. This would be unfair to the public, and also make administering and enforcing the regulation challenging for the SEC. Therefore, if the SEC seeks to adopt the communication protocol system concept, it will need to carefully craft the definition and develop guidance so that market participants—and different SEC personnel across the agency's divisions and regional offices—have a clear and consistent understanding of where regulatory lines begin and end.

Sufficient Regulatory Planning & Preparation

The Commission and SEC staff will not only need to assess the details and nuances of Regulation ATS to ensure that it is appropriate and tailored for the potentially broad range of newly designated systems and technologies, but also carefully review the universe of other regulatory requirements that are keyed off of ATS status—e.g., the SEC's Market Access Rule—and strive to ensure that there are no unintended collateral consequences or uncertainties triggered by the rulemaking.

The Commission will also need to ensure that the agency has the necessary resources to effectively administer a significantly expanded ATS regulatory program. The SEC estimates that the proposal could result in a total of 35 to 46 newly designated ATSs—an estimate that some commenter letters suggest is unrealistically low. The SEC will need to evaluate and confirm that it has sufficient staff and programmatic resources across its units that are responsible for administering the ATS regulatory program—namely, the Division of Trading and Markets, the Division of Examinations and the Office of General Counsel. Strikingly, a significant expansion of the SEC's ATS program could conceivably occur when resources across the agency may be under significant new strains and demands due to a wide array of other SEC initiatives.

Compliance Timing

The SEC's proposal contemplates short, and arguably unrealistic, timelines for institutions to implement and come into compliance with the expanded scheme of ATS regulation. For example, the proposal would require a newly designated fixed income ATS—i.e., a system that for the first time would constitute an exchange due to the rule change and thus need to comply with Regulation ATS—to file a Form ATS with the SEC no later than 30 days after the final rule's effective date. Because SEC effective dates are commonly 60 days after a rule change's date of Federal Register publication, 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 Commission's vote to finalize the rulemaking.

Yet, the design, development and implementation of an effective compliance framework and program is a complex, time-intensive and costly process, which requires significant coordination across an institution's business, compliance, controls, legal, operations and technology departments.

Among other basic steps, it would require:

- Legal and regulatory analysis to scope and evaluate status under the rule and guidance—and then if the exchange definition is met;
- Registering or affiliating with a broker-dealer—if the institution has not already done so;
- Gathering and disclosing to the SEC required information about the ATS and its operations and broker-dealer operator; and
- The design, development and implementation of policies and procedures, controls and training.

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The SEC will need to balance its perceived need for newly designated systems and technologies to expeditiously come into compliance with Regulation ATS against the competing interest of providing institutions with a fair and reasonable amount of time to evaluate the status of their systems and technologies—and build an effective compliance infrastructure. Striking the right balance—e.g., providing 18 to 24 months— would demonstrate that the Commission understands the day-to-day realities and complexities of establishing and maintaining a credible compliance and controls framework. It would also send an important message to the securities industry concerning the level of thoughtfulness, care, and resources that the Commission expects institutions to invest in compliance. An unrealistically short timeframe would send the opposite message.

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