Changes for Alternative Trading Systems in 2024?

On January 26, 2022, the SEC reissued a proposal—first issued in September 2020—to expand and modernize the rules on alternative trading systems (ATSs). The proposal would make the following updates:

- Expand Regulation ATS for ATSs that trade government securities, national market system (NMS) stock, and other securities
- Extend Regulation SCI to ATSs that trade government securities
- Amend the SEC exchange definition to include CPSs

The SEC's most recent regulatory agenda indicates a final rule is expected before April 2024.

Background

ATSs are trading systems for securities that meet the exchange definition under federal securities laws but are not required to register with the SEC as a national securities exchange (NSE) if the ATS complies with certain exemption conditions. Communication protocol systems (CPSs) are platforms that bring together security buyers and sellers and provide similar functionality to marketplaces operated by registered exchanges and ATSs.

Today, ATSs that trade only U.S. government securities and register as broker-dealers or are banks that are exempt from exchange registration do not have to comply with Regulation ATS. ATSs that trade both government securities and nongovernment debt securities are not subject to certain Regulation ATS requirements, the Fair Access Rule (FAR), or Regulation Systems Compliance and Integrity (Regulation SCI).

Since Regulation ATS was adopted in 1998, technology innovations have blurred the lines between exchanges and broker-dealer activities. Under the current exchange definition, CPSs are not subject to the same regulations as NSEs and ATSs and the investors using them do not receive the investor protection, transparency, and oversight benefits as a regulated exchange. CPSs represent approximately 50% of total electronic trading of U.S. Treasuries. A large electronic trading venue for fixed income products estimated that its average daily volume using CPSs increased from $223 million in the second quarter of 2017 to $1.17 billion in the second quarter of 2021.

The SEC adopted Regulation SCI in November 2014 to strengthen the technology infrastructure of the U.S. securities markets by reducing system issues, improving resiliency when technological issues arise, and creating a formalized regulatory framework and to ensure effective SEC oversight. Regulation SCI requires entities to take appropriate corrective action when systems issues occur, provide the SEC with notification and reports on systems problems and changes, inform members and participants about systems issues, conduct business continuity and disaster recovery testing, conduct annual reviews of their automated systems, and make and keep certain books and records. When the rule was issued, fixed income ATSs that traded municipal and corporate debt were exempted from Regulation SCI because those securities relied much less on automation and electronic trading than other securities.

Exchange Definition

The SEC would update the exchange definition as noted in the below table.

Exchange Definition in Exchange Act Rule 3b-16	
Current	Proposed
An organization, association, or group of persons meets the exchange definition if it does not meet one of the exceptions of the rule and it: (1) Brings together the **orders** for securities of **multiple** buyers and sellers (2) Uses established, nondiscretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such **orders** agree to the trade terms	An organization, association, or group of persons meets the exchange definition if it does not meet one of the exceptions of the rule and it: (1) Brings together buyers and sellers of securities using **trading interest** (2) **Makes available** established, nondiscretionary methods (whether by providing a trading facility **or communication protocol** or by setting rules) under which buyers and sellers can interact and agree to trade terms A trading interest includes orders or any nonfirm indication of a willingness to buy or sell a security that identifies at least the security and either quantity, buy/sell, or price. An exclusion would be added for systems that allow an issuer to sell its securities to investors.

If an entity makes available a chat feature, which requires certain information to be included in a chat message, *e.g.*, price or quantity, and sets parameters and structure designed for participants to communicate about buying or selling securities, the system would have established communication protocols. Protocols that a system offers may take many forms and could include:

- Setting minimum criteria for what messages must contain
- Setting time periods under which buyers and sellers must respond to messages
- Restricting the number of persons a message can be sent to
- Limiting the types of securities about which buyers and sellers can communicate
- Setting minimums on the size of the trading interest to be negotiated
- Organizing the presentation of trading interest, whether firm or nonfirm, to participants

These examples are not exhaustive, and the determination of whether a system meets the updated exchange definition would depend on the particular facts and circumstances. The SEC believes that systems that passively display trading interest, such as bulletin boards, but do not provide means for buyers and sellers to contact each other and agree to the trade terms on the system would not be covered under the proposal.

Systems that only provide general connectivity for persons to communicate without protocols, such as utilities or electronic web chat providers, would not fall within the communication protocols prong of the proposed rule because such providers are not specifically designed to bring together buyers and sellers of securities or provide procedures or parameters for buyers and sellers for securities to interact.

A CPS that meets the updated exchange definition has two choices:

- Register as an exchange and be a self-regulated organization (SRO) subject to the requirements of Exchange Act Section 6

- Comply with the conditions of the Regulation ATS exemption, which includes registering as a broker-dealer. CPSs would then be subject to the Regulation ATS investor protection provisions, including the requirement to establish written safeguards and procedures to protect confidential subscriber trading information and operational transparency requirements of Form ATS-N for ATSs that trade NMS stocks or government securities or repos. CPSs also would be subject to FAR. Registering as a broker-dealer would subject a CPS to SEC and Financial Industry Regulatory Authority (FINRA) oversight. As a FINRA member, the CPS would be subject to FINRA's investor protection and examination and market surveillance programs and would be required to comply with FINRA's trade reporting rules

> *The SEC believes that many CPSs would choose to be regulated as an ATS because of the lighter regulatory requirements, compared to an NSE. Unlike an NSE, an ATS can trade any type of security and its users are not limited to broker-dealers. An ATS that is not an SRO would not require SEC approval for its activities. Many CPSs make available for trading fixed income securities that are only traded over the counter and are not registered and approved for exchange listing. Unless an NSE receives an exemption to trade unregistered debt securities, it may only list and trade registered debt securities, whereas CPSs do not need an exemption to trade unregistered debt securities.*

Government Securities ATSs

The updates to Regulation ATS are designed to enhance operational transparency and protections for investors for ATSs that trade government securities or repurchase and reverse repurchase agreements on government securities. The following conditions currently exempt an ATS from compliance with Rule 301(b) of Regulation ATS:

- Is registered as a broker-dealer or is a bank
- Limits its securities activities to government securities, repos, any puts, calls, straddles, options, or privileges on government securities, other than puts, calls, straddles, options, or privileges that are traded on one or more NSEs; or for which quotations are disseminated through an automated quotation system operated by a registered securities association, and commercial paper

The proposal would eliminate the second exemption noted above on trading activity and additional conditions of the Regulation ATS would apply to all currently exempted Government Securities ATSs.

Fair Access Rule

FAR requires an ATS to establish and apply reasonable written standards for granting access on its system. Today, FAR applies if an ATS's trading volume for certain securities exceeds an average daily volume threshold. Currently, FAR only applies to the trading of NMS stocks, equity securities that are not NMS stocks and for which transactions are reported to an SRO, municipal securities, and corporate debt securities, but not to trading in government securities. Under the proposal, a Government Securities ATS will be subject to FAR during at least four of the preceding six calendar months if:

- It had 3% or more of the U.S. Treasury Securities U.S. average weekly dollar volume traded as provided by the SRO to which such transactions are reported
- It had 5% or more of the Agency Securities average U.S. daily dollar volume traded as provided by the SRO to which such transactions are reported

Regulation SCI Amendments for Government Securities ATSs

The SCI ATS definition would be revised to include those ATSs that had during at least four of the preceding six calendar months:

- For U.S. Treasury Securities, 5% or more of the average U.S. weekly dollar volume traded as provided by the SRO to which such transactions are reported
- For Agency Securities, 5% or more of the average U.S. daily dollar volume traded as provided by the SRO to which such transactions are reported

The SEC believes that two Government Securities ATSs trading U.S. Treasury Securities would be subject to Regulation SCI under the 5% volume thresholds and two currently operating CPSs would be subject to Regulation SCI under the proposed 5% threshold in U.S. Treasury Securities.

Conclusion

We will continue to follow this developing situation. If you have questions about these changes, contact your advisor today.

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