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# *SEC Proposes Significant New Regulatory Obligations for Communication Protocol Systems and Government Securities ATSs*

FEBRUARY 9, 2022

*Revised Version*

The Securities and Exchange Commission (SEC) proposed significant changes to the regulation of securities trading systems that use non-firm trading interest and alternative trading systems (ATSs) that trade government securities.<sup>1</sup> Specifically, the SEC proposal would require:

- systems that offer the use of non-firm trading interest and protocols to bring together buyers and sellers of securities (Communication Protocol Systems) to (1) register as an exchange, or (2) be operated by a registered broker-dealer in compliance with Regulation ATS (Reg ATS); and
- ATSs that solely trade government securities or repurchase agreements on government securities (Government Securities ATSs), including those that are operated by a bank, to comply with Reg ATS and, in certain instances, Regulation Systems Compliance and Integrity (Reg SCI).

The SEC has requested comments on the proposal within 30 days of the publication of the proposal in the Federal Register.<sup>2</sup>

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<sup>1</sup> Securities Exchange Act Release No. 94062 (Jan. 26, 2022) (Proposing Release), available at <https://www.sec.gov/rules/proposed/2022/34-94062.pdf>. The SEC previously issued a proposal to amend Reg ATS and Reg SCI to apply to Government Securities ATSs. Securities Exchange Act Release No. 90019 (Sept. 28, 2020), available at <https://www.sec.gov/rules/proposed/2020/34-90019.pdf>.

<sup>2</sup> During the SEC's open meeting on the proposals, SEC Chair Gensler indicated that publication in the Federal Register may take up to six weeks.

## *I. Communication Protocol Systems*

The SEC proposed to expand the definition of an “exchange” in Rule 3b-16 under the Securities Exchange Act of 1934 (Exchange Act) to apply to Communication Protocol Systems.

Communication Protocol Systems, which can use various technologies and connectivity, generally offer the use of non-firm trading interest and established protocols to prompt and guide buyers and sellers to communicate, negotiate and agree to the terms of a trade without relying solely on the use of orders. Communication Protocol Systems may include (1) request-for-quote (RFQ) systems; (2) systems that electronically display continuous firm or non-firm trading interest, or “stream axes,” in a security or type of security to participants on the system; (3) conditional order systems that offer the use of trading interest that may not be executable until after a user takes subsequent action; and (4) systems that bring together buyers and sellers of securities through the use of bilateral negotiation protocols and non-firm trading interest. If adopted, the expanded definition of an exchange would require many negotiation and communication systems that heretofore have been outside of exchange status to register as an exchange or be operated by a registered broker-dealer in compliance with Reg ATS.

### *A. Expanded Definition of “Exchange”*

Exchange Act Rule 3b-16 currently defines an exchange as an organization, association or group of persons that (1) brings together the orders for securities of multiple buyers and sellers; and (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 terms of a trade. The SEC proposed to amend both prongs of this definition to include Communication Protocol Systems.

#### *1. Trading Interest*

The SEC proposed to amend the first prong of the definition of “exchange” in Exchange Act Rule 3b-16(a)(1) to include non-firm indications of a willingness to buy or sell a security in addition to orders. The term “trading interest” would be defined to include orders as well as any non-firm indication of willingness to buy or sell a security that identifies at least the security and either quantity, direction (buy or sell), or price.<sup>3</sup> In addition, the SEC proposed to delete the word “multiple” from the first prong of the definition of “exchange” in Rule 3b-16(a)(1), because it “believes that the term ‘multiple’ could be misconstrued to mean that RFQ systems, for example, do not meet the criteria of Rule 3b-16(a) because a transaction request typically involves one buyer

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<sup>3</sup> Proposed Exchange Act Rule 3b-16(e). *See also* Proposed Rule 300(q) of Reg ATS.

and multiple sellers or one seller and multiple buyers. Under current Rule 3b-16(a), whether a system meets the ‘multiple’ prong depends on whether the system, when viewed in its entirety, includes more than one buyer and more than one seller and is not determined on a transaction-by-transaction basis.”<sup>4</sup>

## 2. *Communication Protocols*

The SEC also proposed to amend the second prong of the definition of “exchange” in Exchange Act Rule 3b-16(a)(2) by adding “communication protocols” as an established method that an organization, association or group of persons can provide to bring together buyers and sellers of securities. Based on the SEC’s experience, communication protocols generally use non-firm trading interest as opposed to orders to prompt and guide buyers and sellers to communicate, negotiate and agree to the terms of the trade. For example, if an entity makes available a chat feature that requires certain information (e.g., price, quantity) to be included in a chat message and sets parameters and a structure designed for participants to communicate about buying and selling securities, the system would have established communication protocols.

While Communication Protocol Systems may not match counterparties’ trading interest, buyers and sellers using these systems can be brought together to interact, either on a bilateral or a multilateral basis, and agree upon the terms of the trade. Although the determination as to whether a system meets Rule 3b-16(a)(2) would depend on the facts and circumstances of each system, communication protocols may include, for example, (1) setting minimum criteria for what messages must contain; (2) setting time periods under which buyers and sellers must respond to messages; (3) restricting the number of persons a message can be sent to; (4) limiting the types of securities about which buyers and sellers can communicate; (5) setting minimums on the size of the trading interest to be negotiated; or (6) organizing the presentation of trading interest, whether firm or non-firm, to participants.

The SEC noted, however, that certain systems would not satisfy the proposed amended definition of an exchange. For example, systems that passively display trading interest, such as systems referred to in the industry as bulletin boards, but do not provide means for buyers and sellers to contact each other and agree to the terms of the trade on the system, would not be encompassed by the proposed amended Rule 3b-16(a). Similarly, a system that displays trading interest and provides only connectivity among participants without providing a trading facility to match orders or

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<sup>4</sup> Proposing Release at 38. The SEC’s proposal to amend Exchange Act Rule 3b-16 comes on the heels of a similar position taken by the Commodity Futures Trading Commission (CFTC) staff concluding that swap intermediaries that offer one-to-many or bilateral communication systems are required to register as swap execution facilities. CFTC Letter No. 21-19 (Sept. 29, 2021).

providing protocols for participants to communicate and interact would not satisfy proposed Rule 3b-16(a).

## *B. Compliance With Exchange Registration or Regulation ATS Exemption*

Under the SEC proposal, Communication Protocol Systems would be required to register as a national securities exchange, comply with Reg ATS or act in accordance with another applicable exemption.

### *1. Register as a National Securities Exchange*

A Communication Protocol System that elects to register as a national securities exchange would be required to comply with the extensive requirements applicable to national securities exchanges. For example, a Communication Protocol System would be required to (1) file Form 1, the application for registration as a national securities exchange, and receive SEC approval of the application, after publication and the opportunity for comment; (2) set standards of conduct for its members, administer examinations for compliance with these standards, coordinate with other self-regulatory organizations (SROs) with respect to the dissemination of consolidated market data, and generally take responsibility for enforcing its rules and the Exchange Act; (3) establish rules that (a) are designed to prevent fraud and manipulation, promote just and equitable principles of trade, and protect investors and the public interest; (b) provide for the equitable allocation of reasonable fees; (c) do not permit unfair discrimination; and (d) do not impose any unnecessary or inappropriate burden on competition; (4) register securities traded on the exchange with the SEC and approve them for listing; (5) file any proposed changes to its rules, including changes to its fees, with the SEC; and (6) limit exchange members to broker-dealers.

### *2. Compliance With Reg ATS*

A Communication Protocol System that elects to operate as an ATS would be required to comply with the requirements of Reg ATS. Under Reg ATS, the operator of a Communication Protocol System would be required to register as a broker-dealer pursuant to Exchange Act Section 15 or as a government securities broker or government securities dealer under Exchange Act Section 15C(a)(1)(A), and to comply with the filing and conduct obligations associated with being a registered broker-dealer, including membership in an SRO, such as the Financial Industry Regulatory Authority (FINRA) and compliance with the SRO's rules. In addition, such ATS would be

required to file detailed initial and continuing disclosures about its operation on Form ATS or ATS-N (depending on the securities traded on the ATS) and Form ATS-R. The ATS also would be required to comply with requirements related to recordkeeping, examination and inspections, and confidential trading information. Depending on the type and amount of securities traded, the ATS also may need to comply with fair access, order display and execution access, and systems-related requirements.

## *II. Government Securities ATSS*

The SEC proposed to eliminate the exemption from compliance with Reg ATS for Government Securities ATSS. Accordingly, a Government Securities ATS, including a Government Securities ATS that relies on a Communication Protocol System, would be required to register as an exchange or comply with Reg ATS.

### *A. Elimination of Exemption From Reg ATS for Government Securities ATSS*

At present, a Government Securities ATS that is operated by a registered broker-dealer or a bank is exempt from the definition of an exchange under Section 3(a)(1) of the Exchange Act via the application of Rule 3a1-1(a)(3) of the Exchange Act and Rule 301(a)(4) of Reg ATS. The SEC proposed to amend Reg ATS to eliminate the exemption under Rule 301(a)(4) for Government Securities ATSS. As a result, any system that meets the definition of an exchange under Section 3(a)(1) of the Exchange Act and Rule 3b-16(a) thereunder and solely trades government securities or repurchase and reverse repurchase agreements (collectively, “repos”) on government securities would no longer be exempt from the definition of an exchange and would have to either register as a national securities exchange or operate pursuant to an exemption to such registration, such as the exemption under Reg ATS.

### *B. Definition of Government Securities ATS*

The SEC proposed to define “Government Securities ATS” to mean an ATS that trades government securities, as defined in Section 3(a)(42) of the Exchange Act,<sup>5</sup> or repos on government securities.

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<sup>5</sup> The definition of a government security in Section 3(a)(42) of the Exchange Act encompasses “any put, call, straddle, option, or privilege” on any government security listed in subsections (A)-(C) of the definition, other than any put, call, straddle, option or privilege that is traded on one or more national securities

The SEC also proposed that a Government Securities ATS may not trade securities other than government securities or repos on government securities, and that trading of other securities would require the separate filing of either a Form ATS or a Form ATS-N, depending on the types of securities traded.<sup>6</sup>

## *C. Compliance With Reg ATS*

If a Government Securities ATS decides to comply with Reg ATS, then the Government Securities ATS would be required to comply with the applicable requirements of Reg ATS, including the following.

### *1. Broker-Dealer Registration*

The operator of a Government Securities ATS must register as a broker-dealer under Section 15 or as a government securities broker or government securities dealer under Section 15C(a)(1)(A) of the Exchange Act,<sup>7</sup> and must comply with the filing and conduct obligations associated with being a registered broker-dealer, including membership in an SRO, such as FINRA, and compliance with the SRO's rules. Notably, and unlike current regulation, the proposed amendments to Reg ATS would not permit a bank or other financial institution to satisfy the broker-dealer registration requirements by registering as a government securities broker or government securities dealer under Section 15C(a)(1)(B) of the Exchange Act. Unlike broker-dealers registered under Section 15, and government securities brokers or government securities dealers registered under Section 15C(a)(1)(A), a bank or other financial institution that registers as a government securities broker or dealer under Section 15C(a)(1)(B) is not required to be a member of an SRO. In the Proposing Release, the SEC stated that it believes it is important for an ATS to be a member of an SRO. As a result, a bank-operated ATS that trades only government securities or repos on government securities would be unable to rely on the exemption provided by proposed amended Reg ATS without becoming a member of an SRO and could not otherwise operate unless registered as a national securities exchange pursuant to Section 5 of the Exchange Act. The SEC noted, however, that a bank that operates an ATS that trades only government securities or repos on government

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exchanges, or for which quotations are disseminated through an automated quotation system operated by a registered securities association. The definition of a government security includes Agency Securities as well as US Treasury Securities, each newly defined in the proposal in a manner similar to the definitions of those terms in FINRA Rules 6710(l) and 6710(p). Proposing Release at 82-83.

<sup>6</sup> Proposed Rule 300(l) of Reg ATS.

<sup>7</sup> Proposed Rule 301(b)(1) of Reg ATS.

securities could move the Government Securities ATS to a registered broker-dealer affiliate to operate the ATS.

## 2. *Form ATS-N*

A Government Securities ATS would be required to file a Form ATS-N and comply with the requirements related to Form ATS-N, including the following:

- Form ATS-N Disclosures. Form ATS-N would require a Government Securities ATS to provide detailed information about the ATS-related activities of the broker-dealer operator and its affiliates and the manner of operation of the ATS, including the proposed revisions to the Form ATS-N disclosures described in Section III below.
- Effectiveness Process. To operate in compliance with Reg ATS, a Government Securities ATS must first file an initial Form ATS-N with the SEC, and the initial Form ATS-N must become effective.<sup>8</sup> An initial Form ATS-N will become effective unless declared ineffective upon the earlier of (1) completion of the review by the SEC and publication on the SEC website or (2) expiration of the SEC review period or, if applicable, the end of the extended review period.<sup>9</sup> The SEC will, by order, declare an initial Form ATS-N ineffective if it finds, after notice and opportunity for hearing, that such action is necessary and appropriate in the public interest and is consistent with the protection of investors.<sup>10</sup> The SEC must, by order, declare ineffective an initial Form ATS-N no later than 120 calendar days from the date of filing with the SEC, or, if applicable, the end of the extended SEC review period. The SEC may extend the initial Form ATS-N review period for 90 calendar days if it finds an extension is appropriate, or for any period to which an ATS representative agrees.<sup>11</sup> If the SEC declares an initial Form ATS-N ineffective, the Government Securities ATS would be prohibited from operating as a Government Securities ATS. An initial Form ATS-N declared ineffective does not prevent the Government Securities ATS from subsequently filing a new Form ATS-N.
- Form ATS-N Amendments. A Government Securities ATS would be required to make certain amendments to its Form ATS-N, including filing amendments to (1) describe material changes to the operation of the ATS or to activities of the broker-dealer operator or certain of its affiliates at least 30 calendar days, or the length of any extended review period, before the implementation of the change; (2) describe fee changes no later than it makes a change to a fee; (3) describe changes related to fair access no later than the date such changes would make the Form ATS-N disclosures inaccurate or incomplete; (4)

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<sup>8</sup> Proposed Rule 304(a)(1)(i) of Reg ATS.

<sup>9</sup> Proposed Rule 304(a)(1)(iii)(A) of Reg ATS.

<sup>10</sup> Proposed Rule 304(a)(1)(iii)(B) of Reg ATS.

<sup>11</sup> Rule 304(a)(1)(ii) of Reg ATS.

correct information that has become incomplete or inaccurate within 30 calendar days after each quarter; and (5) promptly correct information in any previous disclosure on the Form ATS-N, after discovery that such information was materially inaccurate or incomplete when filed. A Government Securities ATS also would be required to report the cessation of its operations.<sup>12</sup>

- Public Disclosure. The SEC would post the Form ATS-N and its amendments as well as SEC orders related to the Form ATS-N on the SEC's website. A Government Securities ATS that has a website would be required to post a direct hyperlink to the SEC's website that contains its Form ATS-N filings.<sup>13</sup>

### 3. *Fair Access*

A Government Securities ATS that is responsible for a significant volume of trading in US Treasury Securities or Agency Securities would be required to comply with the Fair Access Rule under Reg ATS. Specifically, a Government Securities ATS would be subject to the Fair Access Rule if, during at least four of the preceding six calendar months, (1) it had 3 percent or more of the US Treasury Securities average weekly dollar volume traded in the US as provided by the SRO to which such transactions are reported or (2) it had 5 percent or more of the Agency Securities average daily dollar volume traded in the US as provided by the SRO to which such transactions are reported.<sup>14</sup> The Fair Access Rule would require a Government Securities ATS that crosses the volume thresholds to, among other things, (1) establish and apply reasonable written standards for granting, limiting and denying access to the services of the ATS; (2) make and keep records of grants of access and denials and limitations of access; and (3) report information on Form ATS-R regarding grants of access and denials and limitations of access.<sup>15</sup>

### 4. *Other Requirements Under Reg ATS*

Government Securities ATSS also would be required to comply with other aspects of Reg ATS, including the following:

- Examination/Inspection. A Government Securities ATS would be required to permit examination and inspection of its premises, systems and records by the SEC or the SRO of which it is a member and to cooperate with the examination, inspection or investigation

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<sup>12</sup> Rule 304(a)(2)-(3) of Reg ATS.

<sup>13</sup> Rule 304(b) of Reg ATS.

<sup>14</sup> Rules 301(b)(5)(i)(E)-(F) and 301(b)(5)(ii) of Reg ATS.

<sup>15</sup> Proposed Rule 301(b)(5)(iii) of Reg ATS.

of subscribers, whether such examination is being conducted by the SEC or by an SRO of which such subscribers are members.<sup>16</sup>

- Recordkeeping. A Government Securities ATS would be required to make and keep certain records specified in Rule 302 of Reg ATS, including records of subscribers to the ATS, daily summaries of trading in the ATS and time-sequenced records of trading interest information in the ATS. In addition, a Government Securities ATS would be required to preserve records specified in Rule 303 of Reg ATS, including Rule 302 records, notices to subscribers, written safeguards and procedures to protect confidential trading information, governing documents, and reports filed under Reg ATS.<sup>17</sup>
- Form ATS-R. A Government Securities ATS would be required to report transaction volume in government securities and repos on Form ATS-R on a quarterly basis and within 10 calendar days after it ceases operation.<sup>18</sup>
- Confidential Trading Information. A Government Securities ATS would be required to adopt written safeguards and written procedures to protect confidential trading information and to separate ATS functions from other broker-dealer functions.<sup>19</sup>
- Name Limitation. A Government Securities ATS would be prohibited from using in its name the word “exchange” or any derivation of the word “exchange.”<sup>20</sup>

A Government Securities ATSS would not, however, be subject to the order display and execution access provisions under Rule 301(b)(3) or the fees provision of Rule 301(b)(4) applicable to other ATSS, as these requirements are designed for the market structure for NMS stocks.<sup>21</sup>

## *D. Compliance With Reg SCI*

A Government Securities ATS that is responsible for a significant volume of trading in US Treasury Securities or Agency Securities would be required to comply with Reg SCI. A Government Securities ATS would be required to comply with Reg SCI if, during at least four of the preceding six calendar months, (1) it had with respect to US Treasury Securities 5 percent or more of the average weekly dollar volume traded in the US as provided by the SRO to which such transactions are reported (currently, FINRA’s Transaction Reporting and Compliance Engine or TRACE) or (2) it

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<sup>16</sup> Rule 301(b)(7) of Reg ATS.

<sup>17</sup> Rule 301(b)(8) of Reg ATS.

<sup>18</sup> Proposed Rule 301(b)(9) of Reg ATS & Form ATS-R.

<sup>19</sup> Rule 301(b)(10) of Reg ATS.

<sup>20</sup> Rule 301(b)(11) of Reg ATS.

<sup>21</sup> NMS Stock ATS means an alternative trading system that trades NMS stocks. See 17 C.F.R. § 242.300(k).

had, with respect to Agency Securities, 5 percent or more of the average daily volume traded in the US.<sup>22</sup>

Reg SCI, among other things, would require Government Securities ATSS that meet the volume thresholds to establish, maintain and enforce written policies and procedures reasonably designed to ensure that their key automated systems have levels of capacity, integrity, resiliency, availability and security adequate to maintain their operational capability and promote the maintenance of fair and orderly markets, and that such systems operate in accordance with the Exchange Act, and with the rules and regulations thereunder and the entities' rules and governing documents, as applicable. Broadly speaking, Reg SCI also would require such Government Securities ATSS to (1) take appropriate corrective action when systems disruptions, compliance issues or intrusions (Reg SCI Events) occur; (2) provide certain notifications and reports to the SEC regarding Reg SCI Events and systems changes; (3) inform members and participants about Reg SCI Events in certain instances; (4) conduct business continuity and disaster recovery testing and penetration testing; conduct annual reviews of their automated systems; and (5) make and keep certain books and records.

### *III. Amendments to Form ATS-N*

The SEC also proposed a variety of amendments to current Form ATS-N.<sup>23</sup> NMS Stock ATSS and Government Securities ATSS, including those using Communication Protocol Systems, would be required to comply with these enhanced disclosure requirements. Currently operating NMS Stock ATSS would be required to file amendments to their existing Form ATS-N to address the new disclosure requirements. The proposed amendments to Form ATS-N would require disclosures related to, among other things, Government Securities ATSS, Communication Protocol Systems including their non-firm trading interest and communication protocols,<sup>24</sup> an ATS's interaction with

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<sup>22</sup> Rule 1000 of Reg SCI.

<sup>23</sup> The SEC also proposed additional amendments to Reg ATS, Form ATS and Form ATS-R, including (1) removing the exclusion for so-called passive systems from compliance with the Fair Access Rule and the Capacity, Integrity and Security Rule; (2) amending Rule 301(b)(2) of Reg ATS to eliminate confidential treatment for information about the type(s) of securities that an ATS trades as disclosed on Form ATS and Form ATS-R; and (3) amending Reg ATS to require all Forms ATS and Forms ATS-R to be filed electronically via EDGAR.

<sup>24</sup> Proposed Part III, Item 8 of Form ATS-N.

related markets,<sup>25</sup> liquidity providers,<sup>26</sup> segmentation without subscriber direction,<sup>27</sup> visibility of trading interest,<sup>28</sup> fees,<sup>29</sup> and activities an ATS undertakes to monitor and surveil its markets.<sup>30</sup>

#### *IV. Transitional Provisions*

The SEC proposed to clarify how “Legacy Government Securities ATSS” and “Newly Designated ATSS” would satisfy the new requirements without disrupting the operations of the ATS for participants and the markets. A “Legacy Government Securities ATS” is a Government Securities ATS operating as of the effective date of any final rule that was either (1) formerly not required to comply with Reg ATS pursuant to an exemption under Rule 3a1-1(a)(3) (Currently Exempted Government Securities ATS) or (2) operating pursuant to an initial operation report on Form ATS on file with the SEC.<sup>31</sup> A “Newly Designated ATS” is an ATS operating as of the effective date of the final rule that meets the criteria under Exchange Act Rule 3b-16 as of the effective date of the final rule but did not meet the criteria under Rule 3b-16(a) in effect prior to the effective date of the final rule. A “Covered Newly Designated ATS” is a Newly Designated ATS that is a Government Securities ATS or NMS Stock ATS.

- Broker-Dealer Registration. For those Currently Exempted Government Securities ATSS that are operating as banks and not registered broker-dealers, and for Newly Designated ATSS, the SEC proposed a transition period to allow the ATSS to operate without interruption while their broker-dealer registration is pending until the earlier of (1) the date the ATS registers as a broker-dealer under Section 15 of the Exchange Act or Section 15C(a)(1)(A) of the Exchange Act and becomes a member of FINRA, or (2) the date 210 calendar days after the effective date of any final rule.<sup>32</sup>
- Form ATS-N. A Legacy Government Securities ATS or a Covered Newly Designated ATS would be required to file with the SEC an initial Form ATS-N not later than 90 calendar days after the effective date of the final rule.<sup>33</sup> An initial Form ATS-N filed by a Legacy Government Securities ATS or Covered Newly Designated ATS will become effective, unless declared ineffective, upon the earlier of 180 calendar days from the date of filing or,

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<sup>25</sup> Proposed Part III, Item 11 of Form ATS-N.

<sup>26</sup> Proposed Part III, Item 12 of Form ATS-N.

<sup>27</sup> Proposed Part III, Item 13 of Form ATS-N.

<sup>28</sup> Proposed Part III, Item 15 of Form ATS-N.

<sup>29</sup> Proposed Part III, Item 18 of Form ATS-N.

<sup>30</sup> Proposed Part III, Item 9 of Form ATS-N.

<sup>31</sup> Proposed Rule 300(n) of Reg ATS. These would appear to include systems that would meet the current definition of “exchange” but for the exception for systems limited to government securities.

<sup>32</sup> Proposed Rule 301(b)(1) of Reg ATS. This would appear to include systems that are captured by the proposed expansion of the definition of “exchange” to include communication protocols for trading interest.

<sup>33</sup> It is not clear how this proposal would operate in conjunction with the timeline for a Legacy Government Securities ATS or a Covered Newly Designated ATS to register as broker-dealer and become a FINRA member. However, the Commission’s intent is to provide sufficient time for those ATSS to transition to compliance with Reg ATS.

if applicable, the end of the extended SEC review period. The SEC may extend the initial Form ATS-N review period for Legacy Government Securities ATs or Covered Newly Designated ATs by an additional 120 calendar days if it finds an extension is appropriate, or for any period to which an ATS representative agrees.<sup>34</sup> A Legacy Government Securities ATS or Covered Newly Designated ATS may operate on a provisional basis, pursuant to the filed initial Form ATS-N, during the review of the initial Form ATS-N by the SEC. A Legacy Government Securities ATS or Covered Newly Designated ATS that was formerly not required to comply with Reg ATS prior to the effective date of the final rule may continue to operate pursuant to the existing exemption until its initial Form ATS-N becomes effective.<sup>35</sup>

- Form ATS. A Newly Designated ATS (other than a Covered Newly Designated ATS) would be required to file an initial operation report on Form ATS no later than 30 calendar days after the effective date of any final rule.<sup>36</sup>

## V. *Implications for Crypto Platforms Transacting in Digital Asset Securities*

The Proposing Release expands the definition of “exchange” to include Communication Protocol Systems that trade any type of securities. Accordingly, depending on the facts and circumstances of any particular system, both decentralized and centralized mechanisms that offer the ability to transact in digital asset securities may satisfy the definition of an exchange under Rule 3b-16.<sup>37</sup> Indeed, the Proposing Release states that the “Commission would take an expansive view of what would constitute ‘communications protocols’ under Rule 3b-16.”<sup>38</sup> If such a system satisfies the revised definition of an exchange, it would be required to register as a national securities exchange or comply with Reg ATS.

The SEC has long taken the position that if the functional definition of an exchange is satisfied, registration as a national securities exchange or compliance with Reg ATS or another applicable exemption from exchange registration is required.<sup>39</sup> Indeed, the SEC previously settled an

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<sup>34</sup> Proposed Rule 304(a)(1)(iv) of Reg ATS.

<sup>35</sup> Proposed Rule 304(a)(1)(i) of Reg ATS. An initial Form ATS-N filed by a Legacy Government Securities ATS operating pursuant to an initial operation report on Form ATS on file with the SEC as of the effective date of the final rule would supersede and replace for purposes of the exemption the previously filed Form ATS of the Legacy Government Securities ATS.

<sup>36</sup> Proposed Rule 301(b)(2)(i) of Reg ATS.

<sup>37</sup> The SEC has previously used the term “digital asset security” to refer to a digital asset that meets the definition of “security” under the federal securities laws. *See* Securities Exchange Act Release No. 90788 (Dec. 23, 2020), available at <https://www.sec.gov/rules/policy/2020/34-90788.pdf>.

<sup>38</sup> Proposing Release at 44.

<sup>39</sup> In addition, Commissioner Crenshaw has stated that multiple federal regulators, including the SEC, have jurisdiction over aspects of decentralized trading mechanisms. She noted, by way of example, that the SEC

enforcement action with the founder of a decentralized blockchain-based exchange for transacting in digital asset securities and failing to either register as an exchange under Section 5 of the Exchange Act or comply with Reg ATS.<sup>40</sup> If adopted, the proposed expansion of the definition of “exchange” to include “communication protocols” will present additional challenges to and require further diligence on the part of centralized and decentralized platforms for digital asset securities in assessing their status under the federal securities laws.

## VI. Conclusion

The SEC’s proposal, if adopted, would impose significant new regulatory obligations on trading systems that use non-firm trading interest and ATSS that trade government securities. In addition, the proposal would make material changes to the information that Government Securities ATSS, NMS Stock ATSS and all ATSS that use Communication Protocol Systems must provide to the SEC and the general public. The operators of such systems would need to analyze whether the proposed rules would apply to their operations, and if so, how to implement the requirements and what effects the requirements may have on their business.

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has jurisdiction when participants and activities on decentralized platforms involve securities and securities-related conduct. *See* Statement on DeFi Risks, Regulations, and Opportunities (Nov. 9, 2021), available at [https://www.sec.gov/news/statement/crenshaw-defi-20211109#\\_ftnref12](https://www.sec.gov/news/statement/crenshaw-defi-20211109#_ftnref12).

<sup>40</sup> *See* In re Zachary Coburn, Securities Exchange Act Release No. 84533 (Nov. 8, 2018), available at <https://www.sec.gov/litigation/admin/2018/34-84553.pdf>.



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