



BETTER MARKETS

Electronically Filed

October 30, 2023

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: FINRA Proposed Rule Change Relating to Alternative Display Facility New Entrant (File No. SR-FINRA-2022-032)

Dear Ms. Countryman:

Better Markets¹ appreciates the opportunity to comment on the proposed rule change (“Rule”) filed by the Financial Industry Regulatory Authority, Inc. (“FINRA”) with the Securities and Exchange Commission (“SEC” or “Commission”), seeking to add IntelligentCross ATS (“IC”) as a new entrant to the Alternative Display Facility (“ADF”).² The decision by the Commission to stay the approval of the proposed rule change by the Division of Trading and Markets pursuant to delegated authority pending Commission review was necessary and appropriate.

We urge the Commission to issue an order disapproving the proposed Rule because it would violate the Securities Exchange Act of 1934 (“Exchange Act”) in multiple ways, as detailed below. In addition, approving the Rule based on the current record would be arbitrary and capricious, since the Rule submission contains far too little concrete and detailed information about how IC’s trade matching engine operates and how it incorporates artificial intelligence. Moreover, under the Rule, the operational aspects of IC’s platform would be subject to material changes over time without an adequate review and approval process. In short, approval of the Rule would conflict with the law, harm investors, and produce anti-competitive effects.

¹ Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

² Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change Relating to Alternative Display Facility New Entrant, 87 Fed. Reg. 79,401 (Dec. 27, 2022).

OVERVIEW OF COMMENTS

Over the years, Better Markets has repeatedly highlighted the issues with the bifurcation of the current equity market structure and the increasing number of transactions that occur off-exchanges in dark markets.³ Not only does this trend away from lit, public markets harm investors, it has an equally deleterious effect on financial stability and competition in our markets. The Commission should be fostering regulatory policies that reverse this trend, not further incentivizing off-exchange trading at the expense of our well-regulated, lit, public markets. The proposed rule change would, if approved, be another step in further blurring the regulatory lines between lit, public markets (exchanges) and off-exchange, dark markets (ATSs).

The Commission should issue an order disapproving the Rule because it violates the Exchange Act. The Exchange Act requires the rules of a national securities association, such as FINRA “to protect investors and the public interest”⁴ and “not impose any burden on competition not necessary or appropriate in furtherance of the purposes” of the act.⁵ If approved, the proposed rule change would threaten to harm investors and the public interest in three important ways:

- (1) IC’s platform would harm investors and competition. The fastest traders will benefit from the ATS’s matching engine at the expense of other investors and market participants.
- (2) It would further incentivize trading away from well-regulated exchanges to less regulated off-exchange trading platforms, contrary to what’s best for investors and the broader public interest;
- (3) It would substantially harm competition in our markets by providing benefits generally conferred on exchanges (protected quotes) to entities that are subject to substantially less regulation and self-regulatory organization (“SRO”) oversight, such as ATSs.

Additionally, approval of the Rule would be arbitrary and capricious. At a minimum, before acting on the Rule filing, the Commission must require more transparency and disclosure from the IC, specifically as it relates to the use of artificial intelligence in its overnight optimization process for matching orders. The order approving the Rule by delegated authority does not include any individual analysis by the Commission of the optimization process itself, instead seemingly relying on the characterizations of the IC and FINRA. The proposed rule change relies far too much on the IC’s policies and procedures and internal oversight over how artificial intelligence is used to match orders. Moreover, it appears that the IC could decide to change its policies in the

³ See Comment Letter, Better Markets, Amendments to Exchange Act Rule 3b-16 Regarding the Definition of “Exchange”; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities (Apr. 18, 2022), https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_Reg_ATS.pdf; Comment Letter, Better Markets, Regulation of NMS Stock Alternative Trading Systems (Feb. 26, 2016), <https://bettermarkets.org/wp-content/uploads/2021/07/SEC-CL-Regulation-of-NMS-Stock-ATS-2-26-2016.pdf>.

⁴ 15 U.S.C. 78o-3(b)(6).

⁵ 15 U.S.C. 78o-3(b)(9).

future without adequate regulatory oversight by the Commission. We believe the Rule lacks enough detailed disclosure on the process by which orders would be matched, in general, and on the use of artificial intelligence on the IC, in particular, to warrant approval and that any approval on such limited disclosures that are currently in the record would be a violation of the Administrative Procedure Act's arbitrary and capricious standard.

Further, the lack of critical review and justification in this case stands in stark contrast to the Commission's searching and deliberate process in ruling on filings by exchanges that have proposed novel order types or methods of accessing quotations, including quotes that were not protected.⁶ Approving this Rule would be especially arbitrary and capricious in light of the very different approach taken in the case of other impactful filings.

I. The Bifurcation of Our Equity Markets Already Creates Unfair Advantages for ATSS, Which the Proposed Rule Would Exacerbate.

When Congress passed and President Franklin Delano Roosevelt signed the Securities Exchange Act of 1934, it delegated to the newly created Securities and Exchange Commission the authority to facilitate the establishment of a national market system for securities to protect investors and maintain fair and orderly markets. Congress intentionally adopted a broad definition of an "exchange" to enable the Commission to adapt to changes in the markets over the long term.⁷ Section 5 of the Exchange Act requires those that meet the statutory definition of exchange to register with the Commission as a national securities exchange. Over time, however, technological advancements in broker-dealer activities increasingly blurred the lines between the functions of a broker-dealer and those of an exchange.⁸

With the passage of the National Securities Markets Improvement Act of 1996, the Commission received increased authority from Congress to exempt persons from the requirements of the Exchange Act. In 1998, the Commission used its exemptive authority to adopt Regulation ATS, which sought specifically to address the growth of ATSS being operated by broker-dealers that provided many of the same services offered by national securities exchanges.⁹ The Commission's new Regulation ATS exempted registered broker-dealers operating a trading platform from registration as a national securities exchange as long as they simply disclosed certain basic, nonpublic information on Form ATS and filed it with the Commission. At the time the rule was finalized, securities being traded by broker-dealers on ATSS represented 20 percent of orders in securities listed on the Nasdaq and nearly four percent of orders in exchange listed securities.¹⁰

⁶ See, e.g., Securities Exchange Act Release No. 89686, 85 Fed. Reg. 54,438 (September 1, 2020) (approval of IEX's D-Limit Order type); Securities Exchange Act Release 88261, 85 Fed. Reg. 11,426 (February 27, 2020) (rejecting Cboe EDGA Exchange's proposal to apply a delay to orders seeking to access non-protected quotes).

⁷ S. Rep. No. 73-792, at 5 (1934) (noting that "exchanges cannot be regulated efficiently under a rigid statutory program").

⁸ Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSS) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, 87 Fed. Reg. 15496, 15,499 (Mar. 18, 2022).

⁹ Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 70,844 (Dec. 22, 1998).

¹⁰ *Id.* at 70,845.

The decision by the Commission to bifurcate the regulation of platforms that operate under the Exchange Act’s definition of exchange has been fundamentally flawed since its inception. As alternative trading venues began to approach the scale of trading services, trading volume, and complexity that is typical of the exchanges, the Commission could have designed a regulatory framework that created a level playing field between exchanges and ATSS. Instead, they elected to allow ATSS to perform all the essential functions of exchanges with substantially less oversight.

Three core problems grew out of this approach. First, the equity markets became less transparent. As a result, market participants increasingly struggled to identify the venues with the best order execution quality, and market efficiency suffered accordingly. Second, competitive imbalances among and between functionally similar trading centers—ATSS and exchanges—grew. And third, conflicts of interest arising from the operational complexities of ATSS, including the dual roles of the broker-dealer as ATSS operator and broker, proliferated while remaining invisible to investors. As explained below, approval of the Rule would exacerbate these problems, to the detriment of investors and fair competition.

II. The Commission Must Disapprove the Rule Because It is Inconsistent with the Requirements of the Securities Exchange Act of 1934.

The Rule granting the IC access to protected quotes via the ADF must be disapproved by the Commission because it would ultimately harm investors, the public interest, and competition in violation of the Exchange Act. The Exchange Act requires that the rules of a national securities association, in this case FINRA, be designed—

to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers...¹¹

In addition, the Exchange Act requires that FINRA rules must “not impose any burden on competition not necessary or appropriate in furtherance of the purposes” of the act.”¹²

The Rule falls woefully short of these congressionally mandated requirements and therefore must be disapproved by the Commission. The Rule granting the IC access to protected quotes via the ADF would harm investors, competition, and the public interest in at least three important ways: (1) the IC’s matching engine would create opportunities for the fastest traders to gain unfair advantage over other market participants and investors; (2) approval of the Rule would further incentivize trading away from well-regulated exchanges to less regulated off-exchange trading platforms; and (3) approval would create unfair regulatory advantages for ATSS over exchanges. For these reasons, the Commission should disapprove the proposed rule change.

¹¹ 15 U.S.C. 78o-3(b)(6).

¹² See Comment Letter, Better Markets, *supra* note 3; see Comment Letter, Better Markets, *supra* note 3.

A. The proposed rule change would harm investors.

The IC, with its extensive time delay and opportunity to cancel quotes, will enable the fastest traders to gain unfair advantages over other market participants and investors. The ability of the fastest traders to cancel their orders during the random delay on the IC's optimization engine, after the orders have been accepted as part of the order book and prior to execution, would enable some of the fastest traders to cancel prior to execution at the expense of other traders. This is both unfair and anti-competitive.

The order approving the Rule by delegated authority minimized this concern, explaining that “the Commission does not believe that the level of cancellation during the delay imposes unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access to such quotations as it has been shown that non-match events occur in a minority of cases, and market participants receive an execution the majority of the time.”¹³ But even if the fastest traders could only use this ability to cancel during the delay in a minority of cases, it has the potential to exploit ordinary investors, given that only the fastest traders on one side of a trade could effectively use this advantage to decide when to cancel, while agents brokers on the other side of the same trade could not. Further, the way that protected quotes are accessed necessarily affects the NBBO, a critical price measure on which all market participants rely. While the NBBO could be greatly improved in many areas, it is irrational for the Commission to do anything that could potentially make it even worse.

B. The Rule would incentivize trading on off-exchange trading platforms at the expense of well-regulated exchanges.

Nearly half of all trading volume occurs on dark markets rather than the exchanges. While 53 percent of trades occur on lit public exchanges,¹⁴ the other 47 percent of trading occurs on ATSS (9 percent) and off-exchange by wholesalers (38 percent).¹⁵ The evolution of our securities markets from trading conducted on well-regulated exchanges to less regulated trading platforms has materially harmed investors and the public interest. If approved, the Rule would further incentivize off-exchange trading on trading platforms such as ATSS at the expense of trading on well-regulated exchanges. In fact, exchanges themselves would be further incentivized to operate less regulated off-exchange trading platforms such as ATSS than exchanges if both are going to have the benefit of protected quotes. For this reason as well, the Commission must disapprove the proposed rule change.

¹³ Order Approving Proposed Rule Change Relating to Alternative Display Facility New Entrant, 88 Fed. Reg. 59,958, 59,966 (Aug. 30, 2023).

¹⁴ See CBOE, *U.S. Equities Market Volume Summary* (accessed March 15, 2021), available at https://www.cboe.com/us/equities/market_statistics/.

¹⁵ Speech, Gary Gensler, Chairman of the SEC, Prepared Remarks at the Global Exchange and FinTech Conference, June 9, 2021, <https://www.sec.gov/news/speech/gensler-global-exchange-fintech-2021-06-09>.

C. The Rule would impose substantial harm on competition and further blur the line between ATS and exchange activity.

The Rule granting IC access to protected quotes via the ADF would set a dangerous precedent of granting ATSS access to protected quotes, something that has traditionally been reserved for more robustly regulated exchanges. When considering proposed rule changes regarding ATSS, the Commission should take due care to ensure that entities performing similar functions in the markets are treated similarly under the securities laws and regulations. In fact, Exchange Act Section 15A(b)(9) requires that FINRA regulations not impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the act.¹⁶ If approved, the proposed rule change would substantially harm competition in our markets by providing benefits generally conferred on exchanges (protected quotes) to entities that are subject to substantially less regulation and SRO oversight, such as ATSS.

As discussed above, ATSS are subject to far less regulation and less oversight. The benefits of not having to register as an exchange while providing exchange-like functions make ATSS an attractive alternative to operators seeking to bring together buyers and sellers of securities. For example, an ATSS does not have to comply with Regulation SCI in most instances, does not have to conduct market surveillance functions, and may enable trading by their broker-dealer affiliates on their own platform. Additionally, and perhaps most importantly in the context of this Rule, because ATSS are not SROs they are not required to submit any changes to their rules to the Commission prior to implementation.

An important aspect of the Exchange Act when it was passed was that exchanges were required to submit any changes to their operations, fees, and rules to the Commission for approval. This gives the American public the opportunity to comment on the proposed changes sought by the exchange ahead of a determination by the Commission. However, ATSS are not subject to these pre-clearance requirements, meaning they are free to change the rules of the game, overnight, without any input from the public or approval by the Commission to ensure they are consistent with the Exchange Act. The Rule would, in effect, enable an ATSS access to protected quotes while also maintaining the flexibility to change its rules, fees, policies and procedures on a whim. Exchanges on the other hand, which also provide protected quotes, would still need to file proposed rule changes with the Commission and seek approval for making any changes to its rules, fees, or other business operations. If approved, the proposed rule change would confer a benefit traditionally reserved for exchanges (protected quotes) on ATSS while requiring substantially less regulatory oversight and opportunity for the public to comment on, and the Commission to approve, any rule changes by the ATSS. This would further blur the line between ATSS and exchanges, harm competition for order execution, and potentially drive more orders from lit exchanges to dark ATSS.

Crucially, there is nothing in the Commission's existing rules that requires this result. In seeking to demonstrate that the filing meets the standards for approval under the Exchange Act, FINRA and IC could clearly lay out the process by which FINRA would make a rule filing for significant changes and how they would determine which changes are important. FINRA has said

¹⁶ 15 U.S.C. 78o-3(b)(9).

only that it is willing to file for changes that IC deems material and chooses to notify it about. Further, FINRA could agree to conduct market surveillance of trading on the IC of the same type that it conducts on behalf of other markets. Failing this type of commitment, investors will be required to interact with quotes on this market in the same way that trade on exchanges, but without any meaningful level of market oversight.

These concerns are especially acute given the important role of the NBBO. The NBBO is an important, albeit flawed, quote that is disseminated through a public data feed that consolidates executable orders across the U.S. stock exchanges. While the NBBO currently excludes many sources of important data such as odd-lot orders, the quotes that are included in the NBBO are critically important because it is used as a benchmark to measure “price improvement” and ultimately “best execution.” Protected quotes like the ones sought by IC in the Rule directly affect the NBBO on which the markets and investors rely to determine price improvement and best execution. Yet if the Rule and other similar filings are approved, we will see the NBBO shaped by trading on venues that are less regulated, imperiling the integrity of this vital market metric.

III. The Commission Must Also Disapprove the Rule Because the Record Is Opaque and Incomplete.

As explained above, the Commission should reject the proposed Rule outright. However, if it is disinclined to do so, it must at a minimum require more transparency from the proponents of the Rule before approving it. Approval based on the current record would be arbitrary and capricious under the Administrative Procedure Act (APA).

Specifically, the record lacks sufficient information about how the IC optimization engine matches orders. The submission in support of the Rule makes no mention of the use of artificial intelligence or machine learning. However, it has been subsequently disclosed that the IC utilizes an “AI learning process” to determine random time bands during the matching process.¹⁷ The operators of the IC have disclosed in a comment letter that “[t]here are no specific algorithmic formulas to disclose because our optimization process is using an AI learning process. Like many such learning processes, our system is presented with historical data and outcomes and iteratively computes the optimal time bands that maximize price stability after trades.” This disclosure raises more questions than it answers about how artificial intelligence is used by the IC and what affects this could have on the NBBO, in particular.

There is little doubt that the use of artificial intelligence and machine learning will increasingly be used by financial institutions and market participants in ways that are as yet unforeseen. The challenge for the Commission and other financial regulators moving forward is how to analyze and assess the use of these tools in our markets, including how they interact or can substitute for certain functions in our markets and the risks associated with the introduction of this technology into the markets. The Commission must not blindly accept industry arguments and rationales that artificial intelligence and complex algorithms are a substitute for traditional

¹⁷ Comment Letter, Imperative Execution, Order Approving Proposed Rule Change Relating to Alternative Display Facility New Entrant (July 14, 2023), <https://www.sec.gov/comments/sr-finra-2022-032/srfinra2022032-224439-469862.pdf>.

functions in our financial markets without adequate disclosure regarding the inputs and algorithmic formulas used to create these models. In this case, the lack of disclosure in the Rule about how the IC's use of artificial intelligence computes the matching process' time bands is, by itself, fatal to the Rule.¹⁸

Under the APA, the SEC must not issue an approval order that is arbitrary and capricious. The SEC "must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the acts found and the choice made."¹⁹ The SEC order approving the Rule by delegated authority accepts the limited disclosure of how the IC overnight optimization process uses artificial intelligence to determine match schedules for individualized securities.²⁰ However, the order does not include any independent, individual analysis by the Commission of the optimization process itself. Instead, the order apparently relied on the characterizations that the IC's optimization process "uses, among other things, historical performance measurements from prior days' matches."²¹ The order then states that IC "has policies and procedures in place to oversee and to review the calculation and application of its matching schedules."²²

However, as mentioned previously, reliance on IC's policies and procedures provides little comfort that there are any safeguards to ensure that internal review will be adequate, independent, or thorough. Given the lack of regulatory oversight tools available to FINRA and the Commission over the IC after an approval is granted, the order approving the Rule cedes far too much authority to the ATS to ensure its artificial intelligence is actually doing what it says it is doing or doing in a way that protects the NBBO. For these reasons, we believe the Rule lacks enough detailed disclosure on the process by which orders would be matched, in general, and on the use of artificial intelligence on the IC, in particular, to warrant approval and that any approval on such limited disclosures that are currently in the record would be a violation of the APA's arbitrary and capricious standard.

¹⁸ Compare the very much higher level of transparency provided to support the Commission's recent approval of Nasdaq's proposal to use artificial intelligence to set holding periods for its M-ELO order type, which did not involve protected quotations. Securities Exchange Act Release 98321, 88 Fed. Reg. 62,850 (Sep. 13, 2023).

¹⁹ *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

²⁰ 88 Fed. Reg. at 59,964.

²¹ *Id.*

²² *Id.*

CONCLUSION

We hope these comments are helpful as the Commission considers the action made pursuant to delegated authority to approve the rule change.

Sincerely,



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