

## Alert

### SEC Adopts New Transparency Requirements for NMS Stock Alternative Trading Systems

July 31, 2018

On July 18, 2018, the U.S. Securities and Exchange Commission approved amendments (“Amendments”) to Regulation ATS and Rule 3a1-1 under the Securities Exchange Act of 1934, as amended (“Exchange Act”).<sup>1</sup> The Amendments impose extensive new transparency requirements on alternative trading systems<sup>2</sup> (“ATSs”) that effect transactions in NMS Stocks.

The Amendments will require ATSs that trade in NMS Stocks (such as ATSs, “NMS Stock ATSs”) to file new Form ATS-N and publicly disclose detailed information regarding the manner of operation of the ATS and the ATS-related activities of both the ATS’s broker-dealer operator and the operator’s affiliates.<sup>3</sup> The Amendments also require ATS operators to memorialize their safeguards and procedures relating to the protection of subscribers’ confidential trading information.<sup>4</sup>

The Amendments will become effective 60 days from the date that they are published in the Federal Register. However, operators of NMS Stock ATSs will not have to comply with the requirements of Form ATS-N until Jan. 7, 2019. Additionally, an NMS Stock ATS operating pursuant to a previously filed Form-ATS (a “Legacy NMS Stock ATS”) as of Jan. 7, 2019 will be required to file a Form ATS-N no later than Feb. 8, 2019.

#### Background and Current Regulatory Framework

The existing regulatory framework for ATSs was adopted by the SEC in 1998 to address advances in technology and the proliferation of electronic trading systems. Under Regulation ATS, an ATS operator is required to file an initial operation report with the SEC disclosing certain information about the ATS. This includes, among other things, the ATS’s manner of operation and the identity of third parties involved in the operation of the ATS. Material amendments to Form ATS must be filed at least 20 days before the change is implemented. Under the current ATS regulatory regime, the filing of Form ATS and all amendments thereto are “notice-filings” (i.e., the SEC cannot declare a filing ineffective) and are confidential.

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<sup>1</sup> *Regulation of NMS Stock Alternative Trading Systems*, Release No. 34-34-83663, July 18, 2018 (“Adopting Release”).

<sup>2</sup> As that term is defined in Section 300(g) of Regulation ATS.

<sup>3</sup> Form ATS-N filings will be publicly posted through the SEC’s Electronic Data Gathering, Analysis, and Retrieval system (EDGAR).

<sup>4</sup> Currently, ATS operators must have in place safeguards and procedures to protect subscribers’ confidential trading information under Exchange Act rule 301(b)(10). Rule 301(b)(10), however, does not require that these safeguards be in writing.

## Amendments to Regulation ATS

### *New Written Policies and Procedures*

The Amendments require ATS operators to memorialize (i.e., put into writing) their safeguards and procedures designed to limit access to the confidential trading information of ATS subscribers. ATS operators are currently required to have such policies and procedures under Exchange Act rule 301(b)(10), although the rule does not require that these policies and procedures be in writing. ATS operators must comply with this requirement within 60 days of publication of the Adopting Release in the Federal Register.

Additionally, Form ATS-N will require NMS Stock ATS operators to include a description of their written safeguards and procedures designed to protect subscriber confidential trading information.<sup>5</sup> This will include a description of the “written standards controlling employees of the ATS that trade for employees’ accounts.”<sup>6</sup> This will also include a summary of the “roles and responsibilities” of individuals with access to confidential trading information.<sup>7</sup>

### *Form ATS-N*

Effective Jan. 7, 2019, an operator of an NMS Stock ATS will be required to use Form ATS-N. All Form ATS-N filings will be subject to SEC review and, once effective, will be made publicly available. Importantly, Form ATS-N will only apply to ATSs that effect transactions in NMS Stocks. An ATS that transacts in NMS Stocks and other securities (e.g., fixed income securities or options) will have to file Form ATS-N for their NMS Stock operations and Form ATS for their non-NMS Stock operations.

### *Commission Review of Form ATS-N Filings*

The amendments to Regulation ATS establish a process for the Commission to review Form ATS-N filings. Among other things:

- An NMS Stock ATS’s initial Form ATS-N will become effective, unless declared ineffective,<sup>8</sup> upon the earlier of (1) the completion of the Commission’s review and (2) the expiration of the Commission’s review period (including, if applicable, any extension thereof).<sup>9</sup>
- Material amendments to Form ATS-N must be filed at least 30 calendar days prior to the implementation of the change (such amendments, “Material Amendments”). The Adopting Release notes that a change is “material” if there is a substantial likelihood that a reasonable market participant would consider the change important when evaluating the NMS Stock ATS as

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<sup>5</sup> See Part II, Item 7(a) of Form ATS-N.

<sup>6</sup> *Id.*

<sup>7</sup> See Part II, Item 7(d) of Form ATS-N.

<sup>8</sup> A Form ATS-N may be declared ineffective if, for example, the entity making the filing did not meet the definition of an NMS Stock ATS, the filing reveals non-compliance with federal securities laws, or one or more disclosures are materially deficient with respect to their completeness or comprehensibility. See the Adopting Release at p. 85. The Adopting Release further states that “an NMS Stock ATS will have the opportunity to be heard before the Commission declares its Form ATS-N ineffective” and that “if Form ATS-N is declared ineffective by the Commission, the Commission’s order will provide the basis for the declaration of ineffectiveness, and the NMS Stock ATS will have the opportunity to file another Form ATS-N that addresses the basis for the ineffectiveness determination.” See the Adopting Release at p. 105, 106.

<sup>9</sup> The initial review period for both Legacy NMS Stock ATSs and non-Legacy NMS Stock ATSs is 120 calendar days. See the Adopting Release at p. 79. The extended review period is 120 calendar days for Form ATS-N filings by Legacy NMS Stock ATSs and 90 calendar days for filings by non-Legacy NMS Stock ATSs that are unusually lengthy or raise novel or complex issues. *Id.* The operator of the NMS Stock ATS and the SEC may, however, agree to a longer extension period. See the Adopting Release at p. 116.

a potential trading venue.<sup>10</sup> The amended Form ATS-N will be made public upon the expiration of the 30 calendar day period, although a brief summary of the change will be made public upon filing.<sup>11</sup>

- In addition, the operator of an NMS Stock ATS generally must submit an amended Form ATS-N when any information contained therein has become inaccurate or incomplete (such as amendments, “Updating Amendments”).<sup>12</sup> Updating Amendments must be made no later than 30 calendar days after the end of each calendar quarter.<sup>13</sup> Where, however, an NMS Stock ATS operator discovers that information in a previously filed Form ATS-N was “materially inaccurate or incomplete,” the operator must submit an amended Form ATS-N *promptly*.<sup>14</sup>
- The amendments to Regulation ATS will provide a process for the Commission to review *all* Form ATS-N filings and, after notice and opportunity for hearing, and upon certain findings, declare, by order, an NMS Stock ATS’s Form ATS-N ineffective. Form ATS-N includes a mechanism to withdraw a previously submitted Form ATS-N.

#### *Transition for Legacy NMS Stock ATSs*

As noted above, operators of Legacy NMS Stock ATSs must file their initial Form ATS-N with the Commission no earlier than Jan. 7, 2019, and no later than Feb. 8, 2019. The initial Form ATS-N will supersede and replace the Form ATS then on file with the SEC. The SEC will permit the Legacy NMS Stock ATS to continue to operate, on a temporary basis, pursuant to the filed initial Form ATS-N, and any amendment thereto, during the SEC’s review of the initial Form ATS-N.

#### *Form ATS-N Disclosures*

Form ATS-N will require information about the manner of operation of the NMS Stock ATS, including:

- The means of entry for orders and trading interests;
- Trading services, facilities and rules of the NMS Stock ATS;
- Display of orders and other trading interests;
- Procedures for stopping or suspending trading;
- Fees and counter-party selection;
- Procedures regarding trade reporting, clearance and settlement; and
- Sources and uses of market data.

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<sup>10</sup> The Adopting Release notes that “... an NMS Stock ATS should consider whether the cumulative effect of a series of changes to the operations of the NMS Stock ATS or the activities of the broker-dealer operator or its affiliates with regard to the NMS Stock ATS is material.” The Commission further notes that an ATS should consider the following regarding whether a change is material: the competitive dynamics among the ATS subscribers, the execution quality or performance of the orders of any subscribers, the fees that the subscriber would pay to access and/or use the ATS, the nature of counterparties with which a subscriber may interact and the relative speed of access or execution of a subscriber. See the Adopting Release at p. 129.

<sup>11</sup> The cover page of the filed material amendment will be made public by the Commission upon filing, and unless the Commission declares the material amendment ineffective, the entire material amendment will be made public following the Commission’s 30 calendar day review period. The cover page indicates that the NMS Stock ATS has filed a material amendment and provides a brief narrative about the content of the amendment.

<sup>12</sup> See Exchange Act rule 304(a)(2)(i)(B).

<sup>13</sup> *Id.*

<sup>14</sup> See Exchange Act rule 304(a)(2)(i)(C).

Form ATS already requires information regarding a number of these disclosures. As such, NMS Stock ATS operators should have the requested information readily available. However, NMS Stock ATS operators may find some of the new disclosure obligations onerous. For instance, Form ATS-N requires disclosures relating to the fees charged to subscribers of the NMS Stock ATS. Required information includes the fee structure (e.g., fixed fee, volume-based or transaction-based), variables that may impact the fees, differentiation among the types of subscribers and the range of fees charged. Accordingly, operators of NMS Stock ATSs will need to identify and publicly disclose the highest and lowest fee charged to subscribers to trade on the NMS Stock ATS. Multi-service broker-dealers that charge a bundled fee appear to be granted some relief from this obligation. The Adopting Release notes that “[t]o the extent [] a broker-dealer operator bundles its services with its NMS Stock ATS services, *and the ATS services do not have an explicit fee*, then the [] operator would not be required to provide a range of fees charged for the bundled services.”<sup>15</sup> (Emphasis added). While the Adopting Release does not provide an example of what would be considered an “explicit fee,” this language appears to provide some relief from the requirement of Part III, Item 19(b) of Form ATS-N, which requires the disclosure of fees charged for bundled services, including the range of such fees. Multi-service broker-dealers may want to review pricing arrangements across customers to determine whether separate fees to access their NMS Stock ATSs are being charged.

Additionally, Form ATS-N will require information regarding the ATS-related activities of the broker-dealer operator *and its affiliates*, including:

- The trading activities of the broker-dealer operator and its affiliates on the ATS;
- Whether subscribers to the ATS can opt out from interacting with orders and trading interest of the broker-dealer operator and its affiliates;
- Arrangements between the broker-dealer operator or 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; and
- Safeguards and procedures established to protect the confidential trading information of subscribers.

Areas of disclosures that may prove particularly burdensome to operators of NMS Stock ATSs are (1) affiliate trading activity on the ATS; (2) products and services offered to ATS subscribers by the broker-dealer operator and its affiliates; and (3) the activities of service providers to the broker-dealer operator and its affiliates.

#### *Affiliate Trading Activity on the ATS*

NMS Stock ATS operators will have to identify those affiliates and business units that may enter orders into the NMS Stock ATS. Importantly, this appears to include any affiliate or business unit whose orders

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<sup>15</sup> See the Adopting Release at p. 330.

may be routed to the NMS Stock ATS *by the operator's smart order router ("SOR")*.<sup>16</sup> This disclosure also includes any affiliate that may direct orders to the NMS Stock ATS *through a third-party broker-dealer*.<sup>17</sup>

#### *Disclosures Regarding Products and Services Offered to ATS Subscribers by the Broker-Dealer Operator and Its Affiliates*

An operator of an NMS Stock ATS will be required to provide information about the products and services offered to subscribers for the purpose of effecting transactions, or submitting, disseminating or displaying order and trading interest on the NMS Stock ATS.<sup>18</sup> This obligation extends to products and services offered by affiliates of the NMS Stock ATS operator.<sup>19</sup> While the Adopting Release attempts to distinguish between products and services that relate to the functions of the ATS and those that do not (disclosures about the latter would not be required), making this distinction will ultimately require a facts and circumstances analysis given that broker-dealers offer various products and services to their customers. This will include an analysis of how such products and services may be used by a subscriber to an NMS Stock ATS, which will vary. Further, operators of an NMS Stock ATS may be required to submit an amended Form ATS-N where the activity of an affiliate is changing. This will require enhanced communication between affiliates, and may require updates to the operator's policies and procedures.

#### *Disclosures Regarding the Activities of Service Providers to the Broker-Dealer Operator and Its Affiliates*

An operator of an NMS Stock ATS will be required to provide information about its employees who service the NMS Stock ATS as well as other business units of the broker-dealer operator and its affiliates. These disclosures, which require a summary of the role and responsibilities of the relevant employee, are only required for *shared* employees with access to confidential trading information on the ATS. Maintaining and updating these disclosures may prove burdensome as employee roles and responsibilities shift periodically.

The disclosures related to third-party service providers is intended to expand on the current requirement that ATS operators identify any third party (including any affiliate(s)) that will be involved in the operation of the ATS, including the execution, trading, clearing and settling of transactions on behalf of the ATS, and also provide a description of the role and responsibility of each such third party (including any affiliate(s)). NMS Stock ATSs will now be further required to disclose whether these third-party service providers, including any affiliates, use the NMS Stock ATS services, and if so, which ATS services the third party uses. These disclosures are intended to provide information about the extent to which a third-party service provider may be able to influence or control the operations of the ATS.

### **Implications**

The increase in regulatory burdens associated with operating an NMS Stock ATS and the need to disclose potentially sensitive business information could alter the competitive landscape among NMS Stock ATSs. It is further worth noting that:

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<sup>16</sup> See p. 214 of the Adopting Release.

<sup>17</sup> *Id.* Specifically, the Adopting Release states that “[I]f, likewise, if an affiliated asset manager of the broker-dealer operator uses the services of a third-party broker-dealer to route directed orders to the NMS Stock ATS (i.e., the asset manager instructs the third-party broker-dealer to send its orders to the NMS Stock ATS), the NMS Stock ATS would be required to list that affiliated asset manager under Item 2(a).”

<sup>18</sup> See Part II, Item 5(a) of Form ATS-N.

<sup>19</sup> See Part II, Item 5(c) of Form ATS-N.

- Amendments to Form ATS-N will likely become public before the NMS Stock ATS introduces a new functionality to the ATS. This may confuse market participants (e.g., market participants may see a Form ATS-N discussing a functionality that's not yet active).
- NMS Stock ATS operators will have to file amendments at least 30 days before the operator or *its affiliate* implements changes that require a Material Amendment. This may require both operators and their affiliates to adopt policies and procedures designed to ensure that applicable changes are not implemented prior to the effectiveness of a Material Amendment.
- The SEC's ability to declare a Form ATS-N amendment ineffective could impact the willingness of operators to introduce new functionality, particularly where projected development costs are high.
- The SEC is not making a merit-based assessment of Form ATS-N. Rather, the SEC's review will focus on the completeness and comprehensibility of the disclosures.

While the requirement to use Form ATS-N does not go into effect until Jan. 9, 2019, ATS operators should, given the scope of the required disclosures, start assessing their ATS operations and related policies and procedures to ensure they are ready for the compliance date.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the authors.

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