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October 3, 1997

Mr. Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
Mail Stop 6-6
450 5th Street, N.W.
Washington, D.C. 20549

Re: File No. S7-16-97: Regulation of Exchanges

Dear Mr. Katz:

The Bond Market Association (the "Association")¹ appreciates the opportunity to comment on the conceptual framework underlying the United States Securities and Exchange Commission's ("SEC" or "Commission") regulation of organized securities markets.² We commend the Commission and the SEC staff for opening an important dialogue on the effect of technology on the securities markets and support its acknowledgment that the domestic regulatory environment should not impede innovation.³

The SEC staff obviously put a great deal of time and effort into the preparation of a well drafted release. The Association applauds that effort, and welcomes the productive nature of the dialogue that the Concept Release has generated among market participants. We particularly appreciate the opportunity to comment at this early stage and anticipate a continuing interest if, and when, the Commission concludes that proposed rulemaking is necessary.

I. EXECUTIVE SUMMARY

The Association seriously questions the regulatory direction suggested in the Concept Release which we read as a desire to regulate alternative trading systems⁴ as exchanges and to integrate such systems into National Market System mechanisms. As discussed more fully in the Concept Release, the Commission would achieve that goal by adopting a more expansive interpretation of the definition of an exchange.

The principal source of our concern is the application of traditional centralized equity market concepts to the over-the-counter ("OTC") fixed income markets with no apparent consideration of the fundamental differences between these types of markets.⁵ Furthermore, we are concerned that the creation of any new regulatory framework for alternative trading systems involving fixed income securities (considered to be exchanges under the proposed expanded definition) *seriously risks unsettling a highly liquid and efficient market that is, by all measures, extremely competitive and more than adequately regulated at the present time.*

As more fully described below, we believe that the fundamental differences between fixed income and equity markets reflect the characteristics of these securities and the role of intermediaries in these markets. Fixed income securities are contractual obligations which represent claims for identifiable sums of money, whether capital or interest, that often vary greatly in their contractual terms, and are susceptible to quantitative evaluation and independent price discovery. Secondary trading in the fixed income markets also tends to consist of customized, privately negotiated transactions between two counterparties, rather than standardized contracts that are effected through common, centralized facilities that monopolize order flow or that are critical to the price discovery process. The decentralized, competitive, "over-the-counter" structure of the fixed income markets is reinforced by the degree to which taxable fixed income securities generally trade relative to the yield curve for U.S. Treasury securities, rendering any bifurcation among sectors within the fixed income market and among security types economically artificial. These basic differences support a conceptually different approach towards the regulation of the secondary fixed income markets.

The Commission suggests in the Concept Release that the current regulatory approach involving alternative trading systems impedes effective regulation. Although the SEC fails to identify specific abuses, it focuses on issues like market fragmentation, unfair access restrictions, systems capacity and perceived conflicts of interest involving SRO oversight. These concerns may be valid in the context of the equities markets, but their validity and character are significantly different in the bond markets. Indeed, we argue there is no evidence to suggest that fixed income markets have "regulatory gaps," "misallocations of capital" or "widespread inefficiency," all of which were cited in the Concept Release as reasons to reconsider the regulatory framework.⁶

The Concept Release focuses on what appears to be a straight forward choice: Are new and evolving automated market facilities more like "dealers" or more like "exchanges"? Although the SEC should not be faulted for raising this question, we believe that the Commission itself falls victim to the very problem it purports to address -- that is the forced "categorization" of trading systems into statutory classifications. Even within the limits of current law, however, we believe there is enough room to treat these phenomena in ways that cater better to what they are-and, most important, to what functions they are performing--as distinct from forcing them all (merely because they are automated) into one or another definition that is becoming increasingly out-dated.

The Association appreciates that technological advance creates challenges that can unsettle affected parties, including regulators. It is for this reason that we compliment the Commission for assessing whether the regulatory framework should also change. Nevertheless, we do not believe that the "automation" of essentially broker-dealer functions by itself necessarily mandates a different approach or justifies *additional* regulation. OTC broker-dealer markets involving fixed income securities provide a necessary alternative to exchange traded markets and should continue to be appropriately regulated at the individual dealer level.⁷ The Association strongly believes that new regulation requires a demonstrated need for governmental intervention and a clear sense

of purpose. In the case of the fixed income securities markets, the Commission has cited neither.

The Association is concerned that if the Commission establishes a new conceptual framework that expands the scope of "exchanges" to include some existing alternative trading systems, the effort inevitably will result in uncertainty about the status of many existing trading operations as exchanges⁸. The Association believes that the Commission should not expend its resources creating a conceptual framework that will require many organizations to undertake an expensive and time consuming process of obtaining regulatory exemptions, simply to enable the Commission to regulate a handful of systems which the Commission believes require more or different regulatory oversight.

Accordingly, 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.

In summary, the Association:

- * *Strongly opposes* the creation of any new regulatory framework for any sector of the OTC fixed income securities market absent a clear showing of regulatory need;
- * *Supports* retaining the current regulatory framework as applied to trading systems involving fixed income securities and opposes applying "exchange" regulation to entities that intermediate or facilitate participant trading in fixed income securities transactions;
- * *Strongly encourages* the SEC to accommodate the material differences between the fixed income and equity markets when reconsidering the regulatory framework applicable to "alternative" trading systems in those markets;
- * *Strongly opposes* the Commission's focus and reliance on "national market system" goals as guiding the regulation of fixed income securities trading systems;
- * *Strongly supports* the explicit recognition that principal trading systems sponsored by or internal to a dealer that buys and sells for its own account are fully outside any definition of an "exchange";
- * *Strongly opposes* the suggested characterization as "exchanges" of those fixed income securities market participants that provide agency or riskless principal intermediation, based on an assessment of the extent to which they automate the order routing and order interaction process;
- * *Supports* the concept of a tiered regulatory approach suggested by the Commission for trading systems satisfying the existing criteria of an "exchange" with scaled regulatory obligations that reflect a number of factors, including role, volume, membership, governance, and business objectives particular to the market involved;

- * *Suggests* that any tiered regulatory approach expressly exclude trading systems involving fixed income securities or, at least, explicitly recognize the unique circumstances and characteristics of any "fixed income exchange";
- * *Strongly asserts* that no alternative trading system serving fixed income securities market participants today should be required to register as an "exchange" or, at most, be anything other than an exempt exchange; and
- * *Commends* the Commission for its inquiry regarding international cross-border access issues related to exchange regulation.

II. DISCUSSION

A. The Concept Release fails to acknowledge the unique characteristics of OTC fixed income securities, the different role particular intermediaries play in those markets as compared to their counterparts in equity markets, and the significance of their characteristics and structural differences.

Fixed income and equity securities markets are different because of fundamental differences in the products themselves - not because of historical accident. Of the many distinctions between fixed income and equity securities, the following general observations need to be considered and, in our view, support a conceptually different approach towards the regulation of secondary markets:

1. Fixed income securities markets lack the centralizing, auction market intermediation features of equity markets, and unlike the OTC equity markets that have evolved under the rubric of the NASD and its Nasdaq subsidiary, lack the centralized information and execution networks Nasdaq provides to its member users in that market. Nor is a centralized auction market, modeled after leading national securities exchanges, more suitable than the existing decentralized dealer market given the characteristics of fixed income securities.

An inherent premise underlying the Concept Release regarding the role of exchanges is that exchanges play a critical role in the "price discovery" and valuation process. As the SEC is well aware, centralization of "orders" for fixed income securities through exchange facilities is not the paradigm of fixed income securities markets. The Association believes there are good reasons -- founded in the characteristics inherent to fixed income securities -- that market forces have broadly kept these markets highly competitive while being decentralized.

Each equity security represents an interest in a unique bundle of assets and liabilities in an ongoing enterprise, that often cannot be readily quantified or valued other than by supply and demand forces. Because of the unique characteristics of equity securities, the market value of an equity security is best determined by examining prices independently set in securities markets, through a price discovery process that reflects unfettered interaction of supply and demand. While centralization of transactions improves the price

discovery process for equity securities, it also concentrates activity, thereby increasing the risk of manipulation or abuse of the price discovery process, for which various separate forms of regulatory oversight have been established.

As discussed below, fixed income securities are more readily susceptible to independent valuation, bear a fundamental pricing relationship to other fixed income securities with similar credit ratings and maturities, and thus are generally arbitrated or hedged with other fixed income securities.⁹ These characteristics traditionally have discouraged the development of centralized markets in the United States and likely will continue to do so because centralization does not add value. The absence of centralization thereby minimizes the risk of those abuses that exchange regulation is intended to address.

2. Fixed income pricing methodologies, although ultimately subject to the market forces of supply and demand, are substantially more quantitative and susceptible to independent price discovery than equity securities.

The pricing of fixed income securities reflects a limited set of factors that create a tendency for fixed income securities in a particular market sector, or across all market sectors, to maintain fundamental relationships to one another or some objective benchmark, regardless of transparency. These factors include the creditworthiness of the issuer, prevailing interest rates, the duration of the security, and other distinguishing characteristics. Because these factors are more readily subject to quantification than the claims on assets and future income streams that equity securities represent, fixed income securities are more readily susceptible of valuation on their own and in relationship to other fixed income securities than are equity securities.

3. Given the vast number of issuers and products across the credit and maturity spectrum that exist in the fixed income markets, and the degree to which all taxable fixed income securities trade relative to the yield curve for U.S. Treasury securities, bifurcation among "sectors" within the fixed income market and among security types within any particular sector is highly problematic.

The 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.¹⁰ 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. Accordingly, the Commission should be careful not to expand the scope of exchange regulation and to regulate only where necessary to correct imperfections in the marketplace or in those circumstances where specific abuses have been identified, neither of which have been presented with respect to fixed income securities markets.

For example, the Concept Release identifies the need to assure fair access to exchanges as a basis for, and tenet of, federal regulation of "exchanges." The ability to develop a

monopoly franchise in specific fixed income instruments or to exploit such a franchise in an anti-competitive manner is likely to be unsuccessful because of the decentralized nature of fixed income securities markets. This single characteristic has been hailed as giving investors unparalleled choices and unparalleled checks and balances. In other words, the market place will ensure a diverse and competitive OTC fixed income market-government regulation that essentially dictates market structure is unnecessary and unsound public policy.¹¹

4. Fixed income markets are predominantly institutional, rendering the need for Commission intervention less compelling.

Fixed income securities markets are predominantly institutional,¹² which can be expected given the efficiencies associated with large trades as discussed below. Retail investors tend to access the fixed income securities markets through intermediaries, such as investment companies and dealers who sell odd-lots. As discussed in greater detail below, the Association believes that the existing regulatory scheme is more than adequate to safeguard the interests of retail investors, and the Concept Release does not cite any evidence to the contrary. In addition, the Association is convinced that recharacterizing fixed income securities trading systems as exchanges will not advance the Commission's retail investor protection goals in any significant way. Moreover, it is unclear that recharacterizing fixed income securities trading systems as exchanges would benefit institutional investors either, given the flexibility they already possess because of a decentralized OTC market. Accordingly, the Association believes that the need for changing the definition of an exchange in the context of fixed income securities markets is not compelling.

5. The variations in size and settlement conventions and counterparty exposure in the fixed income markets reinforce the negotiated, decentralized character of those markets.

The diversity and complexity of the fixed income markets reflect the negotiated nature of trading in those secondary markets and the importance of intermediaries in those markets. In addition to encompassing more than one million issuers, a standardized trading unit typically ranges between \$100,000 and \$1 million, whereas the standardized trading unit in the equity markets is 100 shares ¹³ (in dollar terms, the minimum trading unit in equity securities is approximately 0.40% to 4.0% of the average minimum trading unit in fixed income securities).¹⁴ Typical settlements range from same day to once each month, depending on the needs of the parties and the characteristics of the security itself.

B. Trading Systems sponsored by, or internal to, entities that are principally engaged in the business of buying and selling securities for their own account are performing traditional dealer functions and should not be viewed as "exchanges".

The Association believes that it is appropriate for the Commission to consider the activity of entities who are principally engaged in the business of buying and selling securities for their own account as performing traditional dealer functions. The Association agrees with the Commission's view as expressed in the Concept Release that a sophisticated market

maker that develops a system to broadcast its own quotations to the public, or who allows its customers to direct orders for execution solely against the market maker's inventory, is conducting broker-dealer and not exchange activity. As such, the Commission draws the correct conclusion when stating that "single market maker systems merely provide a more efficient means of communicating the trading interest of separate customers to one dealer and thus would not be considered exchange activities."

C. The current regulatory framework as applied to trading systems involving fixed income securities is effective and provides the Commission with ample authority to ensure fair and orderly markets, to prevent fraud and manipulation, and to promote market coordination and competition for the benefit of all fixed income investors.

The Association believes that the Commission possesses ample statutory authority to oversee the secondary market for fixed income securities and ensure market participants' compliance with the Exchange Act through the continued regulation of trading systems in fixed income securities as broker-dealers. In each of three primary areas of traditional concern to the Commission, Congress, and investors, the Commission has more than adequate authority to address potential abuses.

Manipulation, Fraud. Because financial intermediaries that comprise the market for debt securities in the United States are generally registered as brokers, dealers, or specialized types of brokers or dealers under the Exchange Act, the Commission has ample authority to proscribe manipulative acts and practices or to direct that a self-regulatory organization with jurisdiction over them regulate their conduct.

Sales Practice Regulation. Various self-regulatory organizations already possess considerable authority to regulate dealer sales practices. The NASD recently completed a rulemaking initiative with respect to fixed income securities, with a particular focus on government securities; the MSRB has longstanding rules in respect to municipal securities, which have been supplemented by the SEC's Rule 15c2-12; and the NASD's and NYSE's suitability and know-your-customer rules have long set a standard for dealers in the corporate bond market.

Surveillance and Audit Trails. Working with the Commission, Congress, and the securities industry, the Association has helped to implement an audit trail for trading in the U.S. Treasury and, with the MSRB, in the municipal securities markets. As the Commission knows from these efforts, and from the effort to establish an extensive audit trail in equity markets, implementing a useful audit trail is both expensive and time-consuming. The Association believes that the recordkeeping requirements set forth in the Commission's rules under Section 17(a) of the Exchange Act should be more than adequate to meet the Commission's regulatory goals under the federal securities laws.

Currently, brokers or dealers who automate their order handling process must determine whether they fall within the rubric of Rule 17a-23.15 As described in greater detail in the Concept Release, that Rule was adopted in 1994 as a mechanism for the Commission to monitor trading systems that provided alternatives to existing centralized markets. Rule

17a-23 requires brokers sponsoring a trading system to provide certain information at least 20 calendar days prior to operating a broker-dealer trading system and additional information on a periodic basis thereafter concerning access to the system and trades effected on the system.

On the whole, the Association believes that Rule 17a-23 represents a substantial regulatory burden on fixed income market innovators and that the Rule should not become a platform for additional, substantive requirements. In addition, the Association would encourage the Commission not to use Rule 17a-23 as a basis for regulating access to sponsored systems. Only when a system achieves the status of, or is tantamount to a monopolistic utility, should access decisions be subject to regulatory scrutiny. Similarly, the Commission should be particularly mindful of the private property interests in market data resulting from the operation of broker-dealer trading systems and should not use Rule 17a-23, or any other regulatory vehicle for appropriation of property rights in that market data.

The Association is not convinced that additional regulation in connection with alternative trading systems, is necessary or appropriate under the terms of the Exchange Act. If the Commission determines that additional regulation of broker-dealer trading systems is necessary and appropriate in the public interest, beyond the reporting requirements currently imposed on broker-dealer trading systems under Rule 17a-23, then the Association would urge that the Commission engage in specific rulemaking that is narrowly tailored to address the specific harms intended to be eliminated.

D. The National Market System Goals Articulated in the Securities Act Amendments of 1975 that Guide the Regulation of Alternative Trading Systems are Largely Inapplicable to the OTC Fixed Income Securities Markets.

The Concept Release suggests that the Commission believes that Section 11A of the Exchange Act sets the parameters for regulation of all exchanges. Indeed, the National Market System framework and goals, as set forth in Section 11A, were born out of the unique circumstances of the market structure for corporate equity securities as it existed in the early 1970s. During the 1970s, fixed income securities markets were structurally different from the corporate equity markets. Despite considerable technological advances in both markets, fixed income securities markets remain structurally different today. As discussed below, the circumstances that engendered a Congressionally sponsored "National Market System" only vaguely contemplated fixed income securities markets when conceived in 1975, an observation the Association contends remains equally valid today.

Under the Securities Acts Amendments of 1975 (the "1975 Amendments"), Congress directed the Commission to facilitate the establishment of a national market system for transactions in securities. Congress authorized the Commission to designate those securities that are qualified for trading in the national market system, referred to as "qualified securities," but specifically excluded "exempt securities," such as U.S. Treasury securities, U.S. Agency securities, municipal securities, and certain corporate

securities, such as commercial paper with maturities of less than nine months. As a result, Section 11A can be interpreted to encompass the corporate fixed income markets (other than the markets for commercial paper). While technically within the Commission's authority, such action would be inappropriate in light of the legislative history surrounding the 1975 Amendments and the subsequent legislation enacted by Congress with regard to the regulation of the Government securities markets. As the legislative history reflects, Congress' intended focus in creating a National Market System was on the regulation of the equity markets and not the fixed income markets.¹⁶

In promulgating Section 11A of the Exchange Act, Congress cited two main objectives for the creation of a National Market System: (i) the maintenance of fair and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements and (ii) the centralization of all buying and selling interest so that each investor will have the opportunity for the best possible execution of his order, regardless of where in the system it originates.¹⁷ Furthermore, Congress believed that achieving a national market system was a necessary step in preserving the fundamental goals of the Exchange Act under changing economic and technological conditions.¹⁸

The Association will not repeat the lengthy history of developments in the government, municipal, and corporate fixed income securities markets since 1975, other than to note its strong belief that the Commission should not use "exchange" regulatory initiatives as the vehicle for mandating expanded price transparency in the fixed income securities markets. As the SEC acknowledged in its 1996 Annual Report, private sector initiatives are increasing price and market transparency for municipal securities and government mortgage securities,¹⁹ in addition to the initiatives already implemented in the U.S. Treasury market and by the MSRB in the municipal market. Because of the complexities of these initiatives and the different interests at stake, the Association remains firm in the views presented before the U.S. Senate in 1991: Transparency in the fixed income markets is an important objective which must continue to be achieved, but at the initiative of the private sector.

E. The characterization of inter-dealer brokers as exchanges under the proposed expanded definition, particularly in cases where such market facilities fully automate the order execution process, relies entirely too much on technology as an excuse to revisit the nature of how they are regulated and completely underestimates the integral role inter-dealer brokers play in providing liquidity to the fixed income markets.

The Association believes that automation of dealer and inter-dealer order handling procedures for fixed income securities should not, by itself, trigger exchange registration or regulation. The application of automation techniques, even if it results in automated trade execution without human intervention, should not as a general rule result in exchange registration requirements. Such a result could impede the natural progression of innovation within the securities industry, without regard to the particular characteristics of fixed income markets and the relative costs and benefits to dealers, intermediaries and market participants. A definition of "exchange" that is keyed to the extent of automation, in the final analysis, could result in a myriad of registered exchanges or "exempt

exchanges," each with limited volume and significance to the market. The Association cautions against establishing a framework of exchange regulation keyed off of the automation of "riskless principal" or "agency" order interaction, above and beyond the existing framework for broker-dealer sponsored trading systems, without careful assessment of the public costs and benefits within the context of specific fixed income markets, as opposed to equity and fixed income markets generally. In this regard, to the extent that the Commission seeks to foster innovation, it is important to remember that adding regulatory risks and burdens to the risks already borne by marketplace innovators will discourage innovation and propel order flow to less efficient venues or overseas markets.

As discussed in Securities Exchange Act Release No. 27611 (January 12, 1990), the Commission recognized that dealer markets have traditionally consisted of loosely organized groups of individual dealers that trade securities OTC, without formal consolidation of orders or trading. In the Concept Release, the Commission correctly observed that as applied to the fixed income market "the majority of trading in corporate, government, and municipal debt instruments has been conducted through such OTC dealers." The Association agrees with the Commission that such markets do not directly "bring together" public purchasers and sellers and that classifying such trading systems as "exchanges" is inappropriate. Rather, such loosely organized traditional dealer markets should remain regulated under the appropriate broker-dealer regulation.

The Association appreciates that the Commission might consider some day regulating dealer markets, that as a result of technological advance become organized so as to assume the characteristics of equity "exchange" markets, as the Commission identified in the Concept Release. However, the Association wishes to remind the Commission that the fixed income securities markets have not become organized in the same "exchange" like way as the equities markets. Despite the advent of technological enhancements, the fixed income securities markets continue to lack the centralizing, auction market intermediation features of the equity markets, and unlike the OTC equity markets that have evolved under the rubric of the NASD and its NASDAQ subsidiary, lack the centralized information and execution networks Nasdaq provides to its member users in that market. Therefore the Commission should continue to regulate broker-dealer activities in fixed income securities, despite automation and technological advancement, under the current regulatory scheme of broker-dealer regulation.

F. The Commission's existing interpretation of what constitutes an exchange as articulated in the "Delta Release" is a reasonable outline of functional criteria that describes alternative trading systems best suited to regulation as an "exchange."

The Commission established a definition of "exchange" in the context of reviewing the clearing agency registration application of the Delta Government Options Corp., which has withstood challenge in the federal appellate courts. That definition draws a distinction based on functions and expectations. In essence, to be an exchange, the marketplace must take steps, either by design or by its rules, to establish the assurance of liquidity through firm quotes and two-sided markets. Under this definition, as interpreted by the

Commission and its staff for more than six years, market facilities which function to enable participants to principally engage in the business of buying and selling securities for their own account do not fall within such a definition. Inherent in this definition is the concept that the automation of order-handling and the interaction of orders does not automatically create the presumption of an exchange, with its attendant regulatory and self-regulatory obligations.

The Association would encourage the Commission to leave the existing definition in place. Changing the definition may well open the door to further litigation on this issue, as it applies to existing markets, non-U.S. markets, or as it might apply to future innovators. If the Commission is convinced of the need to reinterpret the definition of an "exchange," both the redefined term, and the consequences of being characterized as an "exchange," should, in the case of the fixed income securities markets, be narrowly drawn to meet the unique characteristics of fixed income securities markets and investor expectations. The Association is preliminarily of the view that a regulated "exchange," at most, should be limited to those market facilities that by their nature and consequences, are critical to the price discovery process in a particular sector and that centralize or "monopolize" order flow, *and* rely exclusively on auction market automation for firm order handling and interaction in the price discovery process. Notwithstanding the foregoing definition, which we believe more accurately captures the functional attributes of a traditional exchange, the Association does not believe that any trading systems in fixed income securities are now/or in the future likely to be exchanges.

G. The Commission's tiered approach to the regulation of exchanges is a reasonable methodology that narrowly tailors the scope of regulation to categories of market facilities that arguably require differing levels of government intervention or oversight. Although "alternative trading systems" involving fixed income securities should not, by definition be considered exchanges, if future developments create an environment where such market facilities require regulation as exchanges, then the Association believes substantive rules, and not procedural roadblocks, would be more appropriate so as not to inhibit innovation.

The Association applauds the Commission's desire to structure a tiered regulatory approach for trading systems satisfying the criteria of an "exchange," described above, with scaled regulatory obligations that reflect a number of factors, including role, volume, membership, governance, and business objectives. However, the Association is not convinced that at present additional regulation, beyond the recordkeeping and reporting obligations imposed on alternative trading system sponsors under Rule 17a-23, are necessary or appropriate under the terms of the Exchange Act. If the Commission determines that additional regulation of broker-dealer trading systems is necessary and appropriate in the public interest, then the Association would urge that the Commission establish a special category of alternative trading systems that accounts for the unique, competitive and structural characteristics of fixed income markets. Toward achieving that end, the Association believes that any tiered regulatory approach should expressly exclude those trading systems involving fixed income securities or at least explicitly recognize the unique circumstances and characteristics of any "fixed income exchange."

The Association strongly believes that no alternative trading system serving fixed income securities market participants today should be required to register as an "exchange" or at most be anything other than an exempt exchange.

Although we do not conceive that any facilities of fixed income markets are "exchanges" today, we believe it important that the Commission retain the presumption that regulation is designed to address abuses, such as denials of access to market facilities that are natural or franchised monopolies (including industry utilities). Accordingly, should the Commission determine to proceed to propose additional regulatory structures in this area, the Commission might consider creating a category for any fixed income market facilities. In any event, regulations that restrict market facilities should, to the extent possible, prohibit conduct, such as fraud or manipulation, rather than establishing approval, licensing, or privately negotiated rulemaking processes that might inhibit innovation. In the event the Commission determines to propose regulations applicable to market facilities, the Association would welcome the opportunity to provide more specific views.

H. Questions relating to U.S. investor access to foreign markets, as a conceptual matter, raises issues similar to the domestic regulation of trading systems and should be reviewed in the context of reforms to Rule 15(a)(6).

The Association commends the Commission for its inquiry regarding international cross-border access issues related to exchange regulation. Purely as a conceptual matter, the Association preliminarily believes that the views expressed with respect to U.S. fixed income securities markets should apply to non-U.S. markets. Should the Commission determine to take further steps in this area, we would be happy to offer our views. Consistent with our view that alternative trading systems should continue to be regulated as they are today within the framework of broker-dealer regulation, we believe the Commission will at a minimum need to address the issue of broker-dealer registration for foreign market participants that wish to obtain access to U.S. investors through electronic or other means. We appreciate the speed with which the Division of Market Regulation has opened a dialogue with The Bond Market Association and the Securities Industry Association regarding potential reforms to Rule 15a-6 under the Exchange Act, which provides a safe harbor from U.S. broker-dealer registration requirements for foreign broker-dealers conducting certain types of securities transactions with certain classes of U.S. investors. The Association hopes that dialogue will be informed and constructive.

III. CONCLUSION

We would be happy to discuss our views at your convenience. Please contact me at 212/469-8873, Heather Ruth, President of the Association, at 212/440-9416, or Paul Saltzman, Senior Vice President and General Counsel, at 212/440-9459 with any questions or comments.

Sincerely,
/s/

Christopher J. Carroll
Chair, Concept Release 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
Richard R. Lindsey, Director, Division of Market Regulation
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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*

1 The Bond Market Association (formerly PSA The Bond Market Trade Association) represents approximately 220 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 website at 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 Concept Release Task Force, comprised of legal and business representatives of approximately 22 member firms, representing all sectors of the bond market community.

2 *See* SEC Release No. 34-38672 (May 28, 1997) (hereinafter, the "Concept Release").

3 *See* Discussion Paper of SEC Commissioner Steven Wallman released at the Fourth Annual Securities Industry Conference sponsored by the Pace University Center for the Study of Equity Markets (BNA Securities Law Reports Volume 29, No. 38 at 1330).

4 The Association, for purposes of this comment letter, will refer to "alternative trading systems" as those systems that conceptually could fall within the term as defined by the Commission in footnote 1 of the Concept Release even though we believe the phrase is somewhat ambiguous in the context of fixed income markets. Moreover, we note that the concept of "alternative" trading systems itself is misplaced in the context of fixed income securities trading systems which are principally over-the-counter and do not present an "alternative" to an established centralized market.

5 Indeed, the Association questions whether the Commission has laid the appropriate foundation for the application of its conceptual framework to the fixed income securities markets, given the focus of the Concept Release on equity markets in the introductory description of securities markets and market regulation, and the limited discussion of fixed income securities markets thereafter. The Association urges the Commission to provide a more complete record of its assumptions regarding the consequences of its regulatory proposals for fixed income securities markets and participants.

6 *See* Concept Release at p.26.

7 The Association strongly supports the SEC's view as stated in the Concept Release that preserves the exclusion from any exchange definition for "loosely organized traditional dealer markets" and that "broker-dealer regulation should continue to govern individual dealers in those markets". *See* Concept Release at p. 78. We question, however, why the degree of "organization" of fixed income dealer markets, which are inherently decentralized, should alter the view. *See* Concept Release at footnote 138.

8 Moreover, the Association is concerned about the absence of a discussion in the Concept Release regarding the potential civil and regulatory litigation exposure resulting from a "reinterpretation" of a well-established statutory term that has been relied upon by market participants. We hope that any proposed rule release addresses these issues.

9 Some fixed income securities are more hedgable -- and fungible -- than others. For example, due to the exemption of interest from federal income tax on most municipal securities, the relationship of prices in this market to the prices in markets for taxable

securities is more complex and sometimes unpredictable. Thus, hedging a position or portfolio of municipal securities with taxable fixed income securities is imperfect.

10 The U.S. fixed income securities market is by far the world's largest and most liquid securities market. The volume of securities outstanding at year-end 1996 totaled \$11.3 trillion, with estimated dealer-to-dealer daily trading volume of \$278.1 billion, and new issuance of \$8.2 trillion (new issuance statistics exclude new originations of money market instruments while secondary market statistics exclude trading in both asset-backed and money market instruments.)

The U.S. Treasury market represented the largest component of the U.S. fixed income markets at the end of 1996, with \$3.5 trillion in outstanding marketable public debt. Outstanding corporate debt accounted for an additional \$2.0 trillion of the total, followed by the agency mortgage-related market with \$1.7 trillion, money market instruments at \$1.5 trillion, and municipal debt of \$1.3 trillion. Federal agency and asset-backed debt accounted for an additional \$925.8 billion and \$400.0 billion of the total, respectively. (Sources: Federal Reserve System, U.S. Treasury Department, Association estimates.)

Secondary market activity in U.S. fixed income securities was dominated by Treasury securities in 1996, with trading between primary dealers and their customers averaging \$203.7 billion on a daily basis for the year. Primary dealer activity in agency mortgage-related securities averaged \$38.1 billion on a daily basis in 1996, while federal agency volume averaged \$31.1 billion on a daily basis for the year. Dealer-to-dealer trading in OTC corporate securities averaged \$2.8 billion on a daily basis in 1996, while dealer-to-dealer secondary market trading in municipal securities averaged \$2.4 billion on a daily basis for the year. (Sources: Federal Reserve Bank of New York, Municipal Securities Rulemaking Board, National Securities Clearing Corporation.) No statistics for secondary market activity in money market instruments or asset-backed securities were available.

Primary market activity in U.S. fixed income securities was dominated by new debt issuance by federal agency issuers in 1996, with \$4.5 trillion of issuance. It should be noted, however, that most of the total represented short-term securities offerings that were offered on a continual basis by the agencies. New issuance in the Treasury market totaled \$2.5 trillion in 1996, with non-convertible debt issuance by corporations accounting for an additional \$427.1 billion in volume. New issuance in the mortgage-related securities market totaled \$370.5 billion for the full year 1996, with the municipal and asset-backed market accounting for an additional \$226.8 billion and \$150.1 billion in issuance, respectively. (Sources: U. S. Treasury Department, Federal Agencies, Securities Data Company.) No statistics for new originations of money market instruments were available for 1996.

11 See Remarks by Federal Reserve Board Chairman Alan Greenspan at the Financial Markets Conference of the Federal Reserve Bank of Atlanta, Coral Gables, Florida (February 21, 1997) available at <http://www.bog.Frb.Fed.US>.

12 Although definitive statistics on ownership of U.S. fixed income securities are not available for each sector of the market, the Association estimates that institutional investors hold in excess of 90% of the outstanding supply of U.S. fixed income securities (excluding municipal securities). Individual investors typically do not invest directly in fixed income securities but instead invest through professionally managed mutual funds (including money market mutual funds) or through bank trust departments. Available data for several markets do indicate limited participation by individual investors. According to the U.S. Treasury Department, individual investors held \$169.6 billion of the total \$3.5 trillion in outstanding marketable public debt at year-end 1996, representing just 4.9% of the total. Statistics for mortgage-related investments reflect the institutional nature of that market as well. Inside Mortgage Finance Publications estimates that as of June 30, 1996 individual investors held 1.4% of all outstanding mortgage-related securities, representing \$25.8 billion in investments. Ownership statistics by individual investors are not available in other markets.

Investors in municipal securities, however, represent a dichotomy to the profile of the typical fixed income investor, a result of the exemption of interest on municipal bonds from federal income taxes. The tax-exempt feature provides a powerful stimulus to individual investors and, as a result, participation by individual investors in the municipal market is greater than in all other fixed income markets. At the end of 1996, direct holdings of municipal securities by individual investors totaled an estimated \$416.6 billion, representing 31.7% of total supply.

13 Although the Nasdaq Stock Market raised this to 1,000 shares in some issues, it is experimenting with a return to a 100 share minimum firm quote size.

14 The average price per share of a NYSE listed company was \$41.26. See 1997 NYSE Fact Book at 107.

15 Although brokers and dealers that are registered exclusively as government securities brokers and government securities dealers, respectively, are not subject to Rule 17a-23, other fixed income securities brokers and dealers fall within that Rule.

16 See Joint Explanatory Statement of the Committee of Conference, Report No. 94-229; 94th Congress, 1st Session S.249 (1975) (hereinafter "Conference Report"). As the Conference Report reflects, the studies and hearings on which the bills are based were concerned almost exclusively with common stocks. The Conference Report does reflect that it was the intention of both Houses, that all securities, other than exempted securities (which would include government and municipal securities), be made eligible for trading in the National Market System; however, the Conference Report admits that Congress had not determined whether a transactional reporting system is appropriate for fixed income securities.

17 See Senate Report No. 94-75; 94th Congress, 1st Session S. 249 (1975).

18 The basic goals of the Exchange Act remain salutary and unchallenged for all markets: To provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, to ensure that securities can be purchased and sold at economically efficient transaction costs and to provide, to the maximum degree practicable markets that are open and orderly. *See* Conference Report.

19 *See* 1996 SEC Annual Report: Regulation of the Securities Market - Government Securities Market.