Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York

June 13, 2023

Via Electronic Submission: rule-comments@sec.gov

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-02-22; Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] appreciates the decision of the U.S. Securities and Exchange Commission ("**Commission**" or "**SEC**") to reopen the comment period ("**Reopening Release**")[2] for the above-referenced proposal ("**Proposal**")[3] to amend Rule 3b-16 and Regulation ATS under the Securities Exchange Act of 1934 ("**Exchange Act**"), and to provide additional comments on the Proposal, including specific new requests for comment in the Reopening Release. We continue to support the Commission's proposed amendments to increase operational transparency, system integrity, and regulatory oversight of alternative trading systems ("**ATSs**"), including those that trade government securities or repurchase and reverse repurchase agreements on government securities ("**Government Securities ATSs**").

These comments supplement MFA's April 18, 2022 comment letter on the Proposal ("**MFA April Comment Letter**").[4] MFA remains deeply concerned with the breadth and scope of proposed changes to

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[1] MFA represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 170 member firms collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia. www.managedfunds.org.

[2] Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange", Release No. 34-97309 (Apr. 14, 2023), 88 Fed. Reg. 29448 (May 5, 2023), available at https://www.sec.gov/rules/proposed/2023/34-97309.pdf.

[3] Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities, 87 Fed. Reg. 15496 (Mar. 18, 2022), available at https://www.govinfo.gov/content/pkg/FR-2022-03-18/pdf/2022-01975.pdf ("**Proposing Release**").

[4] *See* Letter from Jennifer W. Han, Chief Counsel and Head of Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC, on April 18, 2022, available at https://www.sec.gov/comments/s7-02-22/s70222-20123993-280134.pdf.

Rule 3b-16, the insufficient cost benefit analysis, and the likelihood of unanticipated, adverse consequences to the industry, particularly in the development of new proprietary technologies. MFA is concerned that the SEC's unwarranted efforts to greatly expand what an "exchange" is, in direct contravention of regulatory guidance and industry understanding over the past 90 years, would have a chilling effect on the development of proprietary technologies by investment management firms and related service providers.

I. Executive Summary

Our comments on the SEC's Reopening Release may be summarized as follows:

- MFA continues to support the Commission's proposed amendments to eliminate the current exemption from Regulation ATS for Government Securities ATSs, which would require Government Securities ATSs to register as ATSs, apply the fair access requirements of Regulation ATS to Government Securities ATSs as described in the Proposal and require Government Securities ATSs exceeding certain volume thresholds to meet the requirements of Regulation SCI.

- MFA reiterates its lack of support the proposed changes to Rule 3b-16 which, if adopted as proposed, would drastically alter the landscape for exchanges as many systems would be inappropriately captured within the "exchange" definition for the first time ever and presented with the Hobson's choice of being subject to regulation as an exchange or an ATS.

- The additional requests for comments, including the efforts of the Reopening Release to replace terms in the proposed definition of "exchange," make clear that the shortcomings with the Commission's Proposal are not, without considerable additional definition and clarity, cured by changing the terms used.

- The proposed rules, if adopted as proposed, would have a chilling effect on the technology developed and used by asset managers to the detriment of advisory clients and private fund investors.

Because of the significant impact this aspect of the Proposal would have on market structure and on large numbers of non-financial entities, we again strongly encourage the Commission to consider the comments it receives and to publish a subsequent proposal to amend Rule 3b-16 before moving forward.

II. Discussion Regarding the Proposal

A. MFA Supports Proposed Amendments to Regulation ATS and Application of the Fair Access Rule to Government Securities ATSs

MFA's April Comment Letter noted our support of the Commission's proposal to update Regulation ATS by eliminating the exemption for Government Securities ATSs, and further supports the Commission's proposal to apply Rule 301(b)(5) of Regulation ATS (the **"Fair Access Rule"**) to Government Securities ATSs that meet certain volume thresholds in U.S. Treasury Securities or in a debt security issued or guaranteed by a U.S. executive agency or government-sponsored enterprise (**"Agency Securities"**).[5]

[5] *See id.*

B. The SEC's Considerable Expansion of "Exchange" Regulation Is Unwarranted and Requires Considerable Revision Before a Revised Rule Is Reproposed

1. MFA Does Not Support the Proposed Amendments to Exchange Act Rule 3b-16 to Include the Undefined "Communication Protocol Systems in the Definition of "Exchange"

We remain deeply concerned about the Proposal's other most significant component: the proposed changes to the definition of "exchange" in Exchange Act Rule 3b-16. Most prominently, the Commission has proposed to include, without definition, "communication protocol systems" within the definition of "exchange." In addition, the Commission proposes to replace the term bringing together "the *orders* for securities of multiple buyers and sellers" with bringing together "buyers and sellers of securities using *trading interest*" (emphasis added for both) to expand the definition considerably to include non-firm trading interest that is not an "order." Under the Proposal, "trading interest" would not only include orders, but "any non-firm indication of a willingness to buy or sell a security that identifies at least the security and either quantity, direction (buy or sell), or price." Each of these proposed changes requires significant clarification to ensure that there are no unintended consequences to market participants.

The Commission's proposed changes to Rule 3b-16 would represent a significant recasting of key features of the broader securities market's structures to encompass entities and activities that have never previously been an "exchange" or a system appropriate for regulation under the Regulation ATS regime. Because of the significant impact this aspect of the Commission's proposal could have on market structure, MFA strongly advocates for a re-proposal of this concept after the Commission has had an opportunity to review comments. Absent significant clarification that limits its scope, the Commission's proposal to classify each "communication protocol system" as an "exchange" would represent an expansive approach that both transmogrifies the well-understood meaning of "exchange" and calls into question the Commission's ability to examine and oversee this large number of newly registered exchanges and ATSs.

This is particularly true given the Commission's statement that it intends to "take an expansive view of what would constitute 'communication protocols' under this prong of Rule 3b-16(a)."[6] The potentially expansive language used to describe the Commission's intent in bringing communication protocol systems within the definition of "exchange" is overly broad and conflicts with the Commission's own economic analysis, which suggests that only a small number of systems would subject to the proposed amendments.

Should the Commission elect to move forward with the proposed amendments and include "communication protocol systems" (or as discussed below, "negotiation protocol systems") within Rule 3b-16, it is imperative that the Commission clarify which systems the Commission considers to be excluded from the term "exchange." We once again urge the Commission to clarify that the following systems should specifically be *excluded* from the definition of "exchange":

- *Order/Execution Management Systems* ("**OEMS**"). MFA agrees with the Commission statements in the Reopening Release suggesting that OEMSs generally lack the characteristics of an exchange and otherwise are outside the scope of what Proposed Rule 3b-16 is intending capture as an exchange. MFA believes that an OEMS, which can either be developed internally for proprietary use or provided by a third-party vendor, typically offers a range of customizable tools,

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6 Proposing Release at 15507.

functions, and services that a single end-user (*e.g.*, an investment adviser) can customize to manage holdings across multiple asset classes and products based on its own needs. An OEMS allows a user to perform a broad range of complex functions across the entire investment process, including investment data research and analysis, identification of liquidity in different marketplaces, monitoring of real-time market conditions, order instruction routing to different trading venues, and post-trade processing and execution analysis. OEMSs allow advisers to manage investments more efficiently, enhance fund pricing practices, and reduce overall transaction costs and trading frictions, thereby enhancing the ability to attain best execution on behalf of funds and their investors. While a user could pursue each of these functions individually, an OEMS greatly increases investment and trading efficiency by allowing the user to perform these interrelated activities in an integrated and less costly manner.

While it is impossible to predict how OEMSs may evolve in the future, we focus in this letter on four key functions currently performed by OEMSs that should not cause them to meet the definition of "exchange" under Proposed Rule 3b-16:

(i) Facilitate communication of trading interest by connecting a single end-user to a liquidity source such as a trading venue, exchange, ATS, OTC or an exchange market-maker, futures or options market, broker, dealer, or bank *i.e.*, providing a communications link and conveying trading instructions to such liquidity sources via an OEMS.

(ii) Import and display data fields or information from connected liquidity sources, *e.g.*, facilitating submitting requests-for-quotes ("**RFQs**") or receipt of indications of interest ("**IOIs**"), including from multiple broker-dealers, based on the methods, rules, or protocols set forth by those liquidity sources, including industry-standard message fields.

(iii) Apply protocols that are established by the connected liquidity sources for the single firm that is using the OEMS (*e.g.*, minimum sizes for transactions, time periods for responses, and counterparty credit limits). To the extent that the OEMS is provided by a third-party vendor to a single end-user, the third-party vendor does not impose non-discretionary protocols on how such end-user transacts, and any such protocols are developed by the end-user and the liquidity sources to which it connects. When communicating trading interests to a customer via the customer's OEMS, the liquidity source maintains discretion over exactly which customer can see and can respond to such trading interest, and can display different trading interests to different customers; the OEMS does not aggregate and redistribute trading interests to all its customers.

(iv) Organize, present, or otherwise display trading interest (whether firm or non-firm) that is available at connected liquidity sources in a user-friendly format.

As noted in the Proposal, single counterparty systems were not included in the definition of "exchange."[7] Given the breadth with which communication protocol systems are described, the Commission should clarify that, unless the order management system sets rules by which users must transact, the system should not be covered by the new definition of exchange. MFA would recommend that the SEC expressly clarify that OEMSs as described above are not exchanges.

- *Single Firm Trading Interest Communication Systems*. A number of buy-side firms operate proprietary systems designed to facilitate their trading which, in some instances, may permit

[7] Proposing Release at 15505.

firms to contact one, or multiple, broker-dealers for potential trading interest. Different buy-side firms may license or use the same system, but the individual systems do not interact with one another and as such would not be bringing together the orders (or indications of interest) on a "many-to-many" basis. It is imperative that the Commission clarify that systems used by individual firms to communicate with dealers to trade for themselves or on behalf of their clients are not "exchanges" under the Exchange Act.

- *Order Routing Systems*. Systems that merely route orders are not exchanges. Although Rule 3b-16 already includes an exclusion for certain order routing systems, we reiterate that the Commission should clarify that a firm's internal systems and technologies for handling orders, trading interest and other information among its own (or its affiliates') limit order books are not "exchanges."

One common feature of each of the above systems is that it is a "one-to-many" or a "one-to-one" system, where a single subscriber-user is using the system to assess potential transactions and then communicates with liquidity sources such as trading venues or broker-dealers, subject to the protocols developed by such liquidity sources or the single-subscriber-user, to execute any transaction. The user-subscriber does not interact with other subscribers and as such they are not "many-to-many" systems, which is in our view a prerequisite for any system to be considered an exchange or ATS. Moreover, unless the Commission clearly indicates that it does not intend such systems to be deemed "exchanges" within the scope of the proposed definition, the Proposal warrants a far more extensive and rigorous analysis of the attendant consequences and costs of such a policy decision.

2. The Additional Questions Posed by the Commission Do Not Make the Proposed "Exchange" Definition Any Narrower or More Workable

While MFA appreciates the efforts of the Commission to attempt to define the systems and technologies that it has preliminarily considered that investor protection demands that the systems and technologies subject themselves to exchange or ATS regulation, the Commission's attempts make clear that describing the systems or technologies using different words does not make classifying them as exchanges any more workable or appropriate. We do appreciate the Commission's efforts to provide greater guidance to avoid inappropriately capturing functions that could not fairly be described as acting as an exchange or bringing together buyers and sellers of securities.

To that end, MFA would offer that certain non-discretionary methods or protocols exist that *should* be regulated as exchanges. A system operator that sets rules by which trading interests would match, for example, could be subject to exchange/ATS regulation. As noted above, the rules by which trading interests would match are set by trading venues and not the systems or the systems' users -- any systems operator that could set its own rules and subject the trading venue to those rules may be engaged in activities more akin to those of a trading venue and appropriately subjected to exchange/ATS regulation.

We address certain of the Commission's specific requests for comment in the Reopening Release below.

- **Request for Comment #10. "[S]hould the Commission adopt alternative language to 'makes available'?"**

The Commission proposes to include within the definition of "exchange" a system that "makes available" (rather than "uses," as contained in existing Rule 3b-16) established, non-discretionary methods under which "buyers and sellers" (rather than "orders") can interact and agree to the terms of a trade." As we

noted in the MFA April Comment Letter, these changes alone could have significant impact on the scope of systems that are deemed to be "exchanges."

The Commission asked in the Reopening Release whether it should in effect continue to maintain the existing "uses" language, in lieu of "makes available" so that the revised definition would read in relevant part "[u]ses established, non-discretionary methods (whether by providing, *directly or indirectly*, a trading facility …)." (emphasis in original).[8] MFA supports the use of the existing term "uses" since it has been widely accepted and understood amongst the regulated community since the SEC adopted Regulation ATS over two decades ago.[9] MFA does not object to the inclusion of the phrase "directly or indirectly" since it is a commonly understood axiom of the federal securities laws that one cannot be permitted to do indirectly that which would be prohibited directly, and would more closely align with prior SEC statements in Regulation ATS adopting release,[10] as the Commission suggests in the Reopening Release.[11]

- **Request for Comment #11. Should the Commission adopt amendments to Rule 3b-16(a)(2) that state that an exchange in part is an entity that "*[E]stablishes* non-discretionary methods …"?**

As with our comment to request for comment #10, we support efforts by the Commission to more closely align any revised definition of exchange to minimize confusion amongst entities that would be affected. MFA appreciates the Commission's consideration of the term "establishes," which we believe could offer additional clarity to the "exchange" definition. MFA would note that using the active voice "establishes" focuses on the person that sets the "non-discretionary methods," and as a result, the person that potentially should be subject to regulation. Such a revision could provide some clarity to the systems that potentially would be in scope for exchange/ATS regulation.

- **Request for Comment #12. "Should the Commission adopt [proposed] Exchange Act Rule 3b-16(a)(2) … to include 'communication protocols'?"**

As noted in the MFA April Comment Letter, it is critical that the SEC reevaluate the proposed amendments to the exchange definition as it relates to the still-undefined "communication protocol systems." Classifying communications protocol systems as exchanges would significantly reconceptualize critical components of the entire market structure ecosystem and ensnare entities and activities that have never been previously considered an exchange or a system subject to Regulation ATS. We do not support the SEC defining "communications protocol systems" as exchanges under proposed Rule 3b-16.

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8 Reopening Release at 29459.

9 *See generally* Regulation of Exchanges and Alternative Trading Systems Exchange Act, 63 Fed. Reg. 70844, 70854-56 (Dec. 22, 1998), available at: https://www.govinfo.gov/content/pkg/FR-1998-12-22/pdf/98-33299.pdf ("**Regulation ATS Adopting Release**").

10 *See id.*

11 Reopening Release at 29459.

- **Request for Comment #12. Should the Commission provide guidance on what "non-discretionary methods" means?**

When introducing a completely new regime, potentially to a wide swath of communications systems that have never previously been subject to regulation as an exchange or ATS, MFA believes it is critical that the SEC provide clear guidance to the affected entities and their stakeholders (such as the asset management firms that develop these systems and/or subscribe to the systems provided by third parties. We would encourage the SEC to follow the approach it took in adopting Regulation ATS and Rule 3b-16 when it provided numerous helpful examples of the types of systems it would consider to be included and excluded from the definition of "exchange."[12] Market participants deserve clear guidance, such as through specific examples, of what constitutes a "communication protocol system," or adopting clear exclusions from the definition of "exchange." Accompanying these clearer parameters should be a more carefully considered economic analysis of the systems that will and will not be in scope, as a rigorous economic analysis is critical for interested persons to assess the impact of the Proposal and for the Commission to make an informed decision about whether and how to proceed.

At a minimum, the SEC should specify that non-discretionary parameters do not mean parameters regarding standard message fields (e.g., security name, price, size, or direction), time periods for responses to communications, or organizing or presenting the trading interest to users and/or liquidity sources. Rather the SEC should emphasize that non-discretionary parameters would mean only the rules by which multiple buyers and sellers' trading interest match and as a result, transactions are entered.

- **Request for Comment #14. "What are commenters views on the term 'negotiation protocols'?"**

We appreciate that the Commission has taken into consideration the widespread opposition to the proposed inclusion of "communication protocol systems" as exchanges. Swapping the word "communication" in favor of "negotiation," respectfully, does not provide any additional clarity to the systems that would be captured by this expansive redrawing of exchange regulation generally. The term "negotiation" is defined as the "act or process of negotiating or being negotiated,"[13] and the term "negotiate" means to "confer with another so as to arrive at the settlement of some matter."[14] The word "confer," itself, is a type of communication, and as such MFA would suggest that "negotiate" versus "communicate" is a distinction without a difference. The use of the term "negotiation protocols" would not, without more, limit the considerable expansion of the systems and technologies that would be inappropriately captured in the proposed exchange/ATS landscape.

Replacing the term "communication protocol" with the term "negotiation protocol" could be an improvement only if the Commission defines the term "negotiation protocol" for any revised exchange definition that is adopted. Defining the term "negotiation protocol" would provide the Commission "better focus" on the non-discretionary methods that the Commission intends to capture with the revised

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12 *See supra* note 9 at 70854-56.

13 *Negotiation,* MERRIAMWEBSTER.COM (2023) (avail. at https://www.merriam-webster.com/dictionary/negotiation).

14 *Negotiate,* MERRIAMWEBSTER.COM (2023) (avail. at https://www.merriam-webster.com/dictionary/negotiate).

definition.[15] MFA offers that "negotiation protocols" should mean rules set by a third party (i.e., not the system operator) that is designed for multiple buyers and sellers of securities using trading interest to match and agree to the terms of a trade.

C. The SEC's Proposed Expansion of Exchange and ATS Regulation Would Result in Higher Investor Costs and Chill Development of Order Management Technology in the Asset Management Industry

1. Clients would pay increased transaction costs if their manager uses a system that would now be deemed an exchange or ATS

Any regulatory cost associated with exchange/ATS regulation would be passed along to the asset manager subscriber of the service, which will in turn be passed along to the client or limited partner. As the Commission itself noted, if a system is a niche provider, "some market participants would incur higher trading costs."[16] We appreciate the Commission's recognition of the fact that this sweeping new regulation would directly impact the execution quality received by advisory clients and private fund investors through paying increased trading costs that the system is passing along to its subscribers to offset the costs of exchange/ATS regulation. MFA does not believe that advisory clients and private fund investors should pay indirectly for the cost of exchange/ATS regulation given the lack of demonstrated benefits to the underlying limited partner/investor by classifying the technology used by the manager as an exchange or ATS.

2. Technological development in the asset management industry would be chilled considerably as exchange/Regulation ATS costs are factored into development budgets

One very real consequence of the SEC's proposal, should it be adopted as proposed, is that the treatment of the systems and technologies as "exchanges" would have a chilling effect on technology and development in the asset management industry. Asset managers are adept at using technology to maximize efficiencies and execution quality through efficient order management and related systems. Many of these technologies have been developed in-house by asset management firms and are used by the developing firm and, in some cases, licensed to third party asset managers and others.

The prospect of applying Regulation ATS to these technologies means that any development or launch would be delayed by several months given the time required for FINRA to register the ATS, in addition to the subsequent reporting and regulatory oversight that would go along with it. These costs would be considered by developing firms, along with technology, systems, and human expenses as part of the asset management firm's own cost-benefit analysis in deciding whether to move forward in developing the technology. Some technologies inevitably will not be built as firms consider the increased costs in the management of their own businesses.

We appreciate that the Commission has acknowledged as much in the Reopening Release:

> In addition, market participants would decrease and slow down the development of new products and technologies. Such development may depend on the ability to rapidly develop and deploy

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15 Reopening Release at 29460 (Question #14).

16 Reopening Release at 29481.

> new systems. The need for more extensive compliance review, uncertainty about the application of the Proposed Rules, and concerns that new systems may inadvertently meet the definition of exchange could make such a process more difficult. Market participants may come to regard some areas of new product development as inherently risky, because of the potential for regulatory costs, and decide to stop engaging in them.[17]

MFA agrees and would note that such an outcome is unnecessary. The Commission does not need to adopt a rule that could result in what it describes as "less innovation as a result of the uncertainty and compliance costs associated with the broad formulation of the Proposed Rules."[18] To minimize the very real chilling effect that a broad recasting of the exchange regulatory regime, we recommend the SEC reconsider the consequences more holistically and more realistically assess costs of such a broad, sweeping proposal, particularly in light of the limited investor protection benefits the Proposal, if adopted as proposed, would yield.

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MFA thanks the Commission for its consideration of our supplemental comments on the Proposal and the Reopening Release. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Jeff Himstreet, Vice President and Senior Counsel, or the undersigned at 202.730.2600.

Respectfully Submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Regulatory Affairs

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime Lizárraga, Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets

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17 Reopening Release at 29482 (internal footnotes omitted).

18 *Id.*