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PUBLIC INTEREST COMMENT

CONSIDERATIONS FOR THE ATS PROPOSAL

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Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade US Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade US Treasury Securities and Agency Securities
Agency: Securities and Exchange Commission
Comment Period Opens: January 26, 2022
Comment Period Closes: 30 Days after Publication in the *Federal Register*
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Thank you for the opportunity to comment on the proposed rule (Proposal) to expand the definition of an exchange and the regulation of alternative trading systems (ATSs).[1] I am a scholar with the Mercatus Center at George Mason University. I taught securities regulation at the University of Virginia School of Law, served as deputy general counsel at the SEC, and practiced securities law. The Mercatus Center is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment is not submitted on behalf of any other person or group.

The Proposal would add many regulatory obligations to the operation of the trading markets for fixed-income securities, particularly the markets for US government securities. The SEC should reconsider each of the specific proposals and adopt only those that are within its statutory authority, that address serious social harms that can be meaningfully reduced by further regulation, and that will produce benefits that exceed costs.

1. *Given the importance, length, and complexity of the Proposal, a comment period of 30 days after publication in the* Federal Register *is not sufficient*. Please give public notice of a 60-day extension of the period.

2. *The proposed definition of an exchange should not extend further than the statutory definition*. The statutory definition in section 3(a)(1) of the Securities Exchange Act is a person that provides a marketplace for bringing together purchasers and sellers of securities or performing the

1. 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, Exchange Act Release No. 34-94062 (Jan. 26, 2022), https://www.sec.gov/rules/proposed/2022/34-94062.pdf.

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functions commonly performed by a stock exchange, as that term is generally understood. The traditional features of an exchange have been the bringing together of firm orders of many buyers and sellers of securities and using established, nondiscretionary rules or procedures to execute the orders (Proposal at 17). The Proposal admits that communication protocol systems do not meet the current definition of an exchange and are not subject to regulation as an exchange or an ATS (Proposal at 9, 25, 393).

The SEC does not have power to expand the statutory definition of an exchange to reach actions not within the scope of Congress's decision to regulate. Elsewhere, I have discussed the importance of the SEC having solid statutory authority for new regulations.[2]

The authority to define technical, trade, and accounting terms does not permit the SEC to redefine a critical concept Congress put at the heart of the Securities Exchange Act. The SEC needs statutory authorization from Congress for the definition of exchange to include communication protocol systems. Even if the SEC believes that it has the necessary statutory authority, the better policy approach is to defer and obtain statutory approval because of the significance of the matter.

3. *An expanded definition of exchange and ATSs could have unintended consequences*. For example, some have expressed concern that the proposed definition would cover automatic market makers for blockchain systems. The Proposal does not discuss whether the proposed definition of exchange would apply to digital tokens, which implies that it is not intended to do so. An SEC decision to adopt the definition therefore should explicitly exclude blockchain systems.

4. *Communication protocol systems for fixed-income instruments are innovative and efficient and benefit investors and securities markets* (Proposal at 395–96, 513–16). The SEC should encourage the development of these systems, but adding regulatory obligations discourages them.

5. *The Proposal does not identify, describe, and quantify persistent and serious social harms within the scope of the federal securities laws closely connected to the absence of additional regulation of communication protocol systems*. The purpose of the Proposal is to produce several speculative benefits from expanded application of Regulation ATS and Regulation SCI. No existing actual harm to the markets is cited (see, e.g., Proposal at 459, 468). For example, the Proposal states that, without the added regulation, detection of market irregularities might have been inhibited (Proposal at 387), limited information might have affected trading decisions (Proposal at 389), and discriminatory actions might have hurt investors (Proposal at 389). If some harms had occurred, the SEC should have quantified them and demonstrated that likely benefits from the Proposal would exceed the likely costs.

6. *Instead of genuine harm, a principal concern of the SEC in issuing the Proposal is the inconsistent regulatory treatment of ATSs and between ATSs and communication protocol systems*. Some types of platforms bear a reduced regulatory burden and therefore have a competitive advantage over others (Proposal at 9, 25–26, 27–29, 397, 404, 508–12).

Evening out regulatory burdens is not an acceptable justification for expanding regulation. In this case, the difference in regulation of communication protocol systems is the result of a legislative choice. When Congress draws a line between regulated activity (such as being an

2. Andrew N. Vollmer, Mercatus Center at George Mason University, Does the SEC Have Legal Authority to Adopt Climate-Change Disclosure Rules? 2–3 (2021).

exchange or broker-dealer) and unregulated activity (not being an exchange or broker-dealer), an administrative agency should respect that line and not attempt to impose a regulatory regime in the name of competition on a business that has followed established legal principles and lawfully structured its behavior to avoid the regulatory system.

Even if the SEC has statutory authority to reach communication protocol systems or to impose further regulation on ATSs for fixed-income securities, equalizing regulatory burdens by itself is not a sufficient basis for the SEC to act. The goal of imposing governmental costs is not legitimate. The SEC would need to find a market failure or serious public harm from the currently unregulated actions plus a net market benefit from enlarging coverage of the regulations, such as making prices public or lowering costs for investors.

Regulators should be wary of claims of inconsistent regulatory treatment. Market participants that have a higher regulatory obligation or that voluntarily comply with greater restrictions lobby the government to impose additional obligations and restrictions on those not meeting the more extensive regulations. They do this to increase the costs of competitors and exclude less efficient producers from the market. A regulator should not acquiesce in these efforts unless the less regulated market participant is both within the reach of the statutory authority and causing a serious harm to the public that the regulation will redress.

7. *The cost-benefit analysis in the Proposal is deficient*. It guesses about potential benefits from heavy regulatory systems and states that the SEC is not able to quantify the benefits (Proposal at 455–75). It then projects millions of dollars in compliance costs and acknowledges the risk that the regulatory burdens could raise entry costs for new financial technologies, stifle innovation, and damage the current ability of market participants to locate liquidity in illiquid security markets (Proposal at 475–516). The SEC's conclusion is that maybe the higher compliance costs would not have a significant adverse effect on overall competition in the market for trading services (Proposal at 516–20). The SEC is not sure whether the Proposal would hurt price efficiency and capital formation (Proposal at 529). That analysis does not provide a reasonable basis for adopting the Proposal.

The cost-benefit analysis is also cast into doubt by evidence suggesting that the Proposal is an overly large government response to a limited number of issues with the market for US government securities. A staff working group of several federal agencies recently concluded "that the Treasury market remains deep, liquid, and resilient, and that most shocks do not result in any appreciable market functioning or liquidity stress."[3] The scope of the Proposal does not seem to be proportional to the interests served.

These are reasons for the SEC to look again at the Proposal. The commission should proceed only if confident that a specific regulatory feature is authorized by Congress and narrowly tailored to remedy a genuine problem.

3. U.S. DEP'T OF THE TREASURY ET AL., RECENT DISRUPTIONS AND POTENTIAL REFORMS IN THE U.S. TREASURY MARKET: A STAFF PROGRESS REPORT 7 (2021).