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Securities Alert

SEC Proposes Significant Regulatory Changes for Alternative Trading Systems

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On November 18, 2015, the Securities and Exchange Commission (“SEC” or “Commission”) proposed significant changes to the regulatory requirements applicable to dark pools and other alternative trading systems (“ATs”) that trade national market system stocks (“NMS Stock ATs”).¹ As a general matter, the proposed changes to Regulation ATS² (“Reg ATS”), promulgated under the Securities Exchange Act of 1934 (“Exchange Act”), are designed to: (1) provide detailed public information to market participants about the potential conflicts of interest and operations of NMS Stock ATs, their broker-dealer operators and the affiliates of their broker-dealer operators to allow such market participants to better determine where to send their orders; (2) provide more information to the SEC so it may more effectively regulate NMS Stock ATs; and (3) adjust the regulatory obligations applicable to competing ATs and national securities exchanges.

As the SEC noted in the Proposing Release, in the 17 years since the adoption of Reg ATS, the equity market structure and the role of ATs have evolved significantly. The number of NMS Stock ATs (now 46), as well as the trading volume on those ATs (now 15% of total share trading volume) has increased greatly. NMS Stock ATs increasingly are operated by multi-service broker-dealers engaged in significant brokerage and dealer activities in addition to the operation of their NMS Stock ATs. This has led to NMS Stock ATs becoming increasingly intertwined with the other activities of their operating broker-dealers and their affiliates, giving rise to potential conflicts of interest among the various business interests of each entity. NMS Stock ATs also have grown increasingly complex in terms of the services and functionalities they offer subscribers (e.g., order types, means of access such as via smart order routers (“SORs”) and algorithms, customized trading parameters). The SEC is concerned that despite NMS Stock ATs acting as a significant source of liquidity in today’s markets, there is limited information available to market participants about the operations of ATs and the activities of their broker-dealer operators and their affiliates. As a result, the SEC proposes to:

- Adopt Form ATS-N, which would require an NMS Stock AT to provide, among other things, detailed information about the: (1) manner of operation of the NMS Stock AT; and (2)

¹ Securities Exchange Act Rel. No. 76474 (Nov. 18, 2015), 80 Fed. Reg. 80998 (Dec. 28, 2015) (“Proposing Release”), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-29890.pdf>.

² Securities Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 Fed. Reg. 70844 (Dec. 22, 1998). Reg ATS currently requires an AT to file an Initial Operation Report on Form ATS at least 20 days prior to commencing operations. The Initial Operation Report is a notice filing that is not approved or declared effective by the SEC. A broker-dealer operator must file an amendment to Form ATS prior to making any material change to the AT. Form ATS contains information about an AT, such as the subscribers, securities traded, other entities involved in the operation of the system, system capacity and security, the safeguarding of customer funds and securities, and a description of the manner of operation of the system. Reg ATS also sets trading volume thresholds for when an AT that displays orders to any persons (other than its employees) is required to publicly display such orders and offer fair access to persons seeking to become subscribers.

broker-dealer operator of the NMS Stock ATS and the activities of such broker-dealer operator and its affiliates in connection with the NMS Stock ATS;

- Make Form ATS-N publicly available on the websites of the SEC and the NMS Stock ATS;
- Adopt new Rule 304 of Reg ATS, which would provide a process for the SEC to determine whether an entity qualifies for the exemption from the definition of “exchange” pursuant to Exchange Act Rule 3a1-1(a)(2) regarding NMS stocks and declare an NMS Stock ATS’s Form ATS-N either effective or, after notice and opportunity for hearing, ineffective; and
- Amend Exchange Act Rule 301(b)(10) of Reg ATS to require that all ATSs (not just NMS Stock ATSs) put their safeguards and procedures for protecting subscribers’ confidential trading information in writing.

The SEC believes that the proposed enhanced transparency requirements would benefit a wide range of market participants that rely on NMS Stock ATSs for their trading needs. For example, the proposal would aid broker-dealer subscribers that route customer orders to NMS Stock ATSs in meeting their best execution obligations to their customers as they will be able to better assess the trading venues to which they route orders. Similarly, institutional investors that route orders to an NMS Stock ATS directly or via their brokers would have more information regarding the operation of an NMS Stock ATS and its competitors, including how customer orders are matched and executed. Nevertheless, the regulatory framework proposed by the Commission warrants close scrutiny by all market participants, including the following:

- ATSs/Broker-Dealer Operators. ATSs and their broker-dealer operators will want to review the proposals to weigh the costs and benefits as applied to them. Among other things, such entities will have to carefully assess whether the enhanced disclosures and oversight, and the associated regulatory and business costs, are consistent with their business models.
- Exchanges. The SEC’s proposal attempts to level the playing field between exchanges and ATSs, at least in part. Exchanges will need to evaluate whether the Commission’s approach achieves an appropriate level of parity.
- Institutional Investors. Institutional investors and other users of ATSs will need to evaluate whether ATSs will still be able to meet their business needs in an environment of enhanced disclosure and oversight.

A detailed description of key aspects of the SEC’s proposal is provided below. The SEC requested comment on the proposal by February 26, 2016.

I. Proposed Amendments to Reg ATS and Rule 3a1-1

A. Enhanced Conditions for Exemption from Exchange Registration for NMS Stock ATSs

To more appropriately balance the regulatory oversight of registered national securities exchanges and NMS Stock ATSs, while maintaining the framework that permits NMS Stock ATSs to decide whether to register and be regulated as broker-dealers or as national securities exchanges, the SEC proposes to amend the exemption from the definition of “exchange” under Exchange Act Rule 3a1-1(a) as it would apply to NMS Stock ATSs. Specifically, the SEC proposes to expand the conditions with which NMS Stock ATSs must comply to avail themselves of the exemption from the definition of “exchange.” Currently, Rule 3a1-1(a) provides an exemption from the definition of “exchange” for any system that: (1) is operated by a national securities association; (2) complies with Reg ATS (Rules 300 to 303); or (3) is not required to comply with Reg ATS pursuant to Rule 301(a) of Reg ATS. The proposed amendment to Rule 3a1-1(a)(2) would require an NMS Stock ATS to comply with the requirements of Reg ATS Rules 300 to 303 (except Rule 301(b)(2) governing the filing of Form ATS) as well as proposed Rule 304, which is discussed in detail below.

The SEC proposes to add Rule 300(k) of Reg ATS to define an “NMS Stock ATS” as an ATS³ “that facilitates transactions in NMS stocks.”⁴ As proposed, the definition of NMS Stock ATS would include any ATS that effects transactions in securities that are listed on a national securities exchange (other than options, debt or convertible debt).

The proposed amendments to Rule 3a1-1 and Reg ATS do not extend to ATSs that facilitate trading exclusively in fixed income securities (including government securities),⁵ over-the-counter (“OTC”) equity securities,⁶ or other instruments (*e.g.*, options contracts). The SEC, however, asked whether it should consider making public current Forms ATS filed by fixed income ATSs. The SEC also requested comment on whether ATSs that trade exclusively in government securities should be included within the scope of current Reg ATS and whether the Commission should amend Reg ATS to provide for enhanced operational transparency for such ATSs.

B. Enhanced Filing Requirements for NMS Stock ATSs

To qualify for the exemption from exchange registration in Rule 3a1-1(a)(2), NMS Stock ATSs would continue to be required to comply with the existing requirements of Reg ATS Rules 300-303 (except Rule 301(b)(2) regarding the filing of Form ATS⁷), but also now would be required to comply with proposed Rule 304. The requirements of proposed Rule 304 are described in detail below.

1. Filing and Review of Form ATS-N

Proposed Rule 304(a)(1)(i) states that no exemption from the definition of “exchange” is available to an NMS Stock ATS under Rule 3a1-1(a)(2) unless the NMS Stock ATS files a Form ATS-N with the Commission that the Commission declares effective. If the NMS Stock ATS is operating pursuant to a previously filed initial operation report on Form ATS (*i.e.*, a “legacy NMS Stock ATS”), the legacy NMS Stock ATS would be required to file a Form ATS-N with the SEC no later than 120 calendar days after the effective date of proposed Rule 304. The legacy NMS Stock ATS may continue to operate under the previously filed Form ATS while the Commission reviews its filed Form ATS-N.

Under proposed Rule 304(a)(1)(ii)(A) and (B), the Commission would have 120 calendar days from the filing of a Form ATS-N by a legacy or prospective NMS Stock ATS to declare the Form ATS-N effective or ineffective. The SEC may extend the Form ATS-N review period in two ways. First, the SEC could seek an additional 120 (for legacy NMS Stock ATSs) or 90 (for prospective NMS Stock ATSs) calendar days for review, if the Form ATS-N is unusually lengthy or raises novel or complex issues that require additional time for review. If the SEC intends to extend the additional review time, the Commission must notify the ATS in writing within the initial 120-day review period and briefly describe the reason for the determination that additional time for review is required. Second, the SEC may extend the Form ATS-N review period for “any extended review period” to which a duly-authorized representative of the NMS Stock ATS agrees in writing.

Proposed Rule 304(a)(1)(iii) would require the Commission to: (1) declare effective a Form ATS-N if the NMS Stock ATS qualifies for the Rule 3a1-1(a)(2) exemption; or (2) declare ineffective a Form ATS-N if it finds, after notice and opportunity for hearing, that such action is necessary or appropriate in the public

³ Rule 300(a) of Reg ATS defines an “alternative trading system” generally as a system that brings together purchasers and sellers of securities (or otherwise performs the functions of a stock exchange) that does not also act as a self-regulatory organization.

⁴ For purposes of Reg ATS, “NMS stocks” generally include all exchange traded securities other than debt and convertible securities. See Reg ATS Rule 300(g).

⁵ Under current Reg ATS Rule 301(a)(4), an ATS that solely trades government securities and is registered as a broker-dealer or is a bank is exempt from the requirement to either register as a national securities exchange or comply with Reg ATS.

⁶ For purposes of the Proposing Release, “OTC equity securities” is defined to include those securities identified in FINRA’s 6400 rule series related to the quoting and trading of OTC equity securities.

⁷ Proposed Rule 301(b)(2)(viii) would provide that an ATS that effects transactions in both NMS stocks and non-NMS stocks would be subject to the requirements of proposed Rule 304 with respect to NMS stocks (disclosures and amendments on Form ATS-N) and Rule 301(b)(2) with respect to non-NMS stocks (disclosures and amendments on Form ATS). Similarly, under proposed Rule 301(b)(9), an ATS that trades both NMS and non-NMS stocks would be required to separately report its transactions on separate Forms ATS-R (*i.e.*, transactions in NMS stocks on one Form ATS-R and transactions in non-NMS stocks on another Form ATS-R).

interest, and is consistent with the protection of investors. In making an effectiveness determination, the Commission would evaluate, as a threshold matter, whether the entity satisfies the definition of ATS, and more specifically, the definition of NMS Stock ATS. After notice and opportunity for hearing, the Commission could deem a Form ATS-N ineffective if it finds, among other things, that the Form ATS-N was filed by an entity that does not meet the definition of an “exchange” under Exchange Act Rule 3b-16, or that one or more disclosures on Form ATS-N are materially deficient with respect to their accuracy, currency or completeness.⁸

Proposed Rule 304(a)(1)(iv) would require the Commission to issue an order declaring a Form ATS-N effective or ineffective. Upon the effectiveness of the Form ATS-N, the NMS Stock ATS may operate pursuant to the conditions in proposed Rule 304.⁹ If the Commission declares a Form ATS-N ineffective, however, the NMS Stock ATS will be prohibited from operating as an NMS Stock ATS, but would not be prevented from subsequently filing a new Form ATS-N.

2. Form ATS-N Amendments

Proposed Rule 304(a)(2)(i) would require an NMS Stock ATS to file certain amendments to its Form ATS-N. Specifically, proposed Rule 304(a)(2)(i)(A) would require an NMS Stock ATS to file a Form ATS-N amendment at least 30 days prior to the date of implementation of a material change to the operations of the NMS Stock ATS or the activities of the broker-dealer operator or its affiliates that are subject to disclosure on Form ATS-N. The longer time period of 30 days, as compared to the 20-day period under current Reg ATS, is intended to account for the additional detail and information that would be provided on Form ATS-N as compared to Form ATS.

A change to the operations of an NMS Stock ATS, or the activities of the broker-dealer operator or its affiliates, would be material if there is a substantial likelihood that a reasonable market participant would consider the change important when evaluating the NMS Stock ATS as a potential trading venue. Notably, the Commission indicated that it would consider the following examples, among others, as material changes that would require the filing of a Form ATS-N amendment.¹⁰

- A broker-dealer operator or its affiliates beginning to trade on the NMS Stock ATS;
- A change to the broker-dealer operator’s policies and procedures governing the written safeguards and procedures to protect the confidential trading information of subscribers pursuant to Rule 301(b)(10)(i) of Reg ATS;
- A change to the types of participants on the NMS Stock ATS;
- The introduction or removal of a new order type on the NMS Stock ATS;
- A change to the order interaction and priority procedures;
- A change to the segmentation of orders and participants;
- A change to the manner in which the NMS Stock ATS displays orders or quotes; or
- A change of a service provider to the operations of the NMS Stock ATS that has access to confidential subscriber trading information.

Under proposed Rule 304(a)(2)(i)(B), an NMS Stock ATS also would be required to file an amendment to its Form ATS-N within 30 calendar days after the end of each calendar quarter to correct any information

⁸ Among other things, the Commission may consider a Form ATS-N materially deficient if it fails to describe key attributes of an order type or exceptions to its priority rules. Similarly, the Commission could find a Form ATS-N materially deficient if it has inconsistencies in the disclosed information. See Proposing Release, *supra* note 1, at 81025.

⁹ Once the Commission declares the Form ATS-N of a legacy NMS Stock ATS effective, the previously filed Form ATS would be superseded and would no longer have any legal effect.

¹⁰ See Proposing Release, *supra* note 1, at 81028.

in its Form ATS-N that has become inaccurate for any reason and has not been previously reported to the Commission as a Form ATS-N amendment. Such periodic amendments are intended to update information from the preceding quarter that does not constitute a material change to the Form ATS-N.

Proposed Rule 304(a)(2)(i)(C) would require an NMS Stock ATS to amend its Form ATS-N promptly to correct information in any previous disclosure on Form ATS-N after discovery that any information filed in an initial Form ATS-N or Form ATS-N amendment was inaccurate or incomplete when filed.

Finally, proposed Rule 304(a)(2)(ii) would provide the Commission with the authority to declare ineffective, by order, any Form ATS-N amendment if it finds that such action is necessary or appropriate in the public interest, and is consistent with the protection of investors.¹¹ The SEC must issue such an order no later than 30 calendar days from the filing with the SEC.

3. Notice of Cessation

Under proposed Rule 304(a)(3), an NMS Stock ATS would be required to provide notice of its cessation of operations on Form ATS-N at least 10 business days before ceasing to operate as an NMS Stock ATS. This notice is designed to allow subscribers to the NMS Stock ATS to make alternative arrangements for routing their orders.

4. Suspension, Limitation, or Revocation of the Exemption from the Definition of Exchange

Unlike current Reg ATS, proposed Rule 304(a)(4) would provide the Commission with a process to suspend (for a period not exceeding twelve months), limit or revoke an NMS Stock ATS's exemption from the definition of "exchange" if it finds, after notice and opportunity for hearing, that such action is necessary or appropriate in the public interest, and is consistent with the protection of investors. For example, the Commission believes that a suspension, limitation or revocation of an NMS Stock ATS's exemption from the definition of "exchange" may be appropriate if the SEC finds that an NMS Stock ATS: (1) no longer meets the definition of "NMS Stock ATS"; (2) fails to comply with any part of Reg ATS, including proposed Rule 304; or (3) has violated or is violating any provision of the federal securities laws.

If an NMS Stock ATS's exemption is suspended or revoked, the NMS Stock ATS would be prohibited from operating pursuant to the exemption from the definition of an exchange provided under Rule 3a1-1(a)(2). If an NMS Stock ATS's exemption is limited, the NMS Stock ATS would be prohibited from operating in a manner inconsistent with the terms and conditions of the Commission's order. The Commission believes Rule 304(a)(4) would provide it with the flexibility to address the specific facts and circumstances of each potential deficiency, and to limit the scope of an NMS Stock ATS's exemption in some instances, rather than causing it to cease operations.

5. Public Disclosure of Form ATS-N and Related Commission Orders

The Commission believes that the reasons previously provided in support of maintaining the confidentiality of Form ATS filings – protecting proprietary information and encouraging fulsome Reg ATS filings – are no longer justified for NMS Stock ATSs in light of the benefits of operational transparency. Therefore, a primary objective of the proposed amendment to Reg ATS is to address the limited availability of information related to the operation of NMS Stock ATSs. As such, proposed Rule 304(b)(2) would require the SEC to make public via posting on the SEC's website each Form ATS-N, including any

¹¹ An NMS Stock ATS would not be allowed to operate pursuant to an ineffective Form ATS-N amendment. Rather, it would continue to operate pursuant to the Form ATS-N that was previously declared effective. The NMS Stock ATS may subsequently file a new Form ATS-N amendment that resolves any disclosure deficiency.

amendment thereof, and each Commission order related to the Form ATS-N.¹² In addition, proposed Rule 304(b)(3) would require each NMS Stock ATS that has a website to post on its website a hyperlink to the section of the Commission's website that contains the Form ATS-N and the SEC's orders concerning the NMS Stock ATS. As proposed, Rule 304(b)(3) would apply to NMS Stock ATSs only and would not require non-NMS Stock ATSs to publicly disclose their Forms ATS.

II. Proposed Form ATS-N

NMS Stock ATSs would be required to file the reports under Rule 304 on Form ATS-N. Proposed Rule 304(c)(1) would require that the responses to Form ATS-N be detailed, accurate, current and complete. Proposed Rule 304(c)(2) would require the Form ATS-N to be filed electronically and include an electronic signature. The following describes in detail the information requested on Form ATS-N.

A. Part I of Proposed Form ATS-N

Part I of proposed Form ATS-N would require disclosure of the name (if any) and market participant identifier ("MPID") of an NMS Stock ATS, and the name of the broker-dealer operator of the NMS Stock ATS. Part I would also require an ATS to identify whether it is currently operating pursuant to a previously filed Form ATS.

B. Part II of Proposed Form ATS-N: Broker-Dealer Operator Registration Information

Part II of proposed Form ATS-N would require an NMS Stock ATS to provide certain general information regarding the NMS Stock ATS and its broker-dealer operator. Specifically, Form ATS-N would require information about the broker-dealer operator's legal status (e.g., corporation, partnership, LLC), formation, SEC registration and FINRA membership. The Commission intends to use this information to determine whether the NMS Stock ATS is properly formed and registered as a broker-dealer pursuant to Rule 301(b)(1) of Reg ATS, and to expedite communications with the broker-dealer operator's self-regulatory organization ("SRO").

Part II also would require disclosure of the address of the physical location of the NMS Stock ATS matching system and, to the extent that it differs from such physical location, the mailing address of the NMS Stock ATS. An NMS Stock ATS also must disclose its website address and contact information for a representative of the broker-dealer operator. The Commission intends to keep confidential the contact information of the broker-dealer operator's representative.

Part II also would require an NMS Stock ATS to attach various exhibits to its Form ATS-N. Exhibit 1 would include copies of any materials currently provided to subscribers or other persons related to the operation of the NMS Stock ATS or the disclosures on Form ATS-N (e.g., marketing materials, user manuals, frequently asked questions). Exhibits 2A and 2B would require copies or links to Schedule A (direct owners and executive officers) and Schedule B (indirect owners) of the broker-dealer operator's most recently filed Form BD. The Commission believes that this information will help market participants better understand potential conflicts of interest that may arise from the ownership of the NMS Stock ATS.

C. Part III of Proposed Form ATS-N: Activities of the Broker-Dealer Operator and Its Affiliates

The Commission believes that to better understand the operation of an NMS Stock ATS, market participants must understand the relationship and interactions of the NMS Stock ATS with its broker-dealer operator and the broker-dealer operator's affiliates. A multi-service broker-dealer may use its NMS Stock ATS to complement other services it provides (e.g., algorithmic trading, automated SOR services)

¹² Pursuant to proposed Rule 304(b)(2), the Commission would make public on its website each: (1) order of effectiveness of a Form ATS-N; (2) order of ineffectiveness of a Form ATS-N; (3) effective Form ATS-N; (4) filed Form ATS-N amendment; (5) order of ineffectiveness of a Form ATS-N amendment; (6) notice of cessation; and (7) order suspending, limiting or revoking the exemption from the definition of an "exchange" pursuant to Exchange Act Rule 3a1-1(a)(2). Proposed Rule 304(b)(1) would require that every Form ATS-N filed pursuant to Rule 304 constitutes a "report" for purposes of various recordkeeping and liability provisions of the Exchange Act (e.g., Sections 11A, 17(a), 18(a) and 32(a)).

and to execute orders in-house before seeking contra-side interest at other execution venues. The Commission believes that this may cause the interests of the broker-dealer operator and its affiliates to compete with the interests of an NMS Stock ATS's subscribers for executions on the NMS Stock ATS, thereby giving rise to potential conflicts of interest or potential leakage of subscribers' confidential trading information. Accordingly, Part III of proposed Form ATS-N would require the disclosure of detailed information regarding a broker-dealer operator and its affiliates.

For purposes of the proposed disclosures, an "affiliate" would be defined to mean "with regard to a specified person, any person that directly, or indirectly, controls, is under common control with, or is controlled by, the specified person."¹³ Any affiliate of the broker-dealer operator would be deemed an affiliate of the NMS Stock ATS and, therefore, subject to the disclosure requirements of Part III. Part III would require detailed disclosures that address ten items, as described further below.

1. Item 1: Non-ATS Trading Center of the Broker-Dealer Operator

Item 1 of Part III would require an NMS Stock ATS to disclose whether its broker-dealer operator (or its affiliates) operates or controls any non-ATS trading center that is an OTC market maker, executes orders in NMS stocks internally by trading as principal or crosses orders as agent. If so, among other things, the NMS Stock ATS must identify any such non-ATS trading center and describe any interaction or coordination between the non-ATS trading center and the NMS Stock ATS. Specifically, the NMS Stock ATS must describe:

- The circumstances under which subscriber orders or other trading interest¹⁴ sent to the NMS Stock ATS are displayed or otherwise made known to the non-ATS trading center(s) before entering the NMS Stock ATS;
- The circumstances under which subscriber orders or other trading interest received by the broker-dealer operator (or its affiliates) may execute in the non-ATS trading center(s) before entering the NMS Stock ATS; and
- The circumstances under which subscriber orders or other trading interest are removed from the NMS Stock ATS and sent to the non-ATS trading center.

The SEC believes that these disclosures would reduce informational asymmetries between subscribers and the broker-dealer operator regarding the operation of the NMS Stock ATS.

2. Item 2: Multiple NMS Stock ATS Operations of the Broker-Dealer Operator

Item 2 of Part III would require an NMS Stock ATS to state whether its broker-dealer operator (or its affiliates) operates one or more NMS Stock ATSs other than the NMS Stock ATS named on the Form ATS-N and, if so, to identify the other NMS Stock ATS(s) and to describe any interaction or coordination between each NMS Stock ATS, including:

- The circumstances under which subscriber orders or other trading interest received by the broker-dealer operator (or its affiliates) to be sent to the NMS Stock ATS named on the Form ATS-N may be sent to an NMS Stock ATS(s) identified in Item 2;
- The circumstances under which subscriber orders or other trading interest to be sent to the NMS Stock ATS named on the Form ATS-N are displayed or otherwise made known in an NMS Stock ATS(s) identified in Item 2; and
- The circumstances under which subscriber orders or other trading interest received by the NMS Stock ATS named on the Form ATS-N may be removed and sent to an NMS Stock ATS identified in Item 2.

¹³ Proposing Release, *supra* note 1, at 81044. The Commission also proposes to amend the existing definition of "control" in Rule 300(f) of Reg ATS so that it refers to "the broker-dealer of an alternative trading system," rather than "an alternative trading system."

¹⁴ Other trading interest would include quotes, indications of interest, and conditional orders or messages.

The proposed disclosures are designed to help subscribers evaluate potential conflicts of interest of the broker-dealer operator and the potential for information leakage.

3. Item 3: Products or Services Offered to Subscribers by the Broker-Dealer Operator

Item 3 of Part III would require disclosure of whether the broker-dealer operator (or its affiliates) offers subscribers of the NMS Stock ATS any products or services used in connection with trading on the NMS Stock ATS, such as algorithmic trading products or market data feeds. If such products or services are offered, the NMS Stock ATS would be required to describe them, identify the types of subscribers (*e.g.*, retail, institutional, professional) to which such services and products are offered and indicate whether their terms and conditions vary among subscribers. These disclosures are designed to address instances where a broker-dealer operator may offer certain subscribers different products or services, which could potentially impact the subscribers' access to, or trading on, the NMS Stock ATS (*e.g.*, fee discounts or faster connection speeds).

4. Item 4: Broker-Dealer Operator Arrangements with Unaffiliated Trading Centers

Item 4 of Part III would require an NMS Stock ATS to disclose whether the broker-dealer operator or any of its affiliates have any formal or informal arrangement with an unaffiliated person, or affiliate of such person, that operates a trading center regarding access to the NMS Stock ATS, including preferential routing arrangements. If there are any such arrangements, the NMS Stock ATS would be required to identify the person and the trading center, and describe the terms of the arrangement.

5. Item 5: Trading on the NMS Stock ATS by the Broker-Dealer Operator and Its Affiliates

Item 5 of Part III would require an NMS Stock ATS to disclose whether the broker-dealer operator (or its affiliates) enters orders or other trading interest on the NMS Stock ATS and, if so, to:

- Identify each affiliate and business unit of the broker-dealer operator that may enter orders or other trading interest on the NMS Stock ATS;
- Describe the circumstances and capacity (*e.g.*, proprietary or agency) in which each identified affiliate and business unit enters orders or other trading interest on the NMS Stock ATS;
- Describe the means by which each identified affiliate and business unit enters orders or other trading interest on the NMS Stock ATS (*e.g.*, directly via a FIX connection, or indirectly, by way of a broker-dealer operator's SOR, algorithm, intermediate application or sales desk); and
- Describe the means by which a subscriber can be excluded from interacting or trading with orders or other trading interest of the broker-dealer operator or its affiliates on the NMS Stock ATS.

The Commission believes that these disclosures would help subscribers identify potential conflicts of interest that may arise when the person that operates and owns a trading center also is able to trade on that trading center, and assess whether and how they may avoid trading against orders or other trading interest of the broker-dealer operator or its affiliates.

6. Item 6: Broker-Dealer Operator Smart Order Routers (or Similar Functionalities) and Algorithms

Item 6 of Part III would require an NMS Stock ATS to disclose whether the broker-dealer operator or any of its affiliates uses a SOR (or similar functionality),¹⁵ an algorithm¹⁶ or both to send or receive subscriber

¹⁵ The Commission explains that a SOR (or similar functionality) is generally understood to be "an automated system used to route orders or other trading interest among trading centers, including proprietary non-ATS trading centers operated by the broker-dealer operator, to carry out particular trading instructions or strategies of a broker-dealer." Proposing Release, *supra* note 1, at 81052.

orders or other trading interest to or from the NMS Stock ATS. If so, the NMS Stock ATS must: (1) identify the SOR or algorithm and the person(s) that operate such SOR or algorithm, if other than the broker-dealer operator; and (2) describe the interaction or coordination between the identified SOR or algorithm and the NMS Stock ATS, including any information or messages about orders or other trading interest that the SOR or algorithm send to or receive from the NMS Stock ATS, and the circumstances under which such information may be shared with any person.

The Commission expressed concern that a SOR may obtain information concerning subscriber orders or other trading interest that have been routed to and from the NMS Stock ATS.¹⁷ The Commission notes that most broker-dealer operators that use a SOR or algorithm operate such technology separate and apart from their ATSs. The Commission, however, states that if the technology operates jointly with, or performs a function of, the ATS to bring together the orders of multiple buyers and sellers using nondiscretionary methods, it may be considered part of the ATS for purposes of Reg ATS and related disclosure requirements.¹⁸

7. Item 7: Shared Employees of NMS Stock ATSs

Item 7 of Part III would require an NMS Stock ATS to disclose whether any employee of the broker-dealer operator that services (e.g., performs information technology, programming, testing or system design functions) the NMS Stock ATS's operations also services any other business units of the broker-dealer operator (or its affiliates). If there are such shared employees, the NMS Stock ATS must: (1) identify the business unit(s) and/or affiliate(s) of the broker-dealer operator to which the shared employee(s) provides services and the positions or titles that the shared employee(s) holds in such business unit(s) and/or affiliate(s); and (2) describe the roles and responsibilities of the shared employee(s) at the NMS Stock ATS and the business unit(s) and/or affiliate(s) of the broker-dealer operator. The Commission intends for these disclosures to assist market participants in assessing potential conflicts of interest and information leakage involving shared employees of the broker-dealer operator.

8. Item 8: Service Providers to the NMS Stock ATS

Item 8 of Part III would require an NMS Stock ATS to disclose whether any of its operations, services or functions are performed by any person other than its broker-dealer operator. If so, the NMS Stock ATS must:

- Identify the person (or in the case of a natural person, identify only the person's position or title) performing the operation, service or function and whether the service provider is an affiliate;
- Describe the operation, service or function that the person provides and the person's role and responsibilities; and
- State whether the person or any of its affiliates may enter orders or other trading interest on the NMS Stock ATS and, if applicable, the circumstances and means by which this is done.

The Commission expects detailed descriptions in response to Item 8. For instance, disclosures would have to include information concerning consultants that provide services relating to the trading systems or functionality, cybersecurity, regulatory compliance or recordkeeping of the NMS Stock ATS, as well as any service provider engaged in clearing or settling trades for the NMS Stock ATS. Notably, although the functions performed by a broker-dealer operator would not have to be disclosed, any functions performed by one of its affiliates would have to be disclosed. Functions that are administrative in nature and do not pose a significant risk of leaking confidential information, however, would be excluded from the disclosure.

¹⁶ The Commission explains that an algorithm is generally understood to be "a computer assisted trading tool that, for instance, may be used by or on behalf of institutional investors to execute orders that are typically too large to be executed all at once without excessive price impact, and divide the orders into many small orders that are fed into the marketplace over time." *Id.*

¹⁷ *Id.* at 81052.

¹⁸ *Id.* at 81053.

9. Item 9: Differences in Availability of Services, Functionality or Procedures

Item 9 of Part III would require an NMS Stock ATS to state whether it has any service, functionality or procedure that is available or applies only to the broker-dealer operator or its affiliates and not to other subscribers. If so, the NMS Stock ATS would be required to identify and describe the service, functionality or procedure. The Commission believes that this disclosure would allow market participants to assess whether they are at a disadvantage when competing against the broker-dealer operator or its affiliates for executions on the NMS Stock ATS.¹⁹

10. Item 10: Confidential Treatment of Trading Information

Item 10 of Part III is modeled after the requirements in Rule 301(b)(10) of Reg ATS concerning the confidential treatment of trading information. As proposed, Item 10 would require an NMS Stock ATS to describe its written safeguards and procedures to protect the confidential trading information of its subscribers to the NMS Stock ATS. Specifically, the NMS Stock ATS must:

- Describe the means by which a subscriber can consent or withdraw consent to the disclosure of confidential trading information to any persons, including the broker-dealer operator (or its affiliates);
- Identify persons that have access to confidential trading information, and describe the confidential trading information to which the persons have access and the circumstances under which they can access the confidential trading information;
- Describe the written standards controlling trading by employees of the NMS Stock ATS trading for their own accounts; and
- Describe the written oversight procedures used to ensure that the safeguards and procedures disclosed in Item 10 are implemented and followed.

In proposing Item 10, the Commission emphasized that the identity of subscribers and their orders must be available only to employees of an ATS who operate the system or are responsible for compliance with applicable rules. The Commission also explained that “a broker-dealer operator may not convert confidential trading information of ATS subscribers for use by the non-ATS business units operated by the broker-dealer,” and that “[t]he protection of subscribers’ confidential trading information remains a bedrock component of the regulation of ATSs, including those that trade NMS stocks, and is essential to ensuring the integrity of ATSs as execution venues.”²⁰

D. Part IV of Proposed Form ATS-N: The Manner of Operations of the NMS Stock ATS

Current disclosures on Form ATS are confidential, and the Proposing Release notes that even where an ATS voluntarily discloses its Form ATS publicly, ATSs have often been reluctant to provide more than summary disclosures about their operations. The SEC is concerned that this lack of operational transparency prevents market participants from adequately discerning how orders interact, match and execute on ATSs, and may hinder market participants’ ability to obtain, or monitor for, best execution for their orders. Accordingly, the Commission proposes to require NMS Stock ATSs to submit as Part IV of Form ATS-N detailed information about their operations, as described further below.

1. Item 1: Subscribers

Item 1 of Part IV would require an NMS Stock ATS to disclose information regarding the subscribers that may access the NMS Stock ATS. Such disclosures would include: (1) any eligibility requirements to gain access to the services of the NMS Stock ATS and, if such requirements are not the same for all

¹⁹ The Commission explains that an NMS Stock ATS may treat subscribers differently with respect to the services it offers, unless otherwise prohibited by the federal securities laws, rules or regulations. The Commission, however, also warns that inaccurate or misleading disclosures about an NMS Stock ATS’s operations could result in violations of the antifraud provisions of the federal securities laws. *Id.* at 81057.

²⁰ *Id.* at 81058.

subscribers and persons, any such differences; (2) the terms and conditions of any contractual agreements for granting access to the NMS Stock ATS; (3) the types of subscribers and other persons that use the services of the NMS Stock ATS (e.g., institutional and retail investors, broker-dealers, proprietary trading firms), and any criteria for distinguishing among types of subscribers, classes of subscribers or other persons; (4) any formal or informal arrangement the NMS Stock ATS has with a subscriber or person to provide liquidity to the NMS Stock ATS (e.g., undertaking to buy or sell continuously or to meet specified thresholds of trading or quoting activity); and (5) the circumstances by which access to the NMS Stock ATS for a subscriber or other person may be limited or denied, and any procedures or standards used to determine such action. The Commission believes these disclosures would provide potential subscribers with information about conditions for accessing the NMS Stock ATS, and would allow subscribers to better understand their rights and obligations in connection with their use of the NMS Stock ATS. They also would allow market participants to better evaluate order flow on the NMS Stock ATS.

2. Item 2: Hours of Operation

Item 2(a) of Part IV would require an NMS Stock ATS to provide the days and hours of its operation, including the times when orders or other trading interest are entered on the NMS Stock ATS and the time when pre-opening or after-hours trading occur.

3. Item 3: Types of Orders

Item 3(a) of Part IV would require an NMS Stock ATS to describe any types of orders that may be entered on the NMS Stock ATS, their characteristics, operations and how they are handled. Specifically, an NMS Stock ATS must describe: (1) the priority rules for each order type (i.e., priority and any subsequent change to priority, if applicable); (2) any conditions for each order type, including price conditions, display or non-display conditions, or conditions on the execution or routing of orders; (3) order types designed not to remove liquidity (e.g., post-only orders) and what occurs when such orders are marketable against other trading interest on the NMS Stock ATS when received; (4) order types that adjust their prices as changes to the order book occur (e.g., price sliding orders or pegged orders) or have a discretionary range; (5) time-in-force instructions that can be used or not used with each order type; (6) the availability of order types across all forms of connectivity to the NMS Stock ATS and the difference, if any, between the availability of an order type across those forms of connectivity (e.g., offering certain order types to those subscribers connecting through the broker-dealer operator, such as through a SOR versus those who connect directly through a FIX connection); (7) whether an order type is eligible for routing to other trading centers and, if so, whether it can be used with any routing services offered; and (8) the circumstances under which order types may be combined with a time-in-force or other order type, modified, replaced, canceled, rejected or removed from the NMS Stock ATS.

Separately, Item 3(c) would require an NMS Stock ATS to describe any requirements and handling procedures for minimum order sizes, odd-lot orders or mixed-lot orders.²¹ Item 3(d) would require an NMS Stock ATS to describe any messages sent to or received by the NMS Stock ATS indicating trading interest (e.g., IOIs, actionable IOIs or conditional orders), including information contained in the message, the means by which messages are transmitted, the circumstances in which messages are transmitted (e.g., automatically by the NMS Stock ATS or upon the subscriber's request), and the circumstances by which they may result in an execution on the NMS Stock ATS.

4. Item 4: Connectivity, Order Entry and Co-Location

Item 4(a) of Part IV would require an NMS Stock ATS to describe the means by which subscribers or other persons connect to, and enter orders or other trading interest on, the NMS Stock ATS (e.g., directly via a FIX connection or indirectly through the broker-dealer operator's SOR). Item 4(b) would require the NMS Stock ATS to describe any co-location services or other means by which any subscriber or other

²¹ Such disclosure would include, for instance, any order size requirements that may differ based on factors such as the type of subscriber or person that uses the services of the NMS Stock ATS, or the type of order (e.g., if only certain subscribers or persons are eligible to use that order type).

person may enhance the speed by which they send or receive orders, trading interest or messages to or from the NMS Stock ATS, and the terms and conditions of such services.

5. Item 5: Segmentation of Order Flow and Notice About Segmentation

Item 5(a) of Part IV would require an NMS Stock ATS to describe any segmentation of orders or other trading interest on the NMS Stock ATS (e.g., classification by type of participant, source, nature of trading activity). Such disclosure would include the segmented categories, criteria used to segment these categories, and procedures for determining, evaluating and changing segmented categories. Item 5(b) would require the NMS Stock ATS to state whether the NMS Stock ATS informs subscribers or persons about the segmentation category to which the subscribers or persons are assigned.

Item 5(c) would require an NMS Stock ATS to describe the circumstances by which a subscriber, the broker-dealer operator or any of its affiliates may designate an order or trading interest to interact or not interact with specific orders, trading interest or persons on the NMS Stock ATS (e.g., designating an order or trading interest to be executed against a specific subscriber) and how such designations affect order priority and interaction. The NMS Stock ATS also must describe any means by which subscribers may seek or avoid executions against certain orders, persons or trading interest. This Item would require disclosure of any circumstances by which the NMS Stock ATS would allow a subscriber to designate an order to interact with specific orders resting on the NMS Stock ATS and how such order preferencing works with other rules governing order priority and interaction, and the means by which a subscriber could avoid executing against any order, person or trading interest.

6. Item 6: Display of Order and Trading Interest

Given its concern that market participants may not know the extent to which their trading interest sent to an ATS is displayed outside that ATS, the Commission proposes to require that an NMS Stock ATS disclose in Item 6(a) of Part IV: (1) the circumstances by which orders or other trading interest on the NMS Stock ATS are displayed or made known outside the NMS Stock ATS; and (2) information about such orders and trading interest (i.e., symbol, price, size, attribution or any other information made known). Item 6(b) would require the NMS Stock ATS to identify the subscriber(s) or person(s) (in the case of a natural person, only the person's position or title) to whom the orders and trading interest are displayed or otherwise made known. For purposes of Item 6, the SEC believes that an NMS Stock ATS would display or make known orders or other trading interest on it when it sends electronic messages outside of its system that expose the presence of orders or other trading interest on the NMS Stock ATS. For instance, if an NMS Stock ATS sends to subscribers or other persons a direct data feed that contains real-time information about current quotes, orders or other trading interest on the NMS Stock ATS, the disclosure requirements of Item 6 would have to be satisfied.

7. Item 7: Trading Services

The Commission believes that it is important for market participants to understand an NMS Stock ATS's market and how orders interact and match on that market. Therefore, Item 7(a) of Part IV would require an NMS Stock ATS to describe the means or facilities it uses to bring together the orders of multiple buyers and sellers, including the structure of the market. For instance, NMS Stock ATSs may bring together multiple buyers and sellers using crossing systems, auction markets and limit order matching systems.

Item 7(b) would require an NMS Stock ATS to describe the established, non-discretionary methods that dictate the terms of trading among the multiple buyers and sellers on the NMS Stock ATS, including rules and procedures governing the priority, pricing methodologies, allocation, matching and execution of orders and other trading interest. Item 7(c) would require an NMS Stock ATS to describe any trading procedures related to price protection mechanisms, short sales, locked-crossed markets, the handling of execution errors, timestamping of orders and executions or price improvement functionality.

8. Item 8: Suspension of Trading, System Disruption or Malfunction

Item 8 of Part IV would require an NMS Stock ATS to describe any procedures governing trading in the event the NMS Stock ATS suspends trading or experiences a system disruption²² or malfunction. This would inform market participants whether, among other things, an NMS Stock ATS will continue to accept orders after a suspension, system malfunction or disruption occurs, whether the NMS Stock ATS routes, holds, or continues to execute orders resting in the system prior to the disruption, and the type of notice the NMS Stock ATS provides to subscribers and other market participants during such an event.

9. Item 9: Opening, Reopening and Closing Processes, and After-Hours Procedures

Item 9 of Part IV would require an NMS Stock ATS to describe its opening, reopening and closing processes, if any, and any after-hours trading procedures, including any special procedures or order types for each process. Specifically, Item 9(a) would require a description of how orders or other trading interest are matched and executed prior to the start of regular trading hours or following a stoppage of trading in a security during regular trading hours. Item 9(b) would require a description of how unexecuted orders or other trading interest are handled at the close of regular trading. Item 9(c) would require a description of any after-hours trading procedures, including how orders and trading interest are matched and executed during after-hours trading.

10. Item 10: Outbound Routing

Item 10(a) of Part IV would require an NMS Stock ATS to describe the circumstances under which orders or other trading interest are routed from the NMS Stock ATS to another trading center, including whether outbound routing occurs at the affirmative instruction of the subscriber and/or at the discretion of the broker-dealer operator. Item 10(a) also would require a description of the means by which routing is performed (e.g., via a third party, order management system, SOR or algorithm of the broker-dealer operator or its affiliates). The Commission believes such disclosures would help subscribers evaluate the potential for leakage of their confidential trading information.

11. Item 11: Market Data

Item 11 of Part IV would require an NMS Stock ATS to disclose its sources and uses of market data. In particular, Item 11(a) would require a description of the market data used by the NMS Stock ATS and the source of that market data (e.g., market data feeds disseminated by a securities information processor ("SIP") and market data feeds disseminated directly by an exchange, other trading center or third-party vendor). Item 11(b) would require the NMS Stock ATS to describe the purpose for which market data is used by the NMS Stock ATS, including how market data is used to determine the NBBO, protected quotes, pricing of orders and executions and routing destinations.

12. Item 12: Fees

Item 12 of Part IV would require an NMS Stock ATS to describe its fee and rebate structure. Item 12(a) would require a description of any fees, rebates or other charges of the NMS Stock ATS (e.g., connectivity fees, subscription fees, execution fees, volume discounts), as well as the range of such fees, rebates or other charges. If the fees, rebates or other charges are not the same for all subscribers and persons, the NMS Stock ATS would be required to describe any differences under Item 12(b).²³

²² Systems disruptions would include, for example, internal software problems that prevent the NMS Stock ATS's system from opening or continuing trading, a significant increase in volume that exceeds the ability of the trading system to process incoming orders, and the failure of the trading system to receive NBBO or other external pricing information used in the system's pricing methodology. *Id.* at 81076.

²³ The Commission recognizes that, in some cases, it may not be practical or desirable to require an NMS Stock ATS to disclose the fee schedule applicable to each subscriber. As a result, the SEC proposes to require the disclosure only of fee ranges.

13. Item 13: Trade Reporting, Clearance and Settlement

Item 13 of Part IV would require an NMS Stock ATS to describe its arrangements or procedures for trade reporting, clearance and settlement of transactions. This would include, for instance, any requirements it places on its subscribers, or other persons whose orders are routed to it, to have clearance and settlement systems and/or arrangements with a clearing firm.

14. Item 14: Order Display and Execution Access

If an NMS Stock ATS displays orders in an NMS stock to any person other than its employees and executes five percent or more of the average daily trading volume in that NMS stock for four of the preceding six calendar months, it would be required to provide the following information pursuant to Item 14 of Part IV: (1) the ticker symbol for each such NMS stock; (2) the manner in which the NMS Stock ATS displays such orders on a national securities exchange or through a national securities association; and (3) how the NMS Stock ATS provides access to such orders to non-subscribers. This disclosure would provide a mechanism through which the NMS Stock ATS would notify the Commission, its SRO and market participants that it triggered the order display and execution access requirements in existing Rule 301(b)(3) of Reg ATS.²⁴

15. Item 15: Fair Access

If an NMS Stock ATS triggers the five percent trading volume threshold described above, it would have to disclose pursuant to Item 15 of Part IV: (1) the ticker symbol for each NMS stock for each of the last six calendar months; and (2) a description of its written standards for granting fair access to trading on the NMS Stock ATS. This disclosure requirement is intended to assist in monitoring compliance with the fair access requirements of Rule 301(b)(5) of Reg ATS, which requires an ATS to establish written standards for granting access to trading on its system when it crosses the fair access thresholds in Rule 301(b)(5) and does not meet the exceptions set forth therein.

16. Item 16: Market Quality Statistics Published or Provided by the NMS Stock ATS to Subscribers

If an NMS Stock ATS publishes or otherwise provides to one or more subscribers aggregate platform-wide order flow and execution statistics that are not otherwise required disclosures under Rule 605 of Regulation NMS, Item 16 of Part IV would require the NMS Stock ATS to: (1) list and describe the categories of the aggregate platform-wide order flow and execution statistics published or provided; (2) describe the metrics and methodology used to calculate the aggregate platform-wide order flow and execution statistics; and (3) attach as Exhibit 5 the most recent disclosure of the aggregate platform-wide order flow and execution statistics published or provided to one or more subscribers for each category or metric as of the end of the most recent calendar quarter (*i.e.*, file a Form ATS-N amendment within 30 calendar days after the end of the calendar quarter).

III. Proposed Amendment to Rule 301(b)(10): Written Safeguards and Written Procedures to Protect Confidential Trading Information

Current Rule 301(b)(10) of Reg ATS requires every ATS to have in place safeguards and procedures to protect subscribers' confidential trading information. Rule 301(b)(10), however, does not currently require that the mandated safeguards and procedures be memorialized in writing. Therefore, the Commission proposes to amend Rule 301(b)(10) to require that the safeguards and procedures for both NMS Stock ATSs and other ATSs be reduced to writing. The Commission believes that the proposed amendment would strengthen the effectiveness of the ATS's safeguards and procedures.

²⁴ The SEC noted that it previously proposed lowering the trading volume threshold that triggers public display obligations in Rule 301(b)(3) and revising the definition of "bid" and "offer" in Regulation NMS to clarify that the public quoting requirements apply to actionable indications of interest transmitted by dark pools to select market participants. See Securities Exchange Act Rel. No. 60997 (Nov. 13, 2009), 74 Fed. Reg. 61208 (Nov. 23, 2009). The SEC requested comment on these prior proposals as well. See Proposing Release, *supra* note 1, at 81083.

IV. Recordkeeping Requirements

The SEC would amend the recordkeeping rules of Reg ATS to require the preservation of records that would be created pursuant to (1) the preparation, filing and amendment of proposed Form ATS-N, and (2) the requirement to reduce to writing its safeguards and procedures concerning the confidential treatment of trading information.

V. Alternatives Considered

In drafting the Proposing Release, the SEC considered the advantages and disadvantages of a variety of alternatives to the proposed approach. These alternatives included: (1) requiring NMS Stock ATSS to publicly disclose the current Form ATS; (2) requiring proposed Form ATS-N, but deeming the information filed confidential; (3) requiring NMS Stock ATSS to publicly disclose proposed Form ATS-N, but not declare proposed Form ATS-N effective or ineffective; (4) initiating differing levels of public disclosure depending on the characteristics of the NMS Stock ATS (e.g., trading volume); (5) requiring NMS Stock ATSS to register as national securities exchanges and become SROs; (6) discontinuing quarterly volume reports on Form ATS-R; (7) requiring NMS Stock ATSS to operate as limited purpose entities; (8) lowering the fair access threshold for NMS Stock ATSS; and (9) applying proposed Rule 304 to ATSS that trade fixed income securities and ATSS that solely trade government securities. After considering these alternatives, the SEC concluded that the approach taken in the Proposing Release would enhance regulatory oversight and transparency of the operations of NMS Stock ATSS in a cost-effective manner, while limiting adverse effects on competition. The SEC did recognize, however, that public disclosure of the more expansive and granular information about the operations of NMS Stock ATSS could have some harmful effects on the competitive dynamics of NMS Stock ATSS and result in some exiting the market.

VI. Conclusion

The proposed amendments to Reg ATS would significantly enhance the information available to market participants and the SEC regarding the operations of NMS Stock ATSS and their operating broker-dealers (and their affiliates). They also would tilt the current regulatory playing field for such systems to be much closer to that of national securities exchanges. In doing so, however, the proposed amendments would dramatically increase the obligations of NMS Stock ATSS and, presumably, their related regulatory and business costs. Market participants sponsoring or utilizing the services of NMS Stock ATSS should consider the potential impact of the proposals on their respective businesses.

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