

SEC Proposes New Transparency Requirements for NMS Stock Alternative Trading Systems

December 14, 2015

On November 18, 2015, the Securities and Exchange Commission (“**SEC**”) proposed **amendments** (the “**Proposal**”) to Regulation ATS and related rules under the Securities Exchange Act of 1934 (the “**Exchange Act**”) to impose extensive new transparency requirements on, and greatly increase the SEC’s active oversight of the design of, alternative trading systems (“**ATSs**”) that facilitate transactions in National Market System stocks (generally, exchange-listed equities) (“**NMS Stock ATSs**”).

The extensive level of disclosure that would be required under the Proposal and the SEC’s ongoing involvement in approving or reviewing the design and operations of NMS Stock ATSs would bring the regulation of NMS Stock ATSs closer to the way in which national securities exchanges are regulated. The dramatic 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 and between NMS Stock ATSs and national securities exchanges, or cause some broker-dealers to reconsider the relative value of operating an NMS Stock ATS.

The Proposal is part of the SEC’s broader focus on equity market structure outlined by SEC Chair Mary Jo White in her **June 2014 remarks on equity market structure**, and responds, in part, to several enforcement actions brought in recent years by the SEC and some state regulators alleging that the broker-dealer operators of some NMS Stock ATSs failed to fairly or accurately disclose material information to users.

The SEC has requested comment on the Proposal within 60 days after its publication in the Federal Register (which has yet to occur).

Existing ATS Regulatory Framework

Regulation ATS and related rules were adopted in 1998 to address the rise of electronic trading systems that sought to provide many of the same services as securities exchanges. These rules effectively provide that a registered broker-dealer operating a system that would otherwise be an “exchange” is exempt from registration as a national securities exchange under the Exchange Act so long as it complies with Regulation ATS.

Regulation ATS requires that a broker-dealer file a Form ATS with the SEC disclosing certain general information about the ATS—including “the manner of operation” of the ATS. Form ATS must be filed at least 20 days prior to commencing operations and amended at least 20 days prior to a material change in operations. Form ATS submissions are “notice-filings” only (i.e., approval is not requested or provided) and deemed confidential.

Unlike national securities exchanges, unless certain volume thresholds are exceeded, ATSs are not subject to order display, execution access or fair access requirements. The Proposal would not impact these requirements.

Regulation ATS does not currently impose different obligations on NMS Stock ATSs as compared to ATSs facilitating transactions in other securities (although certain ATSs, primarily those relating only to government securities, are exempt from compliance with Regulation ATS).

Summary of Proposed Requirements

New Operational Transparency Requirements

In order for an NMS Stock ATS to qualify for the exemption from registration as a national securities exchange, the Proposal would require that the NMS Stock ATS—whether existing or new—publicly disclose detailed information about the activities of its broker-dealer operator (and its affiliates) and the operations of the ATS itself on new Form ATS-N, which must be approved by the SEC. In issuing the Proposal, the SEC noted that information provided to the SEC on current Form ATS is often “rudimentary and summary.” In contrast, the SEC believes that the detailed information on Form ATS-N would provide market participants with information allowing them to, among other things, assess potential conflicts of interest that may exist based on the broker-dealer operator’s and its affiliates’ businesses.

Form ATS-N would require extensive new disclosures, including:

- operation of non-ATS trading centers and other NMS Stock ATSs by the NMS Stock ATS’s broker-dealer operator and its affiliates, and details regarding the manners in which those venues may interact with the NMS Stock ATS;
- products or services offered to subscribers by the broker-dealer operator and its affiliates used in connection with the NMS Stock ATS, and details regarding those products or services;
- arrangements with operators of unaffiliated trading centers regarding access to the NMS Stock ATS;
- trading by the broker-dealer operator or any of its affiliates on the NMS Stock ATS, and details regarding other business units’ or affiliates’ dealings on the NMS Stock ATS and whether other subscribers can be excluded from trading with such persons;
- use of smart order routers or algorithms to send or receive subscriber orders;
- use of shared employees who service the operations of the NMS Stock ATS and any other business unit or affiliate of the broker-dealer operator, and details regarding such shared employees’ activities for the NMS Stock ATS and other business unit or affiliate;
- any operations of the NMS Stock ATS performed by a person other than the broker-dealer operator, and details regarding those functions and the persons performing them;
- any differences in the availability of services, functionalities or procedures of the NMS Stock ATS available to the broker-dealer operator and its affiliates that is not available to other subscribers;
- information regarding the NMS Stock ATS’s written safeguards and procedures to protect confidential trading information;
- subscriber eligibility or limitations, terms of use, liquidity provider arrangements and when access may be limited or denied;
- types of orders along with their priority and operational rules and conditions;
- the manner of connectivity and order entry to the NMS Stock ATS and any co-location or similar services offered to any subscriber;
- any segmentation of order flow, notice of segmentation provided to any persons, and any arrangements to permit subscribers to trade or not trade with certain other subscribers or order flow segments;
- any display or making known of orders and other trading interests outside of the NMS Stock ATS;
- trading services, including rules and procedures governing matching methodology, order interaction or other trading procedures;

- procedures governing trading during a suspension, system disruption or malfunction;
- opening, reopening and closing processes, and after-hours procedures;
- procedures and methodology for outbound routing from the NMS Stock ATS;
- sources of market data (i.e., securities information processor or direct private feeds) and the uses of market data by the NMS Stock ATS;
- fees, rebates or other charges of the NMS Stock ATS, and any differences among subscribers;
- procedures and arrangements for trade reporting and clearance and settlement;
- where the volume thresholds under Regulation ATS that trigger order display and execution access requirements are met for one or more particular NMS stocks, the relevant NMS stocks in which these requirements are in effect and how the NMS Stock ATS complies with these requirements;
- where the volume thresholds under Regulation ATS that trigger fair access requirements are met for one or more NMS stocks, the relevant NMS stocks in which these requirements are in effect and how the NMS Stock ATS complies with this requirement; and
- if aggregate platform-wide execution or order flow statistics are published or made available to any subscriber, the categories of those statistics, the method of calculation and a copy of the most recent such disclosure.

SEC Review and Approval of Form ATS-N; New SEC Authority over NMS Stock ATS

Under the Proposal, the Form ATS-N filed by each NMS Stock ATS must be affirmatively declared effective by an SEC order for the NMS Stock ATS to qualify for the exemption from registration as a national securities exchange. Upon filing, the SEC would review the form to determine whether the NMS Stock ATS qualifies for the exemption. The SEC indicated that this would generally include consideration of whether the ATS is, in fact, an NMS Stock ATS, whether the disclosures appear to be materially accurate, current and complete, and whether the manner of operation of the ATS otherwise appears in compliance with other applicable requirements of the federal securities laws.

Any NMS Stock ATS already registered with the SEC prior to the effective date of the Proposal would be required to file Form ATS-N within 120 calendar days of the effective date of the Proposal. The SEC would have up to 120 calendar days (subject to potential extensions) to issue an order declaring the Form ATS-N either effective or, after notice and opportunity for a hearing, ineffective. Such “legacy” NMS Stock ATS would be permitted to continue operating pending the SEC’s review process.

An effective Form ATS-N would also be required to be amended (i) at least 30 calendar days prior to the implementation of a “material” change to the NMS Stock ATS’s operations or the activities of the broker-dealer operator or its affiliates that must be disclosed on Form ATS-N, (ii) within 30 days of the end of each calendar quarter to correct any information on Form ATS-N that has become inaccurate and not otherwise amended, and (iii) promptly, upon discovery that information previously filed was inaccurate or incomplete when filed. Although amendments are not subject to affirmative SEC approval, the SEC could declare the amendment ineffective within 30 calendar days, which would result in the NMS Stock ATS being prohibited from operating in the manner that necessitated the amendment. The 30-day prior filing requirement for material changes could significantly affect the ability of an NMS Stock ATS to pursue business opportunities or respond to competitive challenges.

In addition to providing the SEC with greater authority over existing and new NMS Stock ATSs by virtue of its ability to review and pass upon Form ATS-N filings and amendments, the Proposal also empowers the SEC, after notice and opportunity for hearing, to issue an order suspending for up to 12 months,

limiting or revoking an NMS Stock ATS's exemption from the definition of exchange if it finds that such action is necessary or appropriate in the public interest, and is consistent with the protection of investors.

An NMS Stock ATS that has its Form ATS-N declared ineffective or is otherwise subject to an order revoking its exemption from the definition of exchange would effectively be forced to cease conducting its operations. Without an exemption from exchange registration, the broker-dealer operating the ATS would have to register the ATS as a national securities exchange, which entails a multi-year registration process and subjects the trading system to a more comprehensive and burdensome regulatory scheme and system of oversight than most ATSs are accustomed to. Moreover, even if a broker-dealer determined to register the ATS as a national securities exchange, it may face obstacles in doing so, as the SEC has generally expected the governing documents of an exchange or its parent company to include provisions limiting the concentration of ownership and control of any one entity (or its affiliates), or that of a broker-dealer member of the exchange.

New Written Policies and Procedures for All ATSs

Regulation ATS currently requires every ATS to have in place safeguards and procedures to protect subscribers' confidential trading information. The Proposal would further formalize this requirement, for all ATSs, by mandating that such safeguards and procedures and any oversight mechanisms be documented in writing.

Other Items under SEC Consideration

Although the Proposal is limited to NMS Stock ATSs, the SEC's release accompanying the Proposal contained hundreds of questions seeking public comment on the Proposal and related matters, including whether the SEC should require similar levels of transparency for ATSs that only trade in government securities and other securities that are not NMS Stocks.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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