

REGULATION OF ALTERNATIVE TRADING SYSTEMS

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1. **Introduction.** On December 2, 1998, the Securities and Exchange Commission (“SEC” or “Commission”) adopted final rules regarding the regulation of alternative trading systems.^{2/} With some exceptions, the rules become effective on April 21, 1999.

2. Redefining the Term “Exchange”

- a. **New Definition of Exchange.** Rejecting the *Delta*^{3/} definition, the Commission redefines an exchange to mean any organization, association, or group of persons that:
 - i. brings together the orders of multiple buyers and sellers; and
 - ii. uses established, non-discretionary 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. Rule 13b-16(a).
- b. **Elements of Exchange Definition.** To be an exchange, an entity must satisfy each aspect of the two-prong definition:
 - i. **Brings Together.** A system “brings together” orders when orders entered in the system for a given security have the opportunity to interact with other orders entered into the system for the same security. Examples include:
 - (1) a system which displays or otherwise represents trading interest entered on the system to system users, like consolidated quote screens;
 - (2) a system which receives subscribers' orders centrally for future processing and execution, like a limit order book that allows subscribers to display buy and sell orders in particular securities and to obtain execution against matching orders contemporaneously entered or stored in the system. These activities are currently performed by systems

^{2/} Securities Exchange Act Release No. 40760 (Dec. 8, 1998), 63 Fed. Reg. 70844 (Dec. 22, 1998).

^{3/} Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 Fed. Reg. 1980 (Jan. 19, 1990).

that bring together orders internally for crossing or matching, as well as floor-based markets that impose trading rules; and

(3) interdealer brokers, regardless of their level of automation.

ii. **Multiple Buyers and Sellers.** A system must bring together orders of multiple buyers *and* multiple sellers. Examples of systems which do not meet this requirement include:

(1) single seller systems, like those that permit issuers to sell their own securities to investors (*e.g.*, CP Direct, in which an issuer can offer to sell its commercial paper to the customers of CS First Boston);

(2) systems in which securities are offered by a single seller at successively lower prices;

(3) systems designed for the purpose of executing orders against a single counterparty, such as the dealer operating a system;

(4) systems where a single counterparty that buys and sells securities through a system, where other parties entering orders only execute against the single designated counterparty. Note, however, that the mere interpositioning of a designated counterparty as riskless principal for settlement purposes after the purchasing and selling counterparties to a trade have been matched would not, by itself, mean that the system does not have multiple buyers and sellers.

iii. **Definition of Order.** “Order” is defined as any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order. Rule 3b-16(c).

(1) **Explaining “Firm.”** Whether an indication of interest is “firm” will depend on what actually takes place between the buyer and seller. The label put on an order is not dispositive.

- (a) An indication of interest will be considered firm if it can be executed without the further agreement of the person entering the indication.
 - (b) Even if the person must give its subsequent assent to an execution, however, the indication still will be considered firm if this subsequent agreement is always, or almost always, granted so that the agreement is largely a formality. For example, indications of interest where there is a clear or prevailing presumption that a trade will take place at the indicated price, based on understandings or past dealings, will be viewed as orders.
 - (c) Generally, a system that displays bona fide, non-firm indications of interest -- including, but not limited to, indications of interest to buy or sell a particular security without either prices or quantities associated with those indications -- will not be displaying orders. However, the price and size of an indication of interest may be either explicit or may be inferred from the facts and circumstances accompanying the indication. For example, an indication of interest will be considered to include a price if the system in which the indication of interest is entered defaults automatically to a price pegged to another market, index, rate, or other variable, or if the person entering such indication indicates that such person is interested in trading at a price pegged to another market, index, rate or other variable, which includes market orders. For example, the indications of interest entered into passive pricing systems are orders. While the orders are entered without a specified price, subscribers agree to trade at a price based on the primary market.
- (2) **Form of Order.** An order can be given over the phone or electronically.
 - (3) **“Order” Broader than Bid or Offer.** The definition of an order in Rule 3b-16 is intended to be broader than the terms bid and offer in the Firm Quote Rule.

iv. **Established, Non-Discretionary Methods.** A system uses established non-discretionary methods either by providing a trading facility or by setting rules governing trading among subscribers. The Commission intends for “established, non-discretionary methods” to include any methods that dictate the terms of trading among the multiple buyers and sellers entering orders into the system.

(1) **Examples of Established, Non-Discretionary Methods.** Such methods include:

- (a) those that set procedures or priorities under which open terms of a trade may be determined. For example, traditional exchanges' rules of priority, parity and precedence are “established non-discretionary methods,” as are the trading algorithms of electronic systems;
- (b) systems that determine the trading price at some designated future date on the basis of pre-established criteria (such as the weighted average trading price for the security on the specified date in a specified market or markets).
- (c) However, a requirement that the trade subsequently be ratified does not avoid this element. For example, a system that trades limited partnership units might use established, non-discretionary methods even though approval from the general partner is required prior to settlement.

(2) **Examples of Systems with No Established, Non-Discretionary Methods.** Systems which do not involve established, non-discretionary methods include:

- (a) systems involving rules that merely supply the means of communication with a system (for example, software or hardware tools that subscribers may use in obtaining access to a system);
- (b) where customers of a broker-dealer exercise control over their own orders in a trading system operated by the broker-dealer, that broker-dealer is unlikely

to be viewed as using discretionary methods in handling the order;

- (c) traditional block trading desks, because these desks generally retain some discretion in determining how to execute a customer's order, and frequently commit capital to satisfy their customer's needs. For example, a block positioner may shop the order around in an attempt to find a contra-side interest with another investor. In some cases, the block positioner may take the other side of the order, keeping the block as a proprietary position. While block trading desks do cross customers' orders, these crosses are not done according to fixed non-discretionary methods, but instead are based on the block trading desks' ability to find a contra-side to the order. It may cross customer orders, or it may assemble a block of several customer orders with completion dependent on its willingness to take a proprietary position for part of the block. Execution prices, size of the proprietary position and agency compensation may all be part of a single negotiated deal.
- (d) systems that merely provide information to subscribers about other subscribers' trading interest, without facilities for execution. The Commission reasoned that while such vendors may allow buyers and sellers to find each other, they do not provide a facility or set rules under which those orders interact with each other.
- (e) when a customer gives a broker-dealer flexibility in how to handle an order it relinquishes a degree of control over that order. The Commission recognizes that broker-dealers exercising discretion of judgment over customer orders may use internal systems to trade and manage these orders. The mere use of these systems does not make a broker an exchange, unless those systems themselves predetermine the handling and execution practices for the order, replacing the broker-dealer's judgement and flexibility in working the order.

- (3) **Established, Non-Discretionary Methods Provided by a Trading Facility.** The Commission has stated that this would include:
- (a) a traditional exchange where specialists are responsible for executing orders;
 - (b) a computer system (whether comprised of software, hardware, protocols, or any combination thereof) through which orders interact, or any other trading mechanism that provides a means or location for the bringing together and execution of orders. For example, the Commission considers the use of an algorithm by an electronic trading system that sets trading procedures and priorities to be a trading facility that uses established, non-discretionary methods.
 - (c) the Commission will attribute the activities of a trading facility to a system if that facility is offered by the system directly or indirectly (such as where a system arranges for a third party or parties to offer the trading facility). Therefore, if a system that brings together the orders of multiple parties arranges for a third party vendor to distribute software that establishes non-discretionary methods under which orders interact, that system falls within Rule 3b-16. Examples of such an arrangement include:
 - (i) if a bulletin board operator contracted with another party to provide execution facilities for the bulletin board users, the bulletin board will be deemed to have established a trading facility because it took affirmative steps to arrange for the necessary exchange functions for its users.
 - (ii) if an organization arranges for separate entities to provide different pieces of a trading system, which together meet the exchange definition, the organization responsible for arranging the collective

efforts will be deemed to have established a trading facility. For example, the historical (though not the current) arrangement between the Delta Government Options Corporation, RMJ Options Trading Corporation and Security Pacific National Trust Company as described in the *Delta* Release would together meet the definition of an exchange.

- (iii) a trading system that falls within the Commission's interpretation of exchange will still be considered an exchange, even if it matches two trades and routes them to another system or exchange for execution. Whether or not the actual execution of the order takes place on the system is not a determining factor.

(4) **Established, Non-Discretionary Methods Provided by Setting Rules.** Examples of this would include:

- (a) a system which imposes affirmative quote obligations on its subscribers, such as obligations to post two-sided quotations or to post quotations no worse than the quotes subscribers post on other systems;
- (b) rules imposing execution priorities, such as time and price priority rules;
- (c) a system that standardizes the material terms of instruments traded on the system, such as the system operated by *Delta* (when the *Delta* Release was published);
- (d) Nasdaq, because it imposes affirmative obligations on market makers in Nasdaq NM and SmallCap securities, including obligations to post firm and two-sided quotes and operates SOES and SelectNet which require market makers to accept executions or orders for execution in those securities.

- c. **Systems Excluded from Definition of Exchange.** Rule 3b-16(b) explicitly excludes certain systems from the definition of an exchange that the Commission believes are not exchanges.
- i. **Order Routing Systems.** Systems that merely route orders to a national securities exchange, a market operated by a national securities association or a broker-dealer for execution are specifically excluded from the definition of exchange. Rule 3b-16(b)(1).
- (1) **Examples.** NYSE and Amex's Common Message Switch, BRASS, Amex's Automated Post Execution Reporting System are order routing systems.
- (2) **Outside Definition of Exchange.** The Commission does not believe that these routing systems meet either of the two part definition of exchange either.
- ii. **Dealer Systems.** Systems that display a single dealer's quotes and allow persons to enter orders for execution against the bids and offers of a single dealer are excluded from the exchange definition. Rule 3b-16(b)(2).
- (1) **Matching Activities Incidental to Dealer Activity.** Under this rule, the single dealer system could also match orders that are not displayed to any person other than the dealer and its employees, provided this matching is only incidental to its primary activity as a dealer. Rule 3b-16(b)(2)(i).
- (2) **Market Maker Activities.** If a market maker executes a customer order at the NBBO, rather than at its displayed bid or offer, the Commission will consider the NBBO as the market maker's quote for purposes of that trade. The Commission does not believe that a market maker engaging principally in the business of trading for its own account should be included within Rule 3b-16 solely because it is complying with the Limit Order Display Rule. Therefore, the Commission has excluded from the definition of an exchange a registered market maker that displays its own quotes and customer limit orders, and allows its customers and other broker-dealers to enter orders for execution against the displayed orders. The exclusion also allows such

a registered market maker, as an incidental activity resulting from its market maker status, to match or cross orders for securities in which it makes a market, even if those orders are not displayed. Rule 3b-16(2)(ii).

- (3) **Exclusion Applies to Third Market Makers.** The exclusion includes third market makers as well.
- (4) **Exclusion Permits Broker-Dealers to Execute Against Dealer Quotes.** The Commission intends for this exclusion to cover dealer quotation systems that permit other broker-dealers to execute against the dealer's quotations and therefore uses the term person, instead of customer.
- (5) **Exclusion Does Not Extend to Dealer Affiliates.** One commenter suggested that the Commission modify the exclusion so that trading systems that display quotes of a dealer and its affiliates and allow persons to execute against those quotes be excluded from Rule 3b-16. However, the exclusion as adopted does not extend to a dealer's affiliates.

d. **Status of Various Entities Under New Exchange Definition.**

- i. **Correspondent Clearing Relationships.** The Commission rejected a need for excluding correspondent clearing relationships from the definition of exchange. Whether or not a correspondent clearing relationship is excluded depends on the nature of the systems used in that relationship.
- ii. **Interdealer Brokers.** The Commission believes that most screen-based IDBs function by displaying, on an anonymous basis, the offers to buy and sell securities that are placed with them by subscribers. While typically a subscriber uses a telephone to place the orders and ordinarily uses the telephone to request execution, multiple buyers and sellers are involved and generally customers view some or all orders on screens. Thus, IDBs bring together the orders of multiple buyers and sellers. Where an IDB has set procedures under which it executes subscriber orders against displayed or retained orders in a predetermined fashion, the methods by which these orders are brought together likely would be established and non-discretionary. The Commission believes that IDBs that function in this fashion are covered by Rule 3b-16. If an IDB does not display orders or communicate them verbally to

customers, and does not execute orders according to predetermined, well-understood rules, it may not be covered by the rules the Commission adopted. As a general matter, however, the Commission believes that most IDBs would be covered by the definition of exchange in Rule 3b-16(a) and not excluded by any of its exclusions.

- iii. **Discretion to Commit Capital.** The Commission generally views the willingness to predictably commit capital as a traditional broker-dealer activity. For this reason, it is explicitly excluding registered market maker and single dealer systems, which commit capital in all -- or almost all -- trades. In addition, broker-dealers frequently commit capital as part of their block trading desk activities. The Commission does not believe that traditional block trading desks are covered under paragraph (a) of Rule 3b-16. However, the Commission does not believe that a system engaging in activities as a market should be excluded from the scope of Rules 3b-16 simply because the broker-dealer operating the system may participate as a dealer in that system.

- iv. **Passive Systems.** The Commission does not believe that passive systems like POSIT are simply an automation of traditional brokerage functions, but believes they are markets. Like other markets, passive or derivative pricing systems bring together the orders of multiple buyers and sellers. All subscribers enter orders, which interact at specific times. In addition, passive systems establish non-discretionary methods under which subscribers agree to the terms of the trade. Such systems cross orders at pre-established times during the day according to specified priorities. While these orders are traded at a price that is not known at the time a subscriber enters an order, the parameters under which such price will be determined are established and not subject to discretion by the operator of the passive system. While these systems do not themselves have traditional price discovery mechanisms, they have the potential to -- and frequently do -- affect the markets from which their prices are derived. In addition, the Commission believes that there exists the incentive for subscribers to these passive systems to manipulate the price in the market from which the passive system derives its price in order to obtain a favorable execution on the passive system. The Commission, however, agrees that these systems do not raise the same concerns as ATSS with price discovery mechanisms and therefore, even if such systems have significant trading volume, if they choose to

register as broker-dealers they are not required to meet the fair access and systems capacity requirements. *See* Rules 301(b)(5)(iii) and 301(b)(6)(iii). The Commission, however, plans to monitor the activities of these passive systems and if concerns arise with regard to their activities will reconsider whether these requirements should apply.

- e. **Exemptions from the Definition of Exchange.** Using its NSMIA exemptive authority, the Commission exempts the following from the definition of exchange:
- i. **ATSS Operated by a National Securities Association.** Any ATS operated by a national securities association is exempted from the definition of an exchange. Rule 3a1-1(a)(1). Because national securities associations are subject to requirements virtually identical to those applicable to national securities exchanges, any ATS operated by an national securities association is exempted from the exchange definition and may continue to operate as it does today.
 - ii. **ATSS in Compliance with Regulation ATS.** Any ATS that registers as a broker-dealer and complies with Regulation ATS is exempted from the exchange definition. Rule 3a1-1(a)(2).
 - iii. **ATSS Which Need Not Comply with Regulation ATS.** Any ATS which pursuant to Rule 301(a) of Regulation ATS is not required to comply with Regulation ATS is exempted from the exchange definition. Rule 3a1-1(a)(3). Rule 301(a), as discussed in more detail below, states that the following ATSS need not comply with Regulation ATS:
 - (1) ATSS registered as an exchange;
 - (2) ATSS exempted by the Commission from exchange registration based on limited volume;
 - (3) ATSS operated by a national securities association;
 - (4) ATSS registered as a broker-dealer or bank, which trade only government securities and other related securities. Rule 301(a).
 - iv. **Exemption Must Be In Public Interest.** An ATS's exemption is conditioned on the absence of a Commission determination that the

exemption in a particular case is not necessary or appropriate in the public interest or consistent with the protection of investors taking into account the requirements for exchange registration under Section 6 and the objectives of the national market system under Section 11A. Rule 3a1-1(b)(2).

- (1) **Volume Threshold.** The Commission would not consider making an assessment whether an exemption is in the public interest unless that system, during three of the preceding four calendar quarters had:
 - (a) 50% or more of the average daily dollar trading volume in any security and 5% or more of the average daily dollar trading volume in any class of security; or
 - (b) 40% or more of the average daily dollar trading volume in any class of securities. Rule 3a1-1(b)(1).
- (2) **Notice and Opportunity to Respond.** The Commission would also provide such a system with notice and an opportunity to respond before making a determination. Rule 3a1-1(b)(2).
- (3) **No Current ATSS Would Be Denied Exemption.** Although certain ATSS exceed the volume levels today, the Commission does not believe that any of these ATSS should be denied the exemption.
- (4) **De-Registration Rules.** The Commission has the authority to promulgate rules for the de-registration of an exchange. The Commission will consider promulgating de-registration rules to ensure a smooth transition from exchange to broker-dealers. Such rules would give the Commission the opportunity to formally consider whether certain exchanges should be prohibited from de-registering.

3. Regulation of ATSS

- a. **Definition of ATS.** An ATS is defined as any organization, association, person, group of persons or system that:

- i. constitutes, maintains, or provides a marketplace or facilities for bringing together purchasers or seller of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange under Rule 3b-16; and
 - ii. does not set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system, or discipline subscribers other than by exclusion from trading. Rule 300(a).
 - iii. **Effect of Definition.** The definition would have the effect of precluding any trading system that performs self-regulatory functions from registering as a broker-dealer, rather than as an exchange. The Commission would consider a trading system to be outside the definition of ATS if:
 - (1) it imposed on subscribers, as conditions of participation in trading, any requirements for which the trading system had to examine subscribers for compliance;
 - (2) if the system imposed as conditions of participation, directly or indirectly, restrictions on subscribers' activities outside of the trading system;
 - (3) if a system prohibits subscribers from placing orders on its system at prices inferior to those subscribers place on other systems.
 - iv. **ATS May Impose Credit Conditions.** This limitation does not preclude ATSs from imposing credit conditions on subscribers or requiring subscribers to submit financial information to ATSs.
- b. **ATSs Excluded from Compliance with Regulation ATS.** The following systems need not comply with Regulation ATS.
- i. **ATSs Registered as Exchanges.** ATSs registered as exchanges are not required to comply with Regulation ATS. Rule 301(a)(1).
 - ii. **ATSs Exempt from Exchange Registration Based on Low Volume.** ATSs exempt from exchange registration based on limited volume are not required to comply with Regulation ATS. Rule 301(a)(2).

- iii. **ATSS Operated by National Securities Association.** ATSS operated by a national securities association are not required to comply with Regulation ATS. Rule 301(a)(3).
- iv. **Exclusion of ATSS Trading Solely Government and Related Securities.** Rule 301(a)(4) excludes from Regulation ATS trading systems that are registered as broker-dealers or are banks which limit their securities activities to the following instruments:
 - (1) government securities;
 - (2) repurchase and reverse repurchase agreements involving government securities;
 - (3) any put, call, straddle, option, or privilege on a government security, other than a put, call, straddle, option, or privilege that is traded on one or more national securities exchanges or for which quotations are disseminated through an automated quotation system operated by a registered securities association; and
 - (4) commercial paper.
- v. **Effect of Trading Non-Government Securities on Exclusion.** If the system trades other types of securities in addition to the four categories above, this exclusion does not apply. However, the exclusion would still apply if the system offered services for products other than securities, in addition to the government and related securities.
- c. **Exemptions from Certain Requirements of Regulation ATS Pursuant to Application to the Commission.** In unusual circumstances, the Commission may, upon application by an ATS, exempt by order such ATS from one or more of the requirements of Regulation ATS, provided the order would be in the public interest and consistent with national market system goals. Rule 301(a)(5).
- d. **Requirements for All ATSS Subject to Regulation ATS**
 - i. **Register as Broker-Dealer.** ATSS subject to Regulation ATS must register as broker-dealers and therefore, they must be members of an SRO. Rule 301(b)(1). The Commission expects SROs to effectively surveil trading that occurs on ATSS by

integrating ATS trading data into the SRO's existing surveillance system.

ii. **Notice of Operation as an ATS and Amendments.**

- (1) **Initial Operation Report.** Under Regulation ATS, ATSS are required to file an initial operation report with the Commission on Form ATS at least 20 days prior to commencing operation, or if the ATS is operating as of April 21, 1999, no later than May 1, 1999. Rule 301(b)(2)(i).
 - (a) **Form ATS.** Form ATS requests information about the ATS, including a detailed description of how it will operate, its prospective subscribers, the securities it intends to trade, its existing procedures for reviewing systems capacity, security and contingency planning. Most of this information is currently required as part of Form 17A-23, which the Commission has repealed.
 - (b) **Notice Filing.** Form ATS is a notice, not an application; the Commission need not approve it.
- (2) **Amendments for Material Changes.** An ATS is required to notify the Commission of material changes to its operation by filing an amendment to Form ATS at least 20 calendar days prior to implementing such changes. Rule 301(b)(2)(ii). A material change would include any change to the operating platform, the types of securities traded, or the types of subscribers.
- (3) **Quarterly Amendments for Any Changes.** ATSS are required to notify the Commission in quarterly amendments of *any* changes to the information in the initial operation report that have not been reported in an previous amendment. Rule 301(b)(2)(iii).
- (4) **Corrections to Form ATS.** An ATS must promptly file an amendment on Form ATS correcting information previously reported on Form ATS after discovery that any information was inaccurate when filed. Rule 301(b)(2)(iv).

- (5) **Report upon Ceasing Operation.** If an ATS ceases operation, it is required to promptly file a notice with the Commission. Rule 301(b)(2)(v).
 - (6) **Filings Remain Confidential.** The initial operation report, any amendments and the report upon ceasing operation will be kept confidential. Rule 301(b)(2)(vii).
- iii. **Examination, Inspection and Investigation of Subscribers.** An ATS's exemption from exchange registration is conditioned on its cooperation with the Commission's or an SRO's inspection, examination or investigation of the ATS or any of its subscribers. Rule 301(b)(7). The Commission requires this because neither the Commission nor any of the SROs has the authority to directly inspect non-broker-dealer subscribers of an ATS.
- iv. **Recordkeeping.** Regulation ATS requires ATSs to make and keep the records necessary to create a meaningful audit trail. Rule 301(b)(8). These records include:
- (1) **Trading Records.** The ATS must keep daily summaries of trading and time-sequenced records of order information, including the date and time the order was received, the date, time and price at which the order was executed and the identity of the parties to the transaction. Rule 302(b) & (c).
 - (2) **Record of Subscribers.** The ATS must keep a record of subscribers and any affiliations between subscribers and the ATS. Rule 302(a).
 - (3) **Notices to Subscribers.** The ATS must keep records of all notices provided to subscribers, including notices addressing hours of operation, system malfunctions, changes to system procedures and instructions pertaining to access to the ATS. Rule 303(a)(1)(ii).
 - (4) **Duration Records Should Be Kept.**
 - (a) The records in (1)-(3) above must be kept for at least three years, the first two years in an easily accessible place. Rule 303(a)(1).

- (b) Some records, such as partnership articles and articles of incorporation, must be kept for the life of the ATS. Rule 303(a)(2).
 - (5) **Form of Records.** ATSS are permitted to keep records in any form broker-dealers are permitted to keep records under Rule 17a-4(f). Rule 303(b).
 - (6) **Duplicate Records under Rules 17a-3 and 17a-4.** Regulation ATS does not require an ATS to duplicate trading records already required under Rules 17a-3 or 17a-4, provided that the ATS can sort and retrieve system records separately upon request. Rule 303(c).
 - (7) **Recordkeeping Service Allowed.** Like broker-dealers, ATSS are permitted to retain a service bureau, depository or other recordkeeping service to maintain required records on the ATS's behalf as long as the designated party agrees to make the records available to the Commission upon request. Rule 303(d).
- v. **Reporting and Form ATS-R.** Regulation ATS requires ATSS to file with the Commission transaction reports within 30 calendar days of the end of each calendar quarter on Form ATS-R and file Form ATS-R within 10 days after an ATS ceases to operate. Rule 301(b)(9).
- (1) **Reporting Total Volume.** Form ATS-R requires ATSS to report total volume in terms of number of units traded and dollar value for the following categories of securities: listed equity securities, Nasdaq NM securities, Nasdaq SmallCap securities, equity securities that are eligible for resale pursuant to Rule 144A, penny stocks, other equity securities, rights and warrants, listed options and unlisted options.
 - (2) **Reporting Total Settlement Value.** ATSS must also report the total settlement value in US dollars for: corporate debt securities, government securities, municipal securities, mortgage related securities and other debt securities.

- (3) **After-Hours Trading Information.** ATs must file after-hours trading information in listed equity, Nasdaq NM and SmallCap securities as well as listed options.
 - (4) **Elimination of Rule 17a-23.** Form ATS-R will replace Form 17A-23 filed by broker-dealers operating trading systems. Form ATS-R differs from 17A-23 because (1) it provides a template on which ATs are required to file the requested information and (2) Form ATS-R requires ATs to provide information about the volume of particular types of securities that are not listed on an exchange or traded on Nasdaq.
- vi. **Procedures to Ensure Confidential Treatment of Trading Information.** ATs must establish adequate safeguards and procedures to protect subscribers' confidential trading information, including:
- (a) limiting access to confidential trading information of subscribers to those employees of the ATs who are operating the system or responsible for its compliance with these or any other applicable rules;
 - (b) implementing standards controlling employees of the ATs for their own accounts; and
 - (c) adopting and implementing adequate oversight procedures to ensure that the safeguards and procedures established pursuant to this section are followed. Rule 301(b)(10).
- (1) **Quick Implementation.** ATs must implement procedures as quickly as possible.
 - (2) **Clear Procedures.** Procedures must be clear and unambiguous and presented to all employees, regardless of whether they have direct responsibility for the operation of the ATs.
 - (3) **Procedures Not Specified by Commission.** The Commission is not adopting specific procedures because it believes the broker-dealers who operate the ATs are in the best position to know what procedures would best prevent

abuses. The Commission noted that methods currently in use include physical separation, written procedures, separate personnel and restricted access.

- e. **Requirements for ATS with 5% or More of Trading Volume in Any Covered Security.** In addition to the requirements for all ATSs described in Section 3(d) above, ATSs with 5% or more of trading volume in any covered security must publicly disseminate their best priced orders, provide equivalent access to those orders for members of the SRO with which it is linked and limit access fees to amounts consistent with the principle of equivalent access.
- i. **Order Display.** The Commission requires ATSs with 5% or more of the trading volume in any covered security to publicly disseminate their best priced orders in those securities. Specifically, the ATS must provide to a national securities exchange or national securities association the prices and sizes of the orders at the highest buy price and the lowest sell price for such covered security, displayed to more than one person in the ATS, for inclusion in the quotation data made available by the exchange or association to quotation vendors pursuant to Rule 11Ac1-1. Rule 301(b)(3)(ii).
- (1) **Covered Securities.** The public display requirement only applies to covered securities, *i.e.*, exchange-listed, Nasdaq NM and Nasdaq SmallCap securities.
 - (2) **Calculation of 5%.** The order display requirement applies to an ATS with respect to a covered security which, during at least 4 of the preceding 6 calendar months, had an average daily trading volume of 5% or more of the aggregate average daily share volume for such covered security as reported by an effective transaction reporting plan or disseminated through an automated quotation system. Rule 301(b)(3)(i)(B).
 - (3) **Security-by Security Approach.** The display requirement is applied on a security-by-security basis and an ATS is not required to publicly display orders for any securities in which its trading volume accounted for less than 5% of the total volume for such security.

- (4) **Display Only Required if Displayed to More Than One Other Subscriber.** The display rule only requires ATSS to publicly display subscribers' orders that are displayed to more than one other system subscriber. Rule 301(b)(3)(b)(i)(A). Thus, if an ATS, like some crossing systems, by its design does not display orders to other subscribers or only displays a portion of a subscriber's order, the rules do not require those orders or hidden portion to be integrated into the public quote stream. Therefore, the rule allows institutions and non-market makers to guard the full size of their orders by using the reserve size features offered by some ATSS, which allow subscribers to display orders incrementally. Finally, ATSS are not required to provide to the public quote stream orders displayed to only one other ATS subscriber, such as through use of the negotiation feature.
 - (5) **Anonymity Preserved.** Trading anonymity will be preserved because an ATS will comply with any public display requirements by identifying itself rather than the subscriber that placed the order.
 - (6) **Phase-In Display of Institutional Orders in Covered Securities.** In order to monitor the effects of the public display requirement, the rule will permit affected ATSS to phase-in institutional orders in covered securities. Before April 21, 1999, the Commission will publish a schedule for the phase-in of individual securities. 50% of the securities subject to the transparency requirement will be phased-in on April 21, 1999 and the remainder of the securities will be phased-in on August 30, 1999.
- ii. **Access to Publicly Displayed Orders.** With respect to any security in which an ATS is required to publicly display its best priced orders, such ATS must provide for members of the SRO with which it is linked the ability to effect a transaction with those orders. In particular, with respect to any order required to be displayed, an ATS must provide to any broker-dealer that has access to the national securities exchange or national securities association to which the ATS provides the prices and sizes of displayed orders, the ability to effect a transaction with such orders that is:

- (1) equivalent to the ability of such broker-dealer to effect a transaction with other orders displayed on the exchange or by the association; and
 - (2) at the price of the highest priced buy order or lowest priced sell order displayed for the lesser of the cumulative size of such priced orders entered therein at such price, or the size of the execution sought by such broker-dealer. Rule 301(b)(3)(iii).
 - (3) **Phase-In of Access Requirement.** ATSs are not required to provide access to a security until the public display requirement is effective for that security.
- iii. **Limitation on Execution Access Fees Charged to Non-Subscribers.** Because reasonable fees are a component of equal access, the rule prohibits an ATS, with respect to any security in which an ATS is required to publicly display its best priced orders, from setting fees that are inconsistent with the principle of equivalent access to the ATS quotes by members of the SRO to which the ATS is linked. The rules also require an ATS to comply with the rules and standards governing fees established by the national securities exchange or association through which non-subscribers have access. Rule 301(b)(4).
- iv. **Quote Rule Amendment.** The Quote Rule currently requires all market makers and specialists to make publicly available any superior prices that it privately offers through ECNs. The ECN Display Alternative in the Quote Rule permits an ECN to fulfill these obligations on behalf of market makers and specialists using its system by submitting the ECN's best market maker or specialist priced quotation to an SRO for inclusion in the public quotation. The Commission amended Rule 11Ac1-1 to expand the ECN Display Alternative to allow ATSs that display orders and provide equal execution access to those orders under Rule 301(b)(3) of Regulation ATS to fulfill market makers' and specialists' obligations under the Quote Rule. Rule 11Ac1-1.
- f. **Requirements for ATSs with 20% or More of Trading Volume in Equity Securities and Certain Debt Securities.** In addition to the requirements for all ATSs discussed in Section 3(d) above, ATSs with 20% or more of the trading volume in equity securities and certain debt

securities must comply with the additional requirements involving fair access, capacity, integrity and security requirements.

i. **Characteristics of ATSS Subject to Additional Requirements.**

An ATS is only subject to the fair access, capacity, integrity and security requirements if it has the following characteristics:

(1) **20% Volume Threshold.** The ATS must have had, during at least 4 of the preceding 6 calendar months 20% or more the average daily volume in the securities described below.

(2) **Securities Traded by ATSS Subject to Additional Requirements.**

(a) **Equity Securities.**

(i) **Covered Securities.** If an ATS accounts for 20% or more of the average daily volume (as reported by an effective transaction reporting plan or disseminated through an automated quotation system) in any covered security, the ATS must comply with the additional requirements. Rule 301(b)(5)(i)(A).

(ii) **Non-Covered, Equity Securities.** If an ATS accounts for 20% or more of the average daily volume (as calculated by the SRO to which such transactions are reported) in any equity security that is not a covered security, the ATS must comply with the additional requirements. Rule 301(b)(5)(i)(B).

(b) **Debt Securities.** ATSS with 20% or more of the volume in municipal securities, investment grade corporate debt securities, and non-investment grade corporate debt securities must satisfy the additional requirements.

(i) **Municipal Securities.** If an ATS accounts for 20% or more of the average daily volume of municipals traded in the U.S., the ATS must comply with the additional

requirements. Rule 301(b)(5)(i)(C).
Municipals are defined in Section 3(a)(29) of
the Exchange Act.

- 1) **Municipal Volume Calculations.**
Volume data for municipal securities
is available and being published
through the MSRB Daily Volume
Price Reports, including the
Combined Daily Report which
summarizes both intra-dealer and
customer transactions of municipal
securities that are traded four or
more times per day pursuant to Rule
G-14.
- 2) **Effective Date.** The fair access,
systems capacity, integrity and
security provisions requirement for
ATSs with 20% or more of the
volume in municipal securities will be
effective on April 21, 1999.

(ii) **Corporate Debt.**

- 1) **Investment Grade Corporate Debt.**
If an ATS accounts for 20% or more
of the average daily volume of
investment grade corporate debt
traded in the U.S., the ATS must
comply with the additional
requirements. Rule 301(b)(5)(i)(D).
A debt security (other than an
exempted security) with a fixed
maturity of at least one year will be
considered investment grade
corporate debt if it is rated in one of
the four highest ratings categories by
at least one National Recognized
Statistical Ratings Organization.
- 2) **Non-Investment Grade Corporate
Debt.** If an ATS accounts for 20%

or more of the average daily volume of non-investment grade corporate debt traded in the U.S., the ATS must comply with the additional requirements. Rule 301(b)(5)(i)(E). A debt security (other than an exempted security) will be considered non-investment grade corporate debt if it is not rated in one of the four highest ratings categories by at least one National Recognized Statistical Ratings Organization.

3) **Delayed Effectiveness for Corporate Debt.** Because volume data for investment grade and non-investment grade corporate debt is not currently compiled or published, the fair access and systems capacity, integrity and security provisions will not become effective until April 1, 2000.

(iii) **Deferral of Action on Foreign Debt.** The Commission is deferring action on the system reliability standards for ATSs trading a substantial portion of the market in foreign corporate debt and foreign sovereign debt until such time as reliable data is available by which ATSs may determine their relative portion of the market.

ii. **Fair Access.** ATSs which meet the characteristic requirements in 3(f)(i) above must comply with fair access standards. Rule 301(b)(5). Such an ATS must establish standards for access to its system and apply those standards fairly to all prospective subscribers. The fair access requirements is applied on a security-by-security basis.

(1) **Exclusion from Fair Access Requirement.** The Commission is excluding from the fair access requirement those ATSs that match customer orders for securities with other customer orders, at prices for those same securities

established outside such system, provided such customers' orders are not displayed to any person, other than employees of the ATS. Rule 301(b)(5)(iii). Thus, regardless of their trading volume, systems that, for example, match customer orders prior to the market opening and then execute those orders at the opening price for the securities are not required to comply with the fair access requirement. In addition, systems that match unpriced orders at the mid-point of the bid and ask, or at a value weighted average or prices on another market are not subject to the fair access requirement. The Commission, however, would not consider an ATS to be excluded if that system priced any security traded on that system using prices established outside such system for instruments other than the particular security being executed. Therefore, a system would not be excluded if it traded options or other derivatives based on prices established on the primary market for the underlying security.

(2) **Fair Access Requirements.**

- (a) **Establish Standards for Fair Access.** ATSS subject to the fair access requirements must establish written standards for granting access to trading on their systems. Rule 301(b)(5)(ii)(A).
- (b) **Apply Standards Fairly.** An ATS must apply these standards fairly and is prohibited from unreasonably prohibiting or limiting any person with respect to access to the ATS's services. Rule 301(b)(5)(ii)(B).
 - (i) A denial of access may not be unreasonable. It is reasonable if it is based on objective standards, like minimum capital, credit requirements or disciplinary history. Provided that these or other standards were applied consistently to all subscribers, an ATS would be considered to be granting or denying access fairly. A denial of access might be unreasonable, however, if it were discriminatorily applied among similar

subscribers or if it were based solely on the trading strategy of a potential participant.

- (ii) Refusing to open an account for a customer is a denial of access.
 - (iii) If an ATS requires subscribers to open an account with another broker-dealer with which the ATS has a clearing arrangement, the ATS is responsible for ensuring that the clearing broker-dealer does not unfairly deny access to any person.
- (c) **Record of Access Denials.** If an ATS grants, denies or limits access to trading to any person, the ATS is required to make and keep records of each action and the reasons therefor. Rule 301(b)(5)(ii)(C).
 - (d) **Report Access Information on Form ATS-R.** ATSs subject to the fair access requirement must report quarterly on Form ATS-R the person to whom they grant, deny or limit access to the ATS, as well as the date of the action, the effective date of the action and the nature of the denials or limitations of access.
 - (e) **Preserving Records of Standards.** An ATS must preserve a copy of the ATS's access standards, all documents relevant to the ATS's access decisions and any other documents related to compliance with the fair access requirement. Rule 303(a)(1)(iii).
 - (f) **Enforcement of Fair Access.** The Commission intends to enforce the fair access rule by reviewing these reports and investigating any possible violation of the rule. The Commission decided against allowing a right of appeal to the Commission for denials of access.
- iii. **Capacity, Integrity and Security Standards.** ATSs trading 20% or more of the volume in any equity security or in certain categories of debt securities as described above must comply with standards

regarding capacity, integrity and security of their automated systems. Like the fair access requirements above, the volume thresholds are on a security-by-security basis. In particular, an ATS which is subject to the capacity, integrity and security standards must do the following for all its systems that support order entry, order routing, order execution, transaction reporting and trade comparison in the particular security:

- (1) establish reasonable current and future capacity estimates;
- (2) conduct periodic capacity stress tests of critical systems to determine such system's ability to process transactions in an accurate, timely and efficient manner;
- (3) develop and implement reasonable procedures to monitor system development and testing methodology;
- (4) review the vulnerability of its systems and data center computer operations to internal and external threats, physical hazards, and natural disasters;
- (5) establish adequate contingency and disaster recovery plans;
- (6) notify the Commission staff of material systems outages and material systems changes.
- (7) have performed an annual independent review of these systems by competent, independent audit personnel following established procedures and standards. If internal audit personnel are used, these auditors should comply with the standards of the Institute of Internal Auditors and the Electronic Data Processing Auditors Association. If external auditors are used, they should comply with the standards of the American Institute of Certified Public Accountants and the EDPAA. Rule 301(b)(6)(ii).
- (8) preserve documents made (if any) in the course of complying with the systems capacity, integrity and security standards in Rule 301(b)(6), which include all reports to an ATS's senior management, and records concerning current and future capacity estimates, the results of any stress tests conducted, procedures used to evaluate the anticipated impact of new systems when integrated with existing

systems, and records related to arrangements made with a service bureau to operate any automated systems. Rule 303(a)(1)(iv).

4. **Registration as a National Securities Exchange.** Trading systems that fall within the definition of exchange may register as national securities exchanges. At this time, the Commission has determined that those trading systems that choose to register as exchanges should satisfy all requirements that apply to national securities exchanges.

- a. **Self-Regulatory Responsibilities.** An ATS registered as an exchange must be able to enforce compliance by its members and persons associated with its members, with the federal securities laws and the rules of the exchange.
- b. **Fair Representation.** Section 6(b)(3) requires that registered exchange have rules that (1) provide that one or more directors are representative of issuers and investors, and not associated with a member of the exchange, or with any broker-dealer; and (2) “assure a fair representation of its members in the selection of its directors and administration of its affairs.”
 - i. **Public Directors.** The Commission would expect an ATS which applies for registration as an exchange to have public representation on its board of directors.
 - ii. **Fair Representation of Exchange Members.** The Commission intends to allow non-membership, for-profit ATSS that choose to register as exchanges some flexibility in satisfying the fair representation requirement. Although the Commission would not specify in greater detail what types of structures would be acceptable, it provided several examples of ways in which the fair representation requirements may be met in non-traditional ways and believes that there may be other acceptable ways. Examples include:
 - (1) **PCX ASAP Members.** PCX electronic members do not have voting rights and are therefore not represented on the board of the exchange.
 - (2) **Amex/NASD Merger.** As a result of the merger, Amex, reorganized as New Amex, is now a subsidiary of NASD. The Commission found that the fair representation requirement was satisfied by the following:

- (a) the composition of the New Amex Board provided the Amex membership with the opportunity to nominate four Amex floor governors to the New Amex Board;
 - (b) the inclusion of one New Amex floor governor on the NASD Board helped to provide for New Amex input on the parent Board;
 - (c) the corporate governance provisions of New Amex's constitution that require the consent of either Amex (through Membership vote), the Amex Committee (a committee designed specifically to represent the interests of the Amex membership), or both, in situations impacting certain membership interests or material market changes to New Amex;
 - (d) the disciplinary procedures of New Amex which provided for review of all disciplinary matters by a committee composed of both Amex members and public representatives.
- (3) **Clearing Agencies.** The Commission has stated that registered clearing agencies may employ several methods to comply with the fair representation standard, including:
- (a) solicitation of board of directors nominations from all participants;
 - (b) selection of candidates for election to the board of directors by a nominating committee which would be composed of, and selected by, the participants or representatives chosen by participants;
 - (c) direct participation by participants in the election of directors through the allocation of voting stock to all participants based on their usage of the clearing agency;
 - (d) selection by participants of a slate of nominees for which stockholders of the clearing agency would be required to vote their share.

(4) **Other Examples.**

- (a) A proprietary ATS might be able to fulfill the requirement by establishing an independent subsidiary that has final, binding responsibility for bringing and adjudicating disciplinary proceedings and making rules for the exchange, and ensuring that the governance of such subsidiary equitably represents the exchange's participants.
 - (b) Certain directors appointed to the board to represent the interests of trading members or participants could be limited to considering certain topics relating to system use and rules, while consideration of ownership issues could be restricted to board members representing the interests of the owners or stockholders.
- c. **Membership on a National Securities Exchange.** Just as current registered exchanges are required to limit membership to broker-dealers, ATSs that choose to register as exchanges would be prohibited from extending membership to non-broker-dealers. Although membership will continue to be limited to registered broker-dealers and persons associated with registered broker-dealers, institutions would be able to obtain access to ATSs registered as exchanges through a registered broker-dealer member of such a trading system, including an affiliate of an institution. Further, the Commission also noted that a registered exchange is not explicitly prohibited from establishing a broker-dealer subsidiary through which it can provide sponsored access to its non-broker-dealer customers. However, the Commission recognizes concerns about the potential conflict of interest if a registered exchange were the SRO for its subsidiary.
- d. **Fair Access.** Section 6(b)(2) and 6(c) prohibit registered exchanges from denying access to, or discriminating against, members. An ATS registered as an exchange must ensure fair access of registered broker-dealers.
- e. **Fair Competition.** ATSs must also comply with Section 6(b)(8) which prohibits exchanges from adopting any anti-competitive rules.
- f. **Compliance with ARP Guidelines.** ATSs registered as exchanges must comply with the policies and procedures outlined by the Commission in its policy statement concerning the automation review program, including cooperation with any reviews conducted by the Commission.

- g. **Registration of Securities.** Under the Exchange Act, securities traded on a national securities exchange must be registered with the Commission and approved for listing on the exchange. In addition, national securities exchanges are permitted to trade securities listed on other exchanges and Nasdaq pursuant to UTP. ATSS registered as exchanges must comply with these requirements and would be required to have rules for trading the class or type of securities it seeks to trade pursuant to UTP. Moreover, to trade Nasdaq NM securities, such a system would have to become a signatory to an existing plan governing such trading.
- h. **National Market System Participation.** Any ATS registering as an exchange must become a participant in the market-wide transaction and quotation reporting plans currently operated by registered exchanges and the NASD (CQS, CTA, ITS, Options Price Reporting Authority and OTC-UTP). The precise arrangements for inclusion of new exchanges into these plans depends on the structure of these exchanges and will be addressed when an applicant seeks registration as an exchange.
- i. **Uniform Trading Standards.** An ATS registered as an exchange must comply with any Commission instituted trading halt relating to securities traded on or through its facilities. The ATS also must implement circuit breaker rules to temporarily halt trading during periods of extraordinary market volatility or unusual market declines.
- j. **Application for Registration as an Exchange.** The Commission revised Rules 6a-1, 6a-2 and 6a-3 to clarify the requirements for registration as an exchange and to accommodate the registration as exchanges of automated and proprietary trading systems. Additionally, the Commission revised Form 1, the application used by exchanges to register or to apply for an exemption based on limited volume, and repealed Form 1-A.

5. Broker-Dealer Recordkeeping and Reporting Obligations.

- a. **Elimination of Rule 17a-23.** Because ATSS are now subject to recordkeeping and reporting requirements relating to their operation, either as registered exchanges or as broker-dealers under Regulation ATS, the Commission is eliminating duplicative recordkeeping and reporting obligations for ATSS by repealing Rule 17a-23. Only the recordkeeping requirements in Rule 17a-23 as they apply to broker-dealers that are not also ATSS are being moved to the broker-dealer recordkeeping Rules 17a-3 and 17a-4.

- b. **Amendments to Rules 17a-3 and 17a-4.** Internal broker-dealer systems, *i.e.*, certain trading systems operated by broker-dealers which are not ATSS, and therefore are not required to register as an exchange or under Regulation ATS, will continue to be regulated under the traditional broker-dealer regulatory scheme. Amended Rules 17a-3 and 17a-4 will require these internal broker-dealer systems to continue to keep records similar to those required by repealed 17a-23. The Commission also amended Rule 17a-4 to require documents required under amended 17a-3 be preserved for three years, the first two years in an accessible place. Rule 17a-4(b)(1) and (10). 17a-4 was also amended to require the preservation of all notices regarding an internal broker-dealer system provided its participants.

6. **Temporary Exemption of Pilot Trading System Rule Filings.** Currently, SROs are required to submit a rule filing to the Commission and undergo a public notice, comment and approval process before they operate any new trading system. The new pilot trading system rule, Rule 19b-5, permits SROs that develop separate, new systems that qualify as pilot trading systems to begin their operation shortly after submitting new Form PILOT to the Commission. Form PILOT is merely an informational filing and an SRO does not need to await Commission approval to begin operating its pilot trading system. During the operation of the pilot trading system, the sponsoring SRO must submit to the Commission quarterly reports, as well as amendments to Form PILOT concerning any material changes to the system. Rule 19b-5 exempts an SRO from the requirement to file rule changes for the pilot trading system with the Commission for two years. Before two years expire, the SRO must submit a rule filing to obtain from the Commission permanent approval of the pilot trading system or must cease operation of the system. In addition, the temporary exemption under Rule 19b-5 expires 60 days after a pilot trading system exceeds certain volume levels. A pilot trading system that exceeds these volume levels must file for permanent approval before the two-year period expires.

7. Recent Developments

- a. **Alternative Trading Systems.** As of October 28, 1999, thirty-seven (37) trading systems, fifteen (15) of which trade fixed-income products, have filed Form ATS with the Commission.^{4/} The following describes certain regulatory developments regarding some ATSS and Regulation ATS:
 - i. **BondNet.** BondNet, an electronic trading system operating as a division of the Bank of New York, provides automated trade matching and order routing, real time pricing and market information as well as analytic and order management functions in

^{4/} Speech by SEC Commissioner Laura Unger, Bond Market Association, Fifth Annual Legal and Compliance Seminar, New York, N.Y. (Oct. 28, 1999).

U.S. fixed income securities. Using this system, buyers and sellers can match or negotiate live bids and offers, distribute and analyze inventory, and conduct trades on an instantaneous and anonymous basis. On September 7, 1999, the SEC granted BondNet an exemption from compliance with Regulation ATS until October 21, 1999 because BondNet was "currently operating subject solely to regulation by banking authorities, and consequently, BondNet must undertake the registration process with the Commission and the NASD to comply with Regulation ATS."^{5/}

- ii. **BondTrader.** BondTrader is an electronic multi-dealer to customer computerized proprietary pricing display and order routing system for government securities. The system allows subscribers to see live bids and offers from a range of three to five broker-dealers, all on the same screen, and then to execute trades on-line at the displayed prices. On April 21, 1999, the SEC granted BondTrader's no-action request, stating that BondTrader may begin operation in advance of the effective date of Regulation ATS, without registering as an exchange, provided BondTrader complies with Rule 3a1-1 and Regulation ATS.^{6/}

b. **Exchange Trading Systems.**

- i. **Proposed NYSE Electronic Trading System.** On November 5, 1999, NYSE Chairman and CEO Richard Grasso announced the NYSE's plan to establish an electronic share-trading system which is designed to provide fast, low-cost, highly transparent executions. Grasso characterized the initiative as a reengineering of trading on the NYSE to create the equivalent of an ECN.^{7/}
- ii. **Bond Connect No-Action Letter.** In its no-action request, the Boston Stock Exchange ("BSE") stated that it intends to operate Bond Connect, an electronic auction-based trading system that

^{5/} Exchange Act Release No. 41838 (Sept. 7, 1999), 64 Fed. Reg. 49826 (Sept. 14, 1999).

^{6/} Bloomberg LP and Bloomberg Tradebook LLC, SEC No-Action Letter (Apr. 21, 1999).

^{7/} "Grasso Unveils NYSE Plans for Internet-Based Trading System," Securities Law Daily (Nov. 9, 1999).

provides execution of single and multi-security orders in U.S. taxable fixed income securities, as a pilot trading system pursuant to Rule 19b-5 under the Exchange Act. However, Rule 19b-5 states that SROs may permit to trade on a pilot trading system only those securities that are registered under Section 12, not exempted securities. The staff responded that they would not recommend enforcement action if the BSE permits exempted securities to trade on Bond Connect, provided that the BSE otherwise complies with the requirements of Rule 19b-5.^{8/}

- c. **For-Profit Exchanges.** In the ATS Release, the Commission states that registered exchanges may structure themselves as for-profit organizations. Specifically, the Release states that “currently registered exchanges - which are all membership organizations - could choose to demutualize.”
- i. **NYSE and NASD Plan to Demutualize.** In response to the competitive challenges of ATSS and the new opportunities provided by the ATS Release, the NASD and NYSE have announced their intention to demutualize.
- ii. **Applications to Register as Electronic Exchanges.** In the wake of the ATS Release, three entities -- the International Securities Exchange, the Archipelago Securities Exchange, and the Island Stock Exchange -- have each filed a Form 1, the registration application for national securities exchanges, with the SEC, seeking to become fully electronic, for-profit exchanges.
- (1) **International Securities Exchange.** The International Securities Exchange (“ISE”) seeks to become an automated trading system for standardized options. It proposes to operated as an agency-auction market similar to the exchange markets currently in operation; however, the auction would occur electronically, rather than on a floor. The SEC published the notice of, and requested comments on, the ISE's Form 1 filing on June 1, 1999.^{9/} The Commission received approximately 21 comment letters, several of which raised substantive issues. The ISE

^{8/} Bond Connect, SEC No-Action Letter (June 28, 1999).

^{9/} Exchange Act Release No. 41439 (May 24, 1999), 64 Fed. Reg. 29367 (June 1, 1999).

responded to these comments by amending its Form 1 application and by providing a detailed explanation of its governance provisions and trading rules. The SEC published the notice of, and requested comments on, the ISE's Amendment No. 1 of its Form 1 filing on Oct. 22, 1999.^{10/}

- (2) **Archipelago Securities Exchange.** Archipelago Securities Exchange ("Archipelago"), currently an ECN, filed its Form 1 with the SEC on August 9, 1999. As described in its Form 1, Archipelago "proposes to make available for the benefit of its members and their customers an electronic trading system ("ARCA system") to effect the purchase or sale of securities listed or admitted to trade on the Exchange. The ARCA system will allow entry of both limit orders and market orders; maintain and display an electronic limit order book; and match and execute eligible orders internally and route them to other marketplaces for execution as appropriate. The Exchange will not maintain any physical trading floor. Users of the ARCA system will log in from their own computer terminals and communicate with the ARCA system over customary commercial information services and networks of their choice."

- (3) **Island Stock Exchange.** Island Stock Exchange ("Island"), currently the Island ECN, Inc., has also filed its Form 1 with the SEC. Island's Form 1 describes its intended operations in the following manner: Island "will operate a fully automated electronic book ("limit order book") for priced orders ("limit orders") with a continuous, automated matching function. Liquidity will be derived from orders to buy and orders to sell submitted to the Exchange electronically by its members from remote locations; there will be no Exchange trading floor, nor will there be Exchange specialists or market makers with affirmative and negative market making obligations."

^{10/}
1999).

Exchange Act Release No. 42042 (Oct. 20, 1999), 64 Fed. Reg. 57668 (Oct. 26,

- d. **Hot Issues Raised by ATS Release: Chairman Levitt's Major Market Structure Speech.**^{11/} On September 23, 1999, Chairman Levitt discussed the many changes occurring in today's securities markets.
- i. **Self-Regulatory Responsibilities.** Chairman Levitt discussed the need for effective self-regulation with the advent of for-profit exchanges. He said, "The potential for conflicts of interest that may arise if the SRO is enmeshed within a for-profit corporation must be defused. At the very least, I believe that strict corporate separation of the self-regulatory role from the marketplace it regulates is a minimum for the protection of investors in a for-profit structure."
- Levitt continued, "Some have suggested one SRO that regulates all markets, alleviates conflicts, and reduces redundancy, paperwork, and operational costs. Others line up behind a model where each market would maintain the regulatory and surveillance function solely for its own market -- but member regulation, sales practices, and all other aspects of intermarket trading would be overseen by a single SRO. While I certainly am not wedded to any particular model at this point -- a great deal more thinking needs to be done -- this latter approach is intriguing. Any restructuring, however, must ensure that the self-regulatory obligation be vigorously fulfilled, adequately funded, and dedicated to serving the public interest."
- ii. **NYSE Rule 390: Fragmentation vs. Competition.** In his speech, Levitt stated, "[Rule 390] has long prohibited NYSE members from dealing in listed securities off an exchange. For years, proponents have argued that Rule 390 prevents fragmentation. Others contend that the rule is an anti-competitive use of market power by a dominant market. As I see it, Rule 390 may very well be on its ninth life. Now it is the time to ask ourselves: is there a valid justification for a rule that appears to be more a barrier than a benefit? And how, under any circumstances, could such an anti-competitive rule be sustained should the NYSE become a for-profit corporation? While rulemaking is certainly an option, one way or another, Rule 390 should not be part of our future."
- iii. **Linkages.** In his speech, Levitt stated, "In zealously advocating competition, however, I do not dismiss the issue at the core of

^{11/}
23, 1999).

Speech by Chairman Arthur Levitt, Columbia Law School, New York, N.Y. (Sept.

arguments against fragmentation -- the intrinsic value of centrality. . . Basic economics tells us that the greater the supply and demand that congregate in one place, the more efficient the price-setting mechanism . . . Tonight, I call upon the leaders of the securities markets, particularly the public representatives on exchange boards -- to begin a public dialogue on whether technology offers ways to garner the benefits of centrality without stifling competition.”

- iv. **ECNs Fees.** Levitt stated, “While its clear ECNs are subject to today's invigorated competition, it is increasingly evident that the fees they charge to access their quotes are not. Because brokers often have little choice but to pay whatever fee is charged by an ECN, competitive pressures on these fees have been all but paralyzed. ECN access fees stand alone in an otherwise fee-less arena. I believe this imbalance in the marketplace must be addressed. I have asked the Commission's staff to recommend the best approach towards restoring a fair, competitive balance in this important area.”

- v. **Options Markets.**
 - (1) **Generally.** As the technological changes and competition begin to effect the options markets, Levitt called on the options markets to (1) develop the fundamental standards reflected in the equity markets; (2) establish greater linkages to encourage the best possible execution of customer orders; (3) address swiftly the short-coming in their capacity to handle options quote traffic; (4) ensure that the best quote in any market is visible and accessible; and (5) promote more competition.

 - (2) **Intermarket Linkage Plan.** In keeping with the Levitt's remarks, on October 19, 1999, the Commission issued an order requiring the existing option markets (Amex, CBOE, PCX and Phlx) and requesting the ISE (whose application for registration as an exchange is pending before the Commission) to develop an intermarket linkage plan for multiply-traded options and to submit this plan to the Commission within 90 days. The Commission expects the

options markets to act promptly and make rapid progress in developing and implementing this plan.^{12/}

^{12/}
1999).

Exchange Act Release No. 42049 (Oct. 19, 1999), 64 Fed. Reg. 57674 (Oct. 26,