Key Takeaways From SEC's Fixed Income Trading Proposal

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On Sept. 28, the U.S. Securities and Exchange Commission proposed rules to apply Regulation Alternative Trading Systems to systems supporting trading in government securities. Regulation ATS is a lighter-touch regulatory scheme than full regulation as a securities exchange for automated trading systems operated by broker-dealers.

The proposed rules would establish a regulatory structure for government securities alternative trading systems, or ATSs, similar to the regime established by the SEC in 2015 for ATSs that trade equities with public disclosures relating to the broker-dealer operator and the manner of operations.

The SEC simultaneously issued a concept release soliciting public comment on enhanced regulation of ATSs that facilitate trading in other types of fixed income securities, such as corporate bonds and municipal securities.

As market participants consider the SEC's concept release, there are several important distinctions between the manner in which equity securities and fixed income products trade that should inform the disclosure regime for fixed income ATSs. For example, the number of distinct bonds trading in the secondary market is an order of magnitude greater than for NMS stock.

A single large company may have just one equity trading symbol but over 1,000 CUSIP numbers for its various fixed income issuances.

The higher volume of fixed income securities makes sourcing liquidity for particular bonds more challenging and explains in part why more fixed income trading occurs through interdealer markets rather than on electronic platforms. Most equities also trade with intermarket price protection and firm quotes, requiring that broker-dealers execute trades at the best price across all venues.

There is no comparable pricing authority or guarantee that a bond trading on a particular venue is the best available price for that bond, or that an investor will be able to trade at a displayed quote. At the same time, fixed income trading on platforms is increasing so it should not be surprising that the enhanced regulation of fixed income market structure will follow.

In light of these distinctions, the discussion below highlights some of the key issues for consideration as the SEC contemplates new rules relating to fixed income trading venues.

Request for Quote Systems

Many interdealer markets for fixed income securities are connected through request-for-quote, or RFQ, systems, which are essentially communication systems through which a market participant can solicit quotes or bids from other market participants for a particular fixed income trade.

Typically, after selecting a quote from among those who respond to the RFQ, the two parties to the tentative trade subsequently execute the trade bilaterally, often away from the RFQ system.

However, there is often no clear distinction between what constitutes a RFQ system versus a system that should file as an ATS. The test for whether a system must file as an ATS is whether it meets the definition of an "exchange" as defined under Section 3(a)(1) of the Securities Exchange Act of 1934 and Rule 3b-16 thereunder.

Systems that bring together the orders of multiple buyers and sellers using established, nondiscretionary methods, such as by setting rules governing how such orders interact, generally meet the definition of an exchange and must file as an ATS.

Whether or not a particular RFQ system is a mere communication system or could be viewed as performing the functions of an exchange is a facts and circumstances analysis. This distinction will increasingly matter as regulatory scrutiny of fixed income trading increases and market participants consider whether they need to establish an ATS.

Fair Access Requirements and Regulation SCI

Another consideration regarding the regulation of fixed income ATSs will be the thresholds that trigger fair access and system integrity requirements. Under Regulation ATS, an ATS that accounts for a substantial volume of a particular equity security or a particular type of security is required to establish written standards that do not unreasonably prohibit or deny access.

The purpose of this requirement is to guarantee market participants access to trading venues that constitute a significant pool of liquidity for that security. Similarly, these higher-volume ATSs can become subject to requirements under Regulation Systems Compliance and Integrity.

Regulation SCI is designed to promote systems and operational integrity of the core technology used by higher-volume trading venues and to facilitate SEC oversight. Currently, fixed income ATSs are not subject to Regulation SCI, although the SEC has proposed to apply Regulation SCI to government securities ATSs.

Fixed income ATSs are, however, subject to the fair access requirements if the ATS accounts for 5% of the average daily volume for all corporate debt securities and/or municipal securities during four of the preceding six months.

If these thresholds are relaxed or revised to apply, for example, to 5% of the average daily volume of just a single given bond, small ATSs could find themselves subject to onerous additional regulatory obligations simply for having done a single trade on a thinly traded bond. This could raise barriers to entry for small firms and chill competition.

Different Types of Fixed Income Securities

There are numerous different types of fixed income securities including corporate bonds, municipal securities, mortgage-backed securities, and money markets. Many of these bonds trade differently from each other. For example, many corporate bonds, municipal securities, and mortgage-backed securities clear and settle through the Fixed Income Clearing Corporation.

In contrast, government securities, including those issued by the federal government and government-sponsored enterprises, clear and settle through the Federal Reserve Bank's Fedwire Securities Services. Municipal securities often trade in retail sizes with retail end-investors, while many other fixed income securities are dominated, and sometimes are limited to, qualified institutional buyers or other institutional traders. Some bonds are actively traded every day while others may not trade for months at a time.

As a result of these and other differences, a one-size-fits all approach may not be appropriate for an overhaul of the regulatory requirements for fixed income ATSs.

Additionally, certain fixed income markets may only be in the early stages of electronic trading. Increasing the regulatory burdens associated with operating an electronic trading venue for these fixed income products might deter those seeking to establish such systems, and have the perverse effect of decreasing liquidity in markets where liquidity already may be difficult to find.

Moreover, if the proposed rules for government securities ATSs are adopted, there will be three separate forms an ATS must file with the SEC depending on the types of securities for which it supports trading: (1) Form ATS-G for government securities; (2) Form ATS-N for NMS stock; and (3) Form ATS for all other securities (e.g., restricted securities and fixed income securities).

If the SEC were to propose a separate set of regulatory disclosures for fixed income ATSs (e.g., Form ATS-F), a system supporting trading in both fixed income securities and government securities may have to separately file pursuant to two separate forms for effectively the same system.

It's also possible given differences in how varying fixed income securities trade that there could be several different forms, such as Form ATS-MB for mortgage-backed securities and Form ATS-MU for municipal securities. This could double or triple disclosure requirements for ATSs that support trading in multiple different types of securities.

Both broker-dealers that operate fixed income systems that could be deemed ATSs, and investors that trade in fixed income securities, should consider the SEC's proposed regulatory changes for these markets. The comment deadline for the SEC's proposal and concept release is 60 days after publication in the Federal Register.

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