

Client Update

SEC Proposes Enhanced Disclosure and Oversight Rules for Alternative Trading Systems

NEW YORK

Lee A. Schneider
lschneider@debevoise.com

Camden W. Williams
cwilliams@debevoise.com

Zila Reyes Acosta-Grimes
zracosta@debevoise.com

On November 18, 2015, the Securities and Exchange Commission (the “SEC”) announced proposed rules (the “Proposed Rules”) to enhance operational transparency and regulatory oversight of alternative trading systems (“ATSs”) that trade stocks listed on a national securities exchange (“NMS ATSs”).¹ In summary, the Proposed Rules would (i) require enhanced disclosures for NMS ATSs on new Form ATS-N; (ii) provide the process for broker-dealer operators to make Form ATS-N filings; (iii) provide for the SEC to declare such filings “effective” or “ineffective,” and to limit, suspend or revoke the ATS’s permission to operate; and (iv) require NMS ATSs to develop written safeguards and procedures with respect to confidential information.

The Proposed Rules come nearly six years after the SEC last proposed (but never adopted) rules to increase order flow and trade transparency of ATSs.² In response to the SEC’s 2009 proposal, certain commenters expressed the view that additional disclosures by ATSs were warranted, particularly regarding their operations and functionality. Interestingly, the Proposed Rules do not retain any of the 2009 proposals. Rather, they seem to further acknowledge the exchange-like nature of NMS ATSs by requiring, among other things, detailed disclosures about the operations and functionality of the ATS and a declaration of

¹ SEC Proposes Rules to Enhance Transparency and Oversight of Alternative Trading Systems, SEC Release No. 34-76474; File No. S7-23-15 (Nov. 18, 2015) (hereinafter the “Proposed Rule”).

² That proposal sought to increase transparency by applying quoting requirements to actionable indications of interests, lowering the trading volume threshold at which an ATS is required to publicly display its best-priced order and requiring real-time disclosure of the identity of each ATS that executes a trade in NMS stocks. Proposed Rule, *supra* note 1, at 353.

effectiveness by the SEC before the NMS ATS can commence trading or make material changes to its activities or functionality.³

With this move to regulate NMS ATSs more like stock exchanges, the SEC would exercise greater oversight of such trading facilities both initially and as their operations continue. If the Proposed Rules are adopted, NMS ATSs will have some work ahead of them. Moreover, the public disclosure of each Form ATS-N will allow market participants to more easily compare and contrast the functionality of NMS ATSs and the activities of their operators in the system.

DISCUSSION

Disclosure Requirements

The Proposed Rules would require broker-dealers operating NMS ATSs to file with the SEC newly created Form ATS-N, which would require enhanced disclosures as compared with the existing Form ATS. The information in Form ATS-N would include details about the NMS ATS's operations, trading functionality and types of subscribers, as well as the trading and other activities of its broker-dealer operator and affiliates. These disclosures would include information relating to the types of orders and market data used on the NMS ATS and its execution and priority protocols. The Form ATS-N also must include information about trading by the broker-dealer operator and its affiliates on the NMS ATS. A complete list of the disclosure requirements is set forth in Appendix A. The SEC seems to expect significant detail concerning each aspect of the operations and functionality of both the NMS ATS and its broker-dealer operator. In the preamble to the Proposed Rules, the SEC suggests that existing Form ATS filings have provided only broad, summary disclosure that would become unacceptable if the Proposed Rules are adopted.

Under the Proposed Rules, each Form ATS-N would be made publicly available on the SEC's website. The SEC believes that publication of the Form ATS-N for each NMS ATS will enable market participants to better compare and contrast different NMS ATSs in order to evaluate which trading venues are best suited to accomplish their investing or trading objectives, including meeting best

³ Exchange Act Section 6, 5 U.S.C. § 78f(b)(5) (2015) ; Exchange Act Rule 6a-1, 17 C.F.R. § 240.6a-1 (2015). See also *Investors' Exchange LLC – Form 1 Application and Exhibits*, SEC Release No. 34-75925 (Dec. 1, 2015), available at <http://www.sec.gov/rules/other/2015/investors-exchange-form-1.htm> (the application for registration as a national securities exchange).

execution obligations.⁴ In addition, the SEC plans to use the information disclosed on Form ATS-N to oversee the growth and development of NMS ATSs and to evaluate whether those ATSs operate in a manner consistent with federal securities laws.

Filing and Effectiveness of Form ATS-N and Amendments

Initial Filings

Under the Proposed Rules, NMS ATSs currently operating pursuant to a previously filed Form ATS (“legacy NMS ATSs”) would be required to file a Form ATS-N with the SEC no later than 120 calendar days after the effective date of the adopted version of the Proposed Rules. During the SEC’s review of the newly-filed Form ATS-N, the legacy NMS ATS could continue to operate pursuant to its existing Form ATS (while filing amendments thereto to provide notice of changes to the operations of its system, in accordance with existing rules).⁵ A new ATS that meets the definition of an NMS ATS must file an initial Form ATS-N and cannot engage in any activities until the SEC declares it effective.

Under the Proposed Rules, the SEC would be required to declare an initial Form ATS-N filing effective or ineffective no later than 120 calendar days from filing with the SEC.⁶ The SEC’s review of Form ATS-N submissions would focus on an evaluation of the completeness and accuracy of the disclosures and compliance with federal securities laws, including Regulation ATS.⁷ During its review, the

⁴ FINRA, Notice 15-46, *Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets* (Nov. 20, 2015), available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf; see also Debevoise & Plimpton, *Client Update: Questions Stemming from FINRA’s Best Execution Guidance* (Dec. 2, 2015), available at <http://www.debevoise.com/insights/publications/2015/12/questions-stemming-from-finra>.

⁵ Proposed Rule, *supra* note 1, at 109.

⁶ The Proposed Rule would provide a process for the SEC to extend the review period for filings by legacy NMS ATSs for (1) an additional 120 calendar days, if the Form ATS-N is unusually lengthy or raises novel or complex issues that require additional time for review, in which case the SEC will notify the NMS ATS in writing within the initial 120-day review period and will briefly describe the reason for the determination that additional time for review is required; or (2) any extended review period to which the NMS ATS agrees in writing. Proposed Rule 304 would include a similar provision for new NMS ATSs not operating as of the effective date of proposed Rule 304, except that the SEC could extend its review period up to only 90 calendar days. Proposed Rule, *supra* note 1, at 111.

⁷ Proposed Rule, *supra* note 1, at 117.

SEC and its staff may provide comments to the NMS ATS and may request that the entity supplement information or revise its disclosures in Form ATS-N. Presumably, the SEC and its staff may ask questions and seek clarification as appropriate through these requests.

Declarations of Effectiveness or Ineffectiveness

In determining whether to declare effective a Form ATS-N, the SEC would, as a threshold matter, evaluate whether the entity satisfies the definitions of “ATS” and “NMS ATS.” In the preamble to the Proposed Rules, the SEC noted that it would likely declare a Form ATS-N ineffective if it finds, after notice and opportunity for hearing, that:

- the Form ATS-N was filed by an entity that does not meet the definition of “exchange” under Section 3(a)(1) of the Securities and Exchange Act of 1934 because it does not perform functions commonly performed by a stock exchange or exercises self-regulatory organization powers;
- the Form ATS-N was filed by an entity that does not meet the proposed definition of “NMS Stock ATS”; or
- one or more disclosures on Form ATS-N are materially deficient with respect to their accuracy, currency or completeness (examples of deficiencies include a Form ATS-N that (i) discloses an order type but fails to describe its key attributes; (ii) generally describes some of the ATS’s priority rules, but fails to describe conditions or exceptions to its priority rules; or (iii) includes inconsistent information).

Other than with respect to obvious deficiencies, the standards by which the SEC intends to evaluate a Form ATS-N, including the specific factors it will consider in its effectiveness determination, are not described in the Proposed Rules or the preamble.

Amendments

An NMS ATS would be required to amend Form ATS-N in three circumstances:

- at least 30 calendar days prior to the date of implementation of a material change⁸ to the operations of the NMS ATS or to the activities of the

⁸ To determine whether a change is material, and thus subject to the 30-day advance notice requirement, an NMS ATS would need to consider all the relevant facts and circumstances, including the reason for the change and how it might impact the NMS ATS and its subscribers, as well as market participants that may be evaluating it as a

broker-dealer operator or its affiliates that are subject to disclosure on Form ATS-N;

- within 30 calendar days after the end of each calendar quarter to correct any other information that has become inaccurate for any reason and has not been previously reported to the SEC; or
- promptly after discovery that any previous disclosure on Form ATS-N was inaccurate or incomplete when filed.

The Proposed Rules would require the SEC to declare any Form ATS-N Amendment effective or ineffective no later than 30 calendar days from filing with the SEC. The SEC may declare any Form ATS-N Amendment ineffective if it finds that such action is necessary or appropriate in the public interest, and is consistent with the protection of investors. Like the SEC's review of an initial Form ATS-N, their review of a Form ATS-N Amendment would focus on the completeness and accuracy of the disclosures, and the SEC and its staff may provide comments to the NMS ATS or request that the broker-dealer operator supplement or revise the information in the Amendment.

Consequences of an Ineffectiveness Determination

If the SEC declares a Form ATS-N or Form ATS-N Amendment ineffective, the ATS would be prohibited from operating as an NMS ATS or, in the case of an Amendment, may continue to operate pursuant to a Form ATS-N that was previously declared effective. The NMS ATS may subsequently file a new Form ATS-N or Amendment to attempt to address any disclosure deficiencies or compliance issues that caused the original filing to be declared ineffective.

potential trading venue. Scenarios that are particularly likely to implicate a material change include:

- a broker-dealer operator or its affiliates begins to trade on the NMS ATS;
- a change to the broker-dealer operator's policies and procedures governing the written procedures to protect the confidential trading information of subscribers pursuant to Rule 301(b)(10)(i);
- a change to the types of participants accepted to the NMS ATS;
- the introduction or removal of a new order type;
- a change to the order interaction or priority protocols or to the segmentation of orders and participants;
- a change to the manner in which the NMS ATS displays orders or quotes; and
- a change of a service provider that has access to confidential subscriber trading information.

The SEC expects an NMS ATS to consider the facts and circumstances of every change to determine whether advance notice is required. Proposed Rule, *supra* note 1, at 127-128.

Suspension, Limitation or Revocation of Authority to Operate

Regulation ATS currently does not provide a process for the SEC to suspend, limit or revoke the exemption under which an ATS operates from the definition of “exchange” pursuant to Rule 3a1-1(a)(2), other than pursuant to the SEC’s general enforcement authority. The Proposed Rules would provide the SEC with such power if it finds, after notice and opportunity for a hearing, that such action is necessary or appropriate in the public interest, and is consistent with the protection of investors. Any suspension can last no more than twelve months. No restrictions on the ability to limit or revoke are included in the Proposed Rules.

Under the Proposed Rules, an NMS ATS whose exemption had been suspended or revoked would be prohibited from operating pursuant to the Rule 3a1-1(a)(2) exemption. If an NMS ATS’s exemption were to be merely limited, the NMS Stock ATS would be prohibited from operating in a manner otherwise inconsistent with the terms and conditions of the SEC order. Presumably, non-compliance with any suspension, limits or revocation of an NMS ATS’s exemption would result in further disciplinary action.

Written Safeguards and Procedures

Currently, Rule 301 of Regulation ATS requires ATSs to have safeguards and procedures in place to protect subscribers’ confidential trading information and to separate ATS functions from other functions conducted by the broker-dealer operator, including proprietary and customer trading. The Proposed Rules would require each ATS to memorialize in writing both the safeguards and procedures to protect subscribers’ confidential trading information and the oversight procedures adopted and implemented by the ATS to ensure that the safeguards and procedures are followed.

The SEC and the self-regulatory organization of which the ATS’s broker-dealer operator is a member would use these written safeguards and procedures to better understand how each ATS protects subscribers’ confidential trading information from unauthorized disclosure and access. The SEC believes this proposal would assist ATSs in more effectively complying with the existing legal requirements under Regulation ATS.

* * *

Please do not hesitate to contact us with any questions.

APPENDIX**Detailed Disclosure of the Operations of an NMS ATS**

Form ATS-N would require an NMS ATS to disclose information regarding:

- Activities of its broker-dealer operator, and the broker-dealer operator's affiliates, including:
 - operation of non-ATS trading centers and other NMS ATSs;
 - products or services offered to subscribers;
 - arrangements with unaffiliated trading centers;
 - trading activities on the NMS ATS;
 - use of smart order routers (or similar functionality) or algorithms to send or receive subscriber orders;
 - shared employees that service the operations of the NMS ATS and any other business unit or affiliate of the broker-dealer operator;
 - service providers to the NMS ATS;
 - differences in the availability of services, functionalities or procedures available to subscribers, as compared to the broker-dealer operator, and its affiliates; and
 - safeguards and procedures established to protect confidential trading information.
- The manner of operations of the NMS ATS, including:
 - subscribers;
 - types of orders;
 - connectivity, order entry, and co-location;
 - segmentation of order flow and notice of segmentation provided to any persons;
 - display of orders and other trading interest;
 - trading services, including rules and procedures governing priority, pricing methodologies, allocation, matching and execution;
 - procedures governing trading during a suspension, system disruption or malfunction;
 - opening, reopening and closing processes, and after hours procedures;

- outbound routing;
- use of market data;
- fees;
- procedures regarding trade reporting and clearance and settlement;
- order display and execution access;
- fair access standards; and
- market quality statistics published or provided by the NMS ATS to one or more subscribers.