

**MEMO# 35264**

April 26, 2023

# **May 5 ICI Member Call: SEC Submits Supplemental Information and Reopens Comment Period for Proposed Rule 3b-16 Amendments Regarding the Definition of "Exchange"**

[35264]

April 26, 2023

TO: Equity Markets Advisory Committee  
ETF (Exchange-Traded Funds) Committee  
Fixed-Income Advisory Committee RE: May 5 ICI Member Call: SEC Submits Supplemental Information and Reopens Comment Period for Proposed Rule 3b-16 Amendments Regarding the Definition of "Exchange"

On April 14, 2023, the SEC reopened the comment period for its proposal ("Prior Proposal")[\[1\]](#) to amend Rule 3b-16 under the Securities Exchange Act of 1934, as amended, ("Exchange Act") that defines certain terms used in the statutory definition of "exchange" ("Reopening Release").[\[2\]](#) The Prior Proposal also contained several proposed amendments to Regulation ATS, many of which were originally proposed in 2020.[\[3\]](#) The comment period had previously been reopened for comment on May 9, 2022.[\[4\]](#)

The Reopening Release is primarily focused on providing guidance and economic analysis related to proposed amended Rule 3b-16's application to crypto asset securities and blockchain trading systems, but also provides additional commentary on the proposed amendment's application to communication protocol systems (CPSs), including order management systems, order execution systems, and order execution management systems (collectively referred to as "OEMSs"), and ETF portals. This memorandum summarizes the Reopening Release, with particular focus on questions asked by the SEC related to OEMSs and ETF portals.

Comments are due to the SEC on June 13, 2023, or 30 days after the date of publication of the Reopening Release in the Federal Register, whichever is later. ICI will hold a 60-minute member call on Friday, May 5, at 1:00 p.m. (ET) to discuss the Reopening Proposal and ICI's response. Given the specific questions asked by the SEC related to OEMSs and ETF portals, which were the primary focus of our original letter,[\[5\]](#) ICI intends to submit a comment

letter addressing the SEC's OEMS and ETF portal questions. Regarding OEMSs, we believe that our original letter primarily answers the questions raised by the SEC and intend to reiterate those points. Therefore, we intend for our member call to primarily focus on ETF portals given the SEC's questions related to how the portals function.

If you would like to join the call, the Zoom participation information is:

<https://ici-org.zoom.us/j/91698504684?pwd=UjVCamxDZTNlcWhBeXE5alg2by8yUT09>

Meeting ID: 916 9850 4684

Passcode: 201233

## **Summary of Reopening Release**

For crypto asset securities and blockchain trading systems, the Reopening Release provides more clarity on how the proposed Rule 3b-16 amendments would apply to, and therefore regulate as an exchange or ATS, such trading systems, including decentralized finance or "DeFi" systems.<sup>[6]</sup> In particular, because some commenters claimed that "DeFi" trading systems may be unable to comply with exchange or ATS regulatory requirements due to their lack of a central operator, the SEC felt it was necessary to emphasize that "[t]he existence of smart contracts on a blockchain does not materialize in the absence of human activity[.]"<sup>[7]</sup> Thus, the SEC expects someone, or a group of persons, to register as an exchange or ATS if the "DeFi" system satisfies the elements of an exchange, as reflected in the proposed amendments to Rule 3b-16. Further, in response to commenters stating the SEC had not considered the economic effects that the proposed amendments would have on crypto asset securities and blockchain trading systems, the SEC included in the Reopening Release over 100 pages of additional economic analysis.

While the primary purpose of the Reopening Release was to clarify the application of the proposed Rule 3b-16 amendments to crypto asset securities and blockchain trading systems and add supplemental economic analysis into the public record, the Reopening Release also asked for comments on issues that may more directly impact ICI members, such as the application of proposed amended Rule 3b-16 to OEMSs and ETF portals. As background, in the Prior Proposal, the SEC proposed amending who must register as an exchange or ATS by changing who would be subject to Rule 3b-16(a) as follows:

An organization, association, or group of persons shall be considered to constitute, maintain, or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange," as those terms are used in section 3(a)(1) of the Act, (15 U.S.C. 78c(a)(1)), if such organization, association, or group of persons:

- (1) Brings together the orders for buyers and sellers of securities of multiple buyers and sellers using trading interest; and
- (2) Uses Makes available established, non-discretionary methods (whether by providing a trading facility or communication protocols, or by setting rules) under which such orders buyers and sellers can interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.

In response to comments stating that the proposed amendments were "too broad and vague and that it is unclear what activities or entities would be" captured,<sup>[8]</sup> the SEC

proposes amendments to the language in this section and asks for comment as to whether these changes would make the definition more workable. For example, instead of the phrase "makes available," the SEC asks whether the word "establishes" would better clarify who the SEC intends to be captured by the proposed amendments. Further, the SEC asks whether replacing the phrase "communication protocols" with "negotiation protocols" would "better focus the non-discretionary methods that the Commission intended to capture[.]"[\[9\]](#) The SEC then proposes to define "negotiation protocols" as "a nondiscretionary method that sets requirements or limitations designed for multiple buyers and sellers of securities using trading interest to interact and negotiate terms of a trade."[\[10\]](#) Finally, the SEC asks whether ETF portals should be specifically excluded from the proposed amendments to Rule 3b-16.

While the proposed amendments, above, are intended to narrow the systems covered by Rule 3b-16, the SEC also asks for additional information related to OEMSs and ETF portals. Specifically, the SEC asks the following:

17. . . . The proposed amendments to Rule 3b-16 were not designed to capture within the definition of exchange the activities of brokers, dealers, and investment advisers who use an OEMS to carry out their functions (e.g., organizing and routing trading interest). The use of OEMS technology, however, like other types of technology, could be used, in certain circumstances, to perform exchange activities (e.g., crossing orders of multiple buyers and sellers using established non-discretionary methods). The Commission requests comment on what activities are performed today using OEMS technology and how the use of OEMS technology might change in the future. The Commission requests comment on whether and how activities performed through the use of OEMS technology could meet the criteria of Rule 3b-16(a), as proposed to be amended. Please explain why or why not.[\[11\]](#)

28. How do ETF Portals operate for the creation and redemption of securities? Who are the participants in ETF Portals and how do they interact? Are there any trading activities conducted as part of the creation and redemption process through an ETF Portal that are exchange activities or necessitate further clarification by the Commission as to whether such activities are exchange activities? Do an ETF Portal's activities facilitate secondary market activity in the ETF? Why or why not? Does trading in ETF Portals involve multiple buyers and sellers of securities? Why or why not? What non-discretionary methods are generally used by ETF Portals?[\[12\]](#)

29. Do ETF Portals fall within the criteria of existing Exchange Act Rule 3b-16(a) or Rule 3b-16(a), as proposed to be amended? Why or why not? If the activities conducted through ETF Portals fall within the criteria of existing Exchange Act Rule 3b-16(a) or Rule 3b-16(a), as proposed to be amended, should the Commission adopt an exclusion under Exchange Act Rule 3b-16(b)(3) for ETF Portals? If yes, please explain why and explain what the exclusion should apply to. How should an ETF Portal be defined for purposes of the exclusion? For example, should the Commission expressly adopt an exclusion that applies only to ETF Portals that fall within this definition: "a system that allows one or more issuers from the same sponsoring entity to solicit creation or redemption requests for their own securities submitted by authorized participants for those securities"? Should the Commission adopt an exclusion that applies only to platforms that solely support primary market transactions in investment company securities, where the issuer of the security participates in each transaction either as the sole buyer, or as the sole seller? If so, should the exclusion be available only for securities issued by ETFs or also for securities issued by other investment companies? Should the exclusion specify that it is available only for transactions that take place at a price based on the current net asset value of the security,

as required by 17 CFR 270.22c-1 (Rule 22c-1 under the Investment Company Act of 1940)? What ETF Portals should not be excluded from Exchange Act Rule 3b-16(a)? Please explain.<sup>[13]</sup>

Finally, the SEC also asks whether the Commission should adopt a compliance date to delay implementation of the proposed amendments and whether such compliance date should differ based on the securities the exchange or ATS is trading, e.g. NMS stock, OTC equity securities, corporate bonds, municipal securities, government securities, foreign sovereign debt, asset-backed securities, restricted securities, or options, or other factors, such as the type of participants trading on the system or whether the trading system uses blockchain technology.<sup>[14]</sup>

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#### Notes

<sup>[1]</sup> Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, Securities Exchange Act Release No. 94062, 87 Fed. Reg. 15496 (March 18, 2022), available at <https://www.govinfo.gov/content/pkg/FR-2022-03-18/pdf/2022-01975.pdf>.

<sup>[2]</sup> Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange," Securities Exchange Act Release No. 97309 (April 14, 2023), available at <https://www.sec.gov/rules/proposed/2023/34-97309.pdf>.

<sup>[3]</sup> See Regulation ATS for ATSs that Trade U.S. Government Securities, NMS Stock, and Other Securities; Regulation SCI for ATSs that Trade U.S. Treasury Securities and Agency Securities; and Electronic Corporate Bond and Municipal Securities Markets, Securities Exchange Act Release No. 90019, 85 Fed. Reg. 87106 (Dec. 31, 2020), available at <https://www.govinfo.gov/content/pkg/FR-2020-12-31/pdf/2020-21781.pdf>. For a summary of the Prior Proposal, see ICI Memorandum 34028 (Feb. 8, 2022), available at <https://www.ici.org/memo34028>. For a summary of the 2020 proposal related to Regulation ATS, see ICI Memorandum 32795 (Oct. 1, 2020), available at <https://www.ici.org/memo32795>.

<sup>[4]</sup> Reopening of Comment Periods for "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews" and "Amendments Regarding the Definition of 'Exchange' and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities," Securities Exchange Act Release No. 94868, 87 Fed. Reg. 29059 (May 12, 2022), available at <https://www.govinfo.gov/content/pkg/FR-2022-05-12/pdf/2022-10195.pdf>.

<sup>[5]</sup> For a summary of our original comment letter, see ICI Memorandum 34120 (April 21, 2022), available at <https://www.ici.org/memo34120>. The full comment letter is available at <https://www.sec.gov/comments/s7-02-22/s70222-20124231-280809.pdf>.

<sup>[6]</sup> Reopening Release at 6-7.

[\[7\]](#) Id. at 22.

[\[8\]](#) Id. at 45.

[\[9\]](#) Id.

[\[10\]](#) Id.

[\[11\]](#) Id. at 47-48.

[\[12\]](#) Id. at 57.

[\[13\]](#) Id. at 57-58.

[\[14\]](#) Id. at 58-62.

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