

CLIENT MEMORANDUM

SEC Proposes Rules to Require Additional Transparency and Oversight of Dark Pools

November 23, 2015

AUTHORS

Howard L. Kramer | **James R. Burns** | **Katherine D. Hanniford**

As part of SEC Chair Mary Jo White's sustained focus on enhancing the U.S. equity market structure,¹ and in the wake of recent enforcement actions relating to alternative trading systems ("ATs") and their operators, the SEC has released proposed rules that would heighten regulatory disclosure requirements for certain ATs, increase publicly available information regarding their operations, and institute a process for the SEC to review and declare such registrations effective or ineffective.² The proposed rules would apply to all ATs that trade equities listed on a national securities exchange ("NMS Stock ATs"), including dark pools. Thus, the potential reach of the proposed rules is quite broad across the current landscape of ATs operators. For the most part, the proposed rules would not apply to fixed income platforms. However, one proposed provision regarding safeguards and procedures to protect confidential information would apply to all ATs.

For several years, the SEC has promised various rulemaking initiatives to address the dramatically changing landscape of equity trading markets, including the growing use of ATs as venues for equity order flow. Since the SEC in 2009 proposed

¹ See Chair Mary Jo White, "Enhancing Our Equity Market Structure," Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference, New York, NY (June 5, 2014).

² Regulation of NMS Stock Alternative Trading Systems, SEC Release No. 34-76474; File No. S7-23-15 (Nov. 18, 2015) (hereinafter "Rule Release").

SEC Proposes Rules to Require Additional Transparency and Oversight of Dark Pools

Continued

(and never adopted) a rule to amend some of the regulatory requirements for ATSS,³ however, the agency has primarily used enforcement actions rather than rulemaking to address issues relating to these registrants. The current proposal formalizes the SEC's long-stated intention to establish enhanced requirements for, and to more closely monitor, this growing segment of the equity markets, which the SEC has recognized as a significant source of trading and liquidity.⁴

Specifically, the proposed rules would govern how ATSS publicly disclose their broker-dealer activities and potential conflicts of interest as well as details of their operations. The proposed rules would also require all ATSS to implement and maintain written safeguards and procedures to protect the confidential trading information of their subscribers, as well as written procedures to ensure that those safeguards and procedures are followed. In its proposing release, the SEC noted that despite the current confidential disclosure regime, Form ATS does not solicit detailed information and ATS operators in turn have provided only "minimal, summary" disclosures regarding their operations to the SEC.⁵ The SEC cited the increasing complexity of ATS operations as one factor that has led the agency to believe the current disclosure regime has produced inconsistent and potentially insufficient disclosures regarding the operations of ATSS that trade stocks listed on a national securities exchange.⁶ Finally, the proposed rule provides a process for the SEC to revoke, suspend, or limit a NMS Stock ATS's operations if it fails to comply with any part of Regulation ATS⁷ or otherwise violates any provision of federal securities laws.

Disclosure

The proposed rule would create a new Form ATS-N, which is intended to facilitate market participants' ability to assess potential conflicts of interest and ATS order handling and routing decisions, as well as other matters related to the operations of the ATS. Proposed Form ATS-N would supersede current Form ATS. Of particular note, Parts III and IV of Form ATS-N request written responses and descriptions relating to broker-dealer and affiliate activities and the manner of ATS operations.

Part III of proposed Form ATS-N would require disclosures relating to the following activities of an ATS broker-dealer operator, and the broker-dealer operator's affiliates, including:

- operation of non-ATS trading centers and other NMS Stock ATSS;
- products or services offered to subscribers;
- arrangements with unaffiliated trading centers;

³ See Regulation of Non-Public Trading Interest, SEC Release No. 34-60997; File No. S7-27-09 (Nov. 13, 2009).

⁴ Concept Release on Equity Market Structure, SEC Release No. 34-61358; File No. S7-02-10 (Jan. 14, 2010).

⁵ Rule Release at 57.

⁶ Rule Release at 57-58.

⁷ 17 CFR 242.301.

SEC Proposes Rules to Require Additional Transparency and Oversight of Dark Pools

Continued

- trading activities on the 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 ATS and any other business unit or affiliate of the broker-dealer operator;
- service providers to the 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.

Part IV of proposed Form ATS-N would require disclosures relating to the manner of operations of a NMS Stock ATS, including:

- subscribers;
- types of orders (including key execution attributes such as time-in-force limitations), 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 information;
- 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 ATS to one or more subscribers.

SEC Proposes Rules to Require Additional Transparency and Oversight of Dark Pools

Continued

Under the proposed rules, a NMS Stock ATS would be required to amend its Form ATS-N in three circumstances: (i) in the event of a material change to its operations or to the activities of the broker-dealer operator or its affiliates that are subject to disclosure in Form ATS-N, within at least thirty days prior to the date of implementation; (ii) to correct any other information that has become inaccurate and has not been reported to the SEC as a Form ATS-N Amendment, within thirty days after the end of each calendar quarter; or (iii) to correct previously filed information upon discovery that it was inaccurate or incomplete when filed, which should be done “promptly.” Like the Form ATS-N, a Form ATS-N Amendment would also be publicly disclosed.

Public Availability

Under current rules, a Form ATS is “deemed confidential when filed.”⁸ Consequently, there has been limited publicly available information regarding ATS operators, disclosures to subscribers notwithstanding. In contrast, the proposed rules would make all NMS Stock ATS operators’ Forms ATS-N and amendments publicly available on the SEC website. The proposal would also require each NMS Stock ATS to make public on its website a link to its Form ATS-N filings on the SEC’s website.

Declaration of Effectiveness or Ineffectiveness

The proposed rules would also create a new, enhanced process for the SEC to review Form ATS-N filings, including amendments, and declare them effective or, after notice and opportunity for a hearing, ineffective. Existing ATSs would be required to file a Form ATS-N no later than 120 calendar days from the effective date of the final rule. Thus, legacy ATSs may not rely on their current Form ATS filings should the rule become effective in its present form and might be in danger of the SEC declaring their submission to be ineffective.

Under the proposed rules, the SEC could declare a Form ATS-N filing effective or ineffective within 120 days of filing with the SEC. Should the SEC need more time to review the Form ATS-N due to unusual length or novel or complex issues, the SEC will provide notice of the need for additional time and its reasoning. Among the reasons a Form ATS-N filing could be declared ineffective are one or more disclosures that are “materially deficient with respect to their accuracy, currency, or completeness.”⁹ Proposed Rule 304(c)(1) provides requirements for accurate, current, and complete disclosure.

Likewise, the SEC could declare amendments to Form ATS-N ineffective within thirty days from filing with the SEC. In the event a Form ATS-N Amendment would be declared ineffective under the proposed rule, the ATS would be prohibited from operating pursuant to the ineffective amendment, but could continue to operate pursuant to the Form ATS-N that was previously declared effective while it files a subsequent Amendment to cure the disclosure deficiency.

⁸ Rule Release at 17; see 17 CFR 242.301(b)(2)(vii).

⁹ Rule Release at 115.

SEC Proposes Rules to Require Additional Transparency and Oversight of Dark Pools

Continued

Suspension, Limitation, or Revocation of Exemption

The proposed rules also provide a process for the SEC to suspend, limit, or revoke the exemption of a Form ATS-N, after notice and opportunity for a hearing, in the event a NMS Stock ATS fails to comply with any part of Regulation ATS or otherwise violates any provision of federal securities laws. Currently, Regulation ATS does not provide such a process. Proposed Rule 304(a)(4) would permit the SEC, by an order, after notice and opportunity for a hearing, to suspend for up to twelve months, limit, or revoke a NMS Stock ATS's exemption from the definition of "exchange" under Rule 3a1-1(a)(2). If an ATS's exemption were to be suspended or revoked, then it would be prohibited from operating pursuant to the exemption. If an ATS's exemption were to be merely limited, then it would be prohibited from operating in a manner inconsistent with the terms and conditions of the SEC order.

Written Safeguards and Procedures to Protect Confidential Trading Information

While current Regulation ATS Rule 301(b)(10) requires safeguards and procedures to protect subscribers' confidential trading information, the proposed rule would require all ATSs (including non-NMS Stock ATSs) to memorialize these safeguards and procedures in writing. The proposed rule would require written safeguards and procedures that limit ATS employee access to subscribers' confidential trading information to those ATS employees who are operating the system or are responsible for compliance with Regulation ATS and other applicable rules. The proposed rule would require all ATSs to implement written standards controlling employees of the ATS trading for their own accounts. Finally, the proposed rules also would require written oversight procedures to be adopted and implemented to ensure that these safeguards and procedures to protect subscribers' confidential trading information are followed.

Conclusion

With 558 questions posed throughout the 584-page release, commenters will have ample opportunity to offer a wide range of views on the proposal, but must do so within sixty days. At first blush, the proposed rules are particularly noteworthy in two respects: first, they would give subscribers and the broader market deeper insights into how NMS Stock ATSs operate and into associated activities of their broker-dealer operators, with an eye toward enabling market participants to better assess potential conflicts. Second, they outline a path for standardization and comparability of information – not just around how such ATSs operate, but also around important market quality statistics (an area in which we expect to see further initiatives coming from the SEC in due course, especially around Rule 606 statistics). Nevertheless, a key question for both broker-dealer sponsors and buy-side firms who trade through NMS Stock ATSs will be whether the various disclosures the SEC has proposed are the optimal ones to inform good decision-making or whether the information is too granular and of limited utility.

While the SEC asserts that the proposed rule is intended to increase transparency of ATS operations, much of the proposal suggests an additional goal may be to make the ATS filing process more similar to the process for registering as an exchange. The proposal will force ATSs to submit a lengthy initial application and substantive operational amendment filings that would be subject to an SEC approval process. A fair issue for commenters to raise is whether the proposal

SEC Proposes Rules to Require Additional Transparency and Oversight of Dark Pools

Continued

serves to improve disclosures and impose greater discipline and uniformity on ATS behavior or whether it merely creates a more lengthy regulatory review process for ATSS and a disclosure document more laden with potential liability for ATS sponsors.

More broadly, it is also unclear how the proposed rules' heightened disclosure requirements will affect NMS Stock ATSS' incentives and ability to innovate, evolve, and distinguish themselves from competitors. At the same time, the increasing complexity of operations in the equities ATS market sector also raises the issue of whether these new regulations will help or hinder new entrants into the NMS Stock ATS market or whether they will encourage yet more equity trading volume to migrate to other less regulated venues or market centers.

If you have any questions regarding this memorandum, please contact Howard L. Kramer (202-303-1208; hkramer@willkie.com), James R. Burns (202-303-1241; jburns@willkie.com), Katherine D. Hanniford (202-303-1157; khanniford@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

November 23, 2015

Copyright © 2015 Willkie Farr & Gallagher LLP.

This memorandum is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum may be considered advertising under applicable state laws.