



An Expanding “Exchange” Regulatory Construct? The Marketplace Awaits Key SEC Decisions

Jeffrey T. Dinwoodie | Partner – Cravath, Swaine & Moore LLP
November 1, 2024

One of the more significant rulemaking initiatives under Chair Gensler’s SEC that has not yet been finalized is a proposal to expand the universe of what constitutes an “exchange” for regulatory categorization purposes.

This rulemaking has broader relevance than may at first be apparent to market participants, as its implications extend beyond the world of stock exchanges. Indeed, if adopted as proposed, the rulemaking would have the practical effect of subjecting a wide range of technologies and systems that help facilitate trading across securities markets to the SEC’s system of regulation for alternative trading systems (“ATs”), a form of “exchange-light” regulation.

Background

Any entity or system that meets the SEC’s definition of “exchange” must either register with the SEC as a national securities exchange or—as the majority of such entities do—operate in compliance with the SEC’s ATS regulatory program, a regulatory middle ground between the regimes governing national securities exchanges and broker-dealers.¹

The SEC’s current “exchange” definition, created in 1998, applies to all types of securities—but in practice generally contemplates the order-driven equity markets. The definition focuses on entities or systems that bring together firm, actionable “orders” for securities, pursuant to established, non-discretionary methods under which such orders interact and the buyers and sellers entering such orders agree to the terms of a trade.

Over the years, as trading protocols and technologies have evolved, the SEC has examined whether the infrastructure, systems and tools that support securities trading are appropriately regulated. In 2020, the SEC (under Chairman Jay Clayton) proposed to eliminate a long-standing rule that exempts from the national securities exchange and ATS regulatory frameworks those platforms that facilitate trading in only Treasuries and other U.S. government securities (“government securities-only trading platforms”)—i.e., to subject those platforms to exchange/ATS regulation for the first time.²

In early 2022, the Commission (then and now under Chairman Gary Gensler) issued a significantly expanded reproposal.³ It carried over the proposal to subject government securities-only trading platforms to exchange/ATS regulation. It also for the first time sought to broaden the conception of what constitutes an “exchange” (across all types of securities), in two key ways:

- First, it would relax the limitation in the existing definition, noted above, that requires that an exchange bring together firm “orders”—by replacing “orders” with “trading interest,” a concept that would include firm orders and non-firm indications of a willingness to trade.
- Second, it would add “communication protocols” as a form of an established, non-discretionary method to bring together buyers and sellers of securities for purposes of triggering exchange status.

The SEC has estimated that 35 to 46 additional entities and systems (across asset classes) would fall under the proposal’s expanded exchange definition, which many believe is an unrealistically low estimate. In any case, the proposed definition would appear to capture a range of technologies, such as request for quote (“RFQ”) protocols and “stream axes” used to trade fixed income and equity securities, as well as decentralized finance technologies (“DeFi”) protocols and other technologies in crypto asset markets. Covered systems could also possibly include software solutions that interoperate with existing market centers—and some fear, order- and execution-management systems used by sell-side and investment management firms.⁴

Four Central SEC Decisions

Four major decisions will likely determine the practical impact—and long-term legacy—of this rulemaking.

- 1. Whether the Commission Opts for an Incrementalist Approach.** It is widely anticipated that the Commission will adopt its proposal to eliminate the exemption for government securities-only trading platforms, a change proposed under two consecutive SEC Chairmen that received broad support from a wide range of commenters.

By contrast, the proposal to expand the “exchange” construct across all securities types has been met with widespread criticism. So, the central question is whether the Commission will adopt a scaled-back version of this component of the rulemaking—for example, by limiting the application of an expanded exchange definition to certain types of securities—or by adopting only the aspect of the proposal to replace “orders” with “trading interest,” and reconsidering or abandoning the highly controversial “communication protocol” concept.

A measured and gradual approach along these lines has clear benefits. It would provide the SEC with an opportunity to evaluate an incremental expansion of the regulatory perimeter, and ultimately put the agency in a position to make well-informed decisions as to whether further changes are needed in this area.

- 2. How to Explain the Rulemaking’s Regulatory Purpose.** A common criticism of the Commission’s proposal to expand the “exchange” definition is a perceived failure to articulate a clear and persuasive investor or market protection rationale necessitating the rulemaking. Some commenters expressed the view that, at base, the proposal appeared to be motivated by a general desire of the Commission to “regulate the unregulated.”⁵

When reflecting on policy proposals, it is often instructive to evaluate what portions of the affected population support the policy initiative—and why. For example, in securities markets, it is common for institutional investors to support proposals to require enhanced disclosures from securities intermediaries or infrastructure providers regarding their operations or business relationships.⁶

But here, it is difficult to identify any institutional investors—or any market participants at all—that support the Commission’s proposal to expand the “exchange” definition. Across the board, comment letters submitted by market participants—the parties that would theoretically benefit by subjecting trading-related technologies to further regulation—have expressed various concerns about the proposal.⁷

- 3. How to Balance Risks of Stifling Market Advancement.** Technological innovations and advancements have driven the development of more efficient, competitive and lower-cost securities markets, benefiting investors and issuers. In fixed income markets, for example, over the past two decades new technologies have been introduced that allow investment funds to more efficiently identify, and collect pricing information and quotes from, potential liquidity providers. The 2022 proposal cited a report that found that technological advancements in the municipal securities market, including shifts from “voice” to

greater electronic trading, helped reduce transaction costs for dealer customer trades by 51 percent between 2005 and 2018.

Regulation ATS and other requirements triggered by ATS status would introduce costs, complexities and regulatory risks that would materially affect the cost-benefit analyses of developers, operators and users of trading-related technologies and systems. These considerations—quite real—apply both to emerging companies seeking to introduce new technologies, and to banks and other large institutions developing innovative e-trading offerings. The Commission should carefully evaluate how the anticipated benefits of the rulemaking stack up against the risk that the imposition of these costs, complexities and regulatory risks will encumber advancements in markets that have so greatly benefitted investors and issuers.

4. Whether and How to Apply the Rulemaking to Crypto. In 2023, the Commission solicited public comment on the proposal’s application to crypto asset markets and DeFi. This rulemaking proposal, like many other recent SEC proposals, has elicited significant attention and consternation from the crypto asset and DeFi industries. Commenters expressed frustration that the SEC’s regulatory programs for national securities exchanges and ATSS were designed with traditional instruments in mind, and argued that these regulatory frameworks would impose impossible-to-satisfy requirements on crypto asset and DeFi technologies.⁸

Time will tell whether the Commission will take feedback from comment letters into account and endeavor to develop a tailored regulatory framework for crypto asset and DeFi technologies, neither a simple nor straightforward task.

In the interim, the SEC could consider deferring the application of a final rulemaking to crypto asset and DeFi technologies—and work expeditiously together with the CFTC to develop a pragmatic regulatory framework for these technologies that recognizes the operational realities of these emerging technologies. This could include conducting field hearings, industry consultations, studies and pilot regulatory programs, all of which would provide the agencies with further perspective that would help facilitate development of tailored, workable regulatory approaches. This would lead to regulatory outcomes that are not only more durable, but also better protect investors and facilitate capital formation and innovation.

* * *

Jeffrey T. Dinwoodie is a partner in the law firm of Cravath, Swaine & Moore LLP (“Cravath”). The views expressed in this essay are solely the personal views of Mr. Dinwoodie and do not necessarily reflect the views of Cravath or any client of the Firm.

¹ The SEC’s ATS regulatory program requires that the operator of the ATS be a registered broker-dealer, comply with regulatory requirements applicable to registered broker-dealers and, among other things, file detailed initial and continuing disclosures concerning its operations and, depending on the type and volume of its securities traded, comply with fair access, order display and systems-related requirements.

² Regulation ATS for ATSS That Trade U.S. Government Securities, NMS Stock, and Other Securities; Regulation SCI for ATSS That Trade U.S. Treasury Securities and Agency Securities; and Electronic Corporate Bond and Municipal Securities Markets, 85 FR 87106 (Dec. 31, 2020).

³ Amendments Regarding the Definition of “Exchange” and Alternative Trading Systems (ATSS) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, 87 FR 15496 (Mar. 18, 2022).

⁴ See, e.g., Letter from Robert Toomey, Head of Capital Markets, Managing Director, Associate General Counsel, SIFMA, to Vanessa Countryman, Secretary, SEC (June 13, 2023).

⁵ See, e.g., Letter from William C. Thum, Managing Director and Assistant General Counsel, SIFMA AMG and Ellen Greene, Managing Director, SIFMA, to Vanessa A. Countryman, Secretary, SEC (June 28, 2024).

⁶ See, e.g., Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, SEC (Feb. 25, 2016) (expressing support for Commission proposal to enhance disclosure requirements applicable to NMS Stock ATSS).

⁷ See, e.g., Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Regulatory Affairs, Managed Funds Association, to Vanessa Countryman, Secretary, SEC (Apr. 18, 2022); Letter from Michael Nicholas, CEO, Bond Dealers of America, to Vanessa Countryman, Secretary, SEC (Apr. 18, 2022); Letter from Thomas Tesaro, Fidelity, to Vanessa Countryman, Secretary, SEC (June 13, 2023).

⁸ See, e.g., Letter from Paul Grewal, Chief Legal Officer, Coinbase Global, Inc., to Vanessa A. Countryman, Secretary, SEC (Aug. 12, 2024).