

MEMO# 31344

August 22, 2018

SEC Adopts Rules for the Regulation of NMS Stock Alternative Trading Systems

[31344]

August 22, 2018 TO: ICI Members

ICI Global Members

Equity Markets Advisory Committee

ETF (Exchange-Traded Funds) Committee

ETF Advisory Committee SUBJECTS: Trading and Markets RE: SEC Adopts Rules for the Regulation of NMS Stock Alternative Trading Systems

The Securities and Exchange Commission (“SEC” or “Commission”) recently adopted amendments to the regulatory requirements applicable to alternative trading systems (ATSs).^[1] The amendments apply primarily to ATSs that offer trading in stocks listed on a national securities exchange (NMS Stock ATSs) and, broadly speaking, they aim to provide market participants and the Commission more information about the operation of these ATSs. The SEC adopted these amendments to address a lack of operational transparency around ATSs that can limit market participants’ ability to discern adequately how their orders interact, match, and execute on ATSs. ICI supported this rulemaking, and the amendments reflect many of the comments that ICI made at the proposal stage.^[2]

Background

Sections 5 and 6 of the Securities Exchange Act of 1934 (Exchange Act) require all “exchanges” to register with the SEC, and Section 3(a)(1) provides a definition of “exchange.”

In 1998, the Commission adopted Regulation ATS, which provides an exemption from exchange registration to trading venues that comply with the regulation.^[3] Under Regulation ATS, each ATS must register as a broker-dealer and notify the Commission of its intent to operate by filing Form ATS, which requires the ATS to disclose specified information about itself, the types of subscribers who use the ATS, the ATS’s policies and procedures, and the operation of its trading system.^[4] The ATS must update this information as required by SEC rules and must file a report summarizing its activity each quarter. Form ATS, amendments to the form, and ATS quarterly reports are deemed confidential by the SEC, and ATSs are not required to disclose publicly their trading services, operations, or fees.

Changes to NMS Stock ATS Registration and Regulation

The amendments to Regulation ATS subject NMS Stock ATSs to more rigorous registration and disclosure requirements. Starting early next year, each NMS Stock ATS will be required to file with the Commission a new form, Form ATS-N, which requires the ATS to provide extensive information about the activities of its broker-dealer operator and affiliates and the operation of its trading system. The amendments require the Commission to make public via posting on the Commission's website, each effective Form ATS-N and effective amendments to Forms ATS-N. In addition, the amendments provide a process for the Commission to declare a Form ATS-N ineffective if it finds, after notice and opportunity for a hearing, that this action is necessary or appropriate in the public interest and is consistent with the protection of investors.

Enhanced Reporting Requirements (Form ATS-N)

Form ATS-N requires each NMS Stock ATS to disclose significantly more information about its operations and its broker-dealer operator and its affiliates than is required today. The form groups required information into three parts. Part I requires disclosure of basic information about the NMS Stock ATS and its broker-dealer operator. Part II requires the NMS Stock ATS to disclose information about the activities of the broker-dealer operator and its affiliates. Part III requires disclosure of information regarding the manner of operation of the NMS Stock ATS.

The Commission believes the disclosures (especially those in Parts II and III of Forms ATS-N) will increase transparency in the US securities markets by allowing market participants to make more informed order routing decisions and to facilitate better SEC oversight of these trading venues. The amendments to Regulation ATS also could facilitate comparisons among trading venues in NMS stocks, which could help customers of broker-dealers—such as funds—evaluate execution quality of NMS Stock ATSs and aid customers in assessing the routing decisions of their brokers.

The amendments also will provide market participants, including institutional investor clients of an NMS Stock ATS, more information about how the ATS operates, including how it matches and executes orders. These enhanced disclosures are designed, in part, to assure that all market participants have access to the same amount of information about the operations of the NMS Stock ATS.

The disclosures on the activities of an NMS Stock ATS's broker-dealer operator and its affiliates include:[\[5\]](#)

- Broker-dealer operator and affiliate trading activities on the ATS;
- Order interactions with broker-dealer operator and affiliates;
- Arrangements with trading centers (e.g., preferential routing arrangements or mutual access arrangements);
- Other products and services offered to subscribers of the ATS by the broker-dealer operator or its affiliates (e.g., information about the types of ATS subscribers that can receive these products and services);
- Activities of service providers that support key functionalities of the ATS and employees of the ATS that: (1) have access to confidential trading information on the ATS; and (2) service other business units of the broker-dealer or any affiliate of the broker-dealer;[\[6\]](#) and
- Safeguards and procedures to protect subscribers' confidential trading information.

The proposed disclosures on the manner of operations of the NMS Stock ATS include:[\[7\]](#)

- Types of subscribers to the ATS, eligibility requirements and any terms and conditions imposed on subscribers, and any procedures to limit or deny access to the NMS Stock ATS;
- Hours of operation for the ATS, as well as opening, reopening, and procedures;
- Means of entry for orders and other trading interest;
- Connectivity or co-location services offered by the ATS and the terms and conditions on which these services are available;
- Order types and attributes, including their characteristics and operations and how they are handled on the NMS Stock ATS;
- Order size requirements (e.g., minimum or maximum sizes for orders or trading interest, and whether the NMS Stock ATS accepts or executes odd-lot orders);
- Trading services, including matching methodologies and order interaction rules;
- Segmentation of order flow (e.g., classification by type of participant, source, nature of trading activity) and notice given about segmentation;[\[8\]](#)
- Counterparty selection (i.e., whether orders or trading interest can be designated to interact or not interact with certain orders or trading interest in the NMS Stock ATS);
- Display of order and other trading interest;
- Procedures governing the suspension of trading and trading during a system disruption or other malfunction;
- Outbound routing (discretion and means);
- Fees, rebates, or other charges of the NMS Stock ATS, including the type of fees (e.g., connectivity fees or subscription fees), the structure of fees (e.g., fixed, volume-based, transaction-based), variables that impact the fees (e.g., types of securities trades), and differentiation among types of subscribers;
- Sources and use of market data, including how the NMS Stock ATS uses market data to determine the NBBO, protected quotes, pricing of orders and executions, and routing destinations;
- Trade reporting, clearance and settlement arrangements or procedures;
- Order display and execution access and fair access information (for certain NMS Stock ATSs); and
- Aggregate platform-wide order flow and execution statistics.

Compliance Date for NMS Stock ATSs to Begin Using Form ATS-N

NMS Stock ATSs must comply with the amendments to Regulation ATS early next year. As of January 7, 2019, any entity that wishes to operate a new NMS Stock ATS must file a Form ATS-N with the SEC.[\[9\]](#) NMS Stock ATSs that are operating of January 7, 2019 must make their initial Form ATS-N filing between January 7, 2019 and February 8, 2019.[\[10\]](#)

Commission Effectiveness Determination

The amendments to Regulation ATS provide a mechanism for the SEC to declare a Form ATS-N ineffective.[\[11\]](#) This contrasts with the current notice registration regime for ATSs, which permits a broker-dealer to operate an ATS after it files a form notifying the Commission of its intent and does not authorize the Commission to declare a registration ineffective.

The amendments to Regulation ATS afford the Commission 120 calendar days to review a Form ATS-N filing.[\[12\]](#) The Commission may extend the review period: (1) for an additional 90 calendar days if the Form ATS-N is unusually lengthy or raises novel or complex issues

that require additional time for review; or (2) any extended review period that the NMS Stock ATS agrees to in writing.[\[13\]](#) A Form ATS-N becomes effective upon the earlier of: (1) the expiration of the Commission's review period; or (2) the date on which the Commission publishes the form on its website.[\[14\]](#)

Public Disclosure

In contrast to the current practice of deeming ATS filings confidential, Regulation ATS as amended requires the Commission to post all effective Forms ATS-N on its website.[\[15\]](#) The amended regulation also requires each NMS Stock ATS to post on its website a hyperlink to the SEC website that contains its Form ATS-N.[\[16\]](#)

Amendments to Form ATS-N

An NMS Stock ATS must amend its Form ATS-N in the following circumstances:

- At least 30 calendar days prior to the date of implementation of a material change to the operation 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;
- 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 Commission as a Form ATS-N Amendment; or
- Promptly, to correct information in any previous disclosure on Form ATS-N, after discovery that any information filed on a Form ATS-N or an amendment was inaccurate or incomplete when filed;
- No later than seven calendar days, if the "order display and execution access" or "fair access" provisions of the Form ATS-N have become inaccurate or incomplete.[\[17\]](#)

The cover page of a material amendment to a Form ATS-N will be made public by the Commission upon filing and the entirety of the material amendment will be made public by the Commission following the expiration of a 30 calendar-day review period, unless the Commission declares the material amendment ineffective.

Suspension, Limitation, and Revocation of an NMS Stock ATS's Ability to Operate

The amendments to Regulation ATS authorize the Commission, after notice and opportunity for a hearing, to issue an order suspending for a period not exceeding 12 months, limiting, or revoking an NMS Stock ATS's ability to operate.[\[18\]](#) If the Commission suspends or revokes an NMS Stock ATS's ability to operate, that ATS would be prohibited from operating unless it registers as a national securities exchange. If the Commission limits the ability to operate, the NMS Stock ATS could continue to operate, as long as its operations are consistent with the terms and conditions of the Commission's order.

New Requirement for All ATSs: Written Safeguards and Written Procedures to Protect Confidential Trading Information

Regulation ATS currently requires every ATS to have in place safeguards and procedures to protect subscribers' confidential trading information and to separate ATS functions from other broker-dealer functions, including proprietary and customer trading. The amendments to Regulation ATS require ATSs to adopt and maintain these safeguards and procedures in written form.

endnotes

[1] Regulation of NMS Stock Alternative Trading Systems, Securities Exchange Act Release No. 83663 (July 18, 2018), 83 Fed. Reg. 83768 (August 7, 2018), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2018-08-07/pdf/2018-15896.pdf>.

[2] See Letter from David Blass, General Counsel, ICI, to Brent Fields, Secretary, SEC, dated February 25, 2016, *available at* <https://www.ici.org/pdf/29733.pdf>.

[3] See Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Release No. 40760 (Dec. 8, 1998), *available at* <http://www.sec.gov/rules/final/34-40760.txt>.

[4] Under the notice registration regime in Regulation ATS, the Commission does not approve or disapprove Form ATS filings.

[5] These disclosures are described in Part II of Form ATS-N. See 83 Fed. Reg. at 38915-38920.

[6] The SEC tailored this item in response to ICI's suggestion that Form ATS-N disclosures focus on providing information that would allow institutional investors—specifically regulated funds—to assess the threat of information leakage at an NMS Stock ATS.

[7] These disclosures are described in Part III of Form ATS-N. See 83 Fed. Reg. at 38920-38933.

[8] In response to comments from ICI, the Commission added a question to Form ATS-N to solicit information regarding whether an NMS Stock ATS identifies orders or trading interest entered by a customer of a broker-dealer on the NMS Stock ATS as a customer order.

[9] See 17 CFR § 242.301(b)(2)(viii).

[10] See 17 CFR § 242.304(a)(1)(iv).

[11] As proposed these amendments also would have provided a mechanism for the Commission to declare Form ATS-N filings effective. The Commission did not adopt that aspect of the proposal.

[12] See 17 CFR § 242.304(a)(1)(ii).

[13] See 17 CFR § 242.304(a)(1)(ii).

[14] See 17 CFR § 242.304(a)(1)(iii).

[15] See 17 CFR § 242.304(b)(2).

[16] See 17 CFR § 242.304(b)(3).

[17] See 17 CFR § 242.304(a)(2).

[\[18\]](#) See 17 CFR § 242.304(a)(4).

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