

## ATS Supervision Obligations

### FINRA Reminds Alternative Trading Systems of Their Obligations to Supervise Activity on Their Platforms

#### Summary

FINRA is issuing this *Notice* to remind Alternative Trading Systems (ATSs) of their supervision obligations.<sup>1</sup> As registered broker-dealers and FINRA members, ATSs—like other broker-dealer trading platforms—are required to maintain supervisory systems that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules, including, for example, rules on disruptive or manipulative quoting and trading activity.

Questions regarding this *Notice* should be directed to:

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#### Background and Discussion

When the SEC adopted Regulation ATS, it established a framework for the regulation of trading venues that meet the definition of an “exchange” under Section 3(a)(1) of the Securities Exchange Act and SEA Rule 3b-16: They can either apply for registration as a national securities exchange, or they can register as a broker-dealer and comply with Regulation ATS.<sup>2</sup>

Importantly, the requirements of Regulation ATS complement the existing broker-dealer regulatory framework. Regulation ATS specifically requires that “an ATS that registers as a broker-dealer must, in addition to complying with Regulation ATS, comply with the filing and conduct obligations associated with being a registered broker-dealer, including membership in [a Self-Regulatory Organization (SRO)] and compliance with SRO rules.”<sup>3</sup>

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#### Notice Type

- ▶ Guidance

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Systems
- ▶ Trading
- ▶ Training

#### Key Topics

- ▶ Alternative Trading Systems
- ▶ Supervision
- ▶ Trading Practices

#### Referenced Rules & Notices

- ▶ FINRA Rule 2020
- ▶ FINRA Rule 3110
- ▶ FINRA Rule 4370
- ▶ FINRA Rule 5210
- ▶ FINRA Rule 6190
- ▶ FINRA Rule 6191
- ▶ Regulatory Notice 14-10
- ▶ Regulatory Notice 17-22
- ▶ SEA Rule 15c3-5
- ▶ SEC Regulation ATS
- ▶ SEC Regulation NMS
- ▶ SEC Regulation SHO

Accordingly, ATSS must comply with all FINRA rules that are applicable to them and their business activity. For example, ATSS are subject to the new and continuing membership and registration rules in the NASD Rule 1000 Series. ATSS are also subject to the financial and operational rules that apply generally to broker-dealers, such as the financial condition rules in the FINRA Rule 4100 Series, the business continuity plan requirements in Rule 4370, and the recordkeeping and reporting obligations in the Rule 4500 Series.

Other FINRA rules apply to the trading activity that occurs on an ATS. For example, ATSS must report trades—and quotations, to the extent applicable—according to the rules in the FINRA Rule 6000 Series (Quotation, Order, and Transaction Reporting Facilities) and must report order information to FINRA’s Order Audit Trail System pursuant to the Rule 7400 Series. Another example can be found in Rule 6190, which requires ATSS to establish, maintain and enforce written policies and procedures that are reasonably designed to comply with the National Market System Plan to Address Extraordinary Market Volatility. ATSS also must comply with the trading halt requirements in Rule 6120.

Rule 5210 (Publication of Transactions and Quotations) applies to trading activity that occurs on an ATS and states that no member “shall publish or circulate, or cause to be published or circulated, any . . . communication of any kind which purports to report any transaction as a purchase or sale of any security unless such member believes that such transaction was a bona fide purchase or sale of such security; or which purports to quote the bid price or asked price for any security, unless such member believes that such quotation represents a bona fide bid for, or offer of, such security.”

Rule 5210 includes supplementary material that provides further guidance on the type of conduct prohibited by the rule. Supplementary Material .01 states that it shall be deemed inconsistent with the Rule—as well as Rules 2010 (Standards of Commercial Honor and Principles of Trade) and 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices)—for a member “to publish or circulate or cause to be published or circulated, by any means whatsoever, any report of any securities transaction or of any purchase or sale of any security unless such member knows or has reason to believe that such transaction was a bona fide transaction, purchase or sale.”<sup>4</sup> Supplementary Material .03 states that a firm shall not “engage in or facilitate” certain quoting and trading activity that is deemed to be disruptive.<sup>5</sup>

To promote compliance with these and other applicable FINRA rules and the federal securities laws, Rule 3110 requires each firm to maintain a reasonably designed supervisory system.<sup>6</sup> FINRA has provided detailed guidance on the elements of reasonable supervisory procedures, which under Rule 3110(b)(2) must include a review of all transactions relating to a firm's investment banking or securities business.<sup>7</sup> In that guidance, FINRA noted that Rule 3110.05 permits firms to satisfy their obligation to review all transactions related to their investment banking or securities business by employing risk-based review systems—*e.g.*, electronic surveillance—with parameters designed to assess which transactions merit further review.

FINRA is issuing this *Notice* to remind ATSs to evaluate what supervisory systems they use to achieve compliance with FINRA rules including, but not limited to, those referenced above, as well as the federal securities laws including, but not limited to, Regulation ATS, Regulation NMS,<sup>8</sup> Regulation SHO, and the SEC's Market Access Rule (SEA Rule 15c3-5), to the extent applicable.<sup>9</sup> While FINRA recognizes that ATSs do not exercise self-regulatory authority, ATSs may still set rules to govern subscriber conduct on their trading systems, or exclude subscribers from trading as necessary and appropriate to implement a reasonably designed supervisory system.<sup>10</sup> Accordingly, Regulation ATS does not reduce or eliminate a firm's obligation under FINRA rules to supervise the trading activity that occurs on its platform; indeed, as noted above, Regulation ATS requires compliance with FINRA's supervision obligations, as with all other applicable FINRA rules.<sup>11</sup>

As a general matter, consistent with existing supervision obligations, FINRA expects that an ATS's supervisory system be reasonably designed to identify "red flags," including potentially manipulative or non-bona fide trading that occurs on or through its systems.<sup>12</sup> ATSs must regularly assess and evaluate their supervisory systems and procedures to ensure they are reasonably designed to achieve compliance with applicable FINRA rules and the federal securities laws.<sup>13</sup> When reviewing the reasonableness of its supervisory system, an ATS should consider tools that are commonly available and may be used by other similarly situated market participants.<sup>14</sup>

## Endnotes

1. Although this *Notice* reminds ATSS of their existing obligations under generally applicable FINRA rules, FINRA also notes that the same supervision expectations apply to other broker-dealer trading systems that are not ATSSs, such as single dealer platforms.
2. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) (Regulation of Exchanges and Alternative Trading Systems, hereinafter, "Regulation ATS Adopting Release") at 70847.
3. See *id.* at 70903. See also Securities Exchange Act Release No. 83663 (July 18, 2018) (Regulation of NMS Stock Alternative Trading Systems) (stating that ATSSs "are regulated as broker-dealers, and must comply with the rules of FINRA").
4. To the extent an ATS publishes, circulates or causes to be circulated quotations for any security, Supplementary Material .01 similarly prohibits such publication or circulation without reasonable cause to believe that the quotations are bona fide.
5. For more explanation of the types of quoting and trading activity prohibited by Supplementary Material .03, see [Regulatory Notice 17-22](#) (June 2017) and Securities Exchange Act Release No. 76361 (November 21, 2016), 81 FR 85651 (November 28, 2016) (Notice of Filing and Immediate Effectiveness of SR-FINRA-2016-043).
6. There are similar principles of supervision established in Section 15(b)(4)(E) of the Securities Exchange Act.
7. See [Regulatory Notice 14-10](#) (March 2014).
8. See, e.g., *Goldman Sachs Execution & Clearing, L.P.*, FINRA Letter of Acceptance, Waiver and Consent No. 20110307615 (June 5, 2014) (finding that the firm failed to regularly surveil to ascertain the effectiveness of its policies and procedures designed to prevent executions from occurring on its ATS in violation of Rule 611 of Regulation NMS).
9. An ATS that has only broker-dealer subscribers is not subject to the Market Access Rule. See Securities Exchange Act Release No. 63241 (November 3, 2010), 75 FR 69792, 69797 (November 15, 2010) (Adopting Release for Risk Management Controls for Brokers or Dealers with Market Access). However, these ATSSs remain subject to all existing and otherwise applicable obligations, including those cited in this *Notice*. See *id.* at 69803 n.93 ("The Commission emphasizes that, as indicated above, the [Market Access] Rule is intended neither to expand nor diminish the underlying substantive regulatory requirements otherwise applicable to broker-dealers.").
10. See Regulation ATS Adopting Release, *supra* note 2, at 70847, 70859.
11. See *supra* note 3 and accompanying text. Although the SEC noted when adopting Regulation ATS that the Regulation does not require ATSSs to surveil activities on their markets in the same manner as an SRO, ATSSs still must comply with all applicable FINRA rules, including supervision, which Regulation ATS requires them to follow without exception. See Regulation ATS Adopting Release, *supra* note 1, at 70848.

12. *Cf. SEC v. U.S. Environmental, Inc.*, 94-CV-6608, 2003 U.S. Dist. LEXIS 12580, at \*23 (“However, even accepting [Broker’s] assertion that he was unaware of [customer’s] plan [to manipulate prices of OTC equity security through wash sales and other means], the Court does not find that [Broker] reasonably discharged his supervisory duties since the pattern of red flags, apparent from a review of the trading record of [the OTC equity security], would have alerted a supervisor who was reasonably discharging his duties and using the system of procedures in place to detect violations, like the one at issue here.”).
13. ATs are also reminded that any statements or representations they make about the supervision of their platforms must not be misleading. *See, e.g.*, In the Matter of Barclays Capital, Inc., Securities Exchange Act Release No. 77001 (January 31, 2016) (finding, among other things, that Barclays violated Section 17(a)(2) of the Securities Act by making misleading statements about the surveillance it performed on its ATS). *See also* FINRA Rule 2210(d) (providing, among other things, that member communications may not be false or misleading).
14. For example, ATs appear commonly to use surveillance systems to limit certain types of trading behavior or otherwise maintain market quality. *See, e.g.*, Responses to the Frequently Asked Question Concerning Regulation SCI, published by the Division of Trading and Markets, at FAQ 2.06 (“[T]he Staff understands that many ATs maintain [surveillance] systems to surveil market-related activities for compliance with certain federal securities laws and the rules and regulations thereunder (such as Regulation SHO). In addition, the Staff understands that many ATs also maintain such systems to surveil market-related activities for subscriber compliance with the ATs’s own rules and governing documents, as applicable, such as those designed to limit certain types of trading behavior or otherwise maintain the quality of its market.”). FINRA understands that, particularly for equity ATs that offer pegged or mid-point orders, such surveillance often evaluates the trading activity on an ATs in comparison to movements in disseminated quotations.