

published: 7.28.98

July 28, 1998

Mr. Jonathan G. Katz  
Secretary  
United States Securities Exchange Commission  
Mail Stop 6-6  
450 Fifth Street, N.W.  
Washington, D.C. 20549

**Re: Regulation of Exchanges and Alternative Trading Systems  
File No. S7-12-98-18**

Dear Mr. Katz:

The Bond Market Association<sup>1</sup> ("Association") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") proposed regulation of alternative trading systems ("ATS").<sup>2</sup> The ATS Proposal is a thoughtful approach to various issues raised by the innovative use of new trading technology. In general, the Association supports the Commission's desire for a flexible regulatory approach which is tailored toward encouraging the efficient use of new trading systems. At the same time, the Association believes the Commission must proceed with extreme care to ensure any new proposed regulatory structure does not unintentionally impede the very innovation it seeks to foster. To that end, the Association, as described below, urges the Commission to revisit the approach taken in the ATS Proposal and revise its provisions accordingly.

**I. Executive Summary**

The Association strongly encourages the Commission to reconsider the application of its proposed ATS regulation to systems trading fixed income securities<sup>3</sup>. In response to advances in trading technology, the Commission proposes to expand the definition of an exchange to include ATSs trading debt securities and to subject those ATSs to additional regulation, much of which would force the over-the-counter ("OTC"), debt-oriented systems to comply with traditional centralized equity market concepts. The Association believes that fundamental differences between debt and equity securities and how they are traded demands a conceptually different approach to regulation. The imposition of the Commission's proposed regulation may risk unsettling a highly liquid and efficient market which is extremely competitive and more than adequately regulated at the present time. As the Association stated in its comment letter on the Commission's Concept Release,<sup>4</sup> "the Association believes that a wholesale reshuffling of the existing regulatory framework as applied to fixed income securities markets is neither necessary nor appropriate in the public interest to keep pace with the technological advances that are and will be implemented in those markets."<sup>5</sup>

In summary, the Association has the following general comments about the proposed rules. The Association:

*Strongly supports* the Commission continuing to regulate ATSs as it does today and *believes* the current regulatory system for bonds is far more flexible in encouraging continued market innovation without disrupting traditional markets or compromising basic investor protections;

*Strongly supports* the Commission using its recent Congressionally-mandated flexibility under Section 36 of the Securities Exchange Act of 1934 to exempt new trading systems from inappropriate or unnecessary requirements or existing regulations rather than imposing an entirely new regulatory system on existing markets;

*Strongly opposes* the imposition of equity-based national market system goals on fixed income securities trading systems and *supports* allowing free market forces to determine market structure;

*Supports* a definition of exchange which requires an exchange, among other things, to provide market participants with a reasonable expectation of liquidity.

Similarly, if the Commission goes forward with its rule proposal, the Association has the following specific comments regarding the proposal. The Association:

*Advocates* a less expansive definition of exchange given the collateral regulatory consequences of the definition as suggested in the ATS Proposal;

*Strongly supports* excluding from the definition of an exchange broker-dealer functions, like the use of internal broker-dealer systems;

*Strongly supports* excluding all systems trading debt securities, including but not limited to government and municipal securities, from the definition of an exchange;

*Strongly supports* explicit clarification that an order does not include non-executable indicative quotations;

*Supports* a *de minimis* exception to Regulation ATS to foster innovation in new trading systems;

*Advocates* the consideration of the impact of the proposed regulation on banks when the Commission revisits the proposed regulations;

*Strongly supports* raising the volume percentage at which fair access and capacity requirements are applied to ATSs trading debt securities from 20% to 35%;

*Is not opposed* to the five debt categories proposed by the Commission for calculating volume and *suggests* the use of clearing corporation data as the most reliable source of secondary market trading volume in debt securities;

*Supports* the Commission's objective to prevent exchanges from applying participant criteria in a discriminatory manner, but cautions the Commission not to change the commercial contractual relationship between a trading system and its participants; and

*Supports* the Commission's objective of assuring system integrity for exchanges.

## **II. General Comments and Suggestions**

### ***A. The Association supports the Commission's objective of a regulatory framework which enhances efficiency and innovation and allows for the development of "for-profit" exchanges.***

In light of recent technological changes and their effect on the securities markets, the Association appreciates the SEC's review of the market structure in its recent releases. In the ATS Proposal, the Commission states that it "firmly believes that there should be a regulatory framework in place that makes sense both for current and future securities markets. This regulatory framework should encourage market innovation without compromising basic investor protections."<sup>6</sup> The Association agrees with the Commission's stated goal of a regulatory environment flexible enough to accommodate traditional markets as well as new and innovative ones. The Association, however, believes the Commission's approach to fulfilling this goal is, at times, *over-broad and counterproductive*.

The Association recommends that the Commission continue to regulate ATSs within the broker-dealer framework, crafting appropriate regulatory structures to address particular issues presented by unique operations as they develop. The Association believes that the Commission's regulatory efforts to encourage the innovation and development of new, technologically advanced trading systems to date have been successful, as evidenced by the many sophisticated electronic methods created to better serve the interests of investors. The Association also believes the current regime should be retained because it more than adequately provides the Commission with the flexibility to design narrowly tailored regulation to accommodate the Commission's specific market goals where appropriate, like those articulated in the Securities Acts Amendments of 1975.

The Commission has suggested that one of the reasons for revisiting the regulation of ATSs is that it wants to remove any regulatory barriers to the development of for-profit, electronic trading systems. The Association fully supports such an objective, but suggests that the Commission need not accomplish that goal in the way it has proposed. The Association, instead, recommends that the Commission utilize its new exemptive powers under the National Securities Markets Improvement Act ("NSMIA") to exempt a proprietary trading system from any inapplicable requirements imposed on exchanges (as presently defined), like fair representation or membership requirements. In fact, the

Commission proposes to do exactly that, on a case-by-case basis, under its proposed approach,<sup>7</sup> belying the need to alter the definition of exchange in the first place.

Because of the proven track record of the Commission's current approach, the Association cautions the Commission against changing its course of action. If the Commission identifies significant market abuses, then, perhaps, such a fundamental and far-reaching change as suggested in the ATS Proposal, and the corresponding additional cost of regulation, would be warranted. Nevertheless, in neither the Concept Release nor the ATS Proposal does the Commission describe such a profound disruption of the market, particularly with respect to the fixed income market. *Accordingly, the Association urges the Commission to reconsider its proposed rules and to reaffirm its current commitment to an incremental approach to regulatory change, which maximizes certainty and flexibility for technological innovation.* In brief, the Association believes the Commission can achieve its stated goal -- facilitating electronic, for-profit trading systems -- within the existing regulatory regime and that the Commission has not justified the expansive regulatory structure embedded within the ATS Proposal.

***B. The Association believes that the Commission's regulatory efforts will create a complex regulatory infrastructure in contravention of the deregulatory intent of the NSMIA exemptive authority***

With the enactment of NSMIA, Congress provided the Commission with greater flexibility in regulating new trading systems by adding Section 36 to the Securities Exchange Act of 1934. This section gives the Commission broad authority to exempt any person from any of the provisions of the Exchange Act. As a result, the Commission now has a greater ability to tailor regulations to specific issues presented by the regulated entity, rather than applying inappropriate requirements to market participants merely because of an inflexible statutory framework. Accordingly, Congressional intent in enacting NSMIA was essentially deregulatory.

The Association is concerned that the proposed ATS rules will act to increase regulation, rather than decrease it, as intended by Congress.<sup>8</sup> For example, the Commission proposes to expand the definition of exchange to include a potential host of additional ATSs. Once an ATS falls within the exchange rubric, it necessarily will be subject to enhanced regulatory requirements through exchange regulation or Regulation ATS. Granted, the smaller ATSs only may experience an increase in recordkeeping requirements, but, even recordkeeping increases the costs of operation. The larger, more significant ATSs will be required to comply with more considerable regulation, including order display, fair access and capacity requirements. If the Commission were to continue regulating ATSs as it currently does, these ATSs would not be subject to such heightened regulatory oversight. Because the proposal, at a minimum, raises many interpretive issues, and potentially increases the regulatory requirements for a variety of entities, it can not be said to be deregulatory.

The Commission has argued that the proposed rules are deregulatory in the sense that they provide a framework to allow for the development of for-profit exchanges. The

Association believes that this deregulatory intention is eclipsed by the increased regulation for many other ATSs. Accordingly, the Association recommends that the Commission reconsider the proposed rules, keeping in mind the deregulatory Congressional intent in amending the Exchange Act.

***C. The Association is concerned that the ATS Proposal is being interpreted by market participants as an effort by the Commission to mandate a centralized auction market structure for bonds***

Despite the Commission's stated intent, bond market participants are concerned that the ATS Proposal is implicitly signaling a dramatic and fundamental policy shift on the part of the Commission to reverse its stance on allowing free market forces to determine market structure and thereby require the bond markets to conform to a centralized auction market form. As the Association stated in its comment letter on the Concept Release,<sup>9</sup> the Association strongly disagrees with any governmental effort to force the bond markets to conform to the equity markets trading model, given the inherent differences between the two types of securities.

The Association's concern about the Commission altering the structure of the bond markets is not illusory. It is grounded in a variety of indications: (1) the proposed rules would characterize all ATSs, including those solely trading debt securities, as exchanges -- the archetypal example of the centralized auction marketplace; (2) the Commission explicitly has stated in the ATS Proposal that it is interested in "integrat[ing] trading on alternative markets more fully into the NMS;"<sup>10</sup> (3) the Association notes that, although the Commission currently has proposed to require only certain ATSs trading equity securities to be integrated more fully into the NMS, the proposed rules provide a framework for easily expanding the rules to require the integration of ATSs trading debt securities; (4) the Commission has proposed sweeping regulatory changes despite the absence of any identifiable fundamental abuses or problems in the fixed income markets; (5) in the ATS Proposal, the Commission did not address (or even acknowledge) the Association's concerns regarding the application of the proposed rule to the debt markets, as set forth in the Association's letter commenting on the Concept Release;<sup>11</sup> and (6) the Commission's proposal of such an expansive methodology when a more narrowly tailored approach would seem to address the Commission's stated objectives implicitly suggests a greater intended market effect.

As the Commission is well aware, fundamental differences between the nature of debt and equity securities have translated into distinctive trading methods for both types of securities. Bonds are primarily traded in decentralized, negotiated OTC markets, whereas equities generally are traded in the traditional, centralized auction markets, or in markets which, through electronic means, are the functional equivalents of such centralized markets. Traditionally, the Commission has recognized the value of the distinctive characteristics of bonds and equities and their corresponding markets and has supported these differences through regulation tailored to the particular market.<sup>12</sup>

Equity and debt securities are fundamentally different financial instruments and those differences are reflected in the manner each is traded. For example, equity securities represent a claim on the assets and projected future income stream of an ongoing enterprise. The valuation of such equity interests is most easily, and in many cases, most efficiently, discovered in a centralized marketplace. In addition, the relative uniformity of equity securities facilitates their being traded in a centralized marketplace.

On the other hand, fixed income securities are more readily susceptible to independent valuation or valuation based on other fixed income securities. Fixed income securities are priced based on various objective factors, including the creditworthiness of the issuer, prevailing interest rates, the duration of the security and other pricing components. As a result, the prices of fixed income securities bear a fundamental pricing relationship to other fixed income securities with similar credit ratings and maturities. Because these factors are more readily quantifiable than the claims on the assets and future income streams that equity securities represent, fixed income securities are more readily valued on their own and in relationship to other fixed income securities than are equity securities. Therefore, though supply and demand for specific debt instruments play a role in the pricing of fixed income securities generally, the centralized auction model is unnecessary to ensure efficient pricing.

In addition, trading via centralized auctions is most efficient with securities that are limited in complexity and diversity. With debt securities, the vast number of issuers and products across the credit and maturity spectrum, paired with the greater diversity of the products themselves, complicate the development of an efficient auction system for bonds. Experience has suggested that a negotiated style of trading, facilitated by experienced intermediaries, is better suited to the trading of the more diverse, complicated fixed income products.

Regardless of the historical reasons which have led to the development of two distinct market structures for debt and equity, and the technological advancements which may or may not facilitate different approaches to trading, the Association strongly believes that competitive market forces, including investor demands and needs, should dictate market structure. Accordingly, to allay the bond market's concerns about the proposed rules, we believe the Commission should clarify that it recognizes the basic differences between the equity and debt markets, and because of those relevant differences, it has no intention of *mandating* a centralized auction market structure for fixed income markets or integrating fixed income markets into the NMS.<sup>13</sup> Rather, the Association requests that the Commission reiterate that its intent with regard to the debt markets is to provide a regulatory framework for new trading systems to develop unfettered by prior regulatory assumptions.

***D. Alternative trading systems should continue to be regulated as broker-dealers, unless they satisfy the existing Delta interpretation of what constitutes an "exchange," including providing market participants with a reasonable expectation of liquidity***

The Commission proposes to expand the definition of an exchange to include a variety of additional systems, like ATSS, which fall outside the present definition of exchange, as promulgated in the Delta Release.<sup>14</sup> The Association notes that the Commission accomplished the broadening of the meaning by removing the liquidity requirement, which is "generally understood"<sup>15</sup> to be a fundamental characteristic of an exchange. The Association is concerned that eliminating this requirement from the definition leads to an inaccurate description of an exchange, and, perhaps, conflicts with the statutory definition. Therefore, the Association advocates the reintroduction of a liquidity requirement and suggests continued reliance on the Delta definition.

The Association agrees with the Commission's longstanding interpretation that the performance of a liquidity function is a key characteristic of an exchange. The Commission established liquidity as an important indicator of an exchange when it promulgated the Delta definition of an exchange. Approved by the federal appellate courts and followed by the Commission for years, providing the industry with a clear understanding of its meaning, the Delta definition states that, to be an exchange, the marketplace must take steps, either by design or by rules, to establish the assurance of liquidity. In particular, the definition describes an exchange as

includ[ing] only those organizations that are "designed, whether through trading rules, operational procedures or business incentives, to centralize trading and provide buy and sell quotations on a regular or continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations."<sup>16</sup>

Because of the emphasis on liquidity, i.e., "a reasonable expectation that they can regularly execute their orders," in addition to the structural requirements, the Association believes the Delta definition accurately describes the fundamental characteristics of an exchange. Therefore, the Association believes the Delta definition continues to be appropriate, and it also believes that those ATSS which fail to meet that definition should continue to be characterized and regulated as broker-dealers.

In contrast to the Delta definition, the Association interprets the Commission's proposed definition of an exchange as a restatement of the Delta definition shorn of Delta's liquidity standard. The Commission proposes to redefine the basic characteristics of an exchange to be

[a]n organization, association, or group of persons [that] [c]onsolidates orders of multiple parties; and sets non-discretionary material conditions (whether by providing a trading facility or by setting rules) under which the parties entering such orders agree to the terms of the trade.<sup>17</sup>

The Delta requirement that an exchange be "designed, whether through trading rules, operational procedures or business incentives, to centralize trading and provide buy and sell quotations on a regular and continuous basis" may be viewed as substantially similar to the proposed requirement that an exchange "consolidate orders of multiple parties."

Furthermore, the Delta requirement that "purchasers and sellers . . . can . . . execute their orders at those price quotations" seems to parallel the proposed requirement that an exchange must "set non-discretionary material conditions . . . under which the parties entering such orders agree to the terms of the trade." What is missing from the proposed requirement, in contrast to the Delta definition, is the additional requirement that purchases and sellers "have a reasonable expectation that they can regularly" execute such orders. In effect, the Commission apparently has retained the structural characteristics of the Delta definition while deleting the liquidity requirement. Thus, entities, which in the Commission's view, have the structural characteristics of an exchange will be regulated as such, or subject to Regulation ATS, even though they do not provide the liquidity normally associated with an exchange.

Despite the elimination of the "liquidity" condition in the definition of an exchange, the Commission, nevertheless, in effect, reintroduces the concept of liquidity in Regulation ATS. There, the Commission utilizes trading volume as a proxy for determining whether an entity provides liquidity for a certain market. It is the Association's understanding that only when the volume of an ATS reaches a level meaningful for price discovery does the Commission impose the substantive requirements generally associated with exchange markets -- order display, fair access and capacity, for example. The Commission's approach of (1) redefining exchanges without a liquidity requirement to include a substantially greater number of entities within the definition; (2) exempting those entities which comply with Regulation ATS from complying with exchange regulation and then (3) reimposing a liquidity requirement to capture the truly significant ATS -- which appear to be the main focus of the Commission's regulatory efforts -- unnecessarily complicates the regulatory regime.

The Association encourages the Commission to simplify its approach. The Association believes it would be preferable to continue the Delta tradition of including liquidity as a required characteristic of an exchange market. Revising the Commission's approach along these lines, the Association recommends the Commission limit the definition of an exchange to those entities which (1) consolidate orders of multiple parties, (2) set non-discretionary order execution procedures and (3) provide a reasonable expectation of liquidity. In turn, a "reasonable expectation of liquidity" could be presumed whenever an entity accounted for some percent of the relevant market as measured by trading volume.<sup>18</sup> If the Commission were to adopt such a definition, whatever recordkeeping requirements the Commission otherwise considered appropriate for an entity which met the first two prongs could be shifted to Rules 17a-3 and 17a-4 as the Commission already has proposed.

Defining an exchange in this manner has a variety of advantages over the Commission's proposed approach. It would accomplish the Commission's regulatory objectives while limiting the unintended and unnecessary complications of an overly expansive exchange definition.

One benefit of basing new regulatory endeavors on the Delta definition is the maintenance of regulatory continuity. The Delta definition has been explained and



discussed often since it was adopted, creating a general industry understanding of its interpretation and application.<sup>19</sup> By using this definition as a starting point, the Commission will avoid unnecessary interpretive questions for developing systems, while still meeting its regulatory objectives. On the other hand, redefining an exchange and removing the traditional liquidity standard will produce a wide range of interpretive questions for no apparent regulatory purpose. The cost and disruption caused by new and unclear regulations can not be underestimated.<sup>20</sup>

Additionally, making explicit the liquidity standard in the actual definition of an exchange, and thereby focusing the definition on the true targets of the regulation, simplifies the regulatory approach, without losing any of its intended effect. The Commission's regulatory framework introduces unnecessary complexity by proposing an overly expansive definition, which captures a broad variety of entities, which it then exempts from the more significant, traditional exchange-oriented regulation. Where there were two steps, now there would be one. In doing so, it also decreases the amount of regulatory interpretation necessary.

Avoiding the classification of a broad category of systems as "exchanges" when such classification serves no apparent purpose is another positive aspect of the approach advocated by the Association. For example, under Regulation ATS, the Commission proposes to apply essentially the same recordkeeping requirements on the lower volume ATSs as the current requirements set forth in Rule 17a-23. Therefore, it appears the Commission is not enhancing its regulatory oversight of the lower volume ATSs by reclassifying them as exchanges.

Finally, reintroducing the liquidity standard would also prevent certain collateral consequences of broadly defining an exchange, consequences which would still apply even if the entities in question were exempted from the more significant regulation of 20% ATSs. This issue is discussed at length in Section III(A)(1).

### **III. Specific Comments and Suggestions Regarding the ATS Proposal**

If the Commission decides to go forward with its proposal despite the Association's reservations, the Association has the following specific suggestions with regard to the proposed rules:

#### ***A. Proposed Rule 3b-12 is too vague and overly broad and will inadvertently capture trading systems involving debt securities that should not be considered exchanges***

##### ***1. Characterizing trading systems as exchanges has implications beyond the application of Regulation ATS and warrants greater sensitivity to the differences between an exclusion from Rule 3b-12 and an exemption from Rule 3b-12 through compliance with Regulation ATS***

The Commission emphasizes the minimal impact of recategorizing ATSs as exchanges because the Commission exempts ATSs from complying with the full panoply of

exchange regulation if they comply with Regulation ATS. Although the Association agrees that Regulation ATS is less intrusive than current exchange regulatory requirements, the Association maintains that the recategorization has significant negative collateral effects (both real and perceived) that have not been adequately considered.

The framework presented in the ATS Proposal may exempt ATSs from complying with exchange regulation. These entities, however, still fall within the definition of an "exchange." Therefore, any other regulation or regulatory body which bases its own oversight on the Commission's treatment of an entity as an exchange would be affected by the ATS's change in status.<sup>21</sup> By expanding the definition of an exchange, the Commission may have unwittingly subjected all ATSs, even those which choose to comply with Regulation ATS, to increased regulation under other regulatory regimes applicable to exchanges. For example, foreign regulators treat U.S. exchanges in a manner different from U.S. broker-dealers. Although the ATSs still may be treated as broker-dealers by the Commission, foreign countries may view them by their new designation, thereby exposing them to excessive or inappropriate regulatory attention.<sup>22</sup>

In addition, the potential consequences of including a broad array of ATSs in the definition of exchange is not limited to the effects on auxiliary regulators. Designating an entity an "exchange" may influence how investors view that entity, given the long history and general public perception of the term.<sup>23</sup> Given the fact that investor protection is a primary purpose of the Exchange Act, the effect of such a significant definitional change on the investors should not be ignored.

Accordingly, the Association suggests that the Commission utilize a more focused definition of an exchange, consistent with the Association's proposal as described in Section II(D). Or, if the Commission declines to adopt a definition based on the Delta Release, the Association recommends that the Commission exclude those ATSs choosing to comply with Regulation ATS from the definition of an exchange, rather than merely exempting them from the definition. Excluding these Regulation ATS-compliant systems from the definition might help to avoid many of the collateral consequences discussed above.

## ***2. The Association strongly supports the exclusion for internal systems as necessary and appropriate***

As the Association recommended in its comment letter regarding the Concept Release,<sup>24</sup> the Commission explicitly excludes internal broker-dealer systems from the proposed definition of an exchange. The Association strongly supports this exclusion and commends the Commission for explicitly recognizing the functional differences between an exchange and an internal system.<sup>25</sup> The Association, however, requests that the Commission clarify the exclusion to ensure the Commission reaches its regulatory objectives and to provide bond market participants with a clearer understanding of their regulatory duties.<sup>26</sup>

Proposed Rule 3b-12 would exempt internal order routing systems that cross customer orders provided that (1) those orders are not displayed to any person other than the broker-dealer and its employees and (2) those orders are not executed according to a predetermined procedure that is communicated to customers. The Commission's introduction of the new phrases "predetermined procedure" and "communicated to customers" raise questions as to which systems are excluded. In particular, the Association suggests that the Commission clarify that "predetermined procedures" refers to a system's internal rules regarding such trading aspects as priority, parity and precedence, rather than rules complying with best execution obligations or SRO requirements. Although it appears that the Commission intends that result, nevertheless, the Commission's clarification of its intent, consistent with the Association's understanding, would facilitate a more common interpretive approach.

Similarly, the exclusion's requirement that procedures not be communicated to customers may work to include broker-dealers that disclose to their customers their internal procedures for crossing customer orders, when appropriate. Because customers are entitled to know how their order will be handled, categorizing an internal system as an exchange merely because a trader describes the internal procedures to a customer is an inappropriate result. The Association believes that the Commission should revise the rule clearly to exempt such systems as internal order routing systems from exchange regulation.

### ***3. The proposed definition of an exchange needs to be clarified so as to exclude trading systems that broadcast non-executable indicative quotations***

Whether the Commission considers an entity to be an exchange under the proposed definition hinges substantially upon what it considers to be an order. The Commission defines an "order . . . to include any firm indication of a willingness to buy or sell a security, whether made on a principal or agency basis."<sup>27</sup> The Commission explains that "[f]irm indications of buying or selling interest would specifically include bid or offer quotations, market orders, limit orders, and any other priced orders."<sup>28</sup> The Association is concerned that the exchange and order definitions, working together, are too broadly drawn. For example, even markets which quote prices telephonically for a potential transaction -- where the quoted price may or may not be the price at which a transaction is eventually executed -- may be covered by the two definitions.

In a variety of markets, including those involving interdealer brokers ("IDB"), it is the industry practice to communicate an indicative price to a customer, a price which becomes a mere starting point for a negotiation of the final transaction price.<sup>29</sup> The Association believes that such a communication of a negotiable price should not be considered an order for these purposes, because the price is not firm. In addition, the Association cautions the Commission against considering a transaction price to be firm merely because of its display on a screen. The Association believes that the Commission intended to exclude those systems which disseminate merely negotiable prices from the definition of an exchange based on its statement that AutEx does not "consolidate orders of multiple parties" because "AutEx does not require that the price and quantity quoted

on the screen be firm."<sup>30</sup> Because this intention may not be entirely apparent, the Association suggests that the Commission clarify that it did not intend to include non-executable indicative quotations in the definition of an order, and that any systems communicating such indicative quotations would not be considered exchanges.

***4. Trading systems that account for a de minimis amount of volume should be exempted from Regulation ATS because such systems do not represent the utility-like venues for order centralization that is the cornerstone characteristic of an exchange***

It is the Association's understanding that the Commission's tiered approach under Regulation ATS is predicated on the concept of imposing more significant regulation on the more significant market players. A natural corollary to this reasoning is that small, start-up systems, which have a negligible impact on the market, should be subject to minimal regulatory requirements or none at all. Although the smaller ATSs may only be required to comply with various recordkeeping requirements, and not the more intensive order display, access and other requirements imposed on the more substantial systems, the Association is concerned that even those requirements may serve as significant barriers to market entry and innovation. Therefore, the Association favors a *de minimis* exemption from Regulation ATS for those systems in their infancy. Specifically, if an ATS which is otherwise regulated as a broker-dealer or is excepted from registering as broker-dealer, like a bank, is small enough that its trading volume does not exceed 15% of the relevant market, the ATS should be exempted from Regulation ATS and, therefore, not required to comply with the significant recordkeeping requirements the Commission has imposed on all ATSs, small and large alike. The relevant market could be defined as we recommend in Section III(B)(5) of this letter. Such an exemption also makes sense because the additional recordkeeping requirements applicable to ATSs would not provide the Commission with much in the way of new information that it does not receive already under the traditional broker-dealer recordkeeping requirements. Such a *de minimis* exception to Regulation ATS would serve to protect and foster new market entrants, as the Commission has appropriately and effectively done through other regulatory efforts.<sup>31</sup>

***5. The Association encourages the Commission to consider the effect of the proposed rules on banks that operate ATSs***

In promulgating the final rules, the Association encourages the Commission to consider the effects of the proposed rules on banks that operate ATSs. For example, the Commission intends to exempt government securities ATSs from the definition of an exchange if the ATS is registered as a broker-dealer.<sup>32</sup> Yet, the securities laws specifically provide that banks need not register as broker-dealers, even if they perform broker-dealer functions, because banks are subject to regulation by agencies other than the Commission. However, if a bank wishes to operate an ATS, it would appear to have to obtain an exemption from the exchange regulation to register as a broker-dealer, despite its exclusion from broker-dealer regulation in general. Therefore, the Association recommends that the Commission consider revising the proposed rule to ensure equal treatment of banks and broker-dealers operating the same type of ATSs.

***B. The Association appreciates and supports the Commission's explicit recognition of the need for a different approach to regulating alternative trading systems involving debt securities***

***1. The Commission properly concluded that ATSs trading government securities should not be required to register as an exchange or comply with Regulation ATS***

The Association agrees with the Commission's decision not to "change the regulation of alternative trading systems to the extent that they exclusively trade government securities."<sup>33</sup> As the ATS Proposal states, because the government securities market is subject to its own specialized oversight structure, the Commission would not require government securities ATSs "to register as either an exchange or to comply with the requirements of Regulation ATS."<sup>34</sup> The Association applauds the Commission's reasoning and its result.

Although the body of the ATS Proposal clearly states that government securities ATSs are not covered by the definition of an exchange or Regulation ATS, the Association is concerned that the wording of Rule 3b-12 and Regulation ATS needs to be clarified to reflect the Commission's stated intent.<sup>35</sup> Therefore, the Association recommends some technical changes to the proposed rules.

The proposed rules clearly state that government securities ATSs are not required to comply with Regulation ATS. In particular, Proposed Rule 301(a)(4) states that an ATS need not comply with the requirements of Regulation ATS if the ATS is registered as a broker-dealer and trades only government securities, Brady Bonds, and repurchase and reverse repurchase agreements involving government securities or Brady Bonds.

In contrast to the clear treatment of government securities ATSs in Regulation ATS, the proposed rule which would permit these ATSs to avoid exchange regulation is more complicated and requires clarification. The rule states that an organization, association or group of persons shall be exempt from the definition of the term "exchange" if it "is an alternative trading system and *is in compliance with Regulation ATS*." Therefore, to be exempt from the exchange definition, the government securities ATS must be "in compliance with Regulation ATS." Because the rule specifically states that government securities ATSs are not required to comply with the requirements of Regulation ATS, the Association believes that these ATSs should always be deemed "in compliance with Regulation ATS," and, hence, exempt from the definition of an exchange. It appears that the Commission agrees with this interpretation because it states in the narrative of the release that it would not require government securities ATSs to register as an exchange.<sup>36</sup>

To avoid any confusion over the status of government securities ATSs under the proposed regulation, the Association suggests that the Commission explicitly exclude government securities ATSs from the definition of exchange. In fact, the Commission could merely move Rule 301(a)(4) to a new paragraph (4) of Rule 3b-12(b).<sup>37</sup> By moving that section to the section describing exclusions from the definition of exchange, the Commission clarifies its intent and it also simplifies the regulations by replacing two-

steps with one.<sup>38</sup> Nonetheless, this approach still allows the Commission to reach its objective of allowing government securities ATSs to continue being regulated as broker-dealers without requiring them to register as an exchange or comply with Regulation ATS.

***2. The Commission's reasons for exempting ATSs which trade government securities from the definition of an exchange apply equally well to ATSs which trade municipal securities***

In the Concept Release, the Commission appropriately recognized the similarities between government securities and municipal securities. The Commission stated that "[b]oth the government and municipal securities markets are overseen through special regulatory schemes that are tailored to the particular features of those debt markets."<sup>39</sup> Government securities broker-dealers are overseen jointly by the U.S. Department of the Treasury, the Commission and federal banking regulators, under the Exchange Act, particularly the provisions of the Government Securities Act of 1986 and the federal banking laws. Similarly, municipal securities broker-dealers and transactions in municipal securities are overseen by the Commission, the Municipal Securities Rulemaking Board ("MSRB"), the National Association of Securities Dealers, Inc. ("NASD") and the federal banking authorities under the Exchange Act (particularly section 15B) and the federal banking laws. "As a result of these specialized oversight structures, regulation of particular market participants in the government and municipal securities markets as broker-dealers, rather than exchanges, is not likely to weaken the coordination of overall market oversight or create competitive inequities among differently regulated entities that perform similar functions."<sup>40</sup>

Despite the persuasive argument presented by the Commission in the Concept Release regarding the similarity between the government and municipal securities markets and their regulatory framework, the Commission included an exemption for government, but not municipal, securities in the ATS Proposal. The Association believes that limiting the exemption to government securities misses the obvious parallels between the two markets, and, therefore, recommends that the Commission reconsider an explicit exclusion from the definition of exchange for municipal securities.<sup>1</sup>

***3. Likewise, the Association encourages the Commission to evaluate all other classes of debt securities with the same sensitivity it applied to government securities in determining the extent of any additional regulation***

Municipal and government securities are not the only debt securities with special characteristics warranting exclusion from the proposed regulation. In fact, the Association asserts that all debt securities, by their very nature, have unique characteristics requiring specialized regulatory treatment. As discussed in more detail in Section II(C), the fundamental differences between debt and equity securities and their markets demand a conceptually different regulatory approach.

Forcing an ATS that trades debt securities to fit within the equity model threatens to upset a market that is known for its efficiency and liquidity. Altering the markets in such a profound way should only occur in the presence of identified market abuses and the Commission has not pointed to any such abuses. In addition, given that the debt markets are overwhelmingly institutional markets, the need for Commission intervention in the market is less compelling than in the equity markets.

Treating the two types of markets differently is in keeping with the Commission's understanding of trading in debt and equity securities. In crafting the proposed rules, the Commission appropriately recognized the debt/equity distinction in a variety of ways, such as exempting government securities from the definition of exchange and raising the threshold for debt securities to 20% versus the 10% threshold for equities. Although the Association acknowledges and appreciates these provisions, the Association, nevertheless, believes these limited efforts to accommodate the market differences will prove to be inadequate. The Association encourages the Commission to reconsider the reasoning it employed in the ATS Release in deciding to treat debt and equity trading systems differently and follow it to its logical conclusion: excluding ATSs trading all debt securities from the definition of an exchange.<sup>42</sup>

Accordingly, the Association repeats the recommendation made in its letter commenting on the Concept Release that the Commission reconsider how it decided to draw the line between equities and debt securities, given the inherent differences in the securities and their markets, and advocates explicitly excluding all ATSs trading debt securities from the definition of an exchange.<sup>43</sup>

***4. The Association strongly supports the exclusive application of the order display and execution access rules to "covered securities" (the "10% Rule")<sup>44</sup>***

The same reasoning which supports excluding all ATSs trading debt securities from the proposed definition of an exchange and the corresponding regulatory requirements argues in favor of the exclusive application of the order display and execution access rules to exchange-listed securities, Nasdaq NM securities and Nasdaq SmallCap securities. In essence, the unique nature of debt instruments and their specialized trading markets do not easily fit the NMS mold. Therefore, applying order display and execution access rules to those markets would be disruptive and counter-productive. Therefore, the Association strongly supports the continued application of these requirements exclusively to "covered securities" in the final rulemaking.<sup>45</sup>

***5. The volume percentage--at which the fair access and capacity requirements (the "20% Rule") are applied--should be raised to 35% for debt securities in recognition of the fungible nature of debt securities***

The Association applauds the Commission's acknowledgment of the fundamental differences between the debt and equity markets in its decision to restrict additional regulation to ATSs trading debt securities at the 20% level. The Association is concerned, however, that the proposed 20% volume threshold for imposing fair access, capacity and

integrity requirements on systems trading debt securities would inadvertently capture market players with no significant impact on price discovery.

The Commission states that the 20% volume threshold would capture a truly significant debt market player, making capacity, fair access and other requirements a necessary investor safeguard against monopoly-like control. For example, with regard to fair access, the Commission states that "[f]air treatment . . . is particularly important when an [ATS] captures a large percentage of trading volume in a security, because viable alternatives to trading on such a system are limited."<sup>46</sup> Similarly, the Commission asserts that the capacity and integrity requirements would protect the secondary market from the potential failure of a significant system and the ensuing market turmoil. However, given the decentralized and fungible nature of the debt markets, the Association believes that an ATS trading debt securities would need to have a larger market share than 20% to materially affect the markets in the manner in which the Commission is concerned. Therefore, the Association recommends that the Commission raise the percentage from 20 to 35.<sup>47</sup>

***6. The Association, with some minor exceptions, does not oppose the Commission's categorization of the debt markets and suggests that the Commission consider determining volume information by reference to the volume captured by the relevant clearing corporation***

The Commission proposes to impose fair access and capacity requirements on ATSs which trade debt securities if an ATS accounts for more than a certain percentage of the trading volume in any of the designated categories of debt securities. The Association is concerned about the effect of applying different regulatory requirements to different aspects of the debt markets. In particular, the Association believes that "bifurcation among 'sectors' within the fixed income market and among security types within any particular sector is highly problematic."<sup>48</sup> As the Association argued in its comment letter on the Concept Release,

[t]he Association strongly believes that the strength of our fixed income securities markets as a whole is a function of the liquid and fungible relationship between the various sectors of those markets. These relationships reflect the efficiency of U.S. fixed income markets, which facilitates the dissemination of information across all sectors of the markets. The Association believes that establishing different market structure regulations for the various sectors of fixed income markets will lead to the introduction of inefficiencies that will increase the cost of capital for most, if not all, bond market participants.<sup>49</sup>

Therefore, the Association is concerned that the Commission's imposition of its category-based volume test on the debt markets may have a negative effect on the liquidity of the fixed income markets.

Nevertheless, if the Commission decides to go forward with its volume test for the debt markets, despite the Association's concerns about the potential negative effects, the



Association would make the following recommendations regarding the appropriate categorization of debt securities as well as the source for an accurate accounting of total volume traded for each of those categories. In applying the 20% volume threshold to categories of debt securities, the Commission preliminarily has suggested dividing all non-government securities fixed income products into the following categories: mortgage and asset-backed securities (private label issues only), municipal securities, corporate debt securities, foreign corporate debt securities and sovereign debt securities. The Association believes that the proposed categories reflect a reasonable indication of how market participants view and trade debt securities. In addition, the relevant ATSS should be capable of categorizing their debt securities into the above mentioned groups without substantial difficulty.

Another important issue which the Commission needs to address in conjunction with the proposed categorization of debt securities is choosing the most reliable source for total trading volume in the respective categories of debt securities. The Association believes that the only objective source of fixed income trading volume is the relevant clearing corporation data.<sup>50</sup> The Association has considered other sources, but none of those possibilities appears to be as reliable.

Nevertheless, the Commission should be aware of the current limitations with respect to using clearing corporation data to determine market volume in the proposed debt categories. Perhaps most significantly, the clearing corporation data only captures a portion of all trades in a specific debt category. Specifically, the clearing corporation data includes only those trades engaged in by clearing corporation participants, which include mostly wholesale market participants. Therefore, after careful scrutiny of what information is captured by the clearing corporations,<sup>51</sup> the 35% volume level advocated by the Association may need to be raised to reflect the fact that clearing corporation data does not accurately capture the full trading volume in the marketplace.<sup>52</sup>

Additionally, not all clearing corporations separate their data into categories consistent with those proposed by the Commission. Moreover, the ability to collect and report data in accordance with the Commission's debt product classifications may not be feasible, at least at present, for all clearing corporations in all five proposed debt security categories. Another potential issue for consideration by the Commission, should it decide to use clearing corporation data, is how such data would be delivered to the Commission. Despite the limitations of the clearing corporation data,<sup>53</sup> the Association believes that this data is the only objective source currently available for calculating the relevant transaction volume for the proposed debt categories.

***C. The Association does not object to the repeal of Rule 17a-23 and the corresponding books and records amendments to Rule 17a-3 and 17a-4***

The Association recognizes the Commission's effort to reduce duplicative reporting and recordkeeping requirements through the repeal of Rule 17a-23 and the related amendments of Rule 17a-3 and 17a-4. Currently, Rule 17a-23 requires "broker-dealer trading systems" to produce and preserve certain records, and to make periodic reports to

the Commission. Under the proposed regulatory regime, certain ATSs, which currently are required to comply with Rule 17a-23, would be subject to a separate regimen of reporting and recordkeeping requirements, thereby making the 17a-23 requirements duplicative. In addition internal broker-dealer systems would not be subject to recordkeeping requirements proposed for ATSs, and, therefore, the Commission has required those systems to comply with the amended Rules 17a-3 and 17a-4, which are similar in scope and effect to the existing Rule 17a-23 requirements. For these reasons, the Association believes that the repeal of Rule 17a-23 and the amendment of Rules 17a-3 and 17a-4 will not have a significant adverse impact on the affected systems and, therefore, the Association does not object to the change.

***D. The Association supports the Commission's objective to prescribe the ability of exchanges to apply participant criteria in a discriminatory manner, but cautions the Commission not to create an affirmative duty to deal or change the commercial contractual relationship between a trading system and its participants***

The Commission proposes to institute fair access requirements for those ATSs with a market share significant enough that viable alternatives to trading are limited. The Commission seeks to prevent the larger ATSs from unfairly discriminating against market participants by denying them access to one of the few systems responsible for a category of securities. The Association understands that the Commission does not intend to dictate the ATS's customer base, thereby creating an affirmative duty to deal with participants not of its choosing. On the contrary, the Association understands that the Commission appropriately intends to allow an ATS to continue to limit access to the class of participants with whom it currently interacts as determined by its contractual relationship. As long as the ATS has an established criteria for allowing access, *i.e.*, creditworthiness, size of assets under management, institutional investor vs. broker-dealer, etc., and applies the criteria in a non-discriminatory fashion, the Commission will not object to such standards. Given that the Commission does not intend to create an affirmative duty to deal or to alter the contractual relationship between private parties, the Association supports the Commission's intent to prevent anti-competitive behavior via the fair access requirement for exchanges, but not in Regulation ATS.

The Association recommends that the Commission clarify in the rule that ATSs would still be allowed to set standards describing the customers with whom it wishes to transact, provided its standards are applied in a non-discriminatory manner. In addition, the Association suggests that the relief available pursuant to the proposed appellate review of access denials be limited to adjudicating whether or not the entity should or should not be allowed access based on the ATS's standards. The available relief should not be so broad as to allow the Commission to alter the ATS's standards.

***E. The Association supports the Commission's objective of assuring system integrity for exchanges that serve a utility-like function where the incapacity of such systems can have a market destabilizing effect***

As with the fair access requirements, the Commission proposes to require ATSs meeting the 20% threshold (or 35% as recommended by the Association) to comply with various capacity, integrity and security requirements. The Commission argues that such a requirement is necessary "[b]ecause some alternative trading systems now account for a significant share of trading in the U.S. securities markets [and] failures of their automated systems have as much of a potential to disrupt the securities markets as failures of SRO's automated systems."<sup>54</sup> Like the fair access requirement, the Association agrees with the possible need for the integrity standards, but only with regard to those entities which perform a utility-like function, like the traditional exchange. Applying these standards to smaller ATSs, which do not play a role in price discovery, is unnecessary and counterproductive.

#### **IV. Conclusion**

In conclusion, the Association urges the Commission to reconsider the rules proposed in the ATS Release. Although the Association agrees with the Commission's objective of creating a regulatory environment flexible enough to accommodate traditional markets as well as new and innovative ones, the Association believes that the Commission need not achieve its stated goals by fundamentally changing the basic regulatory structure of the securities markets. On the contrary, the Association believes that the flexibility of the existing regulatory regime is more than adequate to accommodate the change brought about by technological innovation.

Again, we thank the Commission for providing this opportunity to express our views on the proposed ATS rules. If you would like to discuss the Association's recommendations presented herein, please feel free to call any of the undersigned or Paul Saltzman, Senior Vice President and General Counsel of The Bond Market Association or Scott C. Rankin, Assistant General Counsel of The Bond Market Association, at 212.440.9400, with any questions or comments.

Very truly yours,

CHRISTOPHER J. CARROLL  
Co-Chair, ATS Task Force  
The Bond Market Association

W. HAL HINKLE  
Co-Chair, ATS Task Force  
The Bond Market Association

cc: The Honorable Arthur Levitt, *Chairman*  
*Securities and Exchange Commission*  
The Honorable Norman S. Johnson, *Commissioner*  
*Securities and Exchange Commission*  
The Honorable Isaac Hunt, Jr., *Commissioner*  
*Securities and Exchange Commission*

The Honorable Laura Unger, *Commissioner*  
*Securities and Exchange Commission*  
The Honorable Paul Carey, *Commissioner*  
*Securities and Exchange Commission*  
Richard R. Lindsey, *Director, Division of Market Regulation*  
*Securities and Exchange Commission*  
Robert L.D. Colby, *Deputy Director, Division of Market Regulation*  
*Securities and Exchange Commission*  
Belinda Blaine, *Counsel to Chairman*  
*Securities and Exchange Commission*  
Elizabeth K. King, *Senior Special Counsel, Division of Market Regulation*  
*Securities and Exchange Commission*  
Edward A. Kwalwasser, *Group Executive Vice President*  
*New York Stock Exchange, Inc.*  
Frank Zarb, *Chairman & CEO*  
*NASD Regulation, Inc.*  
T. Grant Callery, *Senior Vice President and General Counsel*  
*NASD Regulation, Inc.*  
Mary L. Schapiro, *President*  
*NASD Regulation, Inc.*  
Elisse B. Walter, *Executive Vice President, Law and Regulatory Policy*  
*NASD Regulation, Inc.*  
Alden S. Adkins, *General Counsel*  
*NASD Regulation, Inc.*  
Christopher A. Taylor, *Executive Director*  
*Municipal Securities Rulemaking Board*  
Diane G. Klinke, *General Counsel*  
*Municipal Securities Rulemaking Board*  
Gary Gensler, *Assistant Secretary for Financial Markets*  
*U.S. Department of Treasury*  
Roger Anderson, *Deputy Assistant Secretary for Federal Finance*  
*U.S. Department of Treasury*  
Norman Carleton, *Director, Office of Federal Finance Policy Analysis*  
*U.S. Department of Treasury*  
Lori Santamorenna, *Government Securities Specialist, Bureau of Public Debt*  
*U.S. Department of Treasury*  
Members of the Board of Directors  
Members of the ATS Task Force  
Selected Staff  
*N.Y. and D.C. Association Professional Staff*

---

## FOOTNOTES

- **1** The Bond Market Association represents approximately 200 securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. More information about the Association can be obtained from our web-site at [www.bondmarkets.com](http://www.bondmarkets.com). This letter was prepared by Association staff with the assistance of special outside counsel, and has been circulated and reviewed by numerous committees. The Association's comments have been coordinated by our ATS Task Force, comprised of legal and business representatives of approximately 40 member firms, representing all sectors of the bond market community.
- **2** See Securities Exchange Act Release No. 39884 (Apr. 17, 1998), 63 Fed. Reg. 23504 (Apr. 29, 1998) ("ATS Proposal").
- **3** The terms "debt" and "fixed income" securities, as used by the Association in this letter, refer to all non-covered securities, i.e., all securities other than exchange-listed securities, Nasdaq NM securities and Nasdaq SmallCap securities.
- **4** Securities Exchange Act Release No. 38672 (May 23, 1997), 62 Fed. Reg. 30485 (June 4, 1997) ("Concept Release").
- **5** Letter from The Bond Market Association, to Jonathan G. Katz, re Concept Release (Oct. 3, 1997) at 4 ("Association Letter").
- **6** ATS Proposal, 63 Fed. Reg. 23507.
- **7** See, e.g., ATS Proposal, 63 Fed. Reg. 23525 ("[t]he Commission therefore proposes to allow non-membership, for-profit alternative trading systems that choose to register as exchanges some flexibility in satisfying the 'fair representation' requirement in the Exchange Act").
- **8** See, e.g., National Securities Market Improvement Act of 1996, H. R. No. 104-622, at 2 (1996), reprinted in 1996 U.S.C.C.A.N. 3877, 3891 (section including exemptive authority under Exchange Act is entitled "Capital Markets Deregulation and Liberalization").
- **9** Association Letter (Oct. 3, 1997) at 11-13.
- **10** ATS Proposal, 63 Fed. Reg. 23505.
- **11** Association Letter (Oct. 3, 1997) at 5-9.
- **12** See, e.g., Exchange Act Rules: Regulation M, Rule 15c2-11 and Rule 15c3-1 and Securities Act Rules: Rule 144A and Rule 415. See also generally Association Letter (Oct. 3, 1997).
- **13** See generally Association Letter (Oct. 3, 1997) at 13 (NMS goals articulated in the 1975 Amendments that guide the regulation of ATSs are largely inapplicable to the OTC fixed income securities markets).
- **14** Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 Fed. Reg. 1890 (Jan. 19, 1990) ("Delta Release").
- **15** Securities Exchange Act of 1934, § 3(a)(1) ("The term exchange means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.")

- **16** Delta Release, 55 Fed. Reg. 1900.
- **17** Proposed Rule 3b-12 (ATS Proposal, 63 Fed. Reg. 23507).
- **18** See *infra* Section III(B)(5) for a discussion of the appropriate volume percentage levels for describing a significant market player in the debt markets.
- **19** Since the promulgation of the Delta interpretation of "exchange," the Delta definition has been the subject of regulatory interpretation and industry discussion. See, e.g., ProTrade, Inc., SEC No-Action Letter (Feb. 23, 1998); Niphix Investments Inc./ISX Broker-Dealer Trading System, SEC No-Action Letter (Apr. 18, 1997); The Institutional Real Estate Clearinghouse System, SEC No-Action Letter (May 28, 1996).
- **20** The Commission previously has experienced definitional dilemmas regarding innovative electronic systems. For example, the definition of "proprietary trading systems" may have played a role in the undoing of the second proposal to implement Rule 15c2-10. Similarly, the reach of the "broker-dealer trading system" under Rule 17a-23 was greater than many market participants anticipated.
- **21** For example, even though the revised definition of an exchange under the Exchange Act is not dispositive on the point, it will certainly be cited by proponents of a narrow interpretation of the Treasury Amendment to the Commodities Exchange Act, who would seek to broadly define the term "board of trade" beyond its intended meaning as a traditional organized exchange.
- **22** Many foreign securities regimes apply vastly different procedures and rules to brokers/dealers than they do to exchanges. See, e.g., 2 International Securities Regulation, Booklet 1 (of France) at 21-22, 102 (Robert C. Rosen ed., 1998) (describing differing French regulations for stock exchanges than for broker/dealers); *Id.* Booklet 1 (of Germany) at 4-22 (describing differing requirements for broker/dealers and stock exchanges in Germany); 5 International Securities Regulation, Booklet 1 (of the United Kingdom) at 1-13 (discussing the different role of the Financial Services Authority in regulating, *inter alia*, stock exchanges and the role of exchanges in regulating brokers/dealers in the United Kingdom); 3 International Securities Regulation, Booklet 1 (of Japan) at 7-11 (describing the different laws applicable to stock exchanges and securities companies in Japan).
- **23** ATS Proposal, 63 Fed. Reg. 23524 ("systems that elect to register as exchanges may gain added prestige and investor confidence").
- **24** Association Letter (Oct. 3, 1997) at 9.
- **25** The Association notes that some members question whether interdealer brokers ("IDBs"), themselves, should not be viewed as the functional equivalent of internal broker-dealer systems, and, therefore, excluded from the definition of an exchange. In that regard, the Association suggests that the Commission expressly recognize the possibility that some IDBs may be able to rely on the exclusion for internal broker-dealer systems if appropriate analogies can be supplied.
- **26** The Association believes that the exclusion for broker-dealer systems should apply with equal weight to correspondent clearing relationships as well as agreements among and between broker-dealers to handle their respective order flow, even if the broker-dealers develop routing systems to direct such order flow.

In the Association's view, such traditional correspondent relationships should not be viewed as the consolidation of orders of multiple parties, and, hence, should be excluded from the proposed exchange definition.

- **27** Proposed Rule 3b-12(c) (ATS Proposal, 63 Fed. Reg. 23508).
- **28** Id.
- **29** The practice of negotiation is even more pronounced in telephone-based, non-screen-based IDBs as opposed to screen-based IDBs. The bids and offers associated with telephone-based IDBs are generally "subject," i.e., the broker must check back with the dealer client before finalizing the transaction. Even in screen-based IDBs, the market practice is for bids and offers to go "subject" in certain circumstances and upon the occurrence of certain market events (e.g., Federal Reserve Board announcements concerning interest rates).
- **30** ATS Proposal, 63 Fed. Reg. 23508, fn 24.
- **31** For example, the proposed pilot program was crafted to protect innovation. ATS Proposal, 63 Fed. Reg. 23531-23534. Similarly, the Commission exempted an exchange (AZX, formerly known as Wunsch Auction Systems) from registration requirements based on expected limited transaction volume. See Securities Exchange Act Release No. 28899 (Feb. 20, 1991), 56 Fed. Reg. 8377 (Feb. 28, 1991).
- **32** For a more detailed discussion of the treatment of government securities ATSs and the issues presented by the relevant proposed rules, see *infra* Section III(B)(1).
- **33** ATS Proposal, 63 Fed. Reg. 23506, fn 6. The Association strongly urges the Commission to clarify the application of proposed Regulation ATS where trading systems, otherwise satisfying the definition of an exchange, trade government securities as well as other non-government securities.
- **34** ATS Proposal, 63 Fed. Reg. 23512, fn. 69.
- **35** Like the Association's recommendations in Section III(A)(1) regarding exemptions and exclusions, the Association suggests that the Commission clarify that it intends to exclude, rather than exempt, government securities ATSs from the proposed regulation. See ATS Proposal, 63 Fed. Reg. 23512-13 (referring to the government securities ATSs exception as both an exclusion and an exemption).
- **36** Id.
- **37** The relevant portion of Rule 3b-12 would read:
  - (b) An organization, association, or group of persons shall not be considered to constitute, maintain, or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange," solely because such organization, association, or group of persons:
    - (4) is an alternative trading system registered as a broker-dealer under Sections 15(b), or 15C of the Act, (14 U.S.C. 78o(b), and 78o-5), and trades only the following types of securities:
      - (i) Government securities, as defined in Section 3(a)(42) of the Act, (15 U.S.C. 78c(a)(42));
      - (ii) Debt securities that:

(A) Are issued pursuant to the Brady Plan debt-restructuring program; and  
(B) Have all of their principal payments guaranteed by the issuance of government securities; and  
(iii) Repurchase and reverse repurchase agreements solely involving securities included within paragraphs (i) and (ii).

In the alternative, the Commission could move (4)(i)-(iii) above to a new paragraph (3) of Rule 3a1-1(a), the rule describing exemptions from the definition of an exchange.

- **38**This technical clarification also supports the inference that an ATS involving government securities is not a board of trade under the Commodities Exchange Act. See footnote 21.
- **39**Concept Release, 62 Fed. Reg. 30510, fn 148.
- **40**Concept Release, 62 Fed. Reg. 30510.
- **41**We encourage the addition to Rule 3b-12 of an exclusion for ATSs trading municipal securities, not unlike the government securities ATS exclusion described in footnote 37. Or, in the alternative, we suggest an exemption for ATSs trading municipal securities be included in Rule 3a1-1(a).
- **42**In addition, the Association similarly advocates explicitly excluding trading systems that trade only repurchase and reverse repurchase agreements involving debt securities from the definition of an exchange.
- **43**Association Letter (Oct. 3, 1997) at 5-9.
- **44**The Association notes that its statements in this section do not represent an adoption of a position as to whether or not the 10% threshold is an appropriate percentage threshold for covered securities.
- **45**The Association understands and interprets the rule proposals as not requiring the order display of repos and reverse repos in covered securities by ATSs meeting the volume requirements. This result is consistent with previous advice received from the Commission staff and represents good policy because, although repos and reverse repos are structured as purchases and sales for commercial law purposes, the purchase and sale constitute part of a single transaction which is economically equivalent to a secured borrowing. Reporting equity repo transactions involving covered securities would be irrelevant, if not misleading, to the price discovery process, as the "purchase" and "repurchase" prices of such transactions really reflect the financing rate, not the prevailing market price, of the underlying covered security.
- **46**ATS Proposal, 63 Fed. Reg. 23519.
- **47** Although the Association understands that ATSs trading government securities are exempted from the proposed regulation, the Association advocates a 35% standard, in part, because such a percentage is utilized elsewhere in the overall regulatory framework affecting fixed income securities. Specifically, the Treasury auction rules prevent any one primary dealer or any other bidder from being awarded more than 35% of the public offering amount of any one auction. 31 C.F.R. § 356.22(b). The Treasury determined that 35% appropriately reflects a significant portion of the debt markets. Therefore, the Association believes that, not only would the 35% serve the interest of regulatory continuity, but more importantly, it would more accurately describe the more significant debt systems.



- **48** Association Letter (Oct. 3, 1997) at 7.
- **49** Id.
- **50** The market for municipal securities currently is subject to transaction reporting requirements. See MSRB Rule G-14. Therefore, if municipal securities are not exempted or excluded from Regulation ATS and/or the definition of an exchange, the data submitted to the MSRB pursuant to the transaction reporting requirements could be an alternative to using clearing corporation data for the municipal securities category. Therefore, the Association notes that clearing corporation volume data may be unnecessary for municipal securities. The Association, however, cautions the Commission that the MSRB data may face limitations, as is the case with the clearing corporation data. For example, using the MSRB data may present delivery and other logistical and data reliability issues.
- **51** Additionally, independent of information gathered through Form ATS, the Commission could conduct a sampling of available data for the proposed debt security categories and then repropose some acceptable percentage threshold. Should the Commission decide to further study available data sources, the Association would appreciate the opportunity to form a task force of representative industry firms to assist the Commission in collecting and analyzing such data.
- **52** Another option the Commission may want to consider in choosing a source for total volume is to delay the implementation of the proposed rules for 18 months, except for the recordkeeping aspects. If the Commission were to implement a revised definition of an exchange as advocated by the Association, then the Commission could collect trading data via the revised recordkeeping requirements of Rule 17a-3 and 17a-4 during the 18 months to assist the Commission in determining the volume of the relevant transactions.
- **53** There are similar limitations with respect to using clearing corporation data to determine market volume in repurchase and reverse repurchase agreements involving debt securities other than government securities and Brady Bonds. Some clearing corporations do not process repos separately from cash trades, while others have separate systems to allow processing of repos along with other financing transactions, such as pledges to support bank loans.
- **54** ATS Proposal, 63 Fed. Reg. 23520.