ALERTS

SEC Proposes Enhanced Regulatory Oversight for Government Securities Alternative Trading Systems

October 23, 2020

On Sept. 28, 2020, the U.S. Securities and Exchange Commission ("SEC" or the "Commission") announced a proposal extending the requirements of Regulations ATS under the Securities Exchange Act of 1934, as amended ("Exchange Act"), to alternative trading systems ("ATSs") that only trade U.S. government securities or repurchase and reverse repurchase agreements on government securities ("Government Securities ATSs").[1] The proposed amendments would impose extensive new transparency and regulatory requirements on Government Securities ATSs that currently operate under an exemption provided by Regulation ATS.

Background and Current Regulatory Framework

Currently, an ATS that trades only government securities[2] or repurchase and reverse repurchase agreements on government securities (collectively, "Government Securities") is exempt from registering as a national securities exchange and from complying with Regulation ATS. ATSs that trade both Government Securities and non-government securities are exempt from some provisions of Regulation ATS, but generally must comply with the regulations' requirements.

Since the current regulatory framework of Regulation ATS was implemented in 1998, the majority of ATSs trading Government Securities, particularly U.S. Treasury Securities[3] and Agency Securities,[4] have

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising

become increasingly electronic and complex. Currently, Government Securities ATSs closely resemble ATSs that trade NMS stocks[5] and other equity securities. The Commission believes that the increasingly electronic and complex nature of Government Securities ATSs, as well as the increased significance of Government Securities ATSs as venues for trading Government Securities, necessitate the proposed changes and increased regulatory oversight over such trading venues.

Proposed Amendments

The Commission is proposing to amend Regulation ATS to eliminate the exemption from compliance with Regulation ATS for those ATSs that only trade Government Securities. Specifically, Government Securities ATSs would no longer be exempt from the definition of "exchange" under Section 3(a)(1) of the Exchange Act and Government Securities ATSs would either have to register as national securities exchanges or comply with the requirements of Regulation ATS.

Notably, banks currently may operate Government Securities ATSs without having to register as broker-dealers. Under the proposed rule change, banks operating Government Securities ATSs would have to either register as a national securities exchange or divest their ATS operations, including by, among other things, transferring such operations to a broker-dealer affiliate.[6]

Proposed Disclosure Requirements

Currently, the disclosure obligations of Regulation ATS vary depending on whether the ATS trades NMS stocks. Where an ATS trades NMS stocks ("NMS Stock ATSs"), the operator must file and keep current Form ATS-N, which requires public disclosures of, among other things, the ATS' manner of operation and the operator's policies and procedures regarding the protection of subscriber confidential information. ATSs that trade securities other than NMS stocks must file Form ATS, which requires similar, although less detailed, non-public disclosures. Where an ATS permits trading in both NMS stocks and other securities, the operator must file and keep current a Form ATS-N relating to the ATS' NMS stock operations *and* a Form ATS relating to the ATS' other operations.

Under the proposal, the operator of a Government Securities ATS would be required to prepare and file Form ATS-G with the Commission.[7] As a

Copyright © 2024 Schulte Roth & Zabel LLP

general matter, Proposed Form ATS-G is largely duplicative of Form ATS-N and incorporates a large number of Form ATS-N's disclosure items unchanged.[8] Like Form ATS-N, Form ATS-G would be publicly posted on the SEC's website,[9] although operators of Government Securities ATSs would have to separately post their current Form ATS-G on their own website.[10] Further, the SEC's proposal would require that operators of Government Securities ATS comply with Exchange Act rule 304 generally,[11] including the requirement to submit Updating, Material and Correcting Amendments, as applicable.[12] Form ATS-G amendments will be subject to the SEC's current review process applicable to Form ATS-N amendments.[13]

Accordingly, firms that currently operate an NMS Stock ATS should be largely familiar with the proposed disclosure and filing requirements that would apply to Government Securities ATSs. Nevertheless, Form ATS-G, as proposed, does include certain distinctions from Form ATS-N given the differences in the markets for NMS stocks and Government Securities, including:

- Form ATS-G does not have an item corresponding to Part III, Item 16 (Routing) of Form ATS-N;
- Form ATS-G does not have an item corresponding to Part III, Item 24 (Order Display and Execution Access); and
- Form ATS-G added proposed Part III, Item 16 requiring information about non-government securities markets (*g*., futures, currencies, swaps, corporate bonds) used in conjunction with the ATS.

While the SEC recognizes that "almost all requests for information on proposed Form ATS-G are similar to or derived from Form ATS-N;"[14] responses to certain items may be materially different given the differences between the two markets. For instance, while NMS Stock ATSs generally rely on market data disseminated by the national securities exchanges (whether through direct feeds or the SIP), Government Securities ATSs may rely on market data from other Government Securities ATSs and, where the Government Securities ATS allows exchange for physical (EFP) transactions, certain futures markets. Accordingly, Government Securities ATSs' disclosures regarding "Display" and "Market Data" may be materially different from the corresponding disclosures on Form ATS-N.

Copyright © 2024 Schulte Roth & Zabel LLP

The SEC recognizes that there may be additional distinctions between the equities markets and the markets for government securities that have not been considered in the proposal. As such, market participants are encouraged to address other areas they believe might require additional, or amended, disclosures on Form ATS-G by commenting on the Commission's proposal.

Proposed Changes to Regulation SCI

Regulation SCI was adopted to strengthen and safeguard the technological infrastructure of the U.S. securities markets. Regulation SCI applies to certain market participants that the Commission considers essential to the efficient functioning of the U.S. securities markets ("SCI entities"). SCI entities are required to establish, maintain and enforce written policies and procedures reasonably designed to ensure that their systems have the capacity, integrity, resiliency, availability and security adequate to maintain their operational capability and a fair and orderly market.

When the Commission adopted Regulation SCI, fixed-income ATSs were excluded from the requirements of Regulation SCI because the fixed-income markets[15] relied much less on automation and electronic trading than the equity markets, with slower execution times and less complex routing strategies. Due to the changes in market conditions for government securities discussed above, the Commission is proposing to apply Regulation SCI to Government Securities ATSs that trade a significant volume of U.S. Treasury or Agency Securities in order to enhance the integrity and resiliency of these vital markets. Under the proposal, Regulation SCI would apply to those ATSs which, during at least four of the preceding six calendar months had: with respect to U.S. Treasury Securities, 5% or more of the average weekly dollar volume traded in the United States as provided by the SRO to which such transactions are reported; or had, with respect to Agency Securities, 5% or more of the average daily dollar volume traded in the United States as provided by the SRO to which such transactions are reported.

The SEC, when adopting Regulation SCI,[16] noted that it had considered expanding the definition of SCI entity to include *all* broker-dealers (or, alternatively, certain categories of broker-dealers in addition to operators of NMS Stock ATSs), but had ultimately declined to do so. The SEC noted, however, that it would continue to assess whether Regulation SCI should

Copyright © 2024 Schulte Roth & Zabel LLP
Attorney Advertising

be expanded to cover broker-dealers generally. As such, the proposed expansion of Regulation SCI to operators of certain Government Securities ATSs may represent an incremental step as the SEC considers expanding the requirements of Regulation SCI to broker-dealers more generally.

Other Proposed Regulatory Changes

Aside from the major proposals described above, the Commission also announced a number of additional proposals designed to, among other things, clarify certain requirements under Regulation ATS and enhance the disclosure obligations applicable to Form ATS. Specifically, the Release includes proposed rule changes that would:

- Apply the Fair Access Rule to Government Securities ATSs that meet the thresholds detailed above for Regulation SCI;
- Clarify that, for purposes of determining compliance with the Fair Access Rule, ATS' transaction volume is calculated based on the *share* volume for equity securities and *dollar* volume for debt securities;
- Allow Forms ATS and ATS-R to be submitted electronically through EDGAR;
- Make public the types of securities that ATSs disclose that they trade on Forms ATS or ATS-R;
- Require ATSs to specify whether amendments to Form ATS are "material, periodic, or correcting"; and
- Make certain clerical and administrative changes to Form ATS-N.[17]

Conclusion

As a general matter, the proposed rule changes represent the expansion of current rules (*e.g.*, Regulation SCI and the requirements applicable to NMS Stock ATSs under rule 304 of Regulation ATS) to new entities and trading venues. The Proposal recognizes that the proposed expansion, which largely takes existing requirements applicable to NMS Stock ATSs and applies them to Government Securities ATSs with minimal revision, may have failed to account for all relevant distinctions between the markets for NMS stocks and government securities. Accordingly, the SEC

Copyright © 2024 Schulte Roth & Zabel LLP

has invited comments from markets participants on whether, and how, the Proposal may be better tailored to Government Securities markets.

Importantly, market participants that are ultimately subject to the proposed rules may already be largely familiar with (and subject to) the requirements of Regulations ATS and SCI, including by already filing and keeping current Form ATS-N for their equity NMS Stock ATSs. However, this expansion of existing rules, including the proposed expansion of Regulation SCI to certain Government Securities ATSs, may represent an incremental expansion as the SEC determines whether additional broker-dealers and participants should be subject to the requirements of Regulation ATS and Regulation SCI (or to rules closely modeled after these regulations).

Comments are due within 60 days of publication of the Proposal in the Federal Register. Please contact any of the SRZ attorneys below with questions regarding this *Alert*.

Authored by Julian Rainero, Derek N. Lacarrubba, David S. Sieradzki, William J. Barbera and *Jacqueline Srour.*

---

[1] *Regulation ATS for ATSs that Trade U.S. Government Securities, NMS Stock, and Other Securities; Regulation SCI for ATSs that Trade U.S. Treasury Securities and Agency Securities; and Electronic Corporate Bond and Municipal Securities Markets*, Release No. 34-90019, Sept. 28, 2020 ("Proposing Release").

[2] The term "government securities" is defined under Section 3(a)(42) of the Exchange Act.

[3] U.S. Treasury Securities are direct obligations of the U.S. Government issued by the U.S. Department of the Treasury ("Treasury Department") and are the most liquid and commonly traded government securities. Securities issued by the Treasury Department include Treasury bills, nominal coupons notes and bonds, Floating Rate Notes and Treasury Inflation Protected Securities.

[4] Agency Securities include securities issued by or guaranteed by U.S. Government corporations and U.S. Government sponsored enterprises and are generally considered to be very liquid and offer state and local tax advantages to the holder.

Copyright © 2024 Schulte Roth & Zabel LLP

[5] The term "NMS stocks" is defined under Exchange Act Rule 600(b)(48).

[6] While there is no express prohibition on a bank registering as a broker-dealer and sponsoring an ATS, it is generally not practical.

[7] For clarity, this could result in an ATS operator having to maintain three separate disclosure documents, (i) a Form ATS-N for the ATS' NMS stock operations, (ii) a Form ATS-G for the ATS' government securities' operations and (iii) a Form ATS for the ATS' other operations.

[8] Form ATS-N, available here.

[9] *See* Form ATS-N Filings and Information ("SEC's ATS-N Website") for a listing of all Form ATS-N submissions.

[10] Currently, operators of NMS Stock ATSs must link to the SEC's ATS-N Website, but are not separately required to post their current Form ATS-N on their websites.

[11] The Proposing Release also contemplates certain technical amendments to Exchange Act Rule 304, including amendments designed to clarify the rule's applicability to both NMS Stock ATSs and Government Securities ATSs.

[12] *See* Exchange Act Rule 304(a)(2)(i).

[13] *See* Exchange Act Rule 304(a)(2)(ii).

[14] *See* Section III of the Proposing Release.

[15] That is, the fixed-income markets generally.

[16] *See* Exchange Act Release No. 34–73639 (79 Fed. Reg. 72251, Dec. 5, 2014)("Regulation SCI Adopting Release").

[17] See Section V. D. of the Proposing Release.

This communication is issued by Schulte Roth & Zabel LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising. ©2020 Schulte Roth & Zabel LLP.

All rights reserved. SCHULTE ROTH & ZABEL is the registered trademark of Schulte Roth & Zabel LLP.

Related People

Julian Rainero

Partner

New York

Derek Lacarrubba

Special Counsel

New York

William Barbera

Partner

New York

Practices

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising

Attachments

Download Alert

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising