

SEC Proposes Enhanced Transparency and Oversight of Certain Alternative Trading Systems

The proposal would subject ATs that effect transactions in listed stocks to significant new disclosure and transparency requirements.

On November 18, 2015, the US Securities and Exchange Commission (SEC) proposed rules (the ATS Transparency Proposal) to enhance operational transparency and regulatory oversight of alternative trading systems (ATs) that trade stocks listed on a national securities exchange (NMS stocks).¹ According to the SEC, because ATs, including “dark pools,” have gained significant market share in NMS stocks and have evolved to more complex and sophisticated trading centers, the SEC believes that improving information transparency would enable market participants to better assess ATs as potential trading venues.

Among other requirements, the ATS Transparency Proposal would mandate that ATs effecting transactions in NMS stocks file detailed disclosures on a newly proposed “Form ATS-N” regarding the ATs’ operations and the activities of its broker-dealer operator and affiliates. These disclosures would include information regarding broker-dealer operators’ and affiliates’ trading on the ATS, the types of orders and market data used on the ATS, and the ATs’ execution and priority procedures. This information would be publicly available on the SEC’s website. The ATS Transparency Proposal would also provide a process for the SEC to review Form ATS-N filings for compliance with the form requirements and declare, by order, initial filings and amendments to Form ATS-N effective or ineffective.

Notably, the ATS Transparency Proposal follows recent SEC enforcement actions against dark pool operators for failing to disclose conflicts of interest and, if adopted, would represent a significant change to Regulation ATS. The SEC also posed a number of questions to market participants in the ATS Transparency Proposal and the comment period for the rulemaking will be open for 60 days after the ATS Transparency Proposal is published in Federal Register.²

Scope of the ATS Transparency Proposal

The ATS Transparency Proposal would modify Regulation ATS to further distinguish between those ATs that list NMS stocks and those that do not. Specifically, the requirements in the ATS Transparency Proposal would apply to any ATS that facilitates transactions in securities that are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan, other than options, debt or convertible debt (NMS Stock ATs).

Enhanced Filing Requirements for NMS Stock ATs

Under the ATS Transparency Proposal, no exemption from the definition of “exchange”³ would be available to an NMS Stock ATS, unless the NMS Stock ATS files with the SEC a Form ATS-N and the

SEC declares the Form ATS-N effective.⁴ Form ATS-N would be submitted electronically to the SEC and would require detailed disclosure of, without limitation:

- Activities of the 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
 - Trading activities on the NMS Stock 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 Stock ATS and any other business unit or affiliate of the broker-dealer operator
 - Service providers to the NMS Stock ATS
 - Differences in the availability of services, functionalities, or procedures available to subscribers, as compared to the broker-dealer operator, and its affiliates
 - Safeguards and procedures established to protect confidential trading information

- The manner of operations of the NMS Stock ATS, including:
 - Subscriber eligibility, terms and conditions of use, types of subscribers, etc.
 - 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
 - Order routing
 - Trading services, including rules and procedures governing priority, pricing methodologies, allocation, matching and execution
 - Procedures governing trading during a suspension, system disruption or malfunction
 - Order display and execution access
 - Fair access standards
 - Market quality statistics published or provided by the NMS Stock ATS to one or more subscribers

For an NMS Stock ATS that is not operating on the effective date of the ATS Transparency Proposal, the SEC would not permit such entity to commence operations until the SEC has declared the form ATS-N effective.⁵ However, for ATSs that are currently operating and would be subject to the requirements under the ATS Transparency Proposal, the SEC would require such entities to file a Form ATS-N with the SEC no later than 120 calendar days after the effective date of the ATS Transparency Proposal. The SEC would then allow the entity to continue to operate pursuant to a previously filed initial operation report on Form ATS pending the SEC's review of the filed Form ATS-N.⁶

Upon reviewing a Form ATS-N, the SEC would declare such form effective after determining, without limitation, that the entity satisfies the definition of NMS Stock ATS, that the form is not materially deficient with respect to accuracy, currency or completeness, and that the entity complies with the federal securities laws and the rules and regulations thereunder, including Regulation ATS.⁷ The ATS Transparency Proposal sets forth non-exhaustive examples to illustrate various instances in which the SEC would declare a Form ATS-N ineffective because it contains one or more disclosures that are materially deficient, including:

- If an NMS Stock ATS discloses an order type on Form ATS-N but does not describe the key attributes of the order type, such as time-in-force limitations that can be placed on the ability to execute the order, the treatment of unfilled portions of orders or conditions for cancelling orders
- If an NMS Stock ATS generally describes some of its priority rules, but fails to describe conditions or exceptions to its priority rules, or fails to describe any priority overlays
- If a Form ATS-N states that the NMS Stock ATS has only one class of subscribers but the SEC learns through discussions (during the review period) with the NMS Stock ATS or otherwise that the NMS Stock ATS in fact has several classes of subscribers, or if the Form ATS-N states that two classes of subscribers are charged the same trading fees but the SEC learns through discussions with the NMS Stock ATS or otherwise that in fact one class receives more favorable fees than the other
- If a Form ATS-N includes inconsistent information, such as a statement in one part of the form that the entity uses private feeds to calculate the NBBO, but in another part of the form the entity indicates that it uses the Securities Information Processor

During review, the SEC may provide comments to the ATS, and may request that the entity supplement information in the Form ATS-N or revise its disclosures on Form ATS-N.⁸ Moreover, the ATS Transparency Proposal provides that the SEC may not declare a Form ATS-N ineffective without notice and opportunity for hearing.⁹

Amendments to Form ATS-N

The ATS Transparency Proposal would require an NMS Stock ATS to amend an effective form ATS-N at least 30 calendar days prior to the implementation date of a material change to the operations of the NMS Stock ATS or to the activities of the broker-dealer operator or its affiliates that are subject to disclosure on Form ATS-N.¹⁰ According to the SEC, scenarios that are likely to implicate a material change (and necessitate an amendment) are, without limitation:

- A broker-dealer operator or its affiliates beginning to trade on the NMS Stock ATS
- A change to the broker-dealer operator's policies and procedures governing the written safeguards and written procedures to protect subscribers' confidential trading information
- A change to the types of participants on the NMS Stock ATS
- The introduction or removal of a new order type on the NMS Stock ATS
- A change to the order interaction and priority procedures
- A change to the segmentation of orders and participants
- A change to the manner in which the NMS Stock ATS displays orders or quotes
- A change of service provider to the operations of the NMS Stock ATS that has access to confidential subscriber trading information

The ATS Transparency Proposal would also require an NMS Stock ATS to amend an effective 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 as a Form ATS-N amendment.¹¹ In addition, an NMS Stock ATS would be required to amend an effective Form ATS-N promptly to correct information in any previous disclosure on Form ATS-N after discovery that any information filed in a Form ATS-N or Form ATS-N amendment was inaccurate or incomplete when filed.¹²

As with the process for reviewing an initial Form ATS-N, the SEC would review an amendment to Form ATS-N and declare such amendment effective or ineffective within 30 calendar days from filing. If the SEC declares a Form ATS-N amendment ineffective, the NMS Stock ATS would be prohibited from operating pursuant to the ineffective Form ATS-N amendment, but the NMS Stock ATS would be permitted to subsequently file a new Form ATS-N amendment to address any disclosure deficiencies or compliance issues that caused the SEC to declare a Form ATS-N amendment ineffective.¹³

Public Disclosure of Form ATS-N and Related SEC Orders

Under the ATS Transparency Proposal, Form ATS-N (and any amendments thereto) which NMS Stock ATSs filed and SEC orders related to the effectiveness of Form ATS-N will be made publicly available and posted to the SEC's website.¹⁴ The ATS Transparency Proposal would also require that each NMS Stock ATS make public via posting on its website a direct URL hyperlink to the SEC's website that contains such documents.¹⁵ The SEC would not post on its website a filed Form ATS-N before the SEC declares such Form ATS-N effective, but amendments to Form ATS-N would be publically available upon filing.¹⁶

Application of Existing Requirements to NMS Stock ATSs

An NMS Stock ATS would be required to comply with the existing requirements of Regulation ATS, except with respect to the reporting and amendment requirements set forth in Rule 301(b)(2) of Regulation ATS.¹⁷ Existing Rule 301(b)(2) requires an ATS to file with the Commission a Form ATS initial operation report, amendments to the Form ATS initial operation report, and cessation of operations reports on Form ATS, all of which are "deemed confidential when filed." Because the ATS Transparency Proposal would govern the content and manner in which an NMS Stock ATS would be required to disclose information to the public and the SEC on proposed Form ATS-N, the requirements of existing Rule 301(b)(2) would be duplicative and conflict with the requirements under the ATS Transparency Proposal and would therefore not apply to NMS Stock ATSs.¹⁸ However, to the extent that an ATS effects transactions in both NMS stocks and non-NMS stocks, the ATS would be subject to the requirements of the ATS Transparency Proposal with respect to NMS-stocks and Rule 301(b)(2) with respect to non-NMS stocks.¹⁹

In addition, the ATS Transparency Proposal would amend the existing reporting requirements in Regulation ATS to require an ATS to report transaction volume on Form ATS-R on a quarterly basis separately for transactions in NMS stocks and transactions in non-NMS stocks.²⁰ In either case, however, Form ATS-R would continue to be deemed confidential.²¹

Suspension, Limitation or Revocation of NMS Stock ATS Status

The ATS Transparency Proposal would provide a process for the SEC to suspend, limit or revoke an NMS Stock ATS' exemption from the definition of the term exchange under certain circumstances.²² Currently, Regulation ATS does not provide a process for the SEC to suspend, limit or revoke the exemption under which an ATS operates — other than pursuant to the SEC's general enforcement authority. However, the ATS Transparency Proposal would establish a procedure whereby the SEC could do so for a period of 12 months if the SEC finds, after notice and opportunity for hearing, that such action is necessary or appropriate in the public interest and is consistent with the protection of investors.²³ In making such a determination, the SEC would consider, among other things, whether the entity no longer meets the definition of NMS Stock ATS, does not comply with the conditions applicable to NMS Stock ATSs or otherwise violates any provision of federal securities laws.²⁴

Written Procedures to Protect Confidential Trading Information

Regulation ATS currently requires that every ATS implement safeguards and procedures to protect subscribers' confidential trading information and to separate ATS functions from other broker-dealer functions, including proprietary and customer trading.²⁵ At present, however, such safeguards and procedures are not required to be memorialized in writing.²⁶ The ATS Proposal would amend Regulation ATS to require that all ATSS (including non-NMS Stock ATSS) establish written safeguards and written procedures to protect subscribers' confidential trading information.

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Endnotes

- ¹ Regulation of NMS Stock Alternative Trading Systems, Proposed Rule, Release No. 34-76474; File No. S7-23-15 (Nov. 19, 2015), available at: <http://www.sec.gov/rules/proposed/2015/34-76474.pdf> [hereafter, the ATS Transparency Proposal].
- ² As of the date of this *Client Alert*, the ATS Transparency Proposal has not been published in the Federal Register.
- ³ Exchange Act Rule 3a1-1(a) exempts from the definition of “exchange”: (i) any ATS operated by a national securities association, (ii) any ATS that complies with Regulation ATS, and (iii) any ATS that under Rule 301(a) of Regulation ATS is not required to comply with Regulation ATS.
- ⁴ See ATS Transparency Proposal at p. 107.
- ⁵ See *id.*
- ⁶ See ATS Transparency Proposal at p. 109. The ATS Transparency Proposal would provide that the SEC declare a Form ATS-N filed by an NMS Stock ATS, operating as of the effective date of the proposed rules, effective or ineffective no later than 120 calendar days from filing with the SEC. Similarly, the SEC would be required to declare a Form ATS-N filed by an NMS Stock ATS, that was not operating as of the effective date of the proposed rule, effective or ineffective no later than 120 calendar days from filing with the SEC. However, the SEC would be permitted to extend this review period if the Form ATS-N is unusually lengthy or raises novel or complex issues that require additional time for review, or if the NMS Stock ATS agrees to extend the review period.
- ⁷ See ATS Transparency Proposal at p. 115.
- ⁸ See ATS Transparency Proposal at p. 119.
- ⁹ See ATS Transparency Proposal at p. 112.
- ¹⁰ See ATS Transparency Proposal at p. 125. The SEC preliminarily believes that a change to the operations of an NMS Stock ATS, or the disclosures regarding the activities of the broker-dealer operator and its affiliates, would be material if there is a substantial likelihood that a reasonable market participant would consider the change important when evaluating the NMS Stock ATS as a potential trading venue. To determine whether a change is material, and thus subject to the 30-day advance notice requirement, the SEC stated that an NMS Stock ATS would need to consider all the relevant facts and circumstances, including the reason for the change and how the change might impact the NMS Stock ATS and its subscribers, as well as market participants that may be evaluating the NMS Stock ATS as a potential trading venue.
- ¹¹ See ATS Transparency Proposal at p. 130.
- ¹² See ATS Transparency Proposal at p. 133.
- ¹³ See ATS Transparency Proposal at p. 136.
- ¹⁴ See ATS Transparency Proposal at p. 152.
- ¹⁵ See *id.*
- ¹⁶ See ATS Transparency Proposal at p. 155.
- ¹⁷ See ATS Transparency Proposal at p. 104.
- ¹⁸ See ATS Transparency Proposal at p. 105.
- ¹⁹ See *id.*
- ²⁰ See ATS Transparency Proposal at p. 107.
- ²¹ See *id.*
- ²² See ATS Transparency Proposal at p. 142.
- ²³ See ATS Transparency Proposal at p. 143.
- ²⁴ See ATS Transparency Proposal at p. 144.
- ²⁵ See 17 CFR 242.301(b)(10).
- ²⁶ See ATS Transparency Proposal at p. 370.