U.S. Securities and Exchange Commission
Fixed Income Market Structure Advisory Committee

Recommendation Regarding Defining "Electronic Trading" for Regulatory Purposes

October 5, 2020

The Technology and Electronic Trading Subcommittee ("Subcommittee") of the Fixed Income Market Structure Advisory Committee ("FIMSAC" or "Committee") was formed to consider the impact of the growth of electronic trading platforms and the increased use of other electronic systems on the liquidity, efficiency, and resiliency of the corporate and municipal bond markets. On July 16, 2018, the FIMSAC unanimously approved the Subcommittee's recommendation that the SEC review the framework for the oversight of electronic trading platforms for corporate and municipal bonds (the "E-Trading Oversight Recommendation"). The driver behind the E-Trading Oversight Recommendation was the Subcommittee's concern that the existing distinctions in regulatory oversight between electronic trading platforms regulated as broker-dealers, alternative trading systems (ATSs), or, in some cases, not at all, complicated efforts to improve the efficiency and resiliency of the fixed income electronic trading markets. The Committee further believes that a consistent definition of "electronic trading," and an industry standard for reporting "electronic trading volumes," are both necessary for the harmonization of applicable regulation in accordance with the E-Trading Oversight Recommendation, as well as to allow regulators, investors, dealers, analysts, and the public to better understand the liquidity, market share and transaction cost trends across the wide variety of electronic trading venues currently in existence.

I. Current Inconsistencies in the Reporting of Fixed Income Electronic Trading Volume

No consistent standard for publicly reporting electronic trading volumes exists across the over 20 trading platforms currently trading corporate and municipal bonds. Multiple inconsistent practices characterize the discretionary disclosure of volumes by the individual venues. In some cases, the trading and settlement protocols of the varying platforms also impact the volumes that they and dealers report to TRACE. As a result, volumes are reported inconsistently, which makes interpreting them difficult. Some factors that influence the reporting of "electronic trading" volumes to, and away from, TRACE include:

- ATS versus non-ATS: TRACE currently requires trade reports to identify whether the trade occurred on an ATS. Although most such trading is electronic, substantially more electronic trading also takes place on platforms not classified as ATSs, and some trading at ATSs differs from the regulatory definitions of ATS trading that the SEC first developed.

  As noted in the E-Trading Oversight Recommendation, the classification of platforms as ATSs is based on whether the platforms furnish services commonly performed by registered stock exchanges.[1] This definition of an ATS primarily reflects the trading practices of the equity markets, where the use of non-discretionary matching technology is the prevalent form of trading. Accordingly, the fixed income electronic trading platforms that are regulated as ATSs were those that had had live matching trading protocols that brought together the orders of multiple buyers and sellers. Since most of these platforms serve the retail segment of the market, most fixed income ATS volume historically has been associated with retail trading platforms that operate order books. The recent growth of institutional matching platforms now is mixing these two types of electronic volumes into the reported ATS volumes. Importantly, request-for-quote (RFQ) platforms, which execute the large majority of electronically-traded corporate bond volumes, generally are excluded from Regulation ATS based on the characteristics of the RFQ trading protocol.[2]

Although TRACE captures and publicly disseminates bond volumes traded on an ATS, the metric is not reliable as an indicator of total electronic trading volumes due to the above exclusions and limitations. TRACE reporting rules further complicate reliance on the ATS flag because they require each ATS to report all transactions executed "within the ATS" to TRACE.[3] The SEC has not historically precluded ATSs from including non-ATS functionality "within the ATS." Although the various Form ATS filings are not publicly available, the Committee believes that certain ATSs include electronic RFQ volumes and voice-brokered trades in their ATS volumes, even though such protocols would not qualify as an ATS in their own right.

- <u>Fully Electronic Trades versus Processed Trades</u>: Current reporting venue practices often do not distinguish between trades that are "fully electronic" trades versus those that are only "processed." Fully electronic trades are those for which all material interactions between the parties to the trade, including price discovery, occur through the functionality provided by the platform. Processed trades are trades for which counterparties bilaterally negotiate the price and other material terms away from the venue, but then submit the trade to a venue to obtain the benefits of straight-through processing. Currently, some venues report processed trades separately from fully electronic trades, while other venues commingle them.

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1 See 17 CFR § 242.300. An ATS is generally defined as any organization or system which constitutes, maintains or provides "a market place or facilities for bringing together purchases and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange."

2 The nature of the RFQ protocol allows for only the requestor to interact with bids or offers sent in response to a request. As such, this functionality (one-to-many) does not constitute bringing together orders for securities of multiple buyers and sellers (many-to-many) as required under §240.3b-16(a)(1). In addition, the RFQ requestor may have the ability to transact against any quote provided in response to his or her request for quote. This trading discretion puts the protocol outside the requirement that the platform use "established, non-discretionary methods under which such orders interact with each other" as required under §240.3b-16(a)(2).

3 See FINRA Rule 6720(c).

- Single-Dealer versus Multi-Dealer: Current reporting venue practices do not distinguish between electronic trades that result from only a single dealer inquiry as opposed to those trades that result from inquiries sent to multiple dealers or on an all-to-all basis. Volumes reported from single dealer protocols without notation may give a false impression that the trade resulted from a multi-dealer or all-to-all inquiry from which the best responsive price presumably was selected. Single dealer executions are also more likely than multi-dealer trades to be "processed trades" which were agreed bilaterally and then submitted through a venue.

- Inconsistencies with Double-Counting: The Committee believes having a uniform understanding of when transactions should be double-reported in volumes would be helpful. For example, for transactions for which the platform acts as the matched principal counterparty between two participants, the broker-dealer operating the platform will be party to two back-to-back trades in which the platform buys from the seller in one trade and then sells to the buyer in the second trade. Platforms typically include both legs of these transactions in their electronic trading volumes to match the reporting method prescribed by TRACE. However, for electronic trades in which the platform is not a party to the transaction (i.e., disclosed trades), the trades are typically single-counted.

  The method of settling an electronic trade also can give rise to discrepancies in the volumes reported by TRACE. As discussed above, if an ATS executes a trade and acts as the matched principal counterparty between two participants, there will be two transactions disseminated by TRACE. However, if the ATS qualifies for an exemption from the TRACE reporting rules under FINRA Rule 6732, only one transaction will be disseminated.[4] Further, if the ATS "gives up" the trade to another broker-dealer for clearing and settlement, the clearing broker will additionally report the trade(s) to TRACE. This process can result in a single transaction being disseminated three or four times on TRACE depending on how many FINRA member firms are party to the trade.

II. Why is a Common Standard of Reporting Electronic-Trading Volumes Important?

Market participants require reliable and consistent data on electronic trading volumes to best understand where they can find liquidity. The inconsistencies in current reporting practices described above ensure that the ATS volumes captured and disclosed by TRACE do not accurately reflect aggregate electronic trading volumes.[5] ATSs are also permitted to include trades executed via non-ATS protocols. And double (or even triple or quadruple) trade counting

4 FINRA Rule 6732 provides that FINRA staff may grant an exemption from trade reporting obligations to an ATS if, in summary, the trade is between FINRA members; the ATS does not pass the trade through any ATS account or take either side of the trade for clearing or settlement purposes; and the ATS has ensured that any FINRA member that is party to the trade has reported that the trade occurred on the ATS.

5 Aggregate ATS volumes were approximately 7% of high-grade TRACE volumes for July 2020, while Greenwich Associates estimates aggregate high-grade electronic volumes were 31% of TRACE volumes for the same period.

inflates TRACE volumes, which leads to incorrect inferences on market turnover, liquidity and the proportion of electronic trading. Inflated volume numbers can lead to inflated risk limits based on false measures of liquidity at the various venues and in the individual securities.

To determine where bonds are truly trading electronically, practitioners must undertake substantial work to arrive at even an approximation of electronic liquidity across multiple venues. Most market participants do not have the resources to undertake these efforts, and they therefore remain susceptible to misunderstanding the nature of the volumes that each platform discloses.

Inconsistent reporting methods limit the ability of regulators, market participants, investors, and researchers to look at aggregate trends in electronic trading volume and market share across fixed income markets. As a result, determining the effect of electronic trading on liquidity conditions and transaction costs over time is difficult. Investors in the e-trading venues, whether public or private companies, lack precise information on volume and market share trends for the various companies in the fixed income e-trading sector, making investing decisions more difficult. Further, without clear disclosure as to whether the various electronic trading volumes are limited to the retail, inter-dealer, or institutional customer markets, knowing whether electronic trading is bridging these disparate liquidity pools or whether they remain mostly separate is challenging.

Last, as discussed in the E-Trading Oversight Recommendation, the lack of a comprehensive definition of "electronic trading" complicates efforts to improve the efficiency and resiliency of the fixed income electronic trading markets. Without a unifying regulatory definition of "electronic trading," market structures will fragment further should regulators adopt new regulations that apply only to ATSs. Even if regulators broadened electronic trading regulation to all broker-dealers (which would still exclude at least one fixed income trading platform with significant volume in municipal and corporate bond trading that does not fall under any regulatory oversight in the U.S.), a clear definition of "electronic trading" would still be needed to ensure that regulators craft new regulations that capture only the intended electronic trading activities in which they are interested.

III. Recommendations:

Given the broad public interest in reporting standards for fixed income electronic trading, the market would benefit from one common regulatory framework for all fixed income electronic trading venues. The promulgation of industry standards for electronic trade volume reporting would provide a consistent and transparent framework for regulators, analysts, investors, and dealers to easily observe the liquidity, market share, and transaction cost trends across the e-trading venues and all regulated entities.

In conjunction with its July 16, 2018 recommendation to the SEC to establish a common regulatory framework for fixed income electronic trading venues, the Committee, therefore, recommends that the SEC, in coordination with FINRA and the MSRB as appropriate:

- clearly define "electronic trading" so that any new regulation or framework comprehensively covers the platforms and trading functionality that the SEC intends to cover without reliance on the current ATS definition;
- take the above-discussed factors into account when defining "electronic trading," including single dealer versus multi-party execution and fully-electronic versus post-trade processing; and
- establish industry-standards for electronic trade reporting that address the current inconsistencies described above relating to ATS functionality, single-counting versus double-counting, and the treatment of "give-up" trades for settlement.