

CLIENT ALERT

SEC Adopts New Rules to Enhance Public Disclosure of Information and Regulatory Oversight of Alternative Trading Systems

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Overview

On July 18, 2018, the Securities and Exchange Commission (the “SEC” or the “Commission”) voted unanimously to adopt a new Form ATS-N and amendments to Regulation ATS (the “Final Reg. ATS Amendments”) in order to enhance operational transparency and regulatory oversight of alternative trading systems (“ATs”) that trade NMS Stock, as defined in Section 300(g) of Regulation ATS (“NMS Stock”).¹ The amendments require ATs that trade NMS Stock (“NMS Stock ATs”) to publicly disclose on a new Form ATS-N detailed information about their operations and the ATs-related activities of the broker-dealer that operates the ATs (“broker-dealer operator”) and its affiliates that access the ATs.

The SEC noted that since the adoption of Regulation ATS in 1998, the number of ATs and the volume of NMS Stock traded on them has significantly increased. According to the Commission, today, NMS Stock ATs represent a significant source of liquidity – typically over 11% of average daily share volume across NMS stock, and the largest NMS Stock

¹ The new rules apply only to NMS Stock ATs, with the exception of the amendment to Rule 301(b)(10), which applies to all ATs subject to Regulation ATS, including both NMS Stock ATs and non-NMS Stock ATs.

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ATSs trade more volume than many registered national equities exchanges. In distinguishing the existing regulatory requirements applicable to ATSs, the SEC indicated that these requirements have remained largely the same for 20 years; unlike national securities exchanges, ATSs are not required to disclose publicly details about their trading services, operations, or fees. While many brokers have voluntarily made their existing Form ATSs public, some have not, and the SEC concluded that there is no consistency across ATSs with respect to the level of detail provided on Form ATS. In addition, the SEC found that many ATSs today are operated by large broker-dealers, whose diverse other activities have become increasingly intertwined with those of the ATS, resulting in substantial conflicts of interest. The SEC noted that the complex business structure of these broker-dealer operators can also add complexity to the operation of the ATS and can create potential conflicts of interest between the broker-dealer operator and its own affiliates and the ATS's subscribers.

The new Form ATS-N and the Final Reg. ATS Amendments seek to enable market participants to make more informed order routing decisions and to help broker-dealers evaluate how best to handle their customer orders. The rules also implement a process for the SEC to review Form ATS-N filings and declare Form ATS-N either effective or, after notice and opportunity for hearing, ineffective. The process for review of Form ATS-N will facilitate better Commission oversight of ATSs and protection of investors. As noted by the Commission, the purpose of the review is not to evaluate the innovations or merits of ATSs, but primarily to evaluate whether disclosures are sufficient and to provide a process for the SEC to protect investors and the public interest when an ATS's disclosures reveal non-compliance with federal securities laws.

The new Form ATS-N and the Final Reg. ATS Amendments were modified in a number of respects in response to industry comments on the rules proposed in the Proposing Release.² Among other things, the final rule's disclosure requirements with respect to affiliates of the broker-dealer operator were tailored to focus solely on affiliates of the broker-dealer operator that trade on the ATS. The proposed amendments were also modified to address concerns regarding the potential exposure of proprietary or commercially sensitive information (such as, for example, routing tables or numerical order flow segmentation metrics) by narrowing certain disclosures to require that more summary information be provided instead. The Final Reg. ATS Amendments, as opposed to the rules discussed in the Proposing Release, provide that when filing a material amendment to Form ATS-N, an ATS would only be required to submit a brief summary description that would be made public upon filing of the amendment. The full description of the material change would remain confidential until the material amendment itself becomes effective at the end of the 30-day review period.

² For Proposing Release, See Securities Exchange Act ATS Release No. 76474 (Nov. 18, 2015), available at <https://www.sec.gov/rules/proposed/2015/34-76474.pdf>. Comments received on the Proposing Release are available on the Commission's website, at: <https://www.sec.gov/comments/s7-23-15/s72315.shtml>.

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The public disclosures on Form ATS-N under the Final Reg. ATS Amendments are designed to allow all market participants to better understand how their orders may interact, match and execute in an ATS and to enable them to better assess the potential for conflicts of interest and information leakage. Collectively, the public disclosures on Form ATS-N seek to allow market participants to make more informed order routing decisions. In addition, the process for review of Form ATS-N filings, which would allow the SEC to declare a Form ATS-N ineffective after notice and opportunity for a hearing, facilitates more routinized Commission oversight over NMS Stock ATSS and seeks to foster better protection of investors whose orders are routed to those venues.

Heightened Regulatory Requirements for NMS Stock ATSS – Registration and Disclosure

Section 5 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), requires an organization, association or a group of persons that meets the definition of an exchange under Section 3(a)(1) of the Exchange Act and Rule 3b-16 thereunder, to register with the SEC as a national securities exchange, pursuant to Section 6 of the Exchange Act, unless otherwise exempt. One of the available exemptions for ATSS is that contained in Exchange Act Rule 3a1-1(a)(2), which exempts from the definition of an exchange an organization, association or group of persons that complies with the conditions of Regulation ATS. Regulation ATS requires, among other things, that the ATS register as a broker-dealer and file a Form ATS with the SEC, which is not made publicly available. An ATS can operate pursuant to this exemption in compliance with the conditions of Regulation ATS and will not be required by Section 5 to register as a national securities exchange.

New Rule 304 under Regulation ATS sets new conditions to the Rule 3a1-1(a)(2) exemption for ATSS that trade NMS Stock. Rule 304 requires, among other things, that a broker-dealer operator of an NMS Stock ATS file with the Commission an initial Form ATS-N and that the initial Form ATS-N become effective under the rule. The Form ATS-N must contain public disclosures and information related to the following:

- Information about the broker-dealer operator, including identifying information and ownership;
- ATS-related activities of the broker-dealer operator and the broker-dealer operator’s affiliates, including:
 - the trading activities of the broker-dealer operator and its affiliates on the ATS;³
 - whether subscribers of the ATS can opt out from interacting with the orders and trading interests of the broker-dealer operator and its affiliates;

³ The Commission revised the proposed disclosure requirements to limit the scope of the required disclosures with respect to the activities of the broker-dealer operator and its affiliates only to those activities related to the ATS. As a result, most of the required disclosures under Part III, Items 1 and 2 of the proposed Form ATS-N were eliminated and consolidated into Part III, Items 1 and 2 of the final Form ATS-N only to the extent that they are related to activities of the broker-dealer operator or its affiliates on the ATS.

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- arrangements between the broker-dealer operator and its affiliates and trading centers to access the ATS services;
- products and services offered to ATS subscribers by the broker-dealer operator and its affiliates;
- the activities of service providers to the broker-dealer operator and its affiliates;
- the safeguards and procedures established to protect confidential trading information of the subscribers;
- The manner of operation of the ATS, including:
 - types of subscribers, the criteria for eligibility for ATS services, and conditions for excluding subscribers from ATS services;
 - means of entry for orders and trading interest;
 - connectivity and co-location procedures;
 - order types, attributes, and order size requirements and procedures;
 - use of and terms and conditions governing conditional orders and indications of interest;
 - hours of operation, opening, reopening, and closing processes, and procedures for trading outside of regular trading hours;
 - trading services, facilities, and rules of the ATS;
 - arrangements with any subscriber or the broker-dealer operator to provide liquidity;
 - segmentation of orders and trading interest and the provision of notice regarding segmentation;
 - counter-party selection;
 - display of orders and other trading interest;
 - outbound routing from the ATS;
 - fees;
 - procedures for stopping or suspending trading;

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- procedures regarding trade reporting, clearance, and settlement;
- sources and uses of market data;
- as applicable, information about an ATS's obligations related to order display and execution access pursuant to Rule 301(b)(3) of Regulation ATS and fair access pursuant to Rule 301(b)(5) of Regulation ATS; and
- aggregate platform-wide order flow and execution statistics provided by the ATS to one or more subscribers.

Review and Effectiveness of Form ATS-N

New Rule 304 also provides that no exemption from the definition of exchange will be available to the ATS unless its initial Form ATS-N is effective. Under the rule, an initial Form ATS-N becomes effective unless declared ineffective upon the earlier of the completion of the review by the Commission or the expiration of the Commission's review period. The rule provides that the Commission will have 120 calendar days from the date of filing to review the initial Form ATS-N. The Commission may extend the review period by an additional 120 days for NMS Stock ATSs in existence as of January 7, 2019 ("Legacy NMS Stock ATSs") and 90 days for non-Legacy NMS Stock ATSs if the Form ATS-N is unusually lengthy or raises novel or complex issues. The Commission could, depending on the length and complexity of the Form ATS-N, complete the review prior to the expiration date of the review period or the extended review period, in which case the Form ATS-N will become effective upon publication on the SEC's website. The Commission's review period for Amendments to the Form ATS-N is 30 calendar days.

Rule 304 also establishes a process through which the SEC may declare a Form ATS-N ineffective, if the Commission finds, after notice and opportunity for hearing, that such action would be necessary and appropriate in the public interest, and consistent with the protection of investors. The SEC's review will focus on whether disclosures are materially deficient with respect to completeness and comprehensibility or reveal non-compliance with federal securities laws or rules and regulations thereunder, including Regulation ATS. According to the Adopting Release, the Commission will not conduct a merit-based review of Form ATS-N disclosures, nor approve or disapprove aspects of the NMS Stock ATS operations.⁴

⁴ "Given that the objective of Rule 304 is to provide market participants with information about NMS Stock ATSs through Form ATS-N disclosures, our review is designed to focus on the Form ATS-N disclosures and is not a merit-based review of the operations of the NMS Stock ATS or the ATS-related activities of the broker-dealer operator." See Securities Exchange Act ATS Release No. 83663 (July 18, 2018) ("Adopting Release"), available at <https://www.sec.gov/rules/final/2018/34-83663.pdf>.

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Public Disclosure of Form ATS-N and Related Commission Orders

Rule 304(b) requires that the Commission make public each initial Form ATS-N, as amended, orders of ineffective initial Form ATS-N and amendments to an effective Form ATS-N. The filings will be posted on the SEC's website through the Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. In addition, each NMS Stock ATS will be required to post on its own website a direct hyperlink to the Commission's website where the public Form ATS-N filings are located.

Amendments to Regulation ATS for Written Safeguards and Written Procedures to Protect Confidential Trading Information

Amendments to Rule 301(b)(10) will require that all ATSS subject to Regulation ATS reduce to writing the safeguards and procedures that limit access to the confidential trading information of ATS subscribers, as well as their oversight procedures to ensure that these safeguards and procedures are followed.

Effective Date and Compliance Date

The Final Reg. ATS Amendments will become effective 60 days after the date of publication in the Federal Register. Compliance with the requirement with respect to written safeguards and procedures to protect subscribers' confidential information and written oversight procedures will be required as of the date the rules become effective. Thus, ATSS will have 60 days from the Federal Register publication date to document in writing their safeguards and procedures to protect subscribers' confidential trading information to the extent they are not currently maintained in a written form.

The requirement for filing initial Form ATS-N will become effective as of January 7, 2019. The rules provide for a process for Legacy NMS Stock ATSS to file their initial Form ATS-N and continue to operate while the initial Form ATS-N is under Commission review. Legacy NMS Stock ATSS will be required to file with the Commission an initial Form ATS-N, no earlier than January 7, 2019, and no later than February 8, 2019. The initial Form ATS-N will supersede and replace the Form ATS previously filed by the Legacy NMS Stock ATS, and the NMS Stock ATS will be allowed to operate, on a temporary basis, during the review of the initial Form ATS-N. Until a Legacy NMS Stock ATS files its initial Form ATS-N with the Commission, the Legacy NMS Stock ATS must continue to provide notice of changes to its operations by amending its Form ATS on file with the Commission.

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