

MULTIPLE-MARKETS



Secretary
US Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Subject: File Number S7-17-08

To the Commissioners and Staff of the SEC:

Thank you for the opportunity to provide comments on "References to Ratings of Nationally Recognized Statistical Rating Organizations".

As the Commission undertakes the transformation of the role of credit rating agencies this review and refinement of various Commission rules is fundamental.

We appreciate being part of the process.

We would like to provide comments on several proposals that relate specifically to retail investors.

Our comments relate to proposed amendments for:

- Rule 3a1-1
- Regulation ATS (Rule 301(b)5)
- Regulation ATS (Rule 301(b)6)
- Form ATS-R
- Form Pilot
- Rule 10b-10

We believe the review and refinement of these rules provides the Commission with an opportunity to move towards a new market structure for fixed income markets. This would particularly serve to protect retail investors.

Currently retail investors enjoy minimal transparency in the fixed income space.

The TRACE trade reporting system and its municipal counterpart, RTRS, have provided important post-trade transparency to market participants.

We encourage the Commission to consider rule changes that would similarly enhance pre-trade transparency for investors.

Former [SEC Commissioner Laura S. Unger in a speech](#) to the Bond Market Association in 1999 addressed the Commission's role in facilitating a fair market structure for the fixed income investors.

~~ "...In adopting the 1975 Amendments to the Securities Laws, Congress gave the Commission the authority to facilitate developing a national market system for securities.

Not just equities, mind you, **but all types, including fixed income securities.**

Congress recognized that many of the goals of a national market system were universal ones, such as transparency of quote and trade information, giving investors the opportunity for best execution, self-regulatory coordination, and strengthening Commission oversight of the markets.

At the same time, Congress made clear that it didn't intend for the Commission to force all securities markets into a single mold. The Commission was to classify markets and take into account the differences among them in achieving the goals of a national market system...." ~~

We commend the Commission for its willingness to review all parts of the regulated financial markets.

As markets and investor needs evolve the regulatory structure can be refined to support the principal goal of efficient and fair markets. The specific goals detailed by Commissioner Unger:

- Transparent quote and trade information
- Best execution
- Self-regulatory coordination
- Strengthened Commission oversight of the markets

Retail fixed income investors have suffered from opaque and unfair market practices.

We encourage the Commission to make the development of fair and transparent fixed income markets for retail investors an important and ongoing priority.

>> [Rule 3a1-1](#)

We believe that the Commission has appropriately proposed a change that would remove the distinction between investment grade and non-investment grade debt when evaluating the market share of various trading systems for market concentration.

We support this proposal.

Further we encourage the Commission to reduce the volume threshold for the determination of a "substantial market" and to consider another distinction when examining the concentration of market share for fixed income trading systems.

Rule 3a1-1 provides quantitative thresholds for the determination of "substantial market" for a "trading system" being exempt from registering as an exchange.

These quantitative thresholds are currently defined as:

1. 50% or more of the average daily dollar trading volume (ADDTV) in any security and 5% or more of the ADDTV in any class of securities.
2. 40% or more of the ADDTV in any class of securities

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>>> We propose that the Commission consider a 10% ADDTV in any security a threshold sufficient for the determination of market share concentration for a fixed income trading system.

>>> Additionally we propose that the Commission consider a 5% ADDTV in any class of securities a threshold sufficient for the determination of market share concentration for fixed income trading systems.

>>> Further we propose that the Commission determine the 10% and 5% ADDTV thresholds within the retail and institutional sub sectors of the fixed income markets.

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Quantitative thresholds do not take into account a fundamental aspect of the fixed income markets.

Trading in the fixed income markets is strictly divided between institutional and retail trading platforms. Price discovery, order routing, access and trading for different types of investors are restricted to different liquidity venues.

Using a generalized ADDTV makes the examination of market concentration difficult.

Additionally [studies have shown](#) that retail investors pay wide spreads relative to institutional investors for the same security. It is likely that the two tier market structure perpetuates this pricing disadvantage for retail investors.

We are not aware of any academic research which examines the two-tier market structure in fixed income markets and the correlation to yield differentials between retail and institutional size trades.

The fact that retail and institutional bond trades happen on trading systems which are not linked and restrict access to market participants of certain size clearly disadvantages retail investors.

We encourage the Commission to more closely review this area and examine whether investor protections could be enhanced through liberalized access, improved trading system linkages and a more transparent market structure.

Retail fixed income trading is concentrated on several electronic platforms.

Evaluating market concentration using a generalized ADDTV of institutional and retail trading data will not show the level of market concentration for each class of investors.

We support the definition, used by Finra's TRACE system and others, of "retail trades" as those of \$ 100,000 or less. We believe this is an appropriate definition.

We propose that the Commission review this exemption and its application with a more realistic approach that incorporates the stratified structure of the fixed income markets.

The market stratification is clearest when one examines the access available to various market participants to electronic trading platforms.

E-platforms are clustered into various client and product types. These are further grouped by type of access:

- *Dealer to dealer (interdealer platforms)*
- *Single dealer to institutional clients*
- *Multi-dealer to institutional clients*
- *Single dealer to retail clients*
- *Multi-dealer to retail clients*

SIFMA conducts an excellent annual survey of fixed income electronic trading platforms. This is a useful reference for preliminary mapping of these markets.

We encourage the Commission to review the quantitative application of Rule 3a1-1 within these more narrowly defined market segments. We believe that this review will show excessive market concentration.

And on the basis of this review we believe it would be appropriate for the Commission to require various electronic fixed income trading systems to register as exchanges and/or to create linkages to each other which would mirror the principles in the "Access Rule" (Rule 610) in Reg NMS.

The Commission adopted these Reg ATS rules to regulate "substantial markets". This was necessary and appropriate in the public interest and consistent with the protection of investors.

It would be difficult to argue that retail investors, in particular, are served by the dominant "trading systems" operating solely on the basis of quotation internalization.

The value of eliminating internalization was effectively described in a [2005 letter of Kevin O'Hara](#) of Archipelago (NYSE Euronext) to the Commission on the issue of the separation of NASD and the Nasdaq. The specifics vary but the principles are shared by all securities markets.

~ ~ "... Internalization is in contrast with the principle of transparency, which is a hallmark of the securities markets.

By discouraging public display of limit orders, internalized trades deter price discovery. Reduced price competition results in wider bid/ask spreads, higher implicit transaction costs, reduced depth of liquidity and an associated increased vulnerability to short term price swings.

In addition, internalization promotes the isolation of limit orders. For example, a customer may enter a limit order that improves the current quote. Dealers that match displayed prices rather than executing against displayed orders may leave the displayed order unexecuted. Ultimately this possibility that limit orders remain unexecuted provides a disincentive for customers to enter better-priced orders.

Clearly, internalization has a deleterious effect on investors by discouraging transparency, reducing price competition, and increasing trading costs.

Taking this argument one step further, the Proposals weaken the national securities markets. Nasdaq's competing dealer structure and associated Trade Reporting Facility lack an important element that all national securities exchanges currently must abide by—centralized price, time priority across all orders presented to the exchange.

In the approval order to rescind NYSE Rule 390, the Commission states that “price/time priority rules of limit order markets also can enhance depth and liquidity by providing an incentive for trading interest to stack up at prices that are at or around the best bid and offer...[r]educed order interaction may hamper price competition, interfere with the process of public price discovery, and detract from the depth and stability of the markets.” ... ~ ~

Vibrant markets encourage the display of aggressively priced quotes for a security and provide a mechanism for the aggregation of quotations across various trading venues (ATS and exchanges).

We commend the Commission for the substantial progress made in rulemaking for the equities markets. This rulemaking protects investors by providing market wide price transparency and discovery.

We believe it is appropriate for the Commission to turn to the fixed income markets now with the same intent of protecting investors and refining market structure.

>> **Regulation ATS (Rule 301(b)5)**

This rule imposes a “*fair access*” requirement whereby an ATS that exceeds certain volume thresholds must establish written standards for granting access to the service it offers. Further the ATS cannot reasonably prohibit or limit any person in respect to access to the service that it offers.

The fair access standard applies if an ATS has 5% or more of the average daily volume during at least 4 of the preceding 6 months.

This rule applies to municipal and investment grade and non investment grade debt in addition to other classes of securities.

We support the Commission's proposal to combine the trading volume of investment and non-investment grade debt for the purposes of determining volume thresholds for access requirements.

More generally we encourage the Commission to undertake a review of the various electronic trading platforms to evaluate “fair access”.

An important area of review for the Commission is the stratification of trading venues into institutional and retail platforms.

>> **Regulation ATS (Rule 301(b)6)**

We support the Commission's proposal to combine investment grade and non-investment grade debt for purposes of evaluating volume thresholds in determining standards for the capacity, integrity and security of automated systems.

We propose that the Commission consider a 5% volume threshold sufficient for the capacity, integrity, and security requirements.

>> **Form ATS-R**

Form ATS-R is used by ATS firms to report certain information on a quarterly basis. This information includes total unit volume and total dollar volume for various categories of securities.

We support the Commission's proposal to combine the reporting of investment and non-investment grade debt on Form ATS-R.

Further we encourage the Commission to consider making public the data filed on Form ATS. Making this information available to the public would enhance investor protection by informing market participants where significant liquidity is available for various classes of securities.

We especially encourage the Commission to consider making this information filed on Form ATS-R public. This would especially protect investors if the Commission chooses not to require linkages between the various fixed income markets which it deems "substantial markets".

>> **Form Pilot**

Form Pilot allows an SRO to operate a pilot trading system without filing a proposed rule change.

We support the Commission's proposal to combine the reporting of investment and non-investment grade debt on Form Pilot.

>> **Rule 10b-10**

The Commission has requested comment on the elimination of the reference to "unrated" securities on a 10b-10 confirmation.

We believe that this deletion is appropriate.

Also we would like to point to [proposed rule SR-NASD-2005-100](#) which Finra has before the Commission. This proposed rule relates to additional transaction specific disclosures for TRACE-eligible securities.

The proposed Finra rule would require brokers/dealers to provide information related to the credit quality of the security (after the transaction is completed).

From [FR 72, No. 202, page 59322](#):

(3) **Credit rating.** A member must disclose the lowest credit rating(s) it has received at the time the transaction confirmation is generated, the date of such credit rating(s), and the NRSRO(s) assigning the credit rating(s) of the debt security the member purchased for or from or sold to or for a customer, if:

(A) The member has entered into a written agreement with the NRSRO to receive such credit rating(s);

(B) A service bureau that provides confirmation services to the member for the transaction has entered into a written agreement with the NRSRO to receive such credit rating(s) and provides them to the member as part of the confirmation services at no additional cost; or

(C) A member that acts as a clearing member for, and provides confirmation services to, the member for the transaction has entered into a written agreement with the NRSRO to receive such credit rating(s) and provides them to the member as part of the confirmation services at no additional cost.

The proposed rule requires that investors be informed of the lowest rating on a security.

We believe that the proposal put forward by Finra serves to protect investors but could be enhanced by the addition of an alternative method of showing credit quality of a security on the confirmation.

We suggest an alternative to providing the lowest credit rating. This alternative would allow the member or service provider to aggregate the credit ratings extent on a security and **provide the investor with the "average" rating across NRSROs.**

We do not suggest a method for aggregating ratings but a variety of methods are available including the [method used for the inclusion of securities in the Lehman US Aggregate index](#).

(Must be rated investment grade (Baa3/BBB-/BBB- or above) using the middle rating of Moody's, S&P, and Fitch, respectively).

- *When all three agencies rate an issue, a median or "two out of three" rating is used to determine index eligibility by dropping the highest and lowest rating.*
- *When a rating from only two agencies is available, the lower ("most conservative") of the two is used.*
- *When a rating from only one agency is available, that rating is used to determine index eligibility.*

Providing investors with an “average” credit rating would provide a more complete view of the markets opinion of a particular security.

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We thank the Commission for the opportunity to forward these comments.

We would welcome an opportunity to provide additional input on any of these matters.

We look forward to the new rules.

Very truly yours,

Cate Long

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