226–53–007, Issued: May 7, 1981; Revised: February 17, 1992 or Fairchild SB 227–53–003, Issued: January 29, 1986; Revised: February 13, 1986, whichever is applicable.

(d) Special flight permits may be issued in accordance with sections 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

(e) An alternative method of compliance or adjustment of the compliance times that provides an equivalent level of safety may be approved by the Manager, FAA, Fort Worth Airplane Certification Office, 2601 Meacham Boulevard, Fort Worth, Texas 76193–0150. The request shall be forwarded through an appropriate FAA Maintenance Inspector, who may add comments and then send it to the Manager, Fort Worth Airplane Certification Office.

Note 2: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Fort Worth Airplane Certification Office.

(f) All persons affected by this directive may obtain copies of the documents referred to herein upon request to Fairchild Aircraft, P. O. Box 790490, San Antonio, Texas 78279–0490; or may examine these documents at the FAA, Central Region, Office of the Assistant Chief Counsel, Room 1558, 601 E. 12th Street, Kansas City, Missouri 64106.

Issued in Kansas City, Missouri, on May 29, 1997.

Henry A. Armstrong,

Acting Manager, Small Airplane Directorate, Aircraft Certification Service.

[FR Doc. 97–14544 Filed 6–3–97; 8:45 am]

BILLING CODE 4910–13–U

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34–38672; International Series Release No. IS–1085; File No. S7–16–97 Regulation of Exchanges

AGENCY: Securities and Exchange Commission.

ACTION: Concept release; request for comments.

SUMMARY: The Securities and Exchange Commission (''SEC'' or ''Commission'') is reevaluating its approach to the regulation of exchanges and other markets in light of technological advances and the corresponding growth of alternative trading systems and cross-border trading opportunities. Accordingly, the Commission is soliciting comment on a broad range of questions concerning the oversight of alternative trading systems, national securities exchanges, foreign market activities in the United States, and other related issues. Following receipt of public comment, the Commission will determine whether rulemaking is appropriate.

DATES: Comments must be received on or before September 2, 1997.

ADDRESSES: Interested persons should submit three copies of their written data, views, and opinions to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–16–97; this file number should be included on the subject line if comments are submitted using e-mail. All submissions will be available for public inspection and copying at the Commission's Public Reference Room, Room 1024, 450 Fifth Street, NW, Washington DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: For questions or comments regarding this release, contact: Kristen N. Geyer, Special Counsel, at (202) 942–0799; Gautam S. Gujral, Special Counsel, at (202) 942–0175; Marie D'Aguanno Ito, Special Counsel, at (202) 942–4147; Paula R. Jenson, Deputy Chief Counsel, at (202) 942–0073; or Elizabeth K. King, Special Counsel, at (202) 942–0140, Division of Market Regulation, Securities and Exchange Commission, Mail Stop 5–1, 450 Fifth Street, NW, Washington, DC 20549. For questions or comments regarding corporate disclosure and securities registration issues raised in this release, contact David Sirignano, Associate Director, at (202) 942–2870, Division of Corporation Finance, Securities and Exchange Commission, Mail Stop 3–1, 450 Fifth Street, NW, Washington, DC 20549.

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I. Executive Summary

A. Purpose of Concept Release

Stock markets play a critical role in the economic life of the United States. The phenomenal growth of the U.S. markets over the past 60 years is a direct result of investor confidence in those markets. Technological trends over the past two decades have also contributed greatly to this success. In particular, technology has provided a vastly greater number of investment and execution choices, increased market efficiency, and reduced trading costs. These developments have enhanced the ability of U.S. exchanges to implement efficient market linkages and advanced the goals of the national market system (''NMS'').

At the same time, however, technological changes have posed significant challenges for the existing regulatory framework, which is ill-equipped to respond to innovations in U.S. and cross-border trading. Specifically, two key developments highlight the need for a more forward-looking, flexible regulatory framework: (1) The exponential growth of trading systems that present comparable alternatives to traditional exchange trading; and (2) the development of automated mechanisms that facilitate access to foreign markets from the United States.

The Commission estimates that alternative trading systems [1] currently handle almost 20 percent of the orders [2] in over-the-counter (''OTC'') stocks and almost 4 percent of orders in securities listed on the New York Stock Exchange (''NYSE''). The explosive growth of alternative trading systems over the past several years has significant implications for public secondary market regulation. Even though many of these systems provide essentially the same services as traditional markets, most alternative trading systems are regulated as broker-dealers. As a result, they have been subject to regulations designed primarily to address traditional brokerage, rather than market activities. For example, these systems are typically subject to oversight by self-regulatory organizations (''SROs'') that themselves operate exchanges or quotation systems, which raises inherent competitive concerns.

At the same time, alternative trading systems are not fully integrated into the national market system. As a result, activity on alternative trading systems is not fully disclosed to, or accessible by, public investors. The trading activity on these systems may not be adequately surveilled for market manipulation and fraud. Moreover, these trading systems have no obligation to provide investors a fair opportunity to participate in their systems or to treat their participants fairly, nor do they have an obligation to ensure that they have sufficient capacity to handle trading demand. These concerns together with the increasingly important role of alternative trading systems, call into question the fairness of current regulatory requirements, the effectiveness of existing NMS mechanisms, and the quality of public secondary markets.

The impact of technological change has not been limited to domestic markets. Foreign markets, information vendors, and broker-dealers have developed automated systems that enable U.S. persons to trade directly on foreign markets from the United States. The Commission to date has not addressed the regulatory status of entities that limit their activities to providing U.S. investors access to foreign markets. As a result, many foreign markets have been reluctant to provide these services directly to U.S. investors. This has highlighted the need to establish standards that can accommodate U.S. investors' growing interest in cross-border trading, and better ensure that this type of cross-border trading is subject to appropriate safeguards. At the same time, improved foreign market access would mean that U.S. investors can trade securities of companies listed solely on foreign markets as easily as securities of companies that satisfy the Commission's disclosure and reporting requirements. This would raise additional questions as to how to craft a regulatory scheme that provides sufficient information to investors about the securities they trade.

These and other questions raised by the application of the existing regulatory approach to technologically changing markets are only likely to multiply as technology facilitates ways of trading and enables the creation of market structures that were unimaginable a few years ago. In light of these issues, the Commission is now reevaluating its regulation of the markets, particularly its oversight of alternative trading systems, registered exchanges, and foreign market activities in the United States. In doing so, the Commission seeks to develop a forward-looking and enduring approach that will permit diverse markets to evolve and compete, while preserving market-wide transparency, fairness, and integrity. The issues raised by technology in the domestic markets are summarized in Part B below and discussed in greater detail in Sections II through VI. The issues raised by technology in the foreign markets are summarized in Part

[1] Trading systems not registered as exchanges have been referred to in previous Commission releases as ''proprietary trading systems,'' ''broker-dealer trading systems,'' and ''electronic communications networks.'' The latter two terms are defined in Rules 17a–23 and 11Ac1–1 under the Securities Exchange Act of 1934 (''Exchange Act''), 17 CFR 240.17a–23 and 240.11Ac1–1, respectively. The term ''alternative trading systems'' will be used throughout this release to refer generally to automated systems that centralize, display, match, cross, or otherwise execute trading interest, but that are not currently registered with the Commission as national securities exchanges or operated by a registered securities association.

[2] For purposes of this release, the term ''order'' generally means any firm trading interest, including both limit orders and market maker quotations.

C below and discussed in greater detail in Section VII of this release.

B. Alternatives for Revising Domestic Market Regulation

The questions raised by technological developments in the U.S. markets could be addressed in a variety of ways. As an initial matter, the Commission is soliciting comment on whether the current statutory and regulatory framework remains appropriate in light of the myriad new means of trading securities made possible by emerging and evolving technologies. The Commission is also soliciting comment on alternative ways of addressing these issues within the existing securities law framework. The release discusses two alternatives in particular that would integrate alternative trading systems more fully into mechanisms that promote market-wide transparency, investor protection, and fairness.

First, the Commission could continue to regulate alternative trading systems as broker-dealers and develop rules applicable to these systems, and their supervising SROs that would more actively integrate these systems into NMS mechanisms. The Commission could, for example, require alternative trading systems to provide additional audit trail information to SROs, to assist SROs in their surveillance functions, and to adopt standard procedures for ensuring adequate system capacity and the integrity of their system operations. The Commission could then require SROs to integrate trading on alternative trading systems into their ongoing, real-time surveillance for market manipulation and fraud, and to develop surveillance and examination procedures specifically targeted to alternative trading systems they supervise. In addition, the Commission could require alternative trading systems to make all orders in their systems available to their supervising SROs, and require such SROs to incorporate those orders into the public quotation system. The Commission could also require that alternative trading systems provide the public with access to these orders on a substantially equivalent basis as provided to system participants.

Alternatively, the Commission could integrate alternative trading systems into the national market system as securities exchanges, by adopting a tiered approach to exchange regulation. The first tier, under this type of approach, could consist of the majority of alternative trading systems, those that have limited volume or do not establish trading prices, which could be exempt from traditional exchange requirements. For example, exempt exchanges could be required to file an application and system description with the Commission, report trades, maintain an audit trail, develop systems capacity and other operational standards, and cooperate with SROs that inspect their regulated participants. Most alternative trading systems currently regulated as broker-dealers would be exempt exchanges.

The second tier of exchanges under this approach could consist of alternative trading systems that resemble traditional exchanges because of their significant volume of trading and active price discovery. These systems could be regulated as national securities exchanges. The Commission could then use its exemptive authority to eliminate barriers that would make it difficult for these non-traditional markets to register as exchanges, by exempting such systems from any exchange registration requirements that are not appropriate or necessary in light of their business structure or other characteristics. For example, the Commission could exempt alternative trading systems that register as exchanges from requirements that exchanges have a traditional membership structure, and from requirements that limit exchange participation to registered broker-dealers. The Commission could also use its exemptive authority to reduce or eliminate those exchange requirements that are incompatible with the operation of for-profit, non-membership alternative trading systems.

This approach could integrate these alternative trading systems more fully into NMS mechanisms and the plans governing those systems, potentially by requiring these systems to become members of those plans.[3] Because alternative trading systems differ in several key respects from currently registered exchanges, this could require revision of those plans in order to accommodate diverse and evolving trading systems.

Finally, a third tier of exchanges, consisting of traditional membership exchanges, could continue to be regulated as national securities exchanges. The Commission could then use its exemptive authority to reduce overall exchange requirements. In this regard, the Commission is considering ways to reduce unnecessary regulatory requirements that make it difficult for currently registered exchanges to remain competitive in a changing business environment. The Commission, for example, could further accelerate rule filing and approval procedures for national securities exchanges and securities associations, and allow fully automated exchanges to meet their regulatory requirements in non-traditional ways.

One way for the Commission to implement this tiered approach would be to expand its interpretation of the definition of ''exchange.'' For example, the Commission could reinterpret the term ''exchange'' to include any organization that both: (1) Consolidates orders of multiple parties; and (2) provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of a trade.

C. Alternatives for Revising Regulation Applicable to Foreign Market Activities in the United States

The questions raised by the activities of foreign markets in the United States could also be addressed in a number of ways. As an initial matter, any proposal should address questions about the lack of comparable information about securities of non-reporting foreign companies. In addition, any approach to regulating access to foreign markets from the U.S. should address the issue of whether sufficient information is disclosed to U.S. investors regarding the risks of trading on foreign markets and whether the Commission has the ability to enforce the antifraud provisions of the U.S. securities laws.

This release describes a number of different ideas for addressing foreign market activity in the United States, including applying traditional exchange regulation to foreign markets that seek to enter the United States. At the other extreme, the Commission could rely solely on home country regulation of the foreign market. Alternatively, the Commission could take an intermediate approach by establishing regulatory requirements for entities that provide U.S. persons with direct access to foreign markets (''access providers''), regardless of whether the entity is the foreign market itself, a broker-dealer, or another service provider. Such access providers could be required to comply with limited recordkeeping, reporting, and disclosure requirements, as well as the antifraud provisions of the federal securities laws.

Under this type of approach, an access provider that provides a U.S. member of a foreign market with direct access to that foreign market's trading facilities would register as a securities information processor (''SIP'') under section 11A of the Exchange Act. Foreign markets, information vendors,

[3] *See infra* notes 162 to 175 and accompanying text.

and other access providers could be required to register as SIPs, or to conduct their U.S. activities through another registered SIP. As a condition of registration, SIPs could also be limited to trading foreign securities that are registered with the Commission under the Exchange Act or limited to dealing with sophisticated parties.

Broker-dealers that act as access providers could be required to comply with the same, limited recordkeeping, reporting, disclosure, and antifraud requirements as SIPs. The Commission could also permit broker-dealer access providers to provide both retail and sophisticated investors with electronic links to foreign markets, and to provide such links to foreign markets that trade U.S. and foreign securities, regardless of whether those securities are registered with the Commission. This approach might provide adequate protections to U.S. investors trading on foreign markets, while facilitating greater transparency.

In creating an appropriate regulatory scheme to address U.S. investor access to unregistered foreign securities, the Commission seeks to balance the desire to craft a forward-looking and enduring approach to the oversight of the securities markets with concerns that U.S. investors have access to full and complete disclosure about the securities they trade. The Commission has been working directly with fellow regulators around the world on a variety of initiatives to improve the efficiency of cross-border capital flows.

D. Conclusion

Regulation should not be static. Changes in the markets should be accompanied by corresponding changes in market regulation. In light of the rapid pace of technological advancements during the past two decades, it is critical to develop a regulatory framework that both accommodates traditional market structures and provides sufficient flexibility to ensure that markets of the future promote fairness, efficiency, and transparency. The purpose of this release is to facilitate a dialogue as to how this can best be achieved.

II. Regulation of Domestic Markets

A. Technological Advances

Securities markets serve several basic functions that are critical to facilitating investment and, as a result, materially influence the long-term financial security of a large segment of the population.[4] For example, markets provide the forum for individuals to invest in securities and for financial instruments to be readily converted into cash when needed. Securities markets also serve as a fundamental indicator of national and international economic health, in part because they reveal investors' judgments about the potential earning capacity of corporations.[5] They help to raise and efficiently allocate capital by providing a reliable means of valuing assets and facilitating the flow of capital into private enterprise. They also allocate capital toward productive uses by providing a forum where stocks can compete for investment dollars.[6] U.S. securities markets have been highly successful at fulfilling these functions and are consistently the world's largest, most liquid, efficient, and fair.[7] Moreover, U.S. markets have continued to attract foreign listings and investors even as other markets become more competitive.[8] This success has come about, in part, because the strength and stability of U.S. markets have allowed people throughout the world to feel confident investing a large percentage of their personal wealth in the future of companies trading on those markets.

The ability of U.S. markets to use technology to increase efficiency, reduce the costs of trading, and respond to changing investor demands has also contributed significantly to the success of our markets. Over the past three decades, technology has transformed U.S. markets. Investors, particularly the growing institutional investor base, now have numerous alternatives to traditional exchange trading and the OTC market. Similarly, market participants (including broker-dealers, issuers, and service providers) have integrated technological advancements into their trading and marketing activities.[9] For example, some broker-dealers have made communications with retail customers more efficient by offering various services through the Internet.[10]

As technology has broadened the services that can be delivered by both markets and market intermediaries, market services have become unbundled from traditional brokerage or exchange services. While some entities that perform brokerage services have also begun to perform some of the traditional functions of a stock exchange, other entities (including information vendors, service bureaus, and routing services) now provide many of the services historically provided by exchanges and broker-dealers. One significant example of this has been the development and growing popularity of alternative trading systems, such as the Real-Time Trading Service operated by Instinet Corporation (''Instinet''), The Island System (''Island''),[11] Portfolio System

[4] *See generally* SEC, Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess. Pt. 1, at 9 (1963) (hereinafter Special Study).

[5] Essentially, securities markets centralize information about buying and selling interest, either by physically or electronically centralizing order interaction, or by centralizing quote and trading information. Because of this interaction of supply and demand, a stock price is considered by many to be the best estimate by investors of the present value of a company's future earnings. As a result of such beliefs, stock prices influence investment calculations, the allocation of resources, company business decisions, and economic planning. *See* 2 Thomas Lee Hazen, Treatise on the Law of Securities Regulation, § 10.1, at 4 (3d ed. 1995); U.S. Congress, Office of Technology Assessment, Pub. No. OTA–CIT–469, Electronic Bulls & Bears: U.S. Securities Markets & Information Technology at 3, 26 (1990) (hereinafter Electronic Bulls & Bears). *See generally* Jack Clark Francis, Investment Analysis and Management 57, 196–97 (4th ed. 1986).

[6] *See generally* ELECTRONIC BULLS & BEARS, *supra* note 5, at ch. 2; Francis, *supra* note 5, at 57.

[7] As of December 31, 1996, there were 3,530 securities trading on the NYSE, representing 2907 NYSE-listed companies. *Market Records Shattered in 1996, The Exchange (NYSE), Jan./Feb. 1997, at 1–2. In addition, as of December 31, 1996, the Nasdaq Stock Market (''Nasdaq'') listed over 6300 stocks of 5556 companies, and dollar volume on that market has grown to almost equal that of the NYSE. Conversation with staff of Corporate Communications, National Association of Securities Dealers, Inc. (''NASD'') (Feb. 21, 1997). In 1996, the average daily share volume on Nasdaq was 543,839,000 shares and the total dollar volume was $3,301.8 billion. During that same period, the NYSE's average daily share volume was 409,893,000 shares and its total dollar volume was $4,063.7 billion. See Market Records Shattered in 1996*, The Exchange (NYSE), Jan./Feb. 1997, at 1–2.

[8] Both the NYSE and Nasdaq have experienced significant growth in foreign company listings. Foreign company listings on the NYSE increased from 106 in 1991 to 290 as of the end of 1996. Similarly, foreign listings on Nasdaq increased from 185 in 1991 to 320 as of the end of 1996. Conversation with staff of NYSE (Feb. 21, 1997); Conversation with staff of Corporate Communications, NASD (Feb. 21, 1997); New York Stock Exchange, Inc., 1995 Annual Report 3 (1995); National Association of Securities Dealers, Inc., 1996 Nasdaq Fact Book 37 (1996).

[9] *See, e.g.*, Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, to Jere W. Glover, Chief Counsel for Advocacy, U.S. Small Business Administration, and Gregory J. Dean, Jr., Assistant Chief Counsel for Banking and Finance, U.S. Small Business Administration (Oct. 26, 1996); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, to Bruce D. Stuart, Esq. (Aug. 5, 1996); and Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, to Barry Reder, Esq. (June 24, 1996).

[10] *See* Arthur M. Louis, *Schwab Plays Catchup: Broker Faces Tough Internet Competition*, S.F. Chron., Nov. 26, 1996, at C1. *See also* Letter from Richard R. Lindsey, Director, Division of Market Regulation, SEC, to Scott W. Campbell, Vice President and Associate General Counsel, Charles E. Schwab & Co. (Nov. 27, 1996).

[11] Island is operated by Datek Securities Corp., a registered broker-dealer. Island, Instinet, and other ''matching'' systems (such as Tradebook, which is operated by Bloomberg Tradebook LLC) allow participants to display firm, priced orders to other participants and to execute automatically against other orders in the system.

for Institutional Trading (''POSIT''),[12] and the Arizona Stock Exchange (''AZX''),[13] which allow institutions and other market participants to electronically execute trades in a variety of ways.[14] These and other alternative trading systems have grown to account for a significant percentage of the trading volume of the U.S. securities markets, particularly within the last five years. In 1994, the Commission's Division of Market Regulation reported that alternative trading systems accounted for 13 percent of the volume in Nasdaq securities and 1.4 percent of the trading volume in NYSE-listed securities.[15] In comparison, the Commission estimates that alternative trading systems currently handle almost 20 percent of the orders in Nasdaq securities and almost 4 percent of orders in NYSE-listed stocks.

Technology has also significantly altered the operation of exchange and OTC markets. For example, most exchanges have designed systems that allow members to route orders electronically to the exchange for execution.[16] The NYSE has also established after-hours crossing systems that automate the execution of single stock orders and baskets of securities,[17] and the Cincinnati Stock Exchange (''CSE'') is now a fully automated exchange where members effect transactions through computers located in their own offices.[18] Dealer markets have been similarly transformed. Dealer markets traditionally consisted of loosely organized groups of individual dealers that traded securities OTC, without formal consolidation of orders or trading. As individual dealers and associations of dealers have employed technology to make OTC markets more efficient, however, dealer markets in certain instruments have become organized to such an extent that they have assumed many of the characteristics of exchange markets. This is particularly true in markets that trade instruments that are also listed on registered exchanges. For example, the Nasdaq market, operated by the National Association of Securities Dealers, Inc. (''NASD''), consolidates trading interest of multiple dealers on a computer screen that is displayed in real-time to its members and provides a mechanism for dealers to update displayed quotations.[19] Additional services, such as SelectNet, allow dealers in the Nasdaq market to trade electronically. Through this technology, the NASD has been able to coordinate the dealer market more efficiently.

Overall, these developments have benefited investors by increasing efficiency and competition, reducing costs, and spurring further technological advancement of the entire market. In particular, for those market participants that have access to alternative trading systems, these systems have provided opportunities for the direct execution of orders without the active participation of an intermediary. Alternative markets are likely to grow as technology continues to drive the evolution of the equity markets.

B. Market Regulation

Whether trading electronically or through human intervention, investors are more likely to trade on a market when prices are current and reflect the value of securities, when they are confident that they will be able to buy and sell securities easily and inexpensively, and when they believe that they can trade on a market without being defrauded or without other investors having an unfair advantage. The competition for global investment capital among the world's exchanges and the many opportunities available to U.S. and foreign investors make it more important than ever for U.S. exchanges to protect these investor interests in order to attract order flow. Appropriate regulation is often necessary to protect these interests, by helping to ensure fair and orderly markets, to prevent fraud and manipulation, and to promote market coordination and competition for the benefit of all investors.[20]

In the United States, Congress decided that these goals should be achieved primarily through the regulation of exchanges and through authority it granted to the Commission in 1975 (''1975 Amendments'')[21] to adopt rules that promote (1) economically efficient execution of securities transactions, (2) fair competition, (3) transparency, (4) investor access to the best markets, and (5) the opportunity for investors' orders to be executed without the participation of a dealer.[22] In promulgating the Exchange Act, Congress gave the Commission means to achieve these and other goals of regulation,[23] by requiring

[12] POSIT is operated by ITG Inc., a registered broker-dealer. POSIT and other ''crossing'' systems allow participants to enter unpriced orders, which are then executed with matching interest at a single price, typically derived from the primary public market for each crossed security.

[13] AZX and other ''single-price auction'' systems allow participants to enter priced orders, which the system then compares to determine the single price at which the largest volume of orders can be executed. All orders are then matched and executed at that price.

[14] In addition to these systems, more than 140 broker-dealers have notified the Commission that they operate some type of alternative trading system, either internally for their own traders or for their customers and other market participants. Registered broker-dealers that operate or otherwise sponsor alternative trading systems are required to comply with periodic reporting and recordkeeping requirements pursuant to Rule 17a–23 under the Exchange Act. 17 CFR 240.17a–23. *See generally* Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments app. IV (1994) (hereinafter Market 2000 Study) (general description of proprietary trading systems).

[15] *See* Market 2000 Study, *supra* note 14, at Study II–13.

[16] The NYSE's SuperDOT (Designated Order Turnaround) system enables firms to transmit market and limit orders in all NYSE-listed securities directly to the specialist post for execution. Some NYSE members also allow selected institutional customers to route their orders through the members' connection to SuperDOT. Similar systems are operated by the following exchanges: the American Stock Exchange (''Amex'') (Automated Post Execution Reporting System, or AutoPERS), the Boston Stock Exchange (''BSE'') (BSE Automated Communication and Order Routing Network, or BEACON), the Chicago Board Options Exchange (''CBOE'') (the RAES system), the Chicago Stock Exchange (''CHX'') (Midwest Automatic Execution System, or MAX), the Pacific Exchange (''PCX'') (Pacific Computerized Order Access System, or P/COAST), and the Philadelphia Stock Exchange (''Phlx'') (Phlx Automated Communication and Execution System, or PACE).

[17] *See* Securities Exchange Act Release No. 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991); Securities Exchange Act Release No. 32368 (May 25, 1993), 58 FR 31565 (June 3, 1993).

[18] First organized in 1884, the CSE initially operated with a physical trading floor which it began phasing out in 1976. SEC, Report on the Practice of Preferencing Pursuant to Section 510(c) of the National Securities Markets Improvement Act of 1996, 24 (1997) (hereinafter Preferencing Report).

[19] Like exchange markets, the NASD imposes obligations on market makers to provide a continuous source of liquidity for Nasdaq-traded securities, establishes minimum qualifications that issuers must meet in order for their securities to be quoted on the consolidated computer screen, and sets enforceable rules that govern the priorities dealers must give to certain orders.

[20] Experience in both the United States and world markets has repeatedly shown that commercial incentives alone are insufficient to protect investors adequately and ensure fair markets. In adopting the Exchange Act, Congress noted that, however zealously exchange authorities may supervise the business conduct of their members, the interests with which they are connected frequently conflict with the public interest. H.R. Rep. No. 1383, 73rd Cong., 2d Sess. at 4 (1934); S. Rep. No. 792, 73rd Cong., 2d Sess. (1934). *See also* SEC, Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets (Feb. 2, 1972), 37 FR 5286 (Feb. 4, 1972) (hereinafter Future Structure Statement). Legislative history to key Exchange Act amendments adopted in 1975 also points to the need for regulation. *See, e.g.*, S. Rep. No. 75 and H.R. Rep. No. 229, *infra* note 22. *See also* SEC, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market (1996) (hereinafter NASD 21(a) Report).

[21] Pub. L. No. 29, 89 Stat. 97 (1975).

[22] *See* S. Rep. No. 75, 94th Cong., 1st Sess. 8 (1975); H.R. Rep. No. 229, 94th Cong., 1st Sess. 92 (1975). *See also* Exchange Act section 11A(a)(1), 15 U.S.C. 78k–1(a)(1).

[23] Congress also directed the Commission in the 1975 Amendments to advance the concept of equal regulation so that persons enjoying similar

Continued

every market that meets the definition of ''exchange'' under the Exchange Act to either register as a national securities exchange or be exempted from registration on the basis of limited transaction volume.[24] Congress also gave the exchanges authority to enforce their members' compliance with the goals of the securities laws and, in 1983, required every broker-dealer to become a member of an exchange [25] or securities association.[26] As SROs, every registered exchange and securities association is required to assist the Commission in assuring fair and honest markets, to have effective mechanisms for enforcing the goals of regulation, and to submit their rules for Commission review. This statutory structure has given the Commission ample authority to oversee securities markets and ensure compliance with the Exchange Act. Although regulation cannot prevent all manipulation, fraud, or collusion, it has proven effective in ridding markets of the most egregious of these practices and consequently in inspiring a high degree of investor confidence.

As a result of the technologically-driven developments discussed above, however, the distinctions among market service providers have become blurred, making it more difficult to determine whether any particular entity operates as an exchange, OTC market, broker, or dealer. For example, alternative trading systems incorporate features of both traditional markets and broker-dealers. Like traditional exchanges, alternative trading systems centralize orders and give participants control over the interaction of their orders. Like traditional broker-dealers, alternative trading systems are proprietary and, in some cases, maintain trading desks that facilitate participant trading. Because the activities of alternative trading systems include both traditional exchange and broker-dealer functions, it is often unclear whether such systems should register as exchanges, broker-dealers, or both. Under the existing statutory structure enacted by Congress, however, exchanges and broker-dealers are subject to significantly different obligations and responsibilities.

To date, the Commission has regulated many alternative markets as broker-dealers, rather than as exchanges, in order to foster the development of innovative trading mechanisms within the existing statutory framework.[27] The determination as to whether any particular alternative trading system should be regulated as an exchange or broker-dealer has been decided on a case-by-case basis.[28] This regulatory approach has had two significant, unintended effects: (1) It has subjected alternative trading systems to a regulatory scheme that is not particularly suited to their market activities; and (2) it has impeded effective integration, surveillance, enforcement, and regulation of the U.S. markets as a whole.

1. The Current Regulatory Approach Applies Inappropriate Regulation to Alternative Trading Systems

As broker-dealers, alternative trading systems are subject to regulation designed primarily to address traditional brokerage activities rather than market activities.[29] For example, broker-dealers are required to become members of the Securities Investor Protection Corporation (''SIPC''). While this membership is designed to protect customer funds and securities held by brokers, few alternative trading systems hold customer funds or securities.[30] In addition, broker-dealers are required to be members of an SRO. Thus, alternative trading systems are subject to oversight by exchanges and the NASD, which operate their own markets. Because these markets often compete with alternative trading systems for order flow, there is an inherent conflict between SROs' competitive concerns as markets and their regulatory obligations to oversee alternative trading systems.

Regulating alternative trading systems as traditional broker-dealers, therefore, requires compliance by these systems with obligations that, in many cases, are not pertinent to their principal activities. As discussed below, traditional broker-dealer regulation also fails to address concerns raised by alternative trading systems' market activities.

2. The Current Regulatory Approach Impedes Effective Regulation

The Commission has repeatedly evaluated whether the case-by-case no-action approach has permitted adequate Commission oversight of secondary trading markets, particularly in light of the growth and evolving market significance of such systems. Prior to 1993, the low volume and relatively small number of alternative trading systems appeared to justify such an approach. In 1993, for example, in an attempt to evaluate the effects of regulating alternative trading systems as broker-dealers, the Commission's Division of Market Regulation conducted a study of the U.S. equity markets.[31] This study concluded that, at that time, the Commission did not have sufficient regular information to

privileges, performing similar functions, and having similar potential to affect markets would be treated equally. The Commission was charged with ensuring that no member or class of members had an unfair advantage over other members as a result of a disparity in regulation not necessary or appropriate to further the objectives of the Exchange Act. *See* H.R. Rep. No. 229, *supra* note 22.

[24] There are currently eight registered national securities exchanges and one exempted exchange. AZX (formerly known as Wunsch Auction Systems) was exempted from the registration requirements of Sections 5 and 6 of the Exchange Act, 15 U.S.C. 78e and 78f, based on the exchange's expected limited volume in trading of securities. *See* Securities Exchange Act Release No. 28899 (Feb. 20, 1991), 56 FR 8377 (Feb. 29, 1991) (hereinafter AZX Exemptive Order). *See also* Securities Exchange Act Release No. 37271 (June 3, 1996), 61 FR 29145 (June 7, 1996).

[25] Markets operated by registered securities associations serve many of the same functions as exchanges. Registered securities associations are regulated under section 15A of the Exchange Act, 15 U.S.C. 78*o*–1, and are subject to requirements that are virtually identical to those applicable to registered exchanges under the Exchange Act.

[26] *See* Pub. L. No. 38, 97 Stat. 205 (1983).

[27] *See infra* notes 120 to 124 and accompanying text.

[28] Since 1991, the Commission staff has given operators of trading systems assurances that it would not recommend enforcement action if those systems operated without registering as exchanges. As a result, to date, many automated trading markets have not been required to register as exchanges and have instead been regulated as broker-dealers. For a list of no-action letters issued to system sponsors until the end of 1993 and a short history of the Commission's oversight of such systems, see Securities Exchange Act Release No. 33605, 59 FR 8368, 8369–71 (Feb. 18, 1994) (''Rule 17a–23 Proposing Release''). *See also* Letters from the Division of Market Regulation to: Tradebook (Dec. 31, 1996); The Institutional Real Estate Clearinghouse System (May 28, 1996); Chicago Board Brokerage, Inc. and Clearing Corporation for Options and Securities (Dec. 13, 1995).

[29] Broker-dealers have a responsibility under the Exchange Act for ensuring their own (and their employees') compliance with the federal securities laws and with the rules of all relevant SROs. Broker-dealer requirements generally focus on ensuring adequate employee supervision, financial responsibility and sufficient capital, and fair dealing with customers, including protection of customers' securities and funds, and monitoring sales practices.

[30] Rather than hold customer funds or securities, most alternative trading systems require their customers to arrange for trades executed on the system to be cleared through another broker-dealer. *See, e.g.*, Letter from Brandon Becker, Director, Division of Market Regulation, SEC, to Lloyd H. Feller, Esq., Morgan, Lewis & Bockius (Sep. 9, 1993) (Lattice trading system to have trades cleared and settled by a registered broker-dealer designated by respective system participants); Letter from Larry E. Bergmann, Associate Director, Division of Market Regulation, SEC, to Larry E. Fondren, Intervest Financial Services, Inc. (Nov. 24, 1992) (CrossCom Trading Network to use WFS Clearing Services, Inc.); Letter from William H. Heyman, Director, Division of Market Regulation, SEC, to Daniel T. Brooks, Cadwalader, Wickersham & Taft (Nov. 25, 1991) (LIMITrader to use Mabon Securities Corp. as its initial clearing broker); and Letter from William H. Heyman, (then) Deputy Director, Division of Market Regulation, SEC, to Richard S. Soroko, Esq., Lippenberger, Thompson & Welch (May 16, 1991) (Portfolio Trading Services, Inc. to use Ernst & Company as its clearing broker).

[31] *See* Market 2000 Study, *supra* note 14.

evaluate the effects of alternative trading systems on the U.S. securities markets. Therefore, the Division of Market Regulation recommended that the Commission closely monitor the impact of the proliferation of such systems. In response to this recommendation, the Commission adopted a recordkeeping and reporting rule, Rule 17a–23, specifically for broker-dealers that operate alternative trading systems.[32]

Because traditional broker-dealer regulation is not designed to apply to markets such as alternative trading systems, gaps have developed in the structures designed to ensure marketwide fairness, transparency, integrity, and stability. As discussed in greater detail below, the regulation of the most significant alternative trading systems under traditional broker-dealer regulation calls into question the accuracy of public quotation and trade information, and the fairness of the public secondary markets.[33] In addition, such regulation may impair the detection and elimination of fraudulent and manipulative trading, and the mechanisms to ensure fair and equitable oversight and competition among markets.

a. Market Access and Fairness

While institutional investors are now the dominant players in U.S. financial markets,[34] the United States still has the highest percentage of direct individual participation in the stock markets.[35] Because the needs and interests of small individual investors, money managers, wealthy speculators, and large pension plans are not always the same,[36] market regulation is intended to ensure that these diverse investors are treated fairly and have fair access to investment opportunities.

Specifically, the Exchange Act requires registered exchanges and securities associations to consider the public interest in administering their markets, to allocate reasonable fees equitably,[37] and to establish rules designed to admit members fairly.[38] While these provisions are based on the principle that qualified market participants should have fair access to the nation's securities markets, they are not intended to limit exchanges from having reasonable standards for access.[39] Rather, fair access requirements are intended to prohibit unreasonably discriminatory denials of access. A denial of access would be reasonable, for example, if it were based on unbiased standards, such as capital and credit requirements, and if these standards were applied fairly.

The Exchange Act also requires registered exchanges and securities associations to establish rules that assure fair representation of members and investors in selecting directors and administering their organizations.[40] The purpose of this requirement is to protect the rights and interests of the diverse members of registered exchanges and securities associations. In addition, because registered exchanges and securities associations are also SROs, they exercise governmental powers, such as the imposition of disciplinary sanctions on their members. Fair representation on the body responsible for disciplining members is, therefore, critical to the impartial enforcement of SRO rules.

Market regulation is also designed to remove barriers to fair competition, by prohibiting the rules of registered exchanges and securities associations from being anticompetitive,[41] and by providing for Commission review of the rules of registered exchanges and securities associations.[42] To further emphasize the goal of vigorous competition, Congress required the Commission to consider the competitive effects of exchange rules,[43] as well as the Commission's own rules.[44]

The Commission's authority to review the actions of registered exchanges and securities associations has prevented the implementation of numerous rules that would have been anticompetitive or otherwise detrimental to the market. For example, in December 1990, the American Stock Exchange (''Amex'') submitted a rule proposal to the Commission that would have excluded the orders of competing dealers (*i.e.*, regional exchange specialists and third market makers) from its order routing system and would have imposed trading restrictions on competing dealers in Amex securities. Because the exclusions and restrictions applied only to competing dealers and not to other off-floor broker-dealers trading for their own accounts, the proposal raised market access and competitive concerns.[45] After receiving numerous negative public comments regarding the Amex's proposal, the Commission staff recommended that the Amex either amend or withdraw the proposal.[46] Similarly, several exchanges have proposed prohibiting customer orders from being executed through the

[32] Rule 17a–23 under the Exchange Act generally requires U.S. broker-dealers that sponsor broker-dealer trading systems to provide a description of their systems to the Commission and report transaction volume and other activity to the Commission on a quarterly basis. This rule also requires that such broker-dealers keep records regarding system activity and to make such records available to the Commission. 17 CFR 240.17a–23. *See also* Securities Exchange Act Release No. 35124 (Dec. 20, 1994), 59 FR 66702 (Dec. 28, 1994).

[33] Commenters have repeatedly suggested that the regulatory disparity between exchanges and broker-dealers gives a competitive advantage to alternative trading systems. Concern about this regulatory dichotomy has been voiced by many commenters. Industry and congressional commenters at various times since 1991 have questioned whether regulating alternative trading systems differently from exchanges is advisable. The NYSE, for example, has stated that: ''[R]egulation of participants in our securities markets should be governed by the principle of ''functional regulation'': entities that perform similar functions should be subject to similar regulation * * * firms that establish a market place for providing execution of transactions in securities pursuant to their own trading rules should be regulated in a manner similar to exchanges, regardless of whether they are also brokers and dealers. The name given an entity should not control the manner in which it is regulated.'' Testimony of Edward A. Kwalwasser, Exec. V.P., NYSE, before the Telecommunications and Finance Subcommittee, Committee on Energy and Commerce, U.S. House of Representatives, at 5–6 (May 26, 1993) (hereinafter Testimony of Edward A. Kwalwasser).

[34] In 1960, institutions owned only 14.2 percent of the total $425 billion outstanding U.S. equity securities. By the end of the third quarter of 1996, the percentage had grown to 52.3% of the total $9,387 billion of outstanding U.S. equity securities. Conversation with staff of the Securities Industry Association (Feb. 21, 1997).

[35] From 1989 to 1995, the percentage of U.S. households having direct or indirect stock holdings jumped from 31.7% to over 41%. *See* Arthur B. Kennickell and Annika E. Sunden, *Family Finances in the U.S.: Recent Evidence from the Study of Consumer Finances,* Fed. Reserve Bull., Jan. 1997, at 1.

[36] Electronic Bulls & Bears, *supra* note 5, at 29.

[37] Exchange Act section 6(b)(4), 15 U.S.C. 78f(b)(4); Exchange Act section 15A(b)(5), 15 U.S.C. 78*o*–3(b)(5).

[38] Exchange Act sections 6(b)(2) and 6(c), 15 U.S.C. 78f(b)(2) and (c); Exchange Act section 15A(b)(8); 15 U.S.C. 78*o*–3(b)(8).

[39] ''[R]estraints on membership cannot be justified as achieving a valid regulatory purpose and, therefore, constitute an unnecessary burden on competition and an impediment to the development of a national market system.'' H.R. Rep. No. 123, 94th Cong., 1st Sess. 53 (1975).

[40] Exchange Act section 6(b)(3), 15 U.S.C. 78f(b)(3); Exchange Act section15A(b)(4), 15 U.S.C. 78*o*–3(b)(4).

[41] Exchange Act section 6(b)(8), 15 U.S.C. 78f(b)(8); Exchange Act section 15A(b)(9), 15 U.S.C. 78*o*–3(b)(9).

[42] Exchange Act section 19(b)(1), 15 U.S.C. 78s(b)(1). *See infra* notes 188 to 205 and accompanying text (discussion of obligations of exchanges and securities associations to file rules and rule changes with the Commission).

[43] Exchange Act sections 6(b)(6), 15 U.S.C. 78f(b)(6).

[44] Exchange Act section 23(a), 15 U.S.C. 78w(a)(2).

[45] Securities Exchange Act Release No. 28741 (Jan. 3, 1991), 56 FR 1038 (Jan. 10, 1991). The proposal would have required that orders for the account of competing dealers: (1) Yield priority and parity to all other off-floor orders; (2) accept parity with orders for an account of an Amex specialist; and (3) be excluded from the Amex's order routing system, the Post Executions Reporting system. The Amex subsequently amended its proposal. Securities Exchange Act Release No. 30161 (Jan. 7, 1992), 57 FR 1502 (Jan. 14, 1992).

[46] *See* Market 2000 Study, *supra* note 14, at app. III, at 11. In 1994, the Amex withdrew its proposal.

exchanges' automated systems for guaranteed execution of small customer orders, if those customers used computer and communications technology to generate and transmit those orders. Such a proposal, if implemented, would have had the effect of discouraging the use of new, innovative technology. The tendency to try to discourage innovation in order to protect existing practices is not new. In 1987, for example, the Commission set aside the NYSE's denial of the requests of two of its members for permission to install telephone connections on the floor to enable the members to communicate with their customers.[47]

The fair access and treatment requirements in the Exchange Act are intended to ensure that exchanges and securities associations operating markets treat investors and their participants fairly. Under the current regulatory approach, however, there is no regulatory redress for unfair denials or limitations of access by alternative trading systems, or for unreasonably discriminatory actions taken against, or retaliatory fees imposed upon, participants in these systems. The availability of redress for such discriminatory actions may not be critical when alternative trading systems disclose any discriminatory practices to their participants and when market participants are able to substitute the services of one alternative trading system with those of another. However, when an alternative trading system has no other serious competitor, such as when it has a significantly large percentage of the volume of trading, discriminatory actions may be anticompetitive because market participants must use such trading system to remain competitive. Similarly, significant changes in the operations of alternative trading systems are not subject to either Commission or SRO review—even those changes that may be anticompetitive, unfair to a particular group of market participants, or that have significant effects on the primary public markets.

b. Market Transparency and Coordination

Securities markets have become increasingly interdependent because of the opportunities technology provides to link products, implement complex hedging strategies across markets, and trade on multiple markets simultaneously. While these opportunities benefit many investors, they can also create misallocations of capital, widespread inefficiency, and trading fragmentation if markets do not coordinate. Moreover, a lack of coordination among markets can increase system-wide risks. Congress adopted the 1975 Amendments, in part, to address these potential negative effects of a proliferation of markets.[48] In the 1975 Amendments, Congress specifically endorsed the development of a national market system, and sought to clarify and strengthen the Commission's authority to promote the achievement of such a system. Because of uncertainty as to how technological and economic changes would affect the securities markets, Congress explicitly rejected mandating specific components of a national market system.[49] Instead, Congress granted the Commission ''maximum flexibility in working out the specific details'' and ''broad discretionary powers'' to implement the development of a national market system in accordance with the goals of the 1975 Amendments.[50] The SROs and the Commission have worked hard to achieve these goals. [51]

Recent evidence suggests that the failure of the current regulatory approach to fully coordinate trading on alternative trading systems into national market systems mechanisms has impaired the quality and pricing efficiency of secondary equity markets, particularly in light of the explosive growth in trading volume on such alternative trading systems. Although these systems are available to some institutions, orders on these systems frequently are not available to the general investing public. The ability of market makers and specialists to display different and potentially superior prices on these alternative trading systems than those displayed to the general public created, in the past, the potential for a two-tiered market.[52]

For example, during the Commission's recent investigation of Nasdaq trading,[53] analyses of trading in the two most significant trading systems for Nasdaq securities (Instinet and SelectNet) revealed that the majority of bids and offers displayed by market makers in these systems were better than those posted publicly on Nasdaq.[54] Moreover, the Commission found that, because they could trade with other market professionals through non-public alternative trading systems, market makers did not have a sufficient economic incentive to adjust their public quotations to reflect more competitive prices.[55] Ultimately, the wider spreads quoted publicly by market makers increased the transaction costs paid by public customers, impaired the ability of some institutional investors to obtain favorable prices in those securities, and placed institutions at a potential disadvantage in price negotiations.[56]

In response to these findings, the Commission recently took steps to bring greater transparency into the trading environment of certain alternative trading systems. In September 1996, the Commission adopted rules that require a market maker or specialist to make

[47] *See In the Matter of the Application of William J. Higgins and Michael D. Robbins,* Admin. Proc. No. 3–6609, Securities Exchange Act Release No. 24429 (May 6, 1987).

[48] *See generally* S. Rep. No. 75 and H.R. Rep. No. 229, 94th Cong., *supra* note 22.

[49] S. Rep. No. 75, *supra* note 22, at 2, 8; H.R. Rep. No. 229, *supra* note 22. ''(T)he increasing tempo and magnitude of the changes that are occurring in our domestic and international economy make it clear that the securities markets are due to be tested as never before,'' and that it was, therefore, important to assure ''that the securities markets and the regulations of the securities industry remain strong and capable of fostering (the) fundamental goals [of the Exchange Act] under changing economic and technological conditions.'' S. Rep. No. 75, *supra* note 22, at 3.

[50] S. Rep. No. 75 and H.R. Rep. No. 229, *supra* note 22.

[51] For example, the Intermarket Communications Group links the Commission, the Commodity Futures Trading Commission, and the SROs for the major securities and futures markets. During periods of market stress this interagency and intermarket coordination helps to minimize uncertainty and improve communication for the benefit of investors trading in all U.S. markets. In addition, market-wide trading halts imposed by circuit breaker procedures limit credit risk by providing a brief respite amid frenetic trading, which allows market participants to ensure the solvency of their counterparties. These planned, coordinated trading halts also facilitate price discovery by providing an opportunity to publicize order imbalances in order to attract value traders, and cushion the impact of market movements that would otherwise damage a market's infrastructure.

[52] *See* Securities Exchange Act Release No. 36310 (Sept. 29, 1995), 60 FR 52792 (Oct. 10, 1995) (hereinafter Order Handling Rules Proposing Release).

[53] Following the filing of several class action lawsuits alleging collusion among Nasdaq market makers and public allegations that Nasdaq market makers routinely refused to trade at their published quotes, intentionally reported transactions late in order to hide trades from other market participants, and engaged in other market practices detrimental to individual investors, the Commission opened a formal inquiry to investigate the functioning of the Nasdaq market and to determine whether the NASD was complying fully with its obligations as an SRO. In 1996, as a result of the investigation, the Commission instituted enforcement proceedings against the NASD pursuant to section 19(h) of the Exchange Act and issued a report under section 21(a) of the Exchange Act detailing the Commission's findings. *See* NASD 21(a) Report, *supra* note 20.

[54] These conclusions are based on Instinet and SelectNet data for the months April through June 1994. *See* NASD 21(a) Report, *supra* note 20, at notes 48 to 52 and accompanying text.

[55] The Commission found that ''the ability of market makers to attract trading interest through Instinet allowed them to trade without using odd-eighth quotes and narrowing the Nasdaq spread.'' NASD 21(a) Report, *supra* note 20, at 20.

[56] NASD 21(a) Report, *supra* note 20, at 18.

publicly available any superior prices that it privately offers through certain types of alternative trading systems known as electronic communications networks, or ECNs.[57] The new rules permit an ECN to fulfill these obligations on behalf of market makers using its system, by submitting its best market maker bid/ask quotations to an SRO for inclusion into public quotation displays (''ECN Display Alternative'').

These rules, however, were not intended to fully coordinate trading on alternative trading systems with public market trading. While these rules will help integrate orders on certain trading systems into the public quotation system, they only affect trading that is conducted by market makers and specialists; activity of other participants on alternative trading systems remains undisclosed to the public market unless the system voluntarily undertakes to disclose all of its best bid/ask prices.[58] Moreover, whether an ECN reflects the best bid/ask quotations on behalf of market makers and specialists that participate in its system is wholly voluntary.[59] Specifically, ECNs are under no obligation to integrate orders submitted into their systems into the public quotation system, and the central quotation system is not currently required to accept ECNs as participants.

Because a majority of trading interest on alternative trading systems is not integrated into the national market system, price transparency is impaired and dissemination of quotation information is incomplete. These developments are contrary to the goals the Commission enunciated over twenty years ago when it noted that an essential purpose of a national market system

> is to make information on prices, volume, and quotes for securities in *all* markets available to *all* investors, so that buyers and sellers of securities, wherever located, can make informed investment decisions and not pay more than the lowest price at which someone is willing to sell, and not sell for less than the highest price a buyer is prepared to offer.[60]

This development also thwarts congressional goals for a national market system, where the best trading opportunities are to be made accessible to *all customers,* not just those customers who, due to their size or sophistication, may avail themselves of prices in alternative trading systems not currently available in the public quotation system.

c. Market Surveillance

Market regulation critically enhances the Commission's ability to surveil market activity as a whole in order to prevent fraud and manipulation, which can jeopardize market integrity and stability. Exchanges and securities associations such as the NASD act as SROs and, as such, are responsible not only for complying with the Exchange Act, but also for carrying out the purposes of the Exchange Act, principally by enforcing member compliance with the provisions of the Exchange Act and the rules promulgated thereunder, as well as the exchanges' or associations' own rules.[61] This requires exchanges and securities associations to establish rules and procedures to prevent fraud and manipulation and promote just and equitable principles of trade, typically by establishing audit trails, surveillance, and disciplinary programs. It also requires exchanges and securities associations to enforce the antifraud provisions of the federal securities laws.[62] These requirements are essential to ensure that SROs implement the goals established by Congress vigilantly and effectively. In addition, exchanges and securities associations serve a critical regulatory function by establishing and enforcing just and equitable principles of trade, and by providing a mechanism for preventing inappropriate behavior that damages market integrity, even if such behavior does not rise to the level of fraud under the Exchange Act. As a result of these requirements, exchanges and securities associations carry out much of the day-to-day surveillance for, and initial investigation of, trading improprieties, rule violations, and fraud.

Although the broker-dealers that operate many of the alternative trading systems have certain obligations to individual customers, because these systems are not SROs, they do not have the same market-wide enforcement and surveillance obligations as registered exchanges and the NASD. Moreover, SROs' current programs to surveil their own markets for fraud, insider trading, and market manipulation do not extend to observing quote activity on alternative trading systems. Specifically, although trades executed through certain alternative trading systems are reported to the NASD by either broker-dealer participants in such systems or by the broker-dealer operating the market,[63] the NASD may not receive a consolidated picture of trading activity on alternative trading systems. Because activity on alternative trading systems is only reported to an SRO after a trade has been executed, SROs cannot fully supervise SROs' members' activities on those systems.[64] In addition, because alternative trading systems are often reported as the counterparty to all trades between institutions executed through their systems, SRO surveillance mechanisms may not be able to identify the true counterparties of those trades. As a result, fraudulent or manipulative activity that an institution is carrying on through an alternative trading system may be masked by the overall activities of the system's other participants, and go uninvestigated. As more institutions use alternative trading systems to trade with each other, rather than with

[57] ECNs include any automated trading mechanism that widely disseminates market maker orders to third parties and permits such orders to be executed through the system, other than crossing systems. *See* Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (hereinafter Order Handling Rules Adopting Release). Currently, all ECNs are broker-dealer trading systems, as defined in Exchange Act Rule 17a–23, and are sponsored through registered broker-dealers.

[58] Because such trading interest remains undisclosed, within certain alternative trading systems non-market maker participants are able to display prices that lock and cross the public quotations. If the quotes of such participants were also disclosed to the public, it could result in improved price opportunities for public investors. There is already divergence among ECNs in the extent to which they have chosen to integrate non-market maker orders into the prices they display to the public. Of the four ECNs that are currently linked to Nasdaq, two ECNs display to the public the best prices of any orders entered into their systems (including both market makers and institutions). One ECN displays to the public the best price of any visible order entered into its system by market makers or institutions, but does not display any orders that are designated as ''reserve orders'' (which may interact with orders entered into the ECN's system, but are not generally displayed to participants in the ECN). The fourth ECN displays to the public only orders of market makers and those institutional customers that affirmatively choose to have their orders so displayed.

[59] To date, four trading systems have elected to display quotes under the ECN alternative. *See* Letters dated January 17, 1997 from Richard R. Lindsey, Director, SEC to: Charles R. Hood, Senior V.P. and General Counsel, Instinet Corporation (recognizing Instinet as an ECN); Joshua Levine and Jeffrey Citron, Smith Wall Associates (recognizing the Island System as an ECN); Gerald D. Putnam, President, Terra Nova Trading, LLC (recognizing the TONTO System, now known as Archipelago, as an ECN); and Roger D. Blanc, Wilkie Farr & Gallagher (counsel to Bloomberg) (recognizing Bloomberg Tradebook as an ECN).

[60] Future Structure Statement, *supra* note 20, at 9–10 (emphasis added). *See also,* SEC, Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System 25–28 (1973).

[61] Exchange Act section 6(b) (1), (5), and (6), 15 U.S.C. section 78f(b) (1), (5), and (6); Exchange Act 15A(b)(2), 15 U.S.C. 78*o*–3(b)(2).

[62] *Id.*

[63] Broker-dealers that operate trading systems have the same reporting obligations as other broker-dealers. For trades executed on an alternative trading system, this means that, depending on the circumstances, market makers and broker-dealers trading on the system will report their own trades, and that the broker-dealer sponsor of the system will undertake to report trades between non-broker-dealers.

[64] *See* NASD 21(a) Report, *supra* note 20.

intermediaries, this could result in significant volume that is not integrated into SRO surveillance operations. Finally, alternative trading systems that compete with systems operated by SROs have repeatedly questioned whether particular SRO actions were driven by competitive, rather than regulatory motives. Thus, adequate oversight of alternative trading systems by SROs may be hindered by competitive concerns.

d. Market Stability and Systemic Risks

SROs have substantial, ongoing commitments to maintain sufficient system capacity, integrity, and security. The Commission has instituted a program to monitor capacity planning at SROs, so that it can take preemptive action if necessary, and meets with the SROs on a regular basis and reviews various aspects of their computer operations. In contrast, the Division of Market Regulation's experience in administering the Order Handling Rules and other broker-dealer rules has revealed that, in many cases, ECNs and other alternative trading systems may have serious capacity problems.[65] Even though they have significant trading volume, under the current regulatory scheme ECNs and other alternative trading systems are not required to have sufficient computer capacity to meet ongoing trading demand or to withstand periods of extreme market volatility or other short-term surges in trading volume. Failure to integrate alternative trading systems into the Commission's programs to review and enhance the capacity of alternative trading systems jeopardizes efforts to ensure that all trade execution centers will remain operational during periods of market stress.

C. Conclusion

In sum, the current regulation of alternative trading systems does not address the market activities performed by such systems. As a result, such regulation may not have effectively met the congressional goals of protecting market participants from fraud and manipulation, promoting market coordination and stability, and ensuring regulatory fairness and fair competition.

Question 1: The Commission seeks comment on the concerns identified above and invites commenters to identify other issues raised by the current approach to regulating alternative trading systems.

Question 2: Are the concerns raised in this release with regard to the operation of alternative trading systems under the current regulatory approach unique to such systems? To what extent could these concerns be raised by broker-dealers that do not operate alternative trading systems, such as a broker-dealer that matches customer orders internally and routes them to an exchange for execution or a broker-dealer that arranges for other broker-dealers to route their customer orders to it for automated execution?

III. Approaches to Market Oversight

The Commission recognizes that, in order to promote efficiency, competition, and capital formation in the securities industry, creation of new markets or the evolution of existing ones must not be inhibited. At the same time, the Commission continues to believe that fair and measured market oversight is valuable to protect investors, ensure the integrity and fairness of markets, and otherwise promote the goals reflected in the Exchange Act.

As the problems discussed above illustrate, the current approach for regulating alternative trading systems may not effectively accomplish these objectives. New technologies are continually facilitating innovative means of trading securities, resulting in qualitatively different market structures. In the next decade, the continued growth of the Internet will present even more opportunity for change in financial services. This release solicits comment on whether the current statutory and regulatory framework is appropriate in light of these myriad developments and new means of trading securities made possible by emerging technologies. The release then seeks comment on specific alternatives for addressing these objectives within the existing securities law framework.

A. Regulatory Structure

As technology continues to drive the evolution of markets, the variety and combinations of services offered by markets and intermediaries will continue to blur the distinctions among these entities. Under the Exchange Act, such distinctions determine the obligations and responsibilities of each entity towards customers and the market as a whole. In particular, the Exchange Act categorizes market participants based on their primary activities, such as an ''exchange'' function or a ''broker-dealer'' function. Although Congress defined the terms ''exchange,'' ''broker,'' and ''dealer'' broadly enough to accommodate changes in how these entities carry out their business, they could not anticipate the variety of entities that would develop. The Commission invites commenters to analyze whether, in light of technological advances, market participants might be appropriately regulated without reference to distinctions between markets and intermediaries. In the alternative, the Commission solicits comment on whether new regulatory categories are needed for entities that combine both market and intermediary functions. The Commission also solicits comment on what oversight should apply to these categories.

In addition, as explained above, exchanges and broker-dealer intermediaries each play critical roles in supervising securities activities. The Commission solicits comment on how any changes to the regulatory approach would affect these roles.

Finally, the Commission solicits comment on how any changes to the current statutory and regulatory structure made to accommodate market innovations could be accomplished without undue cost to existing market participants, which have invested significantly to comply with the existing structure.

Question 3: What regulatory approaches would best address the concerns raised by the growth of alternative trading systems and the needs of the market? Is the current approach the most appropriate one?

Question 4: What should be the objectives of market regulation? Are the goals and regulatory structure incorporated by Congress in the Exchange Act appropriate in light of technological changes? Are business incentives adequate to accomplish these goals?

Question 5: Are the regulatory categories defined in the Exchange Act sufficiently flexible to accommodate changes in market structure? If not, what other categories would be appropriate? How should such categories be defined?

B. Regulatory Tools

Technological changes also have significant implications for the tools the Commission relies on to achieve the goals incorporated by Congress into the Exchange Act. As discussed in greater detail in Sections IV and V below, the Commission currently regulates markets largely through its registration, rule filing, examination, and enforcement programs. In light of the changes

[65] The Commission is aware of several occasions on which significant alternative trading systems had to stop disseminating market maker quotations in order to keep from closing altogether due to insufficient system capacity. In one recent occurrence, an interruption in service at an ECN immediately following a key market announcement appears to have seriously affected options market makers' ability to trade the equities underlying their options.

discussed above, the Commission solicits comment on whether these are effective means of accomplishing congressional goals, and, if not, what other means might be more appropriate.

For example, many Commission regulations require market participants to deliver written documents. In order to give broker-dealers and investment advisers the flexibility to comply with these requirements in the most cost-effective and efficient manner, the Commission has issued interpretative guidance regarding the use of electronic communications to fulfill the delivery requirements of the federal securities laws.[66] Rather than specifying acceptable types of electronic delivery, the Commission specified the standards that entities had to achieve in meeting their delivery requirements electronically, leaving it to each entity to determine the best way to meet each standard. This approach allows broker-dealers and investment advisers to avail themselves of technological innovations without first obtaining regulatory approval. The Commission solicits comment on whether such a standard-oriented approach would be appropriate for the regulation of markets, and, if so, what these standards should be.

Question 6: Can the Commission regulate markets effectively through standard-oriented regulation of the type described above?

Question 7: How could the Commission enforce compliance with the Exchange Act under such a standard-oriented approach?

Question 8: Is the current regulatory framework an effective form of oversight, in light of technological changes? Are there other regulatory techniques that would be comparably effective? If so, would the implementation of such techniques be consistent with congressional goals reflected in the Exchange Act?

IV. Proposals Under Consideration To Integrate Alternative Trading Systems into the Existing Regulatory Structure for Market Oversight

Within the existing regulatory framework, the issues currently associated with alternative trading systems could be addressed in large part by integrating alternative trading systems more effectively into national market system mechanisms. Discussed below are two alternative means of effecting such integration. First, the Commission could continue to regulate alternative trading systems as broker-dealers and attempt to integrate these systems more effectively into market regulation mechanisms through a series of rules applicable to broker-dealers operating such systems and to SROs overseeing such systems. Second, the Commission could regulate alternative trading systems as exchanges by expanding the interpretation of the term ''exchange'' to cover those alternative trading systems that engage in many of the same activities as currently registered exchanges, such as operating an electronic limit order book, or matching or crossing participant orders. The Commission could then follow a tiered approach to regulating those alternative trading systems classified as exchanges. The first tier under this approach would consist of those alternative trading systems that have low volume or a passive pricing structure. These trading systems would not be required to register as national securities exchanges (or as broker-dealers, to the extent that such trading systems do not also perform customary brokerage functions),[67] but would be subject to limited requirements. The second tier under this approach would consist of those alternative trading systems with a large volume of trading and active price discovery, but that do not have membership structures. The Commission could require these trading systems to register as exchanges, but would use its new exemptive authority to eliminate unnecessary or inappropriate requirements.[68] Finally, the third tier under this approach would consist of those traditional exchanges that have membership governance structures.

Any new regulatory approach to oversight of alternative trading systems should promote efficiency, competition, and capital formation in the securities industry, without inhibiting the development of new markets. At the same time, it is critical to address the problems discussed above. The Commission solicits comment on the two alternatives for addressing these issues discussed below, and on whether there are other alternatives that may address the Commission's concerns.

Question 9: Are there viable alternatives within the existing Exchange Act structure, other than those discussed below, that would address the concerns raised by the growth of alternative trading systems and congressional goals in adopting the Exchange Act?

A. Integrating Alternative Trading Systems into the National Market System Through Broker-Dealer Regulation

In order to rectify the shortcomings discussed in Section II of this release, the Commission could build upon its current regulation of alternative trading systems as broker-dealers. In particular, alternative trading systems could be overseen and integrated into the NMS through a combination of broker-dealer regulation and regulation of the SROs that supervise these systems. The Commission took a similar approach in its recent adoption of the Order Handling Rules (which are designed to integrate a portion of the trading on ECNs into market transparency mechanisms) and in its adoption of Rule 17a–23 (which established recordkeeping and reporting requirements specifically tailored to broker-dealers operating trading systems).

As discussed below, these broker-dealer regulations could include requiring those broker-dealers that operate alternative trading systems to make all orders of participants in those systems available to the public quotation system. The Commission could also require alternative trading systems to provide the public with access to such systems in order to interact with the orders posted by participants of such systems. In addition, the Commission could impose additional requirements on both the broker-dealers that operate alternative trading systems and their SROs in order to more effectively integrate these systems into SRO surveillance mechanisms. For example, the Commission could require broker-dealers that operate alternative trading systems to provide more audit trail

[66] *See* Securities Exchange Act Release No. 36345, 60 FR 53458 (Oct. 6, 1995); Securities Exchange Act Release No. 36346, 60 FR 53468 (Oct. 6, 1995); Securities Exchange Act Release No. 37183 (May 9, 1996), 61 FR 24652 (May 15, 1996).

[67] *See infra* notes 183 to 184 and accompanying text.

[68] The National Securities Markets Improvement Act of 1996 (hereinafter 1996 Amendments), Pub. L. 104–290, added Section 36 to the Exchange Act, 15 U.S.C. 78mm, which authorizes the Commission to conditionally or unconditionally exempt any person, security, or transaction, or any class thereof, from any provision of the Exchange Act or rule thereunder, so long as the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. Section 36 of the Exchange Act does not authorize the Commission to exempt persons, securities, transactions, or classes thereof from section 15C of the Exchange Act or rules and regulations issued under that section. Section 15C establishes registration requirements for government securities brokers and government securities dealers and gives the U.S. Department of the Treasury authority to promulgate rules governing the activities of these entities. All of the exemptions pursuant to section 36 of the Exchange Act that the Commission is considering in this concept release could be granted by rule or regulation. If the Commission determined instead to issue orders granting exemptive applications, it would need to adopt procedures for doing so pursuant to section 36.

information to their SROs, which would help SROs execute their oversight functions, and could require SROs to use this additional information to integrate these systems into their surveillance programs. Finally, the Commission could adopt measures that would help to ensure that alternative trading systems have adequate systems capacity.

Question 10: What types of alternative trading systems would it be appropriate to regulate in this manner?

1. Fully Integrating the Orders of All Market Participants into the Public Quotation System and Facilitating Public Access to Such Orders

In its efforts to increase competition and transparency in the market, the Commission has encouraged the development of NMS mechanisms, such as the Consolidated Tape Association (''CTA''), the Consolidated Quotation System (''CQS'') and the Intermarket Trading System (''ITS''). These mechanisms make information about trading interest, prices, and volume widely available to market participants. The Commission has worked to continuously update and improve the NMS to reflect technological advances. For example, the new Order Handling Rules require market makers and specialists to make available publicly any superior prices they privately offer through ECNs. As an alternative, the new rules permit, but do not require, an ECN to fulfill these obligations on behalf of the market maker or specialist by submitting the ECN's best bid and offer to an SRO for inclusion into the public quotation system.

As discussed above,[69] however, these rules were not intended to integrate all trading on alternative trading systems into the NMS. These rules focus only on ensuring that market maker and specialist activity on alternative trading systems is reflected in their public quotations. As a result, institutional orders on ECNs remain largely undisclosed to the public, thus hiding the aggregate trading interest on alternative trading systems from public view. Therefore, it might be appropriate to require broker-dealers that operate alternative trading systems to report all orders[70] submitted by participants, including those of non-broker-dealer participants, for integration into the public quotation system.

If alternative trading systems are required in some manner to publicly display the orders of all participants, they could also be required to provide the public with the ability to execute against those orders. Under the Order Handling Rules, an ECN that voluntarily displays market makers' and specialists' quotations to the public must also provide an equal opportunity for participants and non-participants to execute their orders against such quotations. Non-participants, however, may only access market maker and specialist quotations on those ECNs. Alternative trading systems could be required to provide non-participants with the ability to execute against all orders in their system, including those of institutions, in a manner equivalent to that offered participants of the systems. Non-participants would be granted access on a real-time basis under this approach and could be charged reasonable fees for such access.

Question 11: If the Commission decided to further integrate alternative trading systems into the NMS through broker-dealer regulation, should it require alternative trading systems to submit all orders displayed in their systems into the public quotation system? If not, how should the Commission ensure adequate transparency?

Question 12: If the Commission requires alternative trading systems to submit all orders displayed in their systems into the public quotation system, how can duplicate reporting by alternative trading systems and their participant broker-dealers be prevented?

Question 13: Are there other methods for integrating all orders submitted into alternative trading systems into the public quotation system?

Question 14: Are there any reasons that orders available in alternative trading systems should not be available to the public?

Question 15: If the Commission requires alternative trading systems to allow non-participants to execute against orders of system participants, how should it ensure that non-participants are granted equivalent access?

Question 16: If the Commission requires alternative trading systems to allow non-participants to execute against orders of system participants, how should it determine whether the fees charged to non-participants by such systems are reasonable and do not have the effect of denying access to orders?

Question 17: Are there any reasons that non-participants should not be able to execute against orders of participants in alternative trading systems?

2. Improving the Surveillance of Trading Conducted on Alternative Trading Systems

As discussed below, alternative trading systems may not be subject to real-time surveillance for market manipulation and fraud. Broker-dealers that operate these systems are not required to actively surveil the conduct of system participants to ensure against fraud and manipulation. Instead, as discussed above, these surveillance responsibilities lie with the SROs. SROs, however, do not actively incorporate alternative trading systems into their real-time surveillance programs, and broker-dealer trade reporting conventions restrict SRO surveillance capabilities.

Trading by institutions on alternative trading systems is effectively hidden from SRO programs designed to detect fraud and manipulation. SRO surveillance systems generate ''alerts'' that, in their most basic form, indicate when trading in a particular security is outside of normal trading patterns, such as when a previously inactive entity suddenly begins actively trading. Broker-dealers operating alternative trading systems, however, are not required to report the identities of the counterparties to a trade to their supervising SRO. Instead, the broker-dealer may report the trade to the SRO as its own trade. Therefore, SRO surveillance programs do not ''look through'' the alternative trading system to the actual counterparties conducting the trading on such systems. Because the SRO system views the broker-dealer operating the system as the counterparty to trades, unusual trading activity of a participant in an alternative trading system may not trigger an alert. While the anonymity provided by the broker-dealer trading system reporting the trade may be desirable to some because it allows traders to hide their trading strategies from other market participants, it also represents an opportunity for market manipulation that is increasingly difficult for SROs to detect.

In addition, SRO surveillance programs typically are constructed around activity in particular securities. Several alternative trading systems are designed to provide a liquid market in securities that are not traded on exchanges or Nasdaq, such as limited partnerships and certain derivatives.

[69] *See supra* notes 57 to 60 and accompanying text.

[70] Firm prices for securities, whether such firm prices are labeled as ''orders,'' ''quotes,'' or otherwise, could be included in the public quotation system. Priced orders entered into alternative trading systems where the orders are widely disseminated and executable could be viewed as the functional equivalent of quotations, and like quotations, would play a key role in the price discovery process. *See also* Order Handling Rules Adopting Release, *supra* note 57, at 116.

Because SRO surveillance currently focuses primarily on trading in securities listed or approved for trading on the market operated by that SRO, activity on systems trading other securities (particularly non-equity securities) may not receive adequate surveillance for fraud and market manipulation.

Finally, although a broker-dealer is generally obligated to report a trade executed on an alternative trading system to its SRO,[71] the SRO does not receive a composite picture of orders available on that alternative trading system on a real-time basis. Consequently, the SRO is not able to integrate the activity on an alternative trading system into its information about activity in that security on its own market.

For these reasons, if alternative trading systems continue to be regulated as broker-dealers, it may be appropriate to require such systems to provide their SRO, on an automated basis, with real-time information about trading on the systems (including, where appropriate, parties to a trade), in order to enable the SRO to improve its surveillance of such trading. The Commission notes that the identities of the counterparties to a trade would not be made publicly available, but would be provided solely to the market surveillance department of an SRO. In addition, in order for SROs to incorporate the trading on alternative trading systems into their real-time surveillance programs, SROs would have to understand in much greater detail than they do today the manner in which prices are established on alternative trading systems. This would probably require SROs, for example, to examine the trading algorithms, including the programming code, of alternative trading systems. Alternative trading systems would also have to notify SROs of changes to their system. Further, because alternative trading systems that trade non-NMS securities are not currently included within SROs' primary surveillance programs, SROs may have to broaden the scope of their surveillance activities to include more active surveillance of trading in securities not listed or quoted on the market operated by the SRO.

Under this approach, the surveilling SRO would integrate the additional data provided by the alternative trading systems into the SRO's audit trail and real-time surveillance function. The SROs could use this data to enhance their ongoing, real-time surveillance of these alternative systems by developing specifically tailored surveillance and examination procedures to detect fraud and manipulation on particular systems and among systems.

Question 18: Should the Commission require alternative trading systems to provide additional information (such as identifying counterparties) to their SRO in order to enhance the SRO's audit trail and surveillance capabilities?

Question 19: What other methods could the Commission use to enhance market surveillance of activities on alternative trading systems?

Question 20: Should SROs be required to surveil trading by their members in securities that are not listed or quoted on the market operated by that SRO?

3. Ensuring Adequate Capacity of Alternative Trading Systems

As alternative trading systems play an increasingly important role in the securities markets, their ability to continue to operate during periods of high volume or volatility becomes critical. Existing standards regarding the review of the capacities and other operational requirements of markets could apply to alternative trading systems if they continue to be regulated as broker-dealers.[72]

The Commission currently receives limited information regarding the operational procedures of alternative trading systems under Rule 17a–23.[73] Although that Rule requires system operators to provide the Commission with a brief description of their trading systems, including significant systems changes and procedures for reviewing systems capacity, security, and contingency planning, it does not require alternative trading systems to adopt such procedures. The Commission in the past has issued guidance to SROs on developing and implementing policies for assessing the capacity, security, and contingency planning of their systems.[74] To ensure that alternative trading systems have adequate capacity for order execution and other services they provide, the Commission could consider whether broker-dealers that operate such systems should be required to follow similar guidelines. For example, alternative trading systems could be required to arrange for independent systems reviews, including an assessment of anticipated capacity requirements, contingency protocols, and processes for preventing, detecting, and controlling threats to their systems. In addition, alternative trading systems could be required to report significant systems outages to the Commission and their SRO on a real-time basis.

Question 21: Should alternative trading systems be required to follow guidelines regarding the capacity and integrity of their systems? If not, how should the Commission address systemic risk concerns associated with potentially inadequate capacity of alternative trading systems, particularly those systems with significant volume?

Question 22: With what types of standards regarding computer security, capacity, and auditing of systems, should alternative trading systems be required to comply?

Question 23: To what extent would complying with systems guidelines similar to those implemented by exchanges and other SROs require modification to the current procedures of alternative trading systems? What costs would be associated with such modifications? How much time would be required to implement the necessary modifications and systems enhancements? Please provide a basis for these estimates.

4. Potential Problems with Regulating Alternative Trading Systems Under the Broker-Dealer Regulatory Scheme

Although broker-dealer regulation provides a framework for integrating alternative trading systems into the most significant aspects of the NMS, such an

[71] *See, e.g.,* NASD Manual Rules 4630–32.

[72] In particular, the Commission is considering adopting certain additional procedures, pursuant to section 15(b)(7) of the Act, 15 U.S.C. 78*o*(b)(7), to ensure that alternative trading systems have adequate facilities and operational capabilities for the services they provide.

[73] *See* Item 5, Part I of Form 17A–23, 17 CFR 249.636.

[74] *See* Securities Exchange Act Release No. 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991); Securities Exchange Act Release No. 27445 (Nov. 16, 1989), 54 FR 48703 (Nov. 24, 1989). These releases encourage SROs to establish comprehensive planning and assessment programs that accomplish three objectives: (1) Each SRO should establish current and future capacity estimates; (2) each SRO should conduct capacity stress tests periodically; and (3) each SRO should obtain an annual independent assessment of whether the affected systems can perform adequately in light of estimated capacity levels and possible threats to the systems. An ''independent review'' might be performed by any qualified party that has the organizational status and objectivity such that it operates separately from and is not controlled by the SRO's technology staff. The Commission recommended that these independent reviews evaluate the following areas: computer operations; telecommunications; systems development methodology; capacity planning and testing; and contingency planning. The Commission also presented the SROs with guidelines for additional means for providing the Commission with information regarding automation developments or enhancements and system outages, specifically: (1) Annual reports through which SRO technical staff would describe for Division staff the current automated system operations and planned changes; (2) SRO notification of the Division of significant changes to automated systems; and (3) real-time notification of significant interruptions of service in SRO automated trading systems.

approach may not address certain of the regulatory gaps discussed above in Section II. First, the broker-dealer approach may not ensure the fair treatment of investors by alternative trading systems. Second, as broker-dealers, these systems would continue to be required to comply with regulations designed for more traditional brokerage activities. For example, the operators of alternative trading systems would be subject to oversight and heightened surveillance by SROs, which may operate competing trading systems. Third, alternative trading systems, even those with a significant share of trading volume, would not be subject to provisions designed to address anticompetitive activities.

a. Alternative Trading Systems Would Not Be Subject to Requirements Designed to Assure Fair Treatment of Investors

In contrast to national securities exchanges, no regulatory redress exists for unreasonably discriminatory action taken by a broker-dealer operating an alternative trading system against a system participant or an applicant.[75] As discussed above,[76] the ability of these systems to unreasonably discriminate can have adverse ramifications for market participants. For example, if a significant percentage of institutional orders are entered into an alternative trading system, broker-dealers denied access to that system would lose the opportunity to interact with that institutional trading interest. They may also be denied the opportunity to display customer limit orders in a forum where they are most likely to be executed. Similarly, an alternative trading system that trades illiquid securities, such as limited partnerships or real estate derivatives, may provide the only efficient means of locating counterparties with which to trade in those securities. Investors denied access to such a system may have limited opportunity to trade those securities, particularly if other participants in the market primarily trade those securities through the alternative trading system.

Fair treatment of potential and actual participants becomes more important as alternative trading systems capture a larger percentage of overall trading volume and display consistently superior prices, particularly if there are no viable alternatives to trading on such systems. The importance of fair treatment by such systems is heightened during periods of significant market activity. Broker-dealer regulation may not provide meaningful redress for unfairly discriminatory acts taken by the operators of these systems. Even if the Commission were to require reporting of denials of access to a system or its services, investors might continue to be without regulatory redress for discriminatory actions.

Question 24: Is access to alternative trading systems an important goal that the Commission should consider in regulating such systems? If so, are there circumstances in which alternative trading systems should be able to limit access to their systems (for example, should the Commission be concerned about access to an alternative trading system that has arranged for its quotes to be displayed as part of the public quotation system)?

Question 25: If alternative trading systems were to continue to be regulated as broker-dealers and were subject to a fair access requirement, should the Commission consider denial of access claims brought by participants and non-participants in alternative trading systems? If not, are there other methods that could adequately address such claims?

Question 26: Are commenters aware of any unfair denials of access by broker-dealers operating alternative trading systems, where there were no alternative trading venues available to the entities denied access?

b. Broker-Dealers that Operate Alternative Trading Systems Will Still Be Required to Comply with Potentially Inapplicable Regulation and Be Subject to Oversight by SROs

Alternative trading systems are currently required to comply with regulation intended for traditional broker-dealer activities (*e.g.*, recommending investment strategies and holding customer funds and securities).[77] Moreover, they are subject to surveillance by SROs that operate their own trading systems that may compete with alternative trading systems. In the past, broker-dealers that operated alternative trading systems have been reluctant to comply with SRO requests for compliance data because of their concern that the SRO will use this confidential business data for purposes unrelated to regulatory oversight.

The broker-dealer approach described above contemplates enhancement of SRO oversight to integrate these systems into the mechanisms of the NMS, provide for adequate market surveillance of trading activity on these systems, and prevent fraud and manipulation. SROs may have concerns about the resources that would have to be dedicated to enhance surveillance of alternative trading systems. In addition, alternative trading systems may object to surveillance by the regulatory arm of those entities with which they compete for order flow. For example, alternative trading systems may be reluctant to fully disclose information about the operation of their trading systems to SROs that operate competing markets. Strict separation of market and regulatory functions within an SRO (which some SROs have already undertaken) may help alleviate concerns over whether information provided to the regulatory arm of an SRO could be used for competitive purposes.

It may be more desirable for alternative trading systems to be surveilled by an SRO not under the control of an entity that also operates a competing market. For example, under Section 15A of the Exchange Act, an association of brokers and dealers could establish an SRO that does not operate a market. Such an SRO could be established solely for purposes of overseeing the activities of unaffiliated markets. The Commission seeks comment on the advisability and feasibility of such an approach.

Question 27: Would enhanced surveillance of alternative trading systems by their SROs raise competitive concerns that could not be addressed through separation of the market and regulatory functions of the SROs?

Question 28: If alternative trading systems continue to be regulated as broker-dealers, are there other ways to integrate the surveillance of trading on alternative trading systems?

Question 29: What is the feasibility of establishing an SRO solely for the purpose of surveilling the trading activities of broker-dealer operated alternative trading systems, that does not also operate a competing market?

c. Alternative Trading Systems Will Be Free to Engage in Anticompetitive Activities

Broker-dealer regulation is not designed to address anticompetitive activities. If a traditional broker-dealer acts in an anticompetitive manner, investors and other market participants always have the option of dealing with another broker-dealer. If an alternative trading system operated by a broker-dealer captures a large market share and is a major forum for price discovery in a particular security, however, other

[75] Rule 17a–23 requires a sponsor of a broker-dealer trading system to provide the Commission with a description of the sponsor's criteria for granting access to the system. The Rule does not directly require meaningful disclosure of the underlying reasons for particular denials of access.

[76] *See supra* Section II.B.2.a.

[77] *See supra* Section II.B.1.

trading venues may not be comparable. As a result, anticompetitive activities by that system may have significant effects on investors and other markets.[78]

Because broker-dealers, unlike SROs, are not subject to non-discriminatory standards for access or fees, or prevented under the Exchange Act from using their market position to impose anticompetitive conditions, alternative trading systems that are regulated as broker-dealers would not be restricted from engaging in anticompetitive activities that have a negative impact on investors and other markets.[79]

Question 30: If alternative trading systems continue to be regulated as broker-dealers, how can the Commission address anticompetitive practices by such systems?

5. Conclusion

The approach to regulating alternative trading systems discussed above, which would continue to regulate alternative trading systems as broker-dealers, appears to address some of the Commission's concerns regarding transparency, surveillance, and capacity of alternative trading systems, while balancing business needs of the alternative trading systems. In addition, regulation of the operators of alternative trading systems as broker-dealers has in the past been supported by sponsors of such systems as an appropriate way to regulate, and as a means of fostering the development of, these systems.[80] Similarly, some SROs have expressed their support for basing the regulation of alternative trading systems on the regulation of their sponsors as broker-dealers.[81]

Question 31: Would this approach be an effective means of addressing the issues raised by the growth of alternative trading systems? What would be the benefits of such an approach? What would be the drawbacks of such an approach?

B. Integrating Alternative Trading Systems into Market Regulation Through Exchange Regulation

As discussed above, regulation of alternative trading systems as broker-dealers may not address all of the issues raised by the activities of such systems. A second approach might integrate such systems more fully into market regulation: Rather than continuing to regulate alternative trading systems as broker-dealers, the Commission could use the exemptive authority granted under the 1996 Amendments[82] to explore new approaches to the regulation of exchanges.[83] In particular, under this approach, the interpretation of the term ''exchange'' could be broadened to include *any organization that both: (1) Consolidates orders of multiple parties; and (2) provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of a trade.* This expanded interpretation would significantly broaden the entities that are considered to be exchanges to include currently registered exchanges, certain broker-dealer trading systems (including matching and crossing systems), currently exempted exchanges, certain dealer markets, and other alternative trading systems. For example, this interpretation would capture systems such as Instinet, Tradebook, Island, and Terra Nova's Archipelago system, that operate as electronic limit order books, allowing participants to display buy and sell offers in particular securities and to obtain execution against matching offers contemporaneously entered or stored in the system. In addition, systems that consolidate orders internally for crossing or matching with display to participants such as POSIT, and organized dealer markets (unless operated by a registered securities association) that consolidate orders and set material conditions under which orders can be executed, would also be encompassed by such an interpretation. While interdealer brokers in municipal and government securities could be exempted from any revised interpretation of ''exchange,'' fully automated interdealer brokers would be covered by this interpretation.[84] Any such reinterpretation of ''exchange'' presumably would not be intended to include customary brokerage activities or the activities of information vendors.

The Commission could then use its exemptive authority under section 36 of the Exchange Act[85], as described below, to create a new category of exchanges that are exempt from most statutory exchange registration requirements and are subject only to limited obligations designed to address specific concerns related to their market activities. More significant alternative trading systems could be integrated into the exchange regulatory scheme, with exemptions for such systems from those exchange requirements that are unnecessary or inappropriate for proprietary, automated systems.

At the same time, this type of an approach could potentially open the door for competing exchanges to use national market systems as a vehicle to inhibit innovation by alternative trading systems. For example, it is possible that existing exchanges could try to use participation in joint national market system mechanisms to set marketwide operational standards (as conditions of participation in the national market system plans) that have the effect of inhibiting innovation by alternative

[78] For example, following adoption of the 1975 Amendments, the Commission reviewed SRO rules to confirm that they were in compliance with the Exchange Act as amended. Among other things, the Commission identified several rules that it considered to be anticompetitive in violation of the Exchange Act, such as rules that restricted the types of entities with which their members could trade. *See* Securities Exchange Act Release No. 13027 (Dec. 1, 1976), 41 FR 53557 (Dec. 7, 1976).

[79] Exchange regulation addresses potentially anticompetitive activities through the Commission's oversight of SROs and through the rule filing process. For example, a primary registered market could institute an after-hours trading halt for purposes of news dissemination, but fail to remove that halt until the re-opening of its own facilities the following trading day, even if sufficient time has passed to permit the dissemination of the news. In that situation, the Commission could act to ensure that the registered market was not instituting a trading halt to prevent competitors from engaging in after-hours trading in its securities.

[80] *See, e.g.,* Letter from Daniel T. Brooks, Cadwalader, Wickersham & Taft (counsel to Instinet), to Jonathan G. Katz, SEC (Aug. 2, 1989) at 29 (''When properly analyzed * * * market structure concerns dictate that Instinet be regulated as a broker.'')

[81] *See, e.g.,* Memorandum accompanying Letter from James E. Buck, Senior V.P., NYSE, to Jonathan Katz, SEC (Aug. 2, 1989) at 2 (stating that a rule based approach to regulating alternative trading systems ''strikes a near optimal balance. It represents a significant improvement over the 'no-action' approach, and is significantly superior to the 'no-filing' approach, in retaining minimal regulatory 'costs' and yet maximizing the benefit to the markets.'').

[82] *See supra* note 68.

[83] In adopting the general exemptive authority included in the 1996 Amendments, the Report of the Senate Committee on Banking, Housing and Urban Affairs made specific reference to alternative trading systems: ''The Committee recognizes that the rapidly changing marketplace dictates that effective regulation requires a certain amount of flexibility. Accordingly, the bill grants the SEC general exemptive authority under both the Securities Act and the Securities Exchange Act. This exemptive authority will allow the Commission the flexibility to explore and adopt new approaches to registration and disclosure. It will also enable the Commission to address issues related to the securities market more generally. For example, the SEC could deal with the regulatory concerns raised by the recent proliferation of electronic trading systems, which do not fit neatly into the existing regulatory framework.'' S. Rep. No. 293, 104th Cong., 2d Sess. 15 (1996).

[84] A more detailed discussion of the effects of a revised interpretation of ''exchange'' is provided in Section IV.B.3 *infra.*

[85] *See supra* note 68 for a discussion of the Commission's exemptive authority under Section 36 of the Exchange Act.

trading systems.[86] As discussed below,[87] the Commission would anticipate working with existing exchanges and Nasdaq to integrate alternative trading systems into the national market system without stifling their innovation.

Question 32: If the Commission reinterpreted the term ''exchange,'' are the factors described above (*i.e.*, (1) consolidating orders of multiple parties and (2) providing a facility through which, or setting conditions under which, participants entering such orders may agree to the terms of a trade) sufficient to include the alternative trading systems described above?

Question 33: Is broadening the Commission's interpretation of ''exchange'' to cover diverse markets, and then exempting all but the most significant of these new exchanges from registration, the most appropriate way to address the regulatory gaps discussed above and provide the Commission with sufficient flexibility to oversee changing market structures?

1. Creating a New Category Called ''Exempted Exchanges'' for Smaller and Passive Alternative Trading Systems

The Commission could create a new tier of exchange regulation for most alternative trading systems by expanding its interpretation of the term ''exchange,'' as discussed in greater detail in Section IV.B.3. below, and by exempting from registration alternative trading systems that, although captured within a broader interpretation of ''exchange,'' do not need to be subject to full exchange regulation (''exempted exchanges''). The Commission could then establish limited and narrowly tailored requirements for these exempted exchanges. Regulation as exempted exchanges could be appropriate for two types of alternative trading systems: (1) Systems that are small, start-up entities; and (2) systems that match or cross orders at a price that is primarily or wholly derived from trading on another market (''passive markets''). To the extent that these types of alternative trading systems have a sufficiently low impact on the market or do not establish the price of securities, they should have an insignificant effect on the market as a whole, which would not warrant exchange regulation.[88] At this time, all except the most significant alternative trading systems would appear to fall within one of these two categories.

These exempted exchanges could then be subject to limited requirements that are more appropriate than current broker-dealer regulation for the market activities of such systems, as discussed in Section IV.B.1.c. below. This approach also could address concerns regarding system capacity, confidentiality, integrity, and would clarify the regulatory treatment of alternative trading systems that fall within such a structure. Moreover, treating smaller alternative trading systems and systems with passive pricing mechanisms as exempted exchanges would provide an environment conducive to innovation, which could, in turn, reduce the cost of experimenting with innovative trading techniques.

Question 34: Are there any other categories of alternative trading systems that have sufficiently minimal effects on the public secondary market that they should be treated as exempted exchanges?

a. Low Impact Markets

Small alternative trading systems could be regulated as exempted exchanges under this approach. If the Commission expands its interpretation of ''exchange'' to include alternative trading systems, it would be able to exempt small markets from all exchange registration requirements under either Section 5 or section 36 of the Exchange Act.

Under section 5 of the Exchange Act, the Commission has the authority to exempt any exchange with a limited volume of transactions from registration as a national securities exchange, provided that it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require registration.[89] As noted in the Commission's 1991 order granting an exemption to AZX under this provision, the Exchange Act does not provide specific guidance as to the standard to use in determining whether an exchange has a limited volume of transactions. In considering the limited volume test, the Commission looked to anticipated transaction volume on AZX and compared this to the transaction volume of fully regulated national securities exchanges.[90] While the Commission's AZX order provides useful guidance, the Commission also is considering other ways of assessing whether an exchange has a limited impact on the overall market. In many circumstances, the impact that a particular volume has on the market will depend upon a number of factors, including the size and liquidity of the market for the type of security traded. For example, the Commission could use its authority under the 1996 Amendments to exempt small exchanges based on a market's limited share of the relevant market as a whole, rather than the number of its transactions. Similarly, the Commission could base an exemption determination on the dollar value of transactions effected on an exchange, or on other factors.

While an exemption would allow a new market to develop without unnecessary and costly regulatory burdens, if that market achieved a greater market presence, its exemption would no longer apply. Once a market has attained more than a significant level of business, such that it no longer can be considered to have a low impact on the securities market, it would no longer be eligible for treatment as an exempted exchange. Instead, it would be required to register as a national securities exchange and be subject to greater regulatory responsibilities and oversight. In order to give exempted exchanges that attain significant volume sufficient time to prepare for registration as a national securities exchange, it might be appropriate to allow exempted exchanges to delay registration as an exchange for up to one year after they consistently attain more than *de minimis* volume. Treatment of low impact markets as exempted exchanges could also allow existing exchanges that consistently fall below minimum volume levels for an extended period of time to deregister and instead comply with any requirements applicable to exempted exchanges.

Question 35: Should low impact markets be regulated as exempted exchanges, rather than as broker-dealers?

[86] For example, as discussed below, national securities exchanges participate in national market systems plans, which are jointly drafted and operated, and the terms of these plans must be approved by all of the markets that are plan participants. *See infra* Section IV.B.4. By specifying operational requirements that each exchange must meet in order to participate in the national market system mechanisms, these plans can have the effect of setting marketwide standards. As a result, these plans could be used to require newly registered exchanges to comply with particular trading increments, reporting methods, and fee arrangements, for example.

[87] *See infra* notes 163 to 169 and accompanying text.

[88] The integration of trading on exempted exchanges with public trade and quote reporting mechanisms could be accomplished by continuing to require broker-dealer participants in exempted exchanges to report trades to the primary market on which a security trades and to comply with the Commission's rules. Similarly, as a condition of exemption, these exchanges could be required to report trades between non-SRO member participants to an SRO designated by the Commission.

[89] 15 U.S.C. 78(e). In 1991, the Commission used this authority to exempt AZX from the requirement to register as an exchange. *See* AZX Exemptive Order, *supra* note 24.

[90] *Id.*

Question 36: What measure or measures should be used in determining whether a market has a low impact? What is the level above which an alternative trading system should not be considered to have a low impact on the market? At what level should an already registered exchange be able to deregister?

Question 37: Should an alternative trading system be considered to have a low impact on the market and be treated as an exempted exchange if it trades a significant portion of the volume of one security, even if the trading system's overall volume is low in comparison to the market as a whole?

Question 38: In determining whether an alternative trading system has a low impact, what factors other than volume should the Commission consider? Should this determination be affected if the operator of an alternative trading system was the issuer of securities traded on that system?

b. Passive Markets

The Commission also could treat passive markets as exempted exchanges. Passive markets are alternative trading systems that match or cross orders at a price that is primarily or wholly derived from trading on another market. For example, the POSIT system allows participants to enter unpriced orders, which other participants cannot view, and periodically crosses the orders. Any orders that match other trading interest in this periodic cross are executed at the mid-point of the bid/ask spread on the primary market for the security. Like traditional exchanges, these systems centralize orders and set the conditions under which participants agree to trade. Unlike active pricing markets, however, passive pricing systems do not establish the price at which securities trade on the system through the interaction of priced orders of sellers with priced orders of buyers, or through participant dissemination of quotes.

Question 39: Should passive markets be regulated as exempted exchanges, rather than as broker-dealers?

c. Requirements for Exempted Exchanges

As a general matter, regardless of their regulatory status, markets should comply with certain minimum requirements designed to clarify their obligations as markets and to prevent harm to investors or overall market integrity.[91] These requirements could be less burdensome than the broker-dealer regulation to which these markets are currently subject. This would continue to encourage the robust development of U.S. markets. In cases in which alternative trading systems do not also conduct customary brokerage activities, these conditions could replace the broker-dealer regulation to which alternative trading systems are now subject.[92]

Specifically, alternative trading systems seeking an exemption from exchange registration could file an application for exemption (including a system description) with the Commission prior to operation. The Commission could establish a time period in which an alternative trading system's application would automatically become effective, unless disapproved by the Commission. Under this procedure, disapproval of a system's exemptive application would probably be rare and limited to specific circumstances, such as where a controlling person of the system is subject to a statutory disqualification or where the system fails to meet one of the requirements to be an exempted exchange. In addition to an initial application, an exempted exchange could also be required to: (1) Notify the Commission in the event of a material change in operations or control; (2) maintain a record of trading through the system and make such information available to the Commission upon request; (3) implement procedures for surveillance of employees' trading comparable to those adopted by existing SROs to ensure that employees do not misuse confidential customer information for insider or manipulative trading; (4) cooperate with registered SRO investigations and examinations of the exempted exchange's participants; (5) report trades to one or more designated SROs, unless a trade is reported by a trade participant pursuant to its SRO membership obligations; and (6) require participants to make adequate clearance and settlement arrangements prior to participation in trading on the exempted exchange.[93]

Question 40: Are the requirements described above appropriate to ensure the integrity of secondary market oversight?

Question 41: Should any other requirements be imposed upon exempted exchanges, such as requirements that an exempted exchange provide fair access or establish procedures to ensure adequate system capacity, integrity, and confidentiality?

Question 42: Should requirements vary with the type of alternative trading system (*e.g.*, should passive systems be subject to different conditions than systems exempted on the basis of low impact)?

Question 43: Should the Commission require that securities traded on exempted exchanges be registered under section 12 of the Exchange Act? Should different disclosure standards be applicable to such securities if they are only traded on such exchanges?

2. The Application of Exchange Regulation to Alternative Trading Systems That Are Not Exempted Exchanges

If the term ''exchange'' is expanded to include alternative trading systems, alternative trading systems that have active pricing mechanisms and significant volume could be required to register as national securities exchanges.

In the past, the Commission avoided requiring alternative trading systems to register as exchanges because it had limited authority to tailor exchange regulation to diverse market structures and because the volume and number of alternative trading systems was relatively small.[94] In particular, prior to the adoption of the 1996 Amendments, the Commission had limited authority to reduce or eliminate the consequences of exchange registration for innovative systems.[95] In light of these limitations,

[91] The only currently exempted exchange, AZX, is subject to a number of exemption conditions. Among other things, it is required to provide the Commission with regular activity reports, adopt and implement procedures to surveil for potential insider trading or manipulative abuses by participants, and cooperate with the registered SROs. *See* AZX Exemptive Order, *supra* note 24, 56 FR at 8383.

[92] Based on the information that the Commission currently has regarding the activities of alternative trading systems, it believes that only a few of the systems that would be exempted exchanges also conduct customary brokerage functions. Regulation of broker-dealer activities and market activities being conducted by the same alternative trading system could be integrated. *See infra* Section IV.B.4.d.

[93] 15 U.S.C. 78*l*.

[94] Throughout the past 60 years, the Commission has attempted to accommodate market innovations within the existing statutory framework to the extent possible in light of investor protection concerns, without imposing regulation that would stifle or threaten the commercial viability of such innovations. For example, at various times prior to 1991, the Commission considered the implications of evolving market conditions on exchange regulation. *See* Securities Exchange Act Release No. 8661 (Aug. 4, 1969), 34 FR 12952 (initially proposing Rule 15c2–10); Securities Exchange Act Release No. 11673 (Sep. 23, 1975), 40 FR 45422 (withdrawing then-proposed Rule 15c2–10 and providing for registration of securities information processors); Securities Exchange Act Release No. 26708 (Apr. 13, 1989), 54 FR 15429 (reproposing Rule 15c2–10); and Securities Exchange Act Release No. 33621 (Feb. 14, 1994), 59 FR 8379 (withdrawing proposed Rule 15c2–10).

[95] Prior to adoption of the 1996 Amendments, the Commission's authority under the Exchange Act to reduce or eliminate negative consequences of

Continued

the Commission believed that regulating alternative trading systems as exchanges would stifle the development of such systems.

The 1996 Amendments, however, provide the Commission with considerable authority to exempt markets from provisions of the Exchange Act. Given this expanded authority, the Commission's past concerns that classification as an exchange would stifle innovation may no longer outweigh competing concerns regarding the need to establish a consistent, long-term approach to the regulation of alternative trading systems and to better integrate the most significant of these systems into the NMS.

a. Using the Commission's Exemptive Authority To Encourage Innovation and To Eliminate Barriers to Non-Traditional Exchanges

Alternative trading systems encompassed by a revised interpretation of the term ''exchange'' and not eligible for treatment as an exempted exchange could be subject to fundamental statutory requirements applicable to national securities exchanges, in order to ensure that the goals of market regulation are met. These non-traditional exchanges could be required, for example, to file an application for registration,[96] be organized and have the capacity to carry out the purposes of, and comply and enforce compliance with, the Exchange Act, the rules thereunder, and their own rules. These non-traditional exchanges may also need to ensure that they have rules designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to refrain from imposing any unnecessary or inappropriate burden on competition. In addition, they could be required to assure regulatory oversight of their participants, participate in national market systems, and take the public interest into account in administering their markets.

The Commission recognizes that these responsibilities would have significant consequences for non-traditional markets. For example, imposing SRO oversight obligations on existing proprietary systems would change the relationship between such systems and their participants significantly, and could raise transaction costs for participants. Alternative trading systems have adopted different corporate structures than the traditional non-profit, membership exchanges and generally have entered into primarily commercial relationships with their participants.[97] While expanding the common understanding of how exchanges operate and the functions that they perform, these developing market structures do not fit easily into the current regulatory scheme, which has been designed and applied primarily to non-profit, membership exchanges.

Prior to adoption of the 1996 Amendments, it was difficult to reconcile the private, commercial structure of these markets with the membership structure and public obligations traditionally assigned to national securities exchanges under the Exchange Act. For example, one reason the Commission has been hesitant to adopt an expansive interpretation of the term ''exchange'' is that it would impose a participant-controlled board of directors on these markets.[98] Applying exchange regulation to new markets could dictate their structure and could prevent them from adopting innovative means of carrying out exchange obligations.

There does not appear to be an overriding regulatory reason to require markets to adopt homogenous structures. To the contrary, Congress clearly intended the 1975 Amendments to encourage innovation by exchanges and recognized that future exchanges may adopt diverse structures.[99] Accordingly, the Commission could use its exemptive authority to relieve alternative markets from requirements it does not believe are critical to achieving the objectives of the Exchange Act. In particular, the Commission could permit institutions to access registered exchange facilities directly. In addition, the Commission could consider ways in which exchanges that are not participant-owned can meet fair representation requirements.

(i) The Commission Could Consider Permitting Institutional Access to Exchanges

Without exemptive relief, exchange registration would prevent alternative trading systems from serving their institutional customers. Historically, exchange members were individuals (and broker-dealers and other organizations affiliated with those individuals) that traded directly on the exchange floor and had an ownership interest in the exchange.[100] In keeping with this structure, many requirements applicable to registered exchanges pertain to their relationship with their ''members.'' [101] In addition, in order to

exchange registration was limited. For example, the Commission could only exempt an exchange from registration if the exchange had limited transaction volume. *See* Exchange Act section 5, 15 U.S.C. 78e. Once an exchange was registered, the Commission only had authority to exempt an exchange from a limited number of requirements relating to an exchange's obligations as an SRO. Although the Commission has authority under various sections of the Exchange Act (including Sections 17 and 19) to exempt a registered exchange from specific provisions, its exemptive authority under these sections relates only to an exchange's obligations as an SRO to oversee its members. These sections do not give the Commission flexibility with respect to other requirements, such as the obligation of an exchange to file rule changes with the Commission for approval. The Exchange Act also did not give the Commission the flexibility or authority to tailor regulation to reflect technological and economic differences among markets. For example, although Congress gave the Commission greater flexibility to address rapidly changing market and technological conditions when it added Section 11A to the Exchange Act in the 1975 Amendments, that section does not provide the Commission with authority to reduce or eliminate existing exchange requirements for innovative trading structures. S. Rep. No. 75, *supra* note 23, at 3.

[96] Pursuant to Section 19(a)(1) of the Exchange Act, when an applicant submits an application to register as a national securities exchange under section 6 of the Exchange Act, the Commission must publish a notice of the filing and within ninety days must either grant the registration or institute proceedings to determine whether the registration should be denied. Proceedings for a denial of registration must be concluded within one hundred eighty days, with an extension period available of up to another ninety days. 15 U.S.C. 78s(a)(1).

[97] This effect has not been limited to U.S. alternative trading systems. In the seven years since the Delta Decision, *see infra* note 124, a growing number of stock exchanges throughout the world have adopted fully automated structures similar to those of alternative trading systems and appear to conduct trading without a specialist or market maker structure. The Commission determined in the Delta Release, *see infra* note 121, that the definition of the term exchange in section 3(a)(1) of the Exchange Act requires the Commission to view an entity as an exchange *only if*, in ''bringing together purchasers and sellers,'' the entity performs the functions commonly understood to be performed by exchanges. This reading is based on the view that the words ''bringing together purchasers and sellers'' in the definition cannot be read in a vacuum, but must be read in the context of how exchanges commonly operate. At the time that the Delta Release was issued, few exchanges had adopted structures similar to alternative trading systems.

[98] *See* Delta Release, *infra* note 121, at 1900. The court in the Delta Decision stated that: ''The Delta system cannot register as an exchange because the statute requires that an exchange be controlled by its participants, who in turn must be registered brokers or individuals associated with such brokers. So all the financial institutions that trade through the Delta system would have to register as brokers, and [the system sponsors] would have to turn over the ownership and control of the system to the institutions. The system would be kaput.'' Delta Decision, *infra* note 124, at 1272–73.

[99] *See* S. Rep. No. 75, *supra* note 22, at 7–9.

[100] *See* Special Study, *supra* note 4, at 11–13.

[101] The Exchange Act defines an exchange 'member' as: ''The term ''member'' when used with respect to a national securities exchange means (i) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker, (ii) any registered broker or dealer with which such a natural person is associated, (iii) any registered broker or dealer permitted to designate as a

give the Commission adequate authority over persons trading on exchanges under section 6(c)(1) of the Exchange Act, Congress prohibited exchanges from granting membership to any person that is not, or is not associated with, a registered broker-dealer.[102] Taken together, these statutory provisions have traditionally been interpreted to mean that all persons trading on an exchange would be members of that exchange, and would be registered as, or associated with, broker-dealers.[103]

Alternative trading systems do not fit neatly into this structure for several reasons. Unlike traditional exchanges that restrict membership to broker-dealers, most alternative trading systems give comparable access and trading privileges to both institutions and broker-dealers.[104] If all entities that have access to an alternative trading system are treated as ''members'' under the Exchange Act, section 6(c)(1) would prevent these systems from continuing to provide direct access to their institutional participants. On the other hand, if institutional entities that have access to an alternative trading system are not treated as members, the system's statutory obligations that pertain expressly to its ''members'' under the Exchange Act would not apply to those institutions, and provisions of the Exchange Act that apply primarily to exchange members, such as prohibitions regarding the trading of unlisted securities under section 12, would no longer apply to all participants on an exchange. This could result in neither the Commission nor the market having sufficient authority to enforce trading rules against those participants. It could also lessen the effectiveness of oversight of trading on those markets. In either case, if such systems were registered as exchanges, the statute's reliance on the term ''member'' and the prohibition against exchange members that are not affiliated with a broker-dealer would make it difficult for alternative trading systems to continue meeting the trading needs of institutional investors. The Commission also notes that, as markets evolve, exchanges may ultimately wish to not only allow institutions to access their trading facilities along with broker-dealers, they may wish to provide trading facilities exclusively to institutions or other non-broker-dealer participants (such as retail investors).

There is no direct evidence that Congress intended these provisions to prohibit institutional investors from accessing the facilities of an exchange. On the contrary, in the course of adopting the 1975 Amendments, Congress saw no overriding regulatory reason to prohibit non-broker-dealers from obtaining direct access to the execution facilities of exchanges.[105] There also does not appear to be a regulatory need to require entities to register as broker-dealers in order to obtain direct access to exchanges.[106] Because institutions primarily trade for their own account, do not execute orders for unaffiliated customers, and do not undertake to maintain orderly markets for the exchange, institutional trading on an exchange does not necessarily raise the type of concerns that broker-dealer regulation was designed to address.[107]

Congress did, however, provide the Commission and exchanges with sufficient authority in such circumstances to oversee the trading of non-members on exchanges. Section 6(f) of the Exchange Act authorizes the Commission to require any non-member that is effecting transactions on an exchange without the services of another person acting as broker to comply with the rules of such exchange.[108] In addition, any person required by the Commission to comply with an exchange's rules pursuant to section 6(f) would be deemed a ''member'' of such exchange for most relevant provisions of the Exchange Act.[109] Congress therefore envisioned

representative such a natural person, and (iv) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of this title, the rules and regulations thereunder, and its own rules.'' 15 U.S.C. 78c(a)(3)(A). The Commission notes that this definition does not require an entity to participate in the ownership of an exchange in order to be considered a statutory ''member'' of that exchange.

[102] Section 6(c)(1), 15 U.S.C. 78f(c)(1), prohibits exchanges from granting new memberships to non-broker-dealers. At the time this Section was adopted in 1975, one non-broker-dealer maintained membership on an exchange. This non-broker-dealer was not affected by the prohibition and continues to maintain its membership. Section 15(e) of the Exchange Act, 15 U.S.C. 78*o*(e), gives the Commission authority to require any member of a registered exchange that is not required to register with the Commission as a broker-dealer to comply with any provision of the Exchange Act (other than section 15(a)) and rules thereunder that regulate or prohibit any practice by a broker-dealer.

[103] As discussed below, however, despite this prohibition on non-broker-dealer membership in exchanges, Section 6(f) of the Exchange Act, 15 U.S.C. 78f(f), grants the Commission authority to require non-broker-dealers to comply with the rules of the exchange.

[104] Alternative markets also do not have ''members'' as that term has been traditionally understood and interpreted by existing exchanges. In particular, most alternative markets do not give their participants voting rights or other ownership interests. The Commission does not consider a non-profit membership structure to be an inherent requirement for performing the trading functions of an exchange.

[105] In the legislative history of the 1975 Amendments, Congress expressly noted that advances in communication technologies could permit an entity to trade on an exchange without the services of a member acting as a broker, and without itself becoming a member of that exchange. Reports by both the House of Representatives Committee on Interstate and Foreign Commerce and the Senate Committee on Banking, Housing and Urban Affairs noted the potential for technology to permit non-members (both broker-dealers and institutions) to effect transactions on exchanges without the intermediation of a broker. *See* S. Rep. No. 75, *supra* note 22, at 99 (1975) (''The Committee recognizes that it is impossible at this time to define precisely the manner in which investors, particularly large institutional investors will or should have access to execution facilities in a national market system.''); H.R. Rep. No. 123, *supra* note 39, at 66 (''[I]t is conceivable, that the regulatory reach could be extended to investors or money managers who are not themselves brokers or dealers but who have been permitted the means of making direct executions on an exchange'').

[106] *See, e.g.*, Securities Exchange Act Release No. 35030 (Nov. 30, 1994), 59 FR 63141 (Dec. 7, 1994) (order approving Chicago Match, an electronic matching system operated by the CHX, which provided for the crossing of orders entered by CHX members and non-members, including institutional customers).

[107] For example, expanding the Commission's interpretation of what constitutes an exchange to include alternative trading systems with institutional participants could subject such institutions to the constraints of section 11(a) of the Exchange Act. Section 11(a) generally prohibits exchange members from effecting transactions on such exchanges for their own accounts or the accounts of their associated persons, or for their own managed accounts or the managed accounts of their associated persons. 15 U.S.C. 78k(a). Section 11(a) was intended to encourage fair dealing and fair access in the exchange markets by restricting exchange members' proprietary trading, which Congress believed created a conflict between a member's interests as a principal and the member's fiduciary obligations when representing customer trades. Both Congress and the Commission provided exceptions to the rule to accommodate principal trading that does not conflict with the public interest.

Section 11(a) also granted the Commission broad authority to regulate exchange members' trading. Congress explained that it gave the Commission broad authority under section 11(a) for two reasons. First, Congress recognized that it lacked expertise in this area, and thus believed that any doubts should be resolved in favor of maintaining present business practices. Second, Congress wanted the Commission to have sufficient flexibility to accomplish the purposes of the Exchange Act. *See* S. Rep. No. 75, *supra* note 22, at 68.

[108] 15 U.S.C. 78f(f)(1).

[109] Section 3(a)(3)(A) of the Exchange Act provides that: ''For purposes of sections 6(b)(1), 6(b)(4), 6(b)(6), 6(b)(7), 6(d), 17(d), 19(d), 19(e), 19(g), 19(h), and 21 of this title, the term 'member' when used with respect to a national securities exchange also means, to the extent of the rules of the exchange specified by the Commission, any person required by the Commission to comply with such rules pursuant to section 6(f) of this title.'' 15 U.S.C. 78c(a)(3)(A). This would require a registered exchange that permitted institutions to effect transactions without the services of a broker, among other things, to: (1) Enforce compliance by such institutions with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange; (2) allocate equitably its dues, fees, and other charges among its members, issuers, and such institutions; and (3) provide fair procedures for the disciplining of such institutions.

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that it would be possible to allow entities to have electronic access to an exchange without becoming a member, and at the same time, to ensure through section 6(f) that the exchange and the Commission have adequate authority to regulate such electronic access participants.

The development of fully automated markets has revealed an inconsistency in this scheme, however. Both the Commission and Congress have recognized that the ''floor'' of an exchange could include a non-physical trading system operated by such exchange.[110] As a result, any natural person with direct access to an exchange's alternative trading system would appear to be effecting transactions on the ''floor'' of such exchange and, therefore, would be a ''member'' of that exchange under the statute. Despite congressional intent not to unnecessarily restrict non-member access to exchanges under this interpretation, there would appear to be no circumstances in which institutions could electronically access an automated exchange without being considered ''members'' of that exchange.

In order to make it possible for alternative markets to register as exchanges, therefore, congressional intent to allow entities to have access to exchanges without becoming traditional members must be reconciled with the existence of non-physical ''floors.'' Any method of doing so must also ensure that, as Congress intended, exchanges and the Commission have sufficient authority to supervise and oversee all persons accessing an exchange's facilities.

There are at least two ways in which the Commission could achieve this. First, the Commission could interpret the term ''member'' narrowly, to apply only to natural persons who are permitted to effect transactions on a *physical* exchange floor.[111] Under this interpretation, no entity that accesses a fully automated exchange would be deemed a ''member'' of that exchange. In addition, both broker-dealers and institutions could electronically access exchanges that maintain physical floors without being deemed members of those exchanges. With respect to any such non-member participants on an exchange, the Commission could exercise its authority under section 6(f) of the Exchange Act to require the non-member participants of an exchange to comply with that exchange's rules to the extent appropriate. In addition, these non-member participants could be deemed members of such exchanges for certain purposes of the Exchange Act. Depending upon the extent to which the Commission exercised its authority under section 6(f), therefore, there may be little practical difference in an exchange's obligations to surveil traditional members and its obligation to surveil entities that are members by virtue of a Commission order pursuant to section 6(f).[112]

In the alternative, the Commission could interpret the term ''member'' broadly, to apply to any natural persons that are permitted to effect transactions through an exchange's facilities and any persons associated with such natural persons. Under this interpretation, the Commission could then use the exemptive authority granted by the 1996 Amendments to exempt exchanges from the prohibition on non-broker-dealer membership in section 6(c)(1) of the Exchange Act. The Commission could then allow exchanges to revise any rules that would not appropriately apply to non-broker-dealer members. Using this approach, the Commission would not be called upon to exercise its authority under section 6(f).

Question 44: Should the Commission allow institutions to be participants on registered exchanges to the same extent as registered broker-dealers? If so, should the Commission adopt rules allowing registered exchanges to have institutional participants, or should the Commission issue exemptive orders on a case-by-case basis, upon application for relief by registered exchanges?

Question 45: Should the Commission allow exchanges to provide services exclusively to institutions?

Question 46: If the Commission allows institutions to participate in exchange trading, should the Commission view all entities that have electronic access to exchange facilities as ''members'' under the Exchange Act and then exempt exchanges from section 6(c)(1)?

Question 47: Is it foreseeable that exchanges will wish to permit retail investors to be participants in their markets? If so, should the Commission allow retail participation on registered exchanges to the same extent as registered broker-dealers?

Question 48: Should the Commission allow registered exchanges to provide services exclusively to retail investors?

Question 49: Could exchanges have various classes of participants, as long as admission criteria and means of access are applied and allocated fairly? Would it be in the public interest if new or existing exchanges sought to operate primarily or exclusively on a retail basis? What would be the advantages and disadvantages if new or existing exchanges were to admit as participants only highly capitalized institutions or only highly capitalized institutions and broker-dealers?

(ii) The Commission Could Consider Ways in Which Alternative Exchanges Can Meet Fair Representation Requirements

An exchange's obligation to establish fair representation of investors and participants in its decisionmaking process could also significantly affect the structure of proprietary systems. Section 6(b)(3) of the Exchange Act compels an exchange to have rules that: (1) Provide that one or more directors is 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.'' [113] Securities associations have identical fair representation requirements.[114] Because many alternative trading systems are operated as for-profit, non-membership

Exchange Act sections 6(b)(1), (4), (7) and 19(g), 15 U.S.C. 78f(b)(1), (4), (7), and 19(g). Further, an exchange imposing any disciplinary sanction on, denying participation to, or prohibiting or limiting access to any institution would be required to file notice of such action with the Commission. The Commission would have authority to review any such action. Exchange Act sections 19(d) and 19(e), 15 U.S.C. 78s(d) and 78s(e). The Commission would have the same authority to allocate among SROs regulatory responsibilities with respect to institutions effecting transactions on an exchange without the services of a broker as it currently does with respect to exchange members. Exchange Act section 17(d), 15 U.S.C. 78q(d). The Commission would also have the authority to sanction an exchange for failure to enforce compliance with the Exchange Act, the rules thereunder, or the exchange's rules by institutions that were permitted to effect transactions on the exchange, and to commence an investigation under section 21 to determine whether any such institution has violated the Exchange Act. Exchange Act section 21, 15 U.S.C. 78u.

[110] *See* Committee on Interstate and Foreign Commerce Report, H.R. Rep. No. 123, *supra* note 39, at 66 (1975) (''As the market systems make greater use of communications and data processing techniques, the concept of a physical 'floor' of an exchange will disappear. Instead we will have a communications network which will serve as the 'floor' of the future marketplace'').

[111] Persons trading on the physical floor of an exchange, such as floor brokers and specialists, would continue to be ''members'' of that exchange under any construction of the Exchange Act.

[112] In these circumstances, it is not clear how provisions of the Exchange Act that are by their terms applicable only to exchange members or broker-dealers would apply to non-broker-dealers that access exchange facilities. For example, sections 11(a) and 9(b) would not appear to apply directly to non-member participants in exchanges.

[113] Exchange Act section 6(b)(3), 15 U.S.C. 78f(b)(3).

[114] Exchange Act section 15A(b)(4), 15 U.S.C. 78*o*–3(b)(4).

corporations, complying with these representation obligations would potentially change the nature of their operations and relationship with their participants.

With respect to the first requirement, the public's interest in ensuring the fairness and stability of significant markets was of paramount importance to Congress, which adopted a structure that seeks to ensure this through public representation on an exchange's board of directors. Under this structure, fair representation of the public on an oversight body that has substantive authority and decisionmaking ability therefore may be critical to ensure that an exchange actively works to protect the public interest and that no single group of investors has the ability to systematically disadvantage other market participants through use of the exchange governance process.[115]

The second requirement, that of fair representation of an exchange's members, also serves to ensure that an exchange is administered in a way that is equitable to all market members and participants. Because a registered exchange is not solely a commercial enterprise, but also has significant regulatory powers with respect to its members,[116] competition between exchanges may not be sufficient to ensure that an exchange carries out its regulatory responsibilities in an equitable manner. The fair application of an exchange's authority to bring and adjudicate disciplinary procedures may be particularly important in this respect, because these actions can have significant and far-reaching ramifications for broker-dealers. Accordingly, under the Exchange Act structure, it may be essential to give exchange participants equitable and enforceable input into disciplinary and other key processes to prevent them from being conducted in an inequitable, discriminatory, or otherwise inappropriate fashion.

The Commission has not, however, interpreted an exchange's obligation to provide fair representation of its members to mean that all members must have equal rights. Instead, the Commission has allowed registered SROs a degree of flexibility in complying with this requirement. For example, Pacific Exchange ''electronic access members'' (''ASAP Members'') do not have voting rights, and therefore are not represented on the board of that exchange.[117] In addition, with respect to clearing agencies, the Commission has stated that registered clearing agencies may employ several methods to comply with the fair representation standard.[118] Other structures may also provide independent, fair representation for an exchange's constituencies in its material decisionmaking processes, for exchanges that are not owned by their participants. For example, an alternative trading system that registers as an exchange might be able to fulfill this requirement by establishing an independent subsidiary that has final, binding responsibility for bringing and adjudicating disciplinary proceedings and rule making processes for the exchange, and ensuring that the governance of such subsidiary equitably represents the exchange's participants.[119]

Question 50: Should non-membership exchanges (including alternative trading systems that may register as exchanges) be exempt from fair representation requirements?

Question 51: Should all exchanges be required to comply with section 6(b)(3) by having a board of directors that includes participant representation?

Question 52: If not, are there alternative structures that would provide independent, fair representation for all of an exchange's constituencies (including the public)?

3. Expanding the Commission's Interpretation of ''Exchange''

To create a new category of exempted exchanges and to apply exchange registration requirements to the most significant alternative trading systems, the Commission would have to expand its current interpretation of ''exchange'' to encompass many more trading systems than are currently considered ''exchanges.'' Although the Exchange Act definition of ''exchange'' is potentially quite broad,[120] the Commission currently interprets this definition to include only those organizations that are ''designed, whether through trading rules, operational procedures or business incentives, to centralize trading and provide buy and sell quotations on a regular or continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations.'' [121] The Commission analyzed how the definition of exchange applies to alternative trading systems in a 1991 release, explaining its decision not to register a government options trading system as an exchange (''Delta Release'').[122] The Commission concluded that, in light of congressional emphasis on the ''generally understood'' meaning of stock exchange and the Exchange Act as a whole, the definition of exchange should be applied narrowly, to include only those entities that enhanced liquidity in traditional ways through market makers, specialists, or a single price auction structure.[123] Because most alternative

[115] *See* NASD 21a Report, *supra* note 20.

[116] *See supra* Section II.B.1.

[117] *See* Securities Exchange Act Release No. 28335 (Aug. 13, 1990), 55 FR 34106 (Aug. 21, 1990) (order approving rule change establishing electronic access memberships on the PSE, since renamed PCX).

[118] These methods include: (1) Solicitation of board of directors nominations from all participants; (2) 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; (3) 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; or (4) selection by participants of a slate of nominees for which stockholders of the clearing agency would be required to vote their share. *See* Securities Exchange Act Release No. 14531 at 24 (March 6, 1978), 43 FR 10288 (March 10, 1978). *See also* Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980).

[119] The Commission notes that the proprietary exchange Easdaq, a recognized secondary market in Belgium, has established a ''regulatory authority'' that has a degree of independence from Easdaq's board of directors.

[120] The Exchange Act defines an ''exchange'' as: ''any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.'' 15 U.S.C. 78c(a)(1).

[121] *See* Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 FR 1890, 1900 (Jan. 19, 1990).

[122] *Id.* In 1988, the Commission granted Delta Government Options Corporation (''Delta'') temporary registration as a clearing agency to allow it to issue, clear, and settle options executed through a trading system operated by RMJ Securities (''RMJ''). Concurrently, the Commission's Division of Market Regulation issued a letter stating that the Division would not recommend enforcement action against RMJ if its system did not register as a national securities exchange. Subsequently, the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange petitioned the U.S. Court of Appeals for the Seventh Circuit for review of the Commission's actions. Both challenges were premised on the view that RMJ's system unlawfully failed to register as an exchange or obtain an exemption from registration. The Seventh Circuit vacated Delta's temporary registration as a clearing agency, pending publication of a reasoned Commission analysis of whether or not RMJ's system was an exchange within the meaning of the Exchange Act. *Board of Trade v. SEC*, 883 F.2d 525 (7th Cir. 1989). In 1989, the Commission solicited comment on the issue, and in 1990 published its interpretation of the term ''exchange'' and its determination that RMJ's system did not meet that interpretation. *See* Delta Release, *supra* note 121.

[123] *See* Delta Release, *supra* note 121, at 1900. The Commission stated: ''In summary, employing an expansive interpretation of section 3(a)(1) results

Continued

trading systems do not have these features, this narrow interpretation effectively excluded most alternative trading systems from exchange regulation.[124] Thus, many alternative trading systems have not been required to register as exchanges to date and have instead been regulated as broker-dealers.

There are, however, several alternative ways in which the definition of ''exchange'' could be applied more broadly.[125] For example, a large variety of services performed by existing markets and intermediaries could be considered to be functions that are commonly understood to be performed by exchanges within the meaning of section 3(a)(1) of the Exchange Act. Those services include: (1) Centralizing trading interest; (2) providing the opportunity for multiple parties to participate in trading; (3) specifying time, price, size, or other priorities governing the sequence or interaction of orders; (4) providing an opportunity for active price formation (either through interaction of buy and sell interest or through competing dealer quotes); (5) specifying material conditions under which participants may post quotations or trading interest (such as requiring participants to maintain firm, two-sided, or continuous quotes); (6) creating mechanisms for enhancing liquidity, such as giving certain participants special privileges in exchange for assuming market obligations; (7) giving participants control over setting the trading rules; and (8) setting qualitative standards for listing instruments or otherwise standardizing the material terms of instruments traded. Various commenters have identified these and other functions as central characteristics of exchanges.[126]

Each of these functions is performed by existing exchanges and could be incorporated into the Commission's interpretation of the term ''exchange.''[127] Because alternative trading systems do not always offer each of these services, however, if alternative trading systems are integrated into market regulation mechanisms through exchange regulation, a revised interpretation of the term ''exchange'' based on whether a market offers all, or many, of these functions would continue to exclude many alterative trading systems. For example, the application of the term exchange could be broadened to include those entities that provide the opportunity for multiple parties to participate in centralized trading. While many alternative trading systems provide a central execution system, others organize trading by centralizing the display of participant trading interest, and then specifying the sequence or priorities under which participants must trade with each other. Although orders may not directly interact on such markets, the order and price at which they are executed is determined by the market. The fairness of this procedure

in potential conflicts with other central regulatory definitions under the (Exchange) Act as well as adverse effects on innovation and competition. Rather, each system must be analyzed in light of the statutory objectives and the particular facts and circumstances of that system. In conducting such an analysis, the central focus of the Commission's inquiry should be whether the system is designed, whether through trading rules, operational procedures or business incentives, to centralize trading and provide buy and sell quotations on a regular or continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations. The means employed may be varied, ranging from a physical floor or trading system (where orders can be centralized and executed) to other means of intermediation (such as a formal market making system or systemic procedures such as a consolidated limit order book or regular single price auction).'' *Id.*

[124] The Commission's authority to adopt this narrow interpretation was subsequently upheld by the U.S. Court of Appeals for the Seventh Circuit. *Board of Trade of the City of Chicago v. SEC,* 923 F.2d 1270 (7th Cir. 1991)*, reh'g en banc, den'd,* (7th Cir. 1991) (hereinafter Delta Decision). The court noted that ''the Delta system differs only in degree and detail from an exchange . . . Section 3(a)(1) (of the Exchange Act) is broadly worded. No doubt . . . this was to give the Securities and Exchange Commission maximum control over the securities industry. So the Commission could have interpreted the section to embrace the Delta system. But we do not think it was compelled to do so.'' *Id.* at 1273 (quoting *Chevron v. Natural* Resources Defense Council, 467 U.S. 837, 844–45 (1984)). In reaching its decision, the court gave weight to the Commission's belief that classifying the Delta system as an exchange would have destroyed its commercial viability. The court also relied in part on the Commission's position that, because Delta would be registered as a clearing agency and the system sponsor would be a registered broker-dealer, there did not appear to be any overriding regulatory need to regulate the system as an exchange. Delta Decision, *supra* at 1273. The court stated that the Commission ''can determine . . . whether the protection of investors and other interests within the range of the statute is advanced, or retarded, by placing the Delta system in a classification that will destroy a promising competitive innovation in the trading of securities.'' *Id.* Since 1991, the Commission staff has given operators of trading systems assurances, based on the interpretation upheld by the court in *Delta,* that it would not recommend enforcement action if those systems operated without registering as exchanges. For a list of no-action letters issued to system sponsors until the end of 1993 and a short history of the Commission's oversight of such systems, see Securities Exchange Act Release No. 33605 (Feb. 14, 1994), 59 FR 8368, 8369–71 (Feb. 18, 1994) (hereinafter Rule 17a–23 Proposing Release). *See also* Letters from the Division of Market Regulation to: Niphix Investments Inc. (Dec. 19, 1996); Tradebook (Dec. 3, 1996); The Institutional Real Estate Clearinghouse System (May 28, 1996); Chicago Board Brokerage, Inc. and Clearing Corporation for Options and Securities (Dec. 13, 1995).

[125] The Exchange Act, coupled with relevant legislative history, appears to provide the Commission with ample authority to revise its interpretation of an exchange. Courts have consistently upheld an agency's discretion to revise earlier interpretations when a revision is reasonably warranted by changed circumstances. *See, e.g., Rust* v. *Sullivan,* 500 U.S. 173, 186 (1991). In *Rust,* the Court stated that ''an initial agency interpretation is not instantly carved in stone, and the agency, to engage in informed rulemaking, must consider varying interpretations and the wisdom of its policy on a continuing basis. *Id.* at 186 (quoting *Chevron* v. *Natural Resources Defense Council,* 467 U.S. 837, 844–45 (1984)). The Court also stated that ''an agency is not required to 'establish rules of conduct to last forever,' but rather 'must be given ample latitude to adapt its rules and policies to the demands of changing circumstances.'' ' *Id.* at 186–87 (quoting *Motor Vehicles Mfrs. Ass'n of United States* v. *State Farm Mut. Automobile Ins. Co.,* 463 U.S. 29, 42 (1983)).

[126] *See, e.g.,* Robert A. Schwartz, *Technology's Impact on the Equity Markets* (Future Markets: How Information Technology Shapes Competition (C. Kremerer ed., forthcoming 1997)) (''In the U.S., an exchange is an environment where broker/dealer *intermediaries,* not natural buyers and sellers meet. In contrast, broker/dealer member firms provide the services (information analysis and dissemination, provision of dealer capital, order handling, account handling etc.) that bring the customer to the market to trade.''); Ruben Lee, *What is an Exchange?* (1992) (available from author) (regulators should consider 25 attributes when determining whether a trading system is an exchange, including price discovery, liquidity, competition of orders, price priority, secondary priorities, information access, and centralized order execution); Therese Maynard, *What is an ''Exchange''?—Proprietary Electronic Securities Trading Systems and the Statutory Definition of an Exchange,* 49 Wash. & Lee L. Rev. 833 (1991); J. Harold Mulherin et al, *Prices are Property: The Organization of Financial Exchanges from a Transaction Cost Perspective,* 34 J. of Law & Econ. 591 (Oct. 1991) (the establishment of property rights to price quotes is a central function of financial exchanges, although the authors do not discount the fact that exchanges accomplish many other functions); Lawrence Harris, *Liquidity, Trading Rules, and Electronic Trading Systems* (1990) (available from author) (exchanges provide services by creating an environment that encourages traders to offer liquidity, often by establishing a set of rules that provide liquidity suppliers protection in proportion to the service that they provide to the market); Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges,* 75 Cornell L. Rev. 1007 (1990) (in addition to liquidity, organized stock exchanges offer three other services (monitoring, devising standard form contracts, and lending reputational capital to listing firms) that listing firms view as valuable); Ian Domowitz, *An Exchange is a Many Splendored Thing: The Classification and Regulation of Automated Trading Systems,* in The Industrial Organization and Regulation of the Securities Industry 93 (Andrew W. Lo ed., 1996) (the price discovery process with the associated dissemination of price information, and centralization for the purpose of trade execution are the basic functions of trading systems). *See also* Ruben Lee & Ian Domowitz, *The Legal Basis for Stock Exchanges: The Classification and Regulation of Automated Trading Systems* (1996) (available from authors) (there should be no distinction in the regulation of market structure issues between institutions now classified as exchanges and those now classified as broker-operated trading systems).

[127] For example, as noted above, the Commission's current interpretation captures the functions of centralizing trading interest, providing the opportunity for multiple parties to participate in trading, and providing mechanisms to enhance liquidity, such as giving certain participants special privileges in return for assuming market obligations.

will affect participants in those markets no less than the fairness of procedures on an exchange that allows orders to interact centrally.

Similarly, an exchange could be defined as only those entities that provide an opportunity for active price formation (either through interaction of buy and sell interest or through competing dealer quotes). This criteria would capture automated matching systems, such as Instinet, Tradebook, Island and Terra Nova's Archipelago system, but would not include crossing systems that establish a price based on the price already established in another market, such as POSIT, within the term ''exchange.'' Whether or not a market engages in active price formation, however, is not the sole factor that may determine a market's potential to harm investors through unfair treatment or vulnerability to manipulation. Moreover, markets without active price discovery still have the potential to affect the integrity of trading and surveillance on other markets. Depending upon its configuration, for example, a passive pricing system can provide incentives for its participants to manipulate prices in the market from which the passive price is derived in order to affect the outcome of a cross. Finally, while there is general consensus that active price formation occurs through the interaction of orders, there is little consensus on whether the interaction of orders through negotiation, such as occurs within a broker-dealer, should also be considered to be price formation.[128] As market changes continue to affect how securities trade, basing the interpretation of the term ''exchange'' on whether a market engages in price discovery could generate significant uncertainties for markets that develop innovative pricing mechanisms.[129] Therefore, if the Commission expands its interpretation of the term ''exchange,'' it could be appropriate to include passive markets in such an interpretation. Under such an approach, passive markets could be integrated into market regulation by regulating such systems as exempted exchanges.

Reinterpreting the term ''exchange'' based on other traditional exchange functions may have similar drawbacks. For example, unlike existing exchanges, few alternative markets give certain participants special privileges in return for assuming market obligations, give participants control over setting the trading rules, or set listing standards.[130] Moreover, while many exchanges currently provide the services noted above, it is not certain that exchanges will always do so in the future.[131] As a result, if alternative trading systems were integrated into market regulation through exchange regulation, rather than broker-dealer regulation, basing a revised interpretation of ''exchange'' on these traditional functions could result in the same regulatory gaps and lack of flexibility that the current situation has created.

For these reasons, if the Commission were to revise its interpretation of ''exchange,'' it would also consider focusing such a reinterpretation primarily on those essential functions commonly provided by registered exchanges and alternative markets, in order to achieve congressional intent to regulate central marketplaces for securities trading. For example, the Commission could revise its interpretation of the term ''exchange'' to include *any organization that both: (1) Consolidates orders*[132] *of multiple parties; and (2) provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of a trade.* This revised interpretation would closely reflect the statutory concept of ''bringing together'' buying and selling interests. It would also broaden the Commission's concept of what is ''generally understood'' to be an exchange to reflect changes in the U.S. and world markets brought about by automated trading.[133]

Question 53: Would the revised interpretation of ''exchange'' being considered by the Commission adequately and clearly include alternative trading systems that operate open limit order execution systems (even those that also provide brokerage functions)?

Question 54: In light of the decreasing differentiation between market maker quotes and customer orders in trading, should the Commission consider an ''order'' to include any firm trading interest, including both limit orders and market maker quotes?

Question 55: What should the Commission consider to be ''material conditions'' under which participants entering orders may agree to the terms of a trade? For example, should an alternative trading system be considered to be setting ''material conditions'' when it standardizes the material terms of instruments traded on the market, such as standardizing option terms or requiring participants that display quotes to execute orders for a minimum size or to give priority to certain types of orders?

a. Effects of Expanding the Commission's Interpretation of ''Exchange'' on Selected Types of Alternative Trading Systems

One of the principal advantages of expanding the Commission's interpretation of the term ''exchange'' would be to provide sufficient flexibility within the concept of an exchange to encompass both currently registered exchanges and significant existing alternative trading systems, as well as unforeseen alternative trading systems that may arise in the future. At the same time, the Commission has consistently maintained that the definition of exchange should not be interpreted so

[128] *Compare* Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis,* 52 Geo. Wash. L. Rev. 546, 597 (1994) (''price discovery in capital markets arises solely as the result of traders'' orders meeting in the market''); *with* M. Perry, *A Challenge Postponed: Market 2000 Complacency in Response to Regulatory Competition for International Equity Markets,* 34 Va. J. Int'l L. 701, 740 (1994) (''It is not clear whether 'price discovery' means price negotiation between the trading parties or price determination by the market'').

[129] For example, one trading system currently in development, OptiMark, allows participants to enter entire portfolios of securities at a range of prices and sizes at which they would be willing to trade if a variety of other factors are met. It is not clear whether this type of contingent pricing mechanism could be considered ''active price formation.''

[130] Although many alternative trading systems limit trading to securities traded on a registered exchange or Nasdaq, they do not establish or enforce qualitative or quantitative independent listing standards or require that securities be registered under the Exchange Act.

[131] *See, e.g.,* Gerald Novak, *A Failure of Communications: An Argument for the Closing of the NYSE Floor,* 26 U. Mich. J.L. Reform 485, 503 (1993) (while specialists may create enough benefit to the market to allow them to exist within the current regime, the benefits do not seem substantial enough to maintain the physical exchanges solely for the purpose of perpetuating the role of the specialist.) *See also* Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System,* 56 N.Y.U.L. Rev. 883, 956–57 (1981) (arguing for the elimination of the present specialist system in favor of an institutionalized specialist function).

[132] As noted above, the term ''orders'' in this release is intended to be read broadly, to include any firm trading interest. This would include both limit orders and market maker quotations.

[133] *See, e.g.,* AZX Exemptive Order, *supra* note 24; Internet Site of the Australian Stock Exchange, address: http://www.azx.com.au (Dec. 5, 1996) (orders entered on the Australian Stock Exchange are automatically matched and executed through SEATS, a screen based trading system); Internet Site of SIMEX, address: http://www.simex.com (Nov. 6, 1996) (the Singapore International Monetary Exchange is a complete, integrated electronic trading system, which uses an order matching system based upon the use of a matching algorithm reflecting strict price/time priority for all orders entered into the system). In addition, Tradepoint, a recognized investment exchange in the United Kingdom, operates as an order driven, automated system for the trading of shares of U.K. issuers listed on the London Stock Exchange without the use of market makers or specialists.

broadly as to overlap or interfere with other sections of the Exchange Act, such as those governing broker-dealer activities or securities associations. For example, at the time of the Delta Release, the Commission sought to avoid interpreting the term ''exchange'' in a way that could unintentionally and inappropriately subject many broker-dealers to exchange regulation.[134] Therefore, if the Commission decides to broaden its interpretation of ''exchange'' to encompass alternative trading systems, it would have to take into account the potential effects of such an interpretation on entities regulated under other sections of the Exchange Act. This may include entities that provide traditional brokerage activities (*e.g.,* traditional block trading desks or internal programs that allow traders within a firm to search and match orders with customer orders of other traders within the same firm), information vendors, and markets operated by the NASD. For example, the Commission would not intend any revised interpretation of ''exchange'' to capture traditional brokerage activities or the internal automation of traditional brokerage activities. Similarly, it may be inappropriate for a revised interpretation of ''exchange'' to capture certain alternative trading systems, such as interdealer brokers in exempted securities, that are regulated under separate regulatory schemes. Discussed below are the possible effects of an expanded interpretation of ''exchange'' on these market participants.

(i) Broker-Dealer Activities

In light of the blurring distinctions between the services offered by markets and market participants described above,[135] the differences between modern exchange and broker-dealer activities are not easily articulated. Some firms have integrated technology into their activities in ways that appear to have much in common with the trading systems used by modern exchanges. Nonetheless, broker-dealer activities can be distinguished from those of an exchange for several reasons.

First, unlike organized markets, traditional broker-dealer activities do not involve the systematic interaction of customer orders where the customers themselves are informed of and have an opportunity to agree to the terms of their trades (or agree to the priorities under which the terms will be set). For example, broker-dealers may automate part of their intermediary function (such as block trading desk activity) by developing internal programs that allow traders within a firm to search and match orders with customer orders of other traders within the same firm, or with orders and quotes of other traders. Similarly, technologically sophisticated firms may create an internal process for centralizing information regarding customer orders. Such systems, however, generally serve as a means of providing information regarding a firm's customer orders solely to the employees of the broker-dealer operating the system to facilitate the employees' crossing of customer orders on a discretionary basis. In other words, the only participant in such a system is the broker-dealer that operates it. Similarly, while block trading desks provide a central location where employees of a single broker-dealer trade side-by-side, they do not systematically consolidate the customer orders handled by those employees. Although an employee may ultimately match its customer order with a customer order held by a trader sitting across the room, this does not operate as an organized mechanism for ensuring that customer orders are matched, crossed, or otherwise centralized.

Second, a broker-dealer traditionally retains discretion in determining how to handle customer orders. Unlike an exchange, which customers access in part to participate in a particular market or market structure, a customer that gives its order to a broker-dealer typically gives discretion to that broker-dealer regarding which market the order will ultimately be executed in, how the order may be split up or ''worked,'' or whether the broker-dealer will choose to execute the order as principal or as agent. Although a broker-dealer may disclose its standard practices to customers, ultimately these execution decisions are left to the discretion of the broker-dealer, consistent with the responsibilities imposed on broker-dealers. For example, a block positioner may ''shop'' the order around to other traders in his own firm in an attempt to find a contra-side order that has been placed with another trader. In some cases, the block positioner may take the other side of the order, keeping the block as a proprietary position. This decision is dictated by market conditions and typically lies within the block positioner's discretion. Unless otherwise agreed, customers have no rights regarding the system other than the expectation that the broker-dealer will handle the order according to its broker-dealer obligations.

Finally, a sophisticated market maker that develops a system to broadcast its own quotations to the public, or to allow its customers to direct orders for execution solely against that market maker's inventory, is conducting broker-dealer activity. Such systems automate the order routing and execution mechanisms of a single market maker and guarantee that the market maker will execute orders submitted to it at its own posted quotation for the security or, for example, at the inside price quoted on Nasdaq. Single market maker systems merely provide a more efficient means of communicating the trading interest of separate customers to one dealer and thus would not be considered exchange activities.

As noted above, much of this analysis assumes that these activities are being engaged in ''systematically,'' or in a ''traditional'' or ''typical'' fashion. The Commission recognizes that these concepts are not easily defined and that this approach will leave many issues and gray areas to be resolved. The Commission is soliciting comment on how any revised interpretation of the term exchange could clearly distinguish between these activities and those of alternative trading systems.

Question 56: Is it appropriate for the Commission to consider the activities described above as broker-dealer activities?

Question 57: How should a revised interpretation of exchange adequately and clearly distinguish broker-dealer activities, such as block trading and internal execution systems, from market activities?

Question 58: Are the distinctions discussed above accurate reflections of exchange and broker-dealer activities? Are there other factors that may better distinguish a broker-dealer from an exchange?

(ii) Organized Dealer Markets

The term ''exchange,'' as articulated above, would encompass organized dealer markets that operate systems to consolidate participant orders for display, and set material conditions under which orders can be executed (including automatically executing

[134] One key factor in the Commission's decision not to regulate the Delta system as an exchange was the concern that, absent greater exemptive authority, doing so would subject traditional broker-dealer activities to exchange regulation. Delta Release, *supra* note 121. Although some alternative trading systems claim to be the modern analog of traditional brokerage activity, the Commission believes that, while some are, the nature of systems that combine the functions of brokers and exchanges cannot be so readily simplified.

[135] *See supra* notes 14 and 14 and accompanying text.

orders).[136] As discussed in the Delta Release, dealer markets have traditionally consisted of loosely organized groups of individual dealers that trade securities OTC, without formal consolidation of orders or trading. Historically, the majority of trading in corporate, government, and municipal debt instruments has been conducted through such OTC dealers. Individual dealers in such markets generally do not directly ''bring together'' public purchasers and sellers. The court and the parties in the Delta Decision[137] assumed that the term ''exchange,'' as that term is generally understood, would not apply to such a loosely organized market. The approaches described above continue the notion that the definition of ''exchange'' should not cover such loosely organized traditional dealer markets and that broker-dealer regulation should continue to govern individual dealers in those markets.[138] As individual dealers and associations of dealers have employed technology to make OTC markets more efficient, however, dealer markets in certain instruments have become organized to such an extent that they have assumed many of the characteristics of exchange markets. This is particularly true in markets that trade instruments that are also listed on registered exchanges, such as equity securities. For example, Nasdaq consolidates trading interest of multiple dealers on a screen that is displayed real-time to its members, and provides a mechanism for dealers to update displayed quotations. The NASD also imposes obligations on market makers in Nasdaq National Market and SmallCap securities to provide a continuous source of liquidity in Nasdaq, establishes minimum qualifications that issuers must meet in order for their securities to be quoted on the consolidated screen, and sets enforceable rules that govern the priorities dealers must give to certain orders. Through additional services, such as SelectNet, Nasdaq also allows dealers to trade with orders electronically. In other words, a group of market participants, through Nasdaq, act in concert to centralize and disseminate trading interest and establish the basic rules by which securities will be traded on Nasdaq. Because the NASD is already registered as a securities association, the Nasdaq market would not need to be regulated as an exchange. The Commission, however, could consider whether entities that operate similar markets in the United States should be considered exchanges under any expanded interpretation if they are not operated by a registered securities association.

Question 59: How should a revised interpretation of the term ''exchange'' adequately and clearly distinguish broker-dealer activities, such as block trading and internal execution systems, from market activities?

Question 60: What factors should the Commission consider in determining whether an organization of dealers is sufficiently ''organized'' to require exchange registration?

(iii) Information Vendors and Bulletin Boards

The Commission is also concerned that any revised interpretation of the term ''exchange'' not be so broad as to encompass those entities that provide information, but do not provide a central facility for executing trades or set conditions governing trading. Information vendors and ''bulletin boards'' often provide a centralized display of general trading interest, comments, or other information regarding trading, but they generally do not enable customers to communicate directly with each other, execute orders, or otherwise agree to the terms of a trade through their facilities. These entities also do not establish the conditions under which customers negotiate or trade based on displayed information.[139] Because these entities centralize information without standardizing trading based on such information, the approach described above would not regulate these entities as exchanges if they do not allow for execution through their system or set conditions of trading.

The Commission recognizes that the difference between an exchange and an electronic bulletin board depends on the functions that they make available. For instance, a passive bulletin board that merely provides names and addresses of prospective buyers and sellers and the prices at which they are willing to buy or sell would not be an exchange because it would not set priorities that govern trades, and transactions resulting from posted indications of interest, if any, would be executed outside the system. If a system created an electronic link between multiple potential buyers (*e.g.*, a ''chat room''), however, it could be considered to be providing a facility through which participants entering orders may agree to the terms of a trade (*e.g.*, an exchange). The Commission requests comment on whether such a system should be considered to be an exchange, particularly if the customer orders displayed on the system are firm, or if the system specifies the priorities for customer interaction through the electronic linkage or ''chat room.''[140]

Question 61: Does the revised interpretation of ''exchange'' described above clearly exclude information vendors, bulletin boards, and other entities whose activities are limited to the provision of trading information? How should the Commission distinguish between information vendors, bulletin boards, and exchanges?

(iv) Interdealer Brokers

Certain markets that are not centrally organized by a single entity are nonetheless informally organized around interdealer brokers,[141] which display the bids and offers of other dealers anonymously. The importance and role of these interdealer brokers has changed significantly in the past twenty years. While interdealer brokers traditionally had relatively small volume, they are now key players in the government and municipal securities

[136] The only dealer market in the United States that currently appears to both consolidate participant quotes and set conditions governing execution is the Nasdaq market, operated by the NASD. As discussed below, because the NASD is already registered as a securities association, the Commission would not intend for any revised interpretation of ''exchange'' to include the Nasdaq market. The Commission, however, could consider whether other entities that operate similar markets in the United States should be considered exchanges under any expanded interpretation, unless they were also operated by a registered securities association.

[137] *See* Delta Decision, *supra* note 124.

[138] For example, commercial paper trades through several large dealers that disseminate their own quotes to their customers and make a two-sided market in the paper of various issuers. Trading in the commercial paper market is highly concentrated among a few large dealers, some of which provide automated quotation screens for their customers. Unlike an exchange market, however, no entity currently attempts to centralize trading interest by reflecting multiple dealer quotes, or by setting conditions under which the commercial paper of differing issuers may be traded by dealers.

[139] Commission staff has previously indicated that it would not recommend enforcement action if a system operated by an issuer that does not allow transactions to be executed on the system, and that is designed to provide limited information to buyers and sellers of stock, does not register as an exchange. *See* Letter from Catherine McGuire, Martin Dunn, and Jack Murphy, SEC, to Barry Reder, Coblentz, Cahen, McCabe & Breyer, LLP (June 24, 1996) (counsel to Real Goods Trading Corporation).

[140] In addition, it is possible for an information vendor to provide its services by linking its screens to execution facilities provided by other entities with which the vendor has a contractual arrangement. In these circumstances, the information vendor may be captured by the proposed revised interpretation of the term ''exchange,'' depending upon the nature of the services provided.

[141] As used in this release, the term ''interdealer brokers'' includes entities that are referred to as brokers'' brokers and blind brokers in certain markets.

markets,[142] and have begun to operate in other instruments as well. Today, interdealer brokers provide liquidity by providing a central mechanism to display the bids and offers of multiple dealers and by allowing dealers and investors to trade large volumes of securities anonymously and efficiently based on those bids and offers. In the government securities market, for example, interdealer brokers compile and display the anonymous bids and offers of other government securities dealers and traders on screens located in the dealers' offices. Dealers call an interdealer broker via telephone to display their quote information or to execute against a displayed quotation.[143] Automated brokers' brokers in the secondary market for municipal securities operate in a similar manner, disseminating centralized quotation information and executing trades for their customers by telephone.[144]

Operating in this manner, interdealer brokers centralize trading interest and provide a mechanism for agreeing to the terms of a trade in much the same way as registered exchanges and alternative markets do. Interdealer brokers in these markets may also determine certain trading practices.[145] This is a significant change from the way interdealer brokers operated just 30 years ago, when they disseminated last sale information to customers individually, rather than centrally, and operated under less formalized procedures.

Like block trading desks, interdealer brokers now have certain elements in common with markets, but have also retained some of their traditional characteristics. For example, although interdealer brokers do not give advice, they exercise some discretion in matching and executing orders of their dealer customers.[146] Commenters have suggested that these features should distinguish traditional interdealer brokers to some extent from markets that establish priorities for executing participant orders or that otherwise set conditions governing trading between participants. Because interdealer brokers have begun to display quotations in real-time to their customers, centralize the negotiation of trading, and establish conventions under which trading will occur, the issue is whether this difference has become primarily one of degree.[147] Individual brokers at an interdealer broker, in many respects, perform similar functions to exchange specialists. Moreover, if an interdealer broker automated its activities fully, there would appear to be little difference between its activities and those of existing alternative trading systems. Given this evolution, the Commission could consider whether interdealer brokers should be considered exchanges under a revised interpretation.

If the Commission determines that the activities of interdealer brokers should be encompassed by a revised interpretation of ''exchange,'' it could consider whether to use its exemptive authority to exclude those interdealer brokers that trade exempted securities [148] from exchange registration requirements. As noted in the Delta Release, Congress has given no indication that it intended to subject traditional interdealer brokers in the government and municipal securities markets to exchange regulation.[149] Moreover, regulation of traditional interdealer brokers in government and municipal securities as exchanges may not be necessary or appropriate in the public interest at this time, in light of the specialized oversight structures for these markets. Both the government and municipal securities markets are overseen through special regulatory schemes that are tailored to the particular features of those debt markets. Government securities broker-dealers are overseen jointly by the U.S. Department of the Treasury (''Treasury''), the Commission, and federal banking regulators, under the Exchange Act (particularly the provisions of the Government Securities Act of 1986) and the federal banking laws.[150] Municipal securities broker-

[142] Trading by interdealer brokers began to become popular in the government securities market, after trading had moved from the NYSE to the over-the-counter market in the 1920s and the demise of trading agreements in the mid-1950s that had previously provided a foundation for interdealer business. *See* U.S. Congress, Joint Economic Committee, a Study of the Dealer Market for Federal Government Securities 21–26, 49–53 (1960); U.S. Department of the Treasury and U.S. Federal Reserve, Treasury-Federal Reserve Study of the Government Securities Markets 95–100 (1959). By 1972, interdealer brokers handled approximately 14% of the trading of government securities by dealers; by 1990, interdealer brokers handled more than 50% of such business. *See* Marcia Stigum, The Money Market 644–56 (3d ed. 1990).

[143] Dealers and other customers have direct telephone lines to the various individual brokers working at an interdealer broker. The individual brokers typically handle one to three customers each, depending upon activity levels. When customers wish to buy or sell a security through an interdealer broker, they call the individual broker assigned to them at that interdealer broker. Through their assigned broker, customers can hit a bid or take an offer already shown on the screen, tell the broker to post a new, better bid or offer on the screen, or give the broker other information about their activities and trading needs. When customers wish to hit a quote on the screen or enter a new quote, the broker taking that information announces the hit or new bid/offer to other brokers (who are taking information from other customers), and the broker or other staff enter the information so that it is displayed on internal and customer screens. Trading supervisors within the interdealer broker mediate disputes, such as which broker called out an order first. *See generally* U.S. Department of the Treasury, Report of the Secretary of the Treasury on Specialized Government Securities Brokers and Dealers (1995) (hereinafter 1995 Treasury Report); U.S. Securities and Exchange Commission, 1994 Annual Report 29–30 (1994); U.S. Department of the Treasury, U.S. Securities and Exchange Commission, and Board of Governors of the Federal Reserve System, Joint Report on the Government Securities Market 26 (1992) (hereinafter 1992 Joint Report); Stigum, *supra* note 142; U.S. General Accounting Office, U.S. Government Securities: More Transaction Information and Investor Protection Are Needed, 19, 97–100 (1990); U.S. General Accounting Office, U.S. Government Securities: An Examination of Views Expressed About Access to Brokers' Services 28–35 (1987).

[144] See Division of Market Regulation, U.S. Securities and Exchange Commission, Staff Report on the Municipal Securities Market 17–22 (1993) (hereinafter Municipal Securities Report). *See also* Securities Exchange Act Release No. 37998 (Nov. 29, 1996), 61 FR 64782 (Dec. 6, 1996) (Commission approval order for Municipal Securities Rulemaking Board proposals to increase transparency in the municipal securities market); U.S. Securities and Exchange Commission, 1995 Annual Report 31 (1995).

[145] Generally, a broker considers a bid or offer placed with it good until canceled, but the conditions under which they are subject to variation is a matter left up to each interdealer broker. For example, usually, ''when the (Federal Reserve) comes into the market, all bids and offers (become subject to reaffirmation). However, when some key economic number is released, some brokers make the market (subject to reaffirmation), others don't; in this area, there are no formal rules.'' Stigum, *supra* note 142, at 647.

[146] *See* 1992 Joint Report, *supra* note 143, at A9–A11.

[147] ''The government brokers run what amounts to an unlicensed exchange. In the 20-odd years that governments have been brokered, the way in which that exchange operates has slowly changed. At the outset, brokers phoned runs to dealers, then in 1977 to 1978, the era of screens began.'' Stigum, *supra* note 142, at 655. The following quote from a dealer also supports the Commission's view: ''Also, dealers came to view the brokers as just one more place, along with the Chicago pits, to trade—just another place to get business done.'' *Id.* at 652.

[148] Exempted securities are defined in section 3(a)(12) of the Exchange Act to include government securities and municipal securities, among other things. 15 U.S.C. 78c(a)(12).

[149] *See* Delta Release, *supra* note 121, at 1898 n.87.

[150] *See* 1995 Treasury Report, *supra* note 143. ''Under the regulatory structure established by the Government Securities Act of 1986, as amended in 1993, the Treasury was given rulemaking authority over all brokers and dealers in government securities. Specifically, the Treasury was designated by Congress as the sole rulemaker for specialized government securities brokers and dealers (33 firms as of March 1995) and was given rulemaking authority for the government securities activities of financial institutions that filed notice as government securities brokers and dealers (approximately 300 as of January 1995). The Treasury and the SEC have overlapping rulemaking responsibilities for the government securities activities conducted by general securities brokers and dealers (15(b) firms) which numbered about 2,231 as of March 1995. The (Government Securities Act) granted the Treasury the authority

dealers and transactions in municipal securities are overseen by the Commission, the Municipal Securities Rulemaking Board (''MSRB''), the NASD, and the federal banking regulatory authorities under the Exchange Act (particularly section 15B) and the federal banking laws. Unlike equities and other instruments traded primarily on registered exchanges,[151] surveillance of trading in government and municipal securities is not conducted by entities that operate competing markets in those instruments. Instead, surveillance of the government securities market is coordinated among the Treasury, the Commission, and the Board of Governors of the Federal Reserve System. In the municipal securities market, Congress established the MSRB as an SRO for broker-dealers in municipal securities; unlike SROs in other markets, however, the MSRB does not operate a market and was not given inspection or enforcement powers. Surveillance of the municipal securities market for fraud and market manipulation is conducted by the Commission and the NASD.[152]

As a result of these specialized oversight structures, regulation of particular market participants in the government and municipal securities markets as broker-dealers, rather than as exchanges, is not likely to weaken coordination of overall market oversight or create competitive inequities among differently regulated entities that perform similar functions. For these reasons, if the Commission expands its interpretation of ''exchange'' to cover interdealer brokers generally, it could consider expressly exempting traditional government and municipal securities interdealer brokers that trade exempted securities from exchange registration.

It should be noted that the above analysis is based on existing mechanisms for supervising trading in government and municipal securities markets, and on current trading practices of interdealer brokers in such markets. In the event that an interdealer broker automates its services more completely, or operates in a manner more similar to an equity market, for example, this analysis could be reevaluated. Similarly, the above analysis would not apply to derivatives of government and municipal securities.

Question 62: If the Commission expands its interpretation of ''exchange,'' should the Commission exempt interdealer brokers that deal only in exempted securities from the application of exchange registration and other requirements?

Question 63: How could the Commission define interdealer brokers in a way that would implement congressional intent not to regulate traditional interdealer brokers as exchanges, without unintentionally exempting other alternative trading systems operated by brokers?

4. Effect of Broadening the Definition of ''Exchange''

Reinterpreting the definition of ''exchange'' to apply to a broader range of entities would have significant effects, not only on those alternative trading systems classified as exchanges, but also on the securities trading on those exchanges, currently registered exchanges, the NMS, clearance and settlement mechanisms, and market participants. In particular, substantial work would be necessary to ensure that newly registered exchanges could be smoothly integrated into existing market structures.

a. Regulation of Securities Trading on Alternative Trading Systems

Classifying alternative trading systems as exchanges could affect the trading of securities on these systems, particularly on those systems that are required to register as national securities exchanges. Securities traded on a national securities exchange must be registered with the Commission and approved for listing on the exchange, or traded pursuant to Commission regulations governing trading of securities listed on another exchange (''unlisted trading privileges'' or ''UTP''). These requirements are critical to ensuring that securities trading on exchanges provide investors with adequate information and that all relevant trading activity in a security is reported to, and surveilled by, the exchange on which such security is listed.

Specifically, section 12(a) of the Exchange Act makes it unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration statement is in effect as to such security for such exchange in accordance with the provisions of the Exchange Act and the rules and regulations thereunder.[153] Under this requirement, upon registration as exchanges, alternative trading systems that are currently trading unregistered securities could no longer freely trade those securities.[154]

In addition, national securities exchanges are permitted to trade securities listed on other exchanges and Nasdaq only pursuant to UTP regulations, which limit the range of securities that they may trade.[155] Like all exchanges, a newly registered exchange would be required to have in place rules for trading the class or type of securities it seeks to trade.[156] To trade Nasdaq/National Market (''NM'') securities, a newly registered exchange would also be required to become a signatory to an existing plan governing such trading.[157] Moreover, under section 12(f) of the Exchange Act, exchanges cannot trade securities not registered on an exchange or classified as NM securities (such as Nasdaq SmallCap or other OTC securities) without Commission action. Section 12(f) of the Exchange Act authorizes the Commission to permit the extension of UTP to any security registered otherwise than on an exchange. The OTC–UTP plan,[158] which permits UTP for Nasdaq/NM securities, is the only extension approved to date by the Commission.[159] Thus, exchanges cannot currently trade Nasdaq SmallCap, other OTC securities, or exempted securities that are not separately listed on the exchange. This restriction would also apply, absent Commission action, to alternative

to promulgate rules and regulations for each of these entities concerning financial responsibility, protection of investor securities and funds, recordkeeping and financial reporting, and audits.''

Id. at 3.

[151] Although all marketable Treasury notes, bonds, and zero-coupon securities are listed on the NYSE, exchange trading volume is a small fraction of the total over-the-counter volume in these instruments. *See* 1992 Joint Report, *supra* note 143.

[152] Coordinated surveillance of secondary trading in municipal securities is still developing. The MSRB, under the Commission's supervision, has authority to issue rules governing, among other things, professional qualifications, recordkeeping, quotations, and advertising of municipal securities broker-dealers. Enforcement of MSRB rules is divided between banking regulatory agencies (for banks) and the NASD (for non-bank firms), with the Commission having authority over all municipal securities dealers, as well as non-bank municipal securities broker-dealers. *See* Municipal Securities Report, *supra* note 144, at 37. Recently, the Commission approved an MSRB rule change designed to increase the information available about municipal securities and to provide a centralized audit trail of municipal securities transactions. *See* Securities Exchange Act Release No. 37998 (Nov. 29, 1996), 61 FR 64782 (Dec. 6, 1996).

[153] 15 U.S.C. 78*l*(a). Section 12(b), 15 U.S.C. 78*l*(b), contains procedures for the registration of securities on a national securities exchange.

[154] Section 12(a) does not apply to exchanges that the Commission has exempted from registration as national securities exchanges, although the Commission could consider whether it would be appropriate to limit trading on exempted exchanges to securities registered under section 12 of the Exchange Act. *See* AZX Exemptive Order, *supra* note 24. *See also* Securities Exchange Act Release No. 37271 (June 3, 1996), 61 FR 29145 (June 7, 1996).

[155] Exchange Act § 12(f), 15 U.S.C. 78l(f).

[156] Exchange Act Rule 12f–5, 17 CFR 240.12f–5.

[157] *See* OTC–UTP plan, *infra* note 168.

[158] *See infra* note 168 and accompanying text.

[159] *Id.*

trading systems newly registered as exchanges.[160]

These restrictions would have a significant effect on newly registered exchanges. Most alternative trading systems do not independently list securities; securities traded on such systems are generally unlisted or listed on another market. As a result, in order to comply with Exchange Act requirements applicable to national securities exchanges, such systems would need to establish listing procedures and comply with Commission regulations governing unlisted trading privileges. Under the tiered approach to regulating alternative trading systems, the ability of such systems to trade a wide range of securities would be subject to the same UTP conditions as currently registered exchanges. In order to minimize some of these effects, the Commission could consider expanding the category of securities that would be available for UTP trading.

Integrating a broader range of entities into the UTP structure could also affect existing exchange rules, such as NYSE Rule 390 and similar offboard trading restrictions, designed to limit members from effecting OTC transactions in exchange-listed stocks.[161] For example, transactions that are executed through alternative trading systems currently may be considered to be OTC transactions. If significant alternative trading systems were to register as exchanges, activity on those systems could no longer be considered to be OTC. Consequently, rules that expressly prohibit OTC transactions in listed securities by their terms would no longer apply to activity on those alternative trading systems and, as a result, the number of transactions subject to the prohibition of such rules would decrease. The Commission is soliciting comment on whether there would be any customer protection or competitive reasons to preserve these offboard trading restrictions if the interpretation of ''exchange'' is broadened to include alternative trading systems and highly organized dealer markets.

Question 64: How could the Commission foster the continued trading of all securities currently traded on alternative trading systems if these systems are classified as exchanges under the interpretation described above and some of these systems are required to register as national securities exchanges? For example, what would be the effect on alternative trading systems that wish to trade securities exempted from registration under Rule 144A if those systems are required to register as national securities exchanges?

Question 65: How would the requirement to have rules in place for trading unlisted securities affect the viability of alternative trading systems that are required to register as national securities exchanges?

Question 66: Would the specifications in the OTC–UTP plan relating to the trading of Nasdaq/NM securities pose particular problems for systems that are required to register as national securities exchanges?

Question 67: Should the Commission extend UTP to securities other than NM securities, such as Nasdaq SmallCap securities? What effect would an inability to trade Nasdaq SmallCap and other non-Nasdaq/NM securities have upon alternative trading systems that are required to register as national securities exchanges?

Question 68: What effect would the prohibition on UTP trading of newly listed stock until the day following an initial public offering have upon systems that are required to register as national securities exchanges?

Question 69: How should existing exchange rules designed to limit members from effecting OTC transactions in exchange-listed stock be applied, if the Commission's interpretation of exchange were expanded to include alternative trading systems and organized dealer markets? What customer protection and competitive reasons might there be to preserve these rules if alternative trading systems are classified as exchanges?

b. Integration with National Market System Mechanisms and Existing Exchange Practices

A revised interpretation of the term ''exchange'' would not only affect currently registered exchanges and alternative trading systems required to register as exchanges, it could also have a significant impact on the NMS, coordination of market-wide trading policies, listing arrangements, and exchange rules governing member trading in the OTC market. There could also be significant effects on coordination of market-wide surveillance and enforcement efforts among national securities exchanges.

Because alternative trading systems differ in several key respects from currently registered exchanges, a number of issues would need to be resolved before these systems could be integrated into national market system mechanisms. Integrating newly registered national securities exchanges into the NMS mechanisms should not cause the homogenizing of all markets—to the contrary, it is as important today as it was in 1975 to cultivate an atmosphere in which innovation is welcome and possible. Such integration therefore could require revision of NMS mechanisms so that they could accommodate diverse and evolving markets. The Commission solicits comment, as discussed in greater detail below, on what revisions to the structure of NMS mechanisms might be necessary to accommodate alternative trading systems. The Commission also solicits comment on the costs and potential effects on innovation if alternative trading systems were linked to NMS mechanisms. In addition, the Commission solicits comment on the costs and potential effects if revisions to the NMS mechanisms were not effective.

Question 70: What effects would linking alternative trading systems to NMS mechanisms have on those systems? For example, how would such linkages affect the ability of alternative trading systems to operate with trading and fee structures that differ from those of existing exchanges or to alter their structures? To what extent could revision of the NMS plans alleviate these effects?

(i) Inter-Market Plans

If certain alternative trading systems were required to register as national securities exchanges, these systems would be expected to become participants in market-wide plans currently subscribed to and operated by registered exchanges and the NASD. All of the currently registered exchanges and the NASD participate in joint plans for transaction and quotation reporting: the CQS, the CTA, the ITS,[162] the

[160] National securities exchanges are also prohibited, pursuant to Exchange Act Rule 12f–2, from extending UTP to a security subject to an initial public offering (''IPO'') until the trading day following commencement of the IPO. Currently, pursuant to NASD rules, participants in the OTC market, including alternative trading systems, may trade securities subject to an IPO immediately after trading has opened on the listing exchange. NASD Manual Section 6440(j). If registered as an exchange, such entities would be subject to the one-day waiting period prior to trading securities subject to an IPO.

[161] For example, NYSE Rule 390 prohibits NYSE members from effecting certain transactions in NYSE-listed stocks in the OTC market. Exchange Act Rule 19c–1, however, prohibits the application of off-board trading restrictions to trades effected by a member as agent. 17 CFR 240.19c–1. Moreover, Exchange Act Rule 19c–3 prohibits the application of off-board trading restrictions to securities listed on an exchange after April 26, 1979. 17 CFR 240.19c–3.

[162] The CTA provides vendors and other subscribers (including alternative trading systems) with consolidated last sale information for stocks

Options Price Reporting Authority (''OPRA''),[163] and the Nasdaq/National Market System/Unlisted Trading Privileges (''OTC–UTP'').[164] These plans form an integral part of the NMS for the trading of securities, and contribute greatly to the operation of linked, transparent, efficient, and fair markets. In order for any newly registered national securities exchanges to become fully integrated into the NMS, it would be essential that the operations of those new exchanges and the market linkage systems be compatible. If the Commission revises its approach to regulation of alternative trading systems by requiring those with active pricing mechanisms and significant volume to register as national securities exchanges, it may have to take action to ensure the suitable and timely inclusion of new exchanges into the NMS.

(A) Quotation and Transacting Reporting

If certain alternative trading systems are required to register as national securities exchanges, they would be required to have effective quote and transaction reporting plans and procedures in place under section 11A of the Exchange Act.[165] The CTA and CQS plans, which are now operated by the eight national securities exchanges and the NASD, make quote and transaction information in exchange-listed securities available to the public. Both the CTA and the CQS plans have provisions governing the entry of participants to the plans.[166] According to the terms of the CTA plan, any national securities exchange or registered national securities association may become a participant of the CTA by subscribing to the CTA plan[167] and paying to the existing participants an appropriate amount for the ''tangible and intangible assets'' created under the plans that will be made available to the new participant. The CQS Plan has similar terms. Participants in the CTA and CQS plans share in the income and expenses associated with the provision of quotation information according to the terms of the plans.

Under the terms of the OTC–UTP plan governing trading of Nasdaq/NMS securities,[168] any national securities exchange where Nasdaq/NMS securities are traded may become a full participant thereunder. The plan specifically states that a new signatory must pay a share of development costs to become a participant in the plan. The plan provides for the collection, consolidation, and dissemination of quotation and transaction information for Nasdaq/NM securities, sets forth specifications for transmission of data to Nasdaq, and establishes procedures for market access, regulatory trading halts, cost allocation, and revenue sharing. Similarly, the OPRA plan approved by the Commission[169] provides for the collection and dissemination of last sale and quotation information on options that are traded on the participant exchanges. Under the terms of the plan, any national securities exchange whose rules governing the trading of standardized options have been approved by the Commission may become a party to the OPRA plan. The plan provides that any new party, as a condition of becoming a party, must pay a share of OPRA's start-up costs. It also provides for revenue sharing among all parties.

Given the breadth of these plans, existing plan participants would need to work expeditiously with newly registered exchanges to facilitate inclusion of these new exchanges into the NMS plans. Participation in these transaction reporting plans should not seriously impair the functioning of most alternative trading systems. If the Commission revised its approach to regulation of alternative trading systems by requiring those with active pricing mechanisms and high volume to register as national securities exchanges, it may have to take action to ensure the suitable and timely inclusion of new exchanges into these quotation and transaction reporting plans.

Question 71: Are there any insurmountable technical barriers to admission of alternative trading systems into the CTA, CQS, OPRA, or OTC–UTP plans?

Question 72: What costs are associated with the admission of new applicants to these plans?

Question 73: Are there any CTA, CQS, OPRA, or OTC–UTP plan rules that would prevent newly registered national securities exchanges from obtaining fair and equal representation on these entities?

Question 74: What effect would the admission of newly registered national securities exchanges to the CTA, CQS, OPRA, and OTC–UTP plans have upon the governance and administration of those plans?

Question 75: Do admissions fees for new participants required by the terms of the plans present a barrier to admission to the plans? Do the plans' provisions that all participants are eligible to share in the revenues generated through the sale of data affect commenters' views on this issue?

(B) Intermarket Trading System

It has been the Commission's longstanding policy that market centers trading listed stocks be linked. The current linkage, ITS, enables a broker or dealer who participates in one market to execute orders, as principal or agent, in an ITS security at another market center, by sending a commitment to execute with another market through the system. ITS also establishes a procedure that allows specialists to solicit pre-opening interest in a security from specialists and market makers in other markets, thereby allowing these specialists and market makers to participate in the opening transaction. Participation in an opening transaction can be especially important when the price of a security has changed since the previous close. Finally, ITS rules require that the members of participant markets avoid initiating a purchase or sale at a worse price than that available on another ITS

admitted to dealings on any exchange. The CQS gathers quotations from all market makers in exchange-listed securities and disseminates them to vendors and other subscribers. The ITS is a communications system designed to facilitate trading among competing markets by providing each market participating in the ITS pursuant to a plan approved by the Commission (''ITS plan'') with order routing capabilities based on current quotation information. *See, e.g.,* Securities Exchange Act Release Nos. 37191 (May 9, 1996), 61 FR 24842 (May 16, 1996); 17532 (Feb. 10, 1981), 46 FR 12919 (Feb. 18, 1981); 23365 (June 23, 1986), 51 FR 23865 (July 1, 1986) (Cincinnati Stock Exchange / ITS linkage); 18713 (May 6, 1982) 47 FR 20413 (May 12, 1982) (NASD's CAES / ITS linkage); 28874 (Feb. 12, 1991), 56 FR 6889 (Feb. 20, 1991) (Chicago Board Options Exchange / ITS linkage).

[163] *See infra* note 169 and accompanying text for a description of the OPRA plan.

[164] *See infra* note 168 and accompanying text for a description of the OTC–UTP plan.

[165] *See also* Exchange Act Rules 11Ac1–1(b)(1), 17 CFR 240.11Ac1–1(b)(1); 11Aa3–2(c), 17 CFR 240.11Aa3–2(c).

[166] The CTA plan also contains a provision for entities other than participants to report directly to the CTA as ''other reporting parties.'' Pursuant to this provision, parties other than a national securities exchange or association may be permitted to provide transaction data directly to the CTA.

[167] *See* Securities Exchange Act Release No. 37191 (May 9, 1996), 61 FR 24842 (May 16, 1996).

[168] *See* Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Exchange-listed Nasdaq/National Market System Securities and for Nasdaq/National Market System Securities Traded on Exchanges on an Unlisted Trading Privilege Basis (''OTC–UTP plan''). Securities Exchange Act Release No. 24407 (Apr. 29, 1987), 52 FR 17349 (May 7, 1987). Currently, the NASD, the CHX, and the Phlx are participants in the OTC–UTP plan. The BSE is a limited participant, and as such only reports quotation and transaction information for Nasdaq/NM securities that are also listed on the BSE. *See* Securities Exchange Act Release No. 36985, 61 FR 12122 (March 18, 1996).

[169] The OPRA plan was approved pursuant to Section 11A of the Exchange Act and Rule 11a3–2 thereunder. *See* Securities Exchange Act Release No. 17638 (Mar. 18, 1981) (hereinafter OPRA plan). The five exchanges which are participants in the OPRA plan are the Amex, the CBOE, the NYSE, the PCX, and the Phlx.

participant market (''trade-throughs'').[170] Participation in the ITS will give users of these new exchanges full access to, and enable them to execute transactions on other ITS participant markets. Moreover, participation in ITS will require new exchanges to comply with other applicable ITS rules and policies on matters such as, for example, trade-throughs, locked markets,[171] and block trades.[172]

Under an approach that involved broadening the interpretation of ''exchange,'' entities newly registered as national securities exchanges would be expected to sign the plan and become participants in ITS, or an equivalent system if one were developed.[173] Alternative trading systems, however, have developed differently than exchanges and often serve different constituencies. Some practices of alternative trading systems would undoubtedly conflict with the current provisions of the ITS plan, or would be incompatible with participation in ITS. For example, many alternative trading systems allow participants to trade in smaller increments than those available on current plan participants. Similarly, many alternative trading systems have institutional participants who may prefer to trade at an inferior price in order to trade in a larger size, resulting in a locked or crossed market. These characteristics are potentially incompatible with current ITS provisions. If the Commission were to adopt a revised approach to the regulation of alternative trading systems, it likely would be necessary to work with plan participants to accommodate diverse market structures in the plan.

Question 76: What effect would the admission of new, highly automated participants have upon the operation of the ITS?

Question 77: How would compliance with the current ITS rules and policies affect trading on alternative systems that may be regulated as exchanges? How appropriate are these rules and policies for alternative trading systems?

Question 78: What costs would be associated with newly registered exchanges joining ITS? Would those costs represent a barrier for newly registered exchanges to join ITS?

Question 79: Are there any ITS plan rules or practices that would prevent newly registered national securities exchanges from obtaining fair and equal representation on the ITS?

Question 80: What effect would the admission of newly registered national securities exchanges to the ITS plan have upon the governance and administration of the plan?

(ii) Uniform Trading Standards

The Commission is also considering how policies governing market-wide trading, such as trading halts and circuit breakers, would apply to alternative trading systems that register as exchanges. Registered national securities exchanges, the NASD, and the Commission each have the authority to impose trading halts for individual securities, for classes of securities, and on markets as a whole.[174] There are four types of trading halts: (1) Halts due to primary or regional market order imbalance, or operational problems; (2) regulatory halts (as a result of dissemination of material news); (3) halts due to data processing or telecommunications problems (*e.g.*, the inability to disseminate quotations or trade reports); and (4) Commission ordered halts. The existing registered exchanges and the NASD currently have different rules and procedures in place for applying trading halts, and a new interpretation of the term ''exchange'' would result in a broader application of these trading halts in some instances. Because many alternative trading systems are currently operated by registered broker-dealers, they are subject to NASD rules, including rules requiring them to comply with trading halts imposed by the NASD. If registered as national securities exchanges, however, such systems would be required to impose their own trading halts.[175] In addition, a trading system that was regulated as an exchange, would need to implement circuit breaker rules for extraordinary market volatility.

Question 81: What effect would the requirements to impose trading halts or circuit breakers in some circumstances have upon alternative trading systems if such systems were regulated as exchanges?

c. Oversight of Non-Broker-Dealers That Have Access to Exchanges and Clearance and Settlement of Non-Broker-Dealer Trades

As discussed above, Congress intended for an exchange that allowed non-broker-dealers to access its facilities to be responsible for overseeing the trading of such non-broker-dealers.[176] The scheme of self-regulation and market oversight codified in the Exchange Act relies primarily on trading markets to implement and operate market mechanisms for enforcing the federal securities laws and for ensuring that all market participants have adequate access to market information. This system may be able to function effectively only if all significant trading activity and market participants are supervised by an SRO. If entities can participate directly in the market in a significant way without being overseen by an SRO, market mechanisms designed to ensure transparency and to surveil for fraud and manipulation may not be fully effective. The Commission's findings in the NASD 21(a) Report, discussed above, demonstrate the problems that arise when trading occurs on markets that are not subject to effective market oversight.[177] Therefore,

[170] A trade-through occurs when an ITS participant purchases securities at a lower price or sells at a higher price than that available in another ITS participant market. For example, if the NYSE is displaying a bid of 20 and an offer of 20 ⅛ for an ITS security, the prohibition on trade-throughs would prohibit another ITS participant market from buying that security from a customer at 19 ⅞ or selling that security to a customer at 20 ½. *See* ITS plan, *supra* note 162, at Exhibit B. In addition, each participant market has in place rules to implement the ITS Trade-Through Rule. *See, e.g.*, NASD Rule 5262. The plan also provides a mechanism for satisfying a market aggrieved by another market's trade-through. *See* ITS plan, *supra* note 162, at Exhibit B(b)(2).

[171] A locked market occurs when an ITS participant disseminates a bid for an ITS security at a price that equals or exceeds the price of the offer for the security from another ITS participant or disseminates an offer for an ITS security at a price that equals or is less than the price of the bid for the security from another ITS participant. The plan provides a mechanism for resolving locked markets.

[172] The ITS block trade policy provides that the member who represents a block size order shall, at the time of execution of the block trade, send or cause to be sent, through ITS to each participating ITS market center displaying a bid (or offer) superior to the execution price a commitment to trade at the execution price and for the number of shares displayed with that market center's better priced bid (or offer).

[173] To become a participant in ITS, an exchange or association must subscribe to, and agree to comply and to enforce compliance with, the provisions of the plan. *See* ITS plan, *supra* note 162, at section 3(c).

[174] *See, e.g.*, Amex Rule 117, NASD Rule 4120(a)(3), NYSE Rules 80B and 717. Pursuant to Exchange Act sections 12(k)(1)(A) and (B), the Commission may suspend trading in any security for up to 10 days, and all trading on any national securities exchange or otherwise, for up to 90 days. 15 U.S.C. 78*l*(k)(1)(A) and (B).

[175] For example, a newly registered exchange would be required under Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1 (the ''Quote Rule''), to halt trading when neither quotation nor transaction information can be disseminated.

[176] As noted above, Congress adopted section 6(f) specifically to ensure that the Commission and exchanges have sufficient authority both to limit the ability of non-members to utilize exchange facilities and to ensure that transactions on that exchange are effected in accordance with applicable exchange rules regardless of whether the particular transaction is brought to the exchange by a broker-dealer that is not an exchange member or by an investor who is not utilizing a broker. *See supra* section II.B.2.a.(i).

[177] *See* NASD 21(a) Report, *supra* note 20.

it would probably be necessary for any registered exchange to supervise the trading of non-broker-dealer participants in the same manner as it supervises broker-dealer trading. For example, as part of its obligations under the Exchange Act, each exchange currently maintains procedures to surveil for insider trading and manipulation on that exchange. These procedures, while differing among exchanges, generally identify trading anomalies based on historical and current data, review trading data to isolate suspicious activity and, if suspicious activity is found, refer the matter for enforcement proceedings.[178] If an exchange permitted institutions to directly participate in trading as members, the Commission, pursuant to its authority under section 6(f) of the Exchange Act, could require that exchange to enforce its rules with respect to such non-broker-dealers by conducting equivalent surveillance procedures.

Nevertheless, it may not be appropriate to enforce exchange rules for non-broker-dealers in precisely the same manner as for broker-dealers. For example, although an exchange would have to maintain surveillance procedures for all of its participants, an exchange may require a non-broker-dealer participant to provide different information in the course of cooperating with investigations than would be required from broker-dealer participants. Similarly, in addition to the Commission's net capital requirements for broker dealers,[179] each registered exchange currently requires their broker-dealer members to maintain minimum levels of capital.[180] Exchanges could consider applying different financial requirements to non-broker-dealer participants than they currently apply to broker-dealers.

In any case, institutions that trade for accounts other than their own, maintain custody of customer funds or securities, act as specialists or market makers, or otherwise act as brokers or dealers would be required to register as broker-dealers under the Exchange Act. Entities that engage in broker-dealer activities would continue to be required to comply with broker-dealer registration requirements, Exchange Act and SRO capital and books and records requirements, as well as prohibitions under section 11(a) and other provisions of the Exchange Act designed to protect against conflicts of interest between an exchange member trading for its own account on an exchange and its trading on an agency basis for other accounts.[181]

In addition, integration of alternative trading systems that have institutional participants into exchange registration will raise issues regarding clearance and settlement of the trades of those participants. Currently, institutions do not participate directly in the clearance and settlement process at registered clearing agencies such as the National Securities Clearing Corporation (''NSCC'') or The Depository Trust Company (''DTC'').[182] There is, however, no statutory prohibition against the admission of institutions as members of registered clearing agencies.[183] Conversely, there are no provisions under the Exchange Act, the rules thereunder, or current SRO rules, that require a member conducting trades on an exchange to be a direct member of a clearing agency. Currently, for example, broker-dealer members of an exchange may use a clearing broker for processing trades conducted on an exchange. Similarly, the Commission anticipates that institutions that conduct trades on newly registered exchanges could continue to use separate entities for clearance and settlement of trades.

In order to provide future institutional members the same clearance and settlement choices available to current broker-dealer exchange members, it may be appropriate for clearing agency membership to be open to institutions. Such admission would be subject to corresponding clearing agency rules assuring appropriate safeguards and qualifications.

Question 82: What impact would registration of an alternative trading system as an exchange have on the institutional participants of that trading system, including registered investment companies?

Question 83: If the Commission allows institutions to effect transactions on exchanges without the services of a broker, to what extent should an exchange's obligations to surveil its market and enforce its rules and the federal securities laws apply to such institutions?

Question 84: How could an exchange adequately supervise institutions that effect transactions on an exchange without the services of a broker?

Question 85: What, if any, accommodations should be made with respect to an exchange's surveillance, enforcement, and other SRO obligations with respect to institutions that transact business on that exchange?

Question 86: How could institutions that directly access exchanges be integrated into existing systems for clearance and settlement?

d. Application of Broker-Dealer Regulation to Certain Exchanges

Under the alternative discussed above, most alternative trading systems would be regulated as exempted exchanges. A few alternative trading systems, however, combine both the services of a market and those of a broker-dealer. For example, some systems perform market functions by operating electronic limit order books or crossing sessions. These same systems employ persons to actively search for buyers and sellers[184] or use their discretion in executing orders.[185]

Just as broker-dealer regulation has not effectively integrated alternative trading systems into market regulation, the current framework for regulating exchanges is not well-suited to address concerns raised by traditional broker or dealer activities. As a result, the Commission would consider whether markets that are regulated as either exempted exchanges or as registered national securities exchanges, but that also provide traditional brokerage services, should be subject to broker-dealer regulation as well. Application of broker-dealer regulation in such circumstances may not be inappropriate or necessarily duplicative.

[178] An exchange's surveillance depends on the nature of trading that occurs, and the type of securities that are traded on the exchange.

[179] 17 CFR 240.15c3–1. Capital requirements help to ensure that broker-dealers maintain liquid assets in sufficient amounts to enable them to satisfy their obligations promptly and to provide a cushion of liquid assets to protect against potential market and credit risks.

[180] *See, e.g.*, NYSE Rule 325.

[181] For example, broker-dealers are prohibited from trading ahead of a customer's order, frontrunning, free-riding and withholding, and maintaining accounts for the employees of other broker-dealers without notifying such broker-dealers.

[182] Institutions will generally hire a bank or broker-dealer that is a member of DTC to act as custodian on their behalf. Institutions can be members of DTC's Institutional Delivery system for purposes of the confirmation/affirmation process, but the actual settlement of securities transactions (*i.e.*, the transfer of money and securities) at DTC occurs between the institutions' broker-dealers and custodians. Similarly, NSCC is designed to process street-side settlement between financial intermediaries such as broker-dealers. Therefore, institutions are not members of NSCC for the purposes of settlement of trades.

[183] In fact, Section 17A of the Exchange Act requires that registered investment companies and insurance companies be permitted to become members of clearing agencies. 15 U.S.C. 78q–1(b)(3)(B).

[184] The system employee, for example, negotiates or assists in negotiating the terms of a particular trade on behalf of a participant by initiating communications with potential counterparties.

[185] These additional broker-dealer services may include directing the order to another market or broker-dealer for execution, or executing the order as principal.

This approach is consistent with the way in which exchanges and the persons that trade on those exchanges have traditionally been regulated. For example, specialists are registered broker-dealers that carry on a business for themselves while also serving the exchange as a whole. Among other things, specialists help to ensure the maintenance of a continuous and liquid market. They also often provide individualized services to their customers, such as alerting customers to market movements and forwarding orders to other markets. Although they perform many services for exchanges, specialists are regulated as broker-dealers. There is no reason, however, why an exchange could not choose to perform these activities itself rather than rely on third parties to perform them.

In such a situation, the Commission would have to consider how best to integrate the regulation of these broker-dealer activities with the regulation of the exchange's market activities. To the extent that exchange and broker-dealer regulations overlap, the Commission could determine which requirements a dually registered entity would follow.[186]

The Commission does not anticipate that a revised interpretation of the term ''exchange'' would include other entities that currently provide services to participants in the U.S. securities markets without being registered as broker-dealers or as exchanges. Examples of such service providers are those that restrict their activities to providing communication links between exchanges and broker-dealers and between broker-dealers and customers. Entities that only provide such message routing services likely would not be required under this approach to register with the Commission as either broker-dealers or as national securities exchanges.[187] Entities that provide such communication links and also have affiliates that use those links to perform market functions, however, could be deemed to be facilities of an exchange. In general, in determining whether broker-dealer or exchange regulation would be appropriate for a particular entity, communication links offered in conjunction with other services would have to be viewed in their entirety.

Question 87: Under what conditions should an entity be subject to both exchange and broker-dealer regulation?

Question 88: Should a dually registered entity be required to formally separate its exchange operations from its broker-dealer operations (*e.g.*, through use of separate subsidiaries)?

C. Conclusion

The exchange-based approach described above might address the gaps created by the current approach to oversight of alternative trading systems, as well as many of the concerns raised by the broker-dealer based approach, and could result in more consistent market protections over time. In addition, such an approach might contribute substantial regulatory certainty and the application of fair and equitable principles of trade to alternative trading systems. As noted above, however, such an approach might also have significant effects on existing exchanges, alternative trading systems, and market participants. To some extent, many alternative trading systems that would be considered exempted exchanges under this approach would be subject to less regulation than they currently are, while the few significant alternative trading systems would be subject to more substantial regulatory requirements. This approach would also potentially require greater adjustment to existing NMS mechanisms to accommodate newly registered exchanges than would a broker-dealer based approach.

Question 89: Would this approach be an effective means of addressing the issues raised by the growth alternative trading systems? What would be the benefits of such an approach? What would be the drawbacks of such an approach?

V. The Commission Could Consider Ways in Which Requirements Might Be Reduced or Expedited for Registered Exchanges

The effects of technology on domestic markets have not been limited to alternative trading systems. Registered exchanges and Nasdaq are also engaged in applying technology to respond to the fast changing competitive pressures of modern securities markets. In addition to considering the regulatory position of alternative trading systems, the Commission could therefore consider whether there are other areas of its approach to regulation of markets that would benefit from reevaluation. Specifically, the Commission could examine ways to reduce unnecessary regulatory requirements that make it difficult for these registered entities to remain competitive in changing business environments. The Commission has tried to fulfill its obligation under the Exchange Act to oversee the activities of exchanges and securities associations in a manner that is flexible and responsive to market developments and that allows for innovation by these entities. This has entailed ongoing consideration of additional ways in which the obligations imposed by the Exchange Act on registered exchanges and securities associations may be streamlined, without sacrificing investor protection or market integrity.

The Commission could consider what changes might be made to expedite exchanges' and securities associations' procedures for changing their rules, and how automation might be used to lower the costs and improve the effectiveness of their surveillance and enforcement responsibilities. The Commission could also consider what changes might be made to give exchanges and securities associations greater flexibility in determining how to fulfill their regulatory obligations. For example, while it is generally in the public interest for each exchange to retain ultimate responsibility for fulfilling its statutory obligations, it is clear that smaller SROs do not benefit from the economies and efficiencies of scale available to SROs that supervise larger memberships. In addition, larger SROs may obtain greater cost efficiencies by offering their services to other SROs for a fee. This type of ''outsourcing'' could be a useful tool for exchanges and securities associations.

A. Ways to Further Expedite Rule Filings

Section 19(b)(1) of the Exchange Act requires SROs to file copies of proposed rules and rule amendments with the Commission, accompanied by a concise general statement of the basis and purpose of the proposed rule change.[188] Once a proposed rule change is filed, the Commission is required to publish notice of it and provide an opportunity for public comment. This process serves a critical role in giving the Commission sufficient oversight authority to ensure

[186] For example, certain broker-dealer trading systems, which are subject to Exchange Act Rule 17a–23, would be exchanges under the proposed new interpretation of the term ''exchange.'' To prevent an alternative trading system from being subject to the requirements of both Rule 17a–23 and an exempted exchange or a national securities exchange, the Commission could amend Rule 17a–23 as necessary to avoid duplicative regulation.

[187] *See, e.g.*, Letter from Richard R. Lindsey, Director, Division of Market Regulation, SEC, to Scott W. Campbell, V.P. & Assoc. General Counsel, Charles Schwab & Co., Inc. (Nov. 27, 1996).

[188] The scope of this requirement depends upon what constitutes a ''rule'' under the Exchange Act. If something does not rise to the level of a ''rule,'' section 19(b)(1) does not apply. sections 3(a)(27) and (29) of the Exchange Act define the rules of an SRO broadly to include not only the constitution, articles of incorporation, and bylaws, but also any stated policies, practices, and interpretations that the Commission, by rule, determines to be rules of an SRO. *See* Exchange Act Rule 19b–4, 17 CFR 240.19b–4.

that exchanges and securities associations carry out their self-regulatory obligations vigilantly and effectively.

Between 1934 and 1975, the Exchange Act did not give the Commission adequate authority over SRO rulemaking to act promptly and effectively where a rule or proposed rule might be injurious to the public interest.[189] During that time, the Commission carried out this responsibility by relying on inspections and by conducting administrative proceedings to effect needed changes in exchange rules.[190] The Commission had limited authority to prevent the adoption of a particular exchange rule, or to amend rules once they had been adopted; section 19(b) of the Exchange Act only gave the Commission the authority to amend exchange rules related to certain enumerated matters.[191] As a result, with respect to the majority of exchange rules, although exchanges would consider concerns raised by the Commission or its staff, exchanges were not obligated to address those concerns.[192] Moreover, persons with a significant stake were not provided with notice or an opportunity to comment on a proposed rule change or on the need or justification for a proposal.[193]

The 1975 Amendments established a new uniform procedure for both exchanges and securities associations that required SRO rule changes to be justified to, and reviewed by, the Commission after an opportunity for public comment.[194] In addition, Congress expanded the Commission's authority to permit it to amend all SRO rules.[195] The legislative history of the 1975 Amendments indicates that Congress intended to clarify and strengthen the Commission's oversight role with respect to SROs and, specifically, to ensure that the Commission had the tools it needed to provide meaningful oversight of SRO rules and the rulemaking process.[196] Congress intended that the Commission would conduct a comprehensive review of proposed rule changes, including the justification for the change, any burden on competition and the public interest that the change may impose, and public comments received concerning the rule change.[197] The Commission staff fulfills this responsibility by conducting a careful review of every rule filing it receives. This review often requires the Commission staff to weigh complex and serious issues raised by the proposed changes. The rule filing process also gives the public an opportunity to express its views as to the competitive and other effects of any significant rule changes. For all these reasons, it may be appropriate for all exchanges, including newly registered alternative trading systems, to comply with the rule filing requirements of section 19(b).

Nonetheless, the Commission understands that the time required for solicitation and review of public comments can delay exchanges' and securities associations' implementation of innovative proposals and administrative or non-controversial filings. In response to this concern, the Commission has already streamlined its internal process for reviewing and approving SRO rule filings. This has reduced the average number of days between the filing of a proposed rule change by an SRO and the approval, withdrawal, or disapproval of the rule filing from 349 days at the beginning of fiscal year 1994 to 74 days at the end of fiscal year 1996.

In addition, to respond to SRO requests that the rule review process be expedited, in December 1994, the Commission adopted amendments to Rule 19b–4, which expanded the scope of proposed rule changes that may become effective immediately upon filing pursuant to section 19(b)(3)(A) of the Exchange Act.[198] These amendments permitted SRO rule changes concerning routine procedural and administrative modifications to existing order-entry and trading systems to become effective immediately upon filing. Certain non-controversial filings were also permitted to become operational 30 days after filing with the Commission, provided the SRO gave written notice to the Commission five business days prior to the filing.[199] These amendments to Rule 19b–4, in part, were intended to enhance SROs' ability to implement prompt, flexible, and innovative systems changes.[200] The Commission

[189] *See* SEC, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Rep. No. 231, 92d Cong., 1st Sess. 6 (1971).

[190] The Commission's effort to eliminate fixed commission rates is illustrative of this process and why it was problematic. *See* Securities Exchange Act Release No. 11203 (Jan. 23, 1975), 40 FR 7394 (Feb. 20, 1975).

[191] Before 1975, exchanges were allowed to adopt, without Commission approval, any rule not inconsistent with either the Exchange Act or a Commission rule, and were required to furnish the Commission with copies of rule amendments only upon their adoption. The Commission, however, could alter or supplement exchange rules that related to certain enumerated matters pursuant to defined procedures. In contrast, registered securities associations were required to file rule changes with the Commission 30 days before they became effective, and the Commission had the authority to prevent proposals from taking effect. The Commission could also alter, supplement, or abrogate an association's rule in certain circumstances. *See* generally Special Study, *supra* note 4, at 703–06.

[192] *See* Special Study, *supra* note 4, at 711.

[193] *See* Securities Industry Study, Subcomm. on Securities, Senate Committee on Banking, Housing & Urban Affairs, S. Doc. No. 13, 93d Cong., 1st Sess. 156–7, 198 (1973); Note, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 Yale L.J. 832 (1971).

[194] In order to provide interested persons with an opportunity to obtain accurate information on rule proposals and to participate in the review and evaluation of SROs' proposed rule changes, the 1975 Amendments required SROs to file an explanation or justification for their proposals and the Commission to publish notice of the SROs' proposed rule changes. Congress intended this requirement to hold the SROs to the same standards of policy justification that the Administrative Procedures Act imposes on the Commission. *See* Exchange Act section 19(b)(1), 15 U.S.C. 78s(b)(1); S. Rep. No. 75, *supra* note 22, at 29–32.

[195] Exchange Act section 19(c), 15 U.S.C. 78s(c).

[196] *See, e.g.*, S. Rep. No. 75, *supra* note 22. ''In the new regulatory environment created by this bill, self-regulation would be continued, but the SEC would be expected to play a much larger role than it has in the past to ensure that there is no gap between self-regulatory performance and regulatory need, and, when appropriate, to provide leadership for the development of a more coherent and rational regulatory structure to correspond to and to police effectively the new national market system.'' *Id.* at 2.

[197] *Id.*

[198] Section 19(b)(3)(A) of the Exchange Act sets forth certain specified categories of rule changes that may become effective upon filing. These include rule changes that: (1) Constitute a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the SRO; (2) establish or change a due, fee, or other charge imposed by the SRO; or (3) are concerned solely with the administration of the SRO. In addition, consistent with the public interest and the purposes of this subsection, the Commission may specify other categories of rule filings that may become effective upon filing. 15 U.S.C. 78s(b)(3)(A).

[199] *See* Securities Exchange Act Release No. 35123 (Dec. 20, 1994), 59 FR 66692 (Dec. 28, 1994). Particularly in the area relating to new exchange-traded products, the Commission continues to reduce the number of days between filing and allowed trading of those products that do not raise significant regulatory issues or concerns. For example, when an exchange seeks to trade a product that meets generic criteria for listing options on narrow-based indexes, the time period between filing and allowed trading of the product can be shortened considerably. *See, e.g.*, Securities Exchange Act Release No. 38307 (Feb. 19, 1997), 62 FR 8469 (Feb. 24, 1997) (options on The de Jager Year 2000 Index); Securities Exchange Act Release No. 38207 (Jan. 27, 1997), 62 FR 5268 (Feb. 4, 1997) (options and LEAPS on the Phlx Oil Service Index); Securities Exchange Act Release No. 37312 (June 14, 1996), 61 FR 31570 (June 20, 1996) (options on The Morgan Stanley Commodity Related Equity Index); Securities Exchange Act Release No. 37115 (Apr. 15, 1996), 61 FR 17741 (Apr. 22, 1996) (options on the CBOE Gold Index); Securities Exchange Act Release No. 37026 (Mar. 26, 1996), 61 FR 4502 (Apr. 3, 1996) (options on the Chicago Board Options Exchange Computer Networking Index). The exchange may trade the new product 30 days after the date the rule change is filed with the Commission.

[200] It appears that SROs, including exchanges, could take better advantage of the expedited process available under section 19(b)(3)(A) of the Exchange Act. In fiscal year 1996, for example, out of a total of 552 rule changes filed with the Commission, only 18 (or 3.5%) were filed under the expanded

Continued

staff has also taken a flexible approach in applying the expedited procedures under Rule 19b–4. For example, filings that are virtually identical to an SRO filing already approved by the Commission can often be approved on an accelerated basis, particularly in the context of new product listing standards that duplicate listing standards already approved for an identical product on another exchange.[201]

Nonetheless, there may be additional ways in which the Commission could reduce rule filing requirements to facilitate a rapid response by SROs to changing market conditions and competitive pressures. For example, the Commission could consider further expanding the scope of proposed rule changes eligible for effectiveness immediately upon filing to include, for example, any proposed changes to listing standards to accommodate new products. In expanding the scope of rules eligible for this treatment, it may be appropriate to require an SRO to make an affirmative statement that it has undertaken a review of the Commission's eligibility criteria for immediate effectiveness under Rule 19b–4 and is satisfied that the rule filing being submitted conforms to such requirements.

The Commission could also consider exempting certain SRO programs designed to implement innovative new trading systems or mechanisms from rule filing requirements during development and initial operating stages. In the past several years, a few SROs have attempted to implement innovative trading structures for their members. For example, in 1991, the NYSE established after-hours crossing systems that automate the execution of single stock orders and baskets of securities,[202] and in 1994, the CHX developed the Chicago Match system.[203] Although neither program has generated significant trading activity,[204] in both cases, the exchanges submitted rule filings prior to operation. Because of the innovative nature of such systems for the sponsoring exchanges, the approval process was protracted. Alternative trading systems that offer similarly innovative, start-up services today are not required to follow the same procedures prior to operation of the services. In addition, SROs have indicated that revealing the business plans for such innovative programs prior to operation makes it more difficult for them to compete effectively with alternative trading systems in offering start-up services to their members.

The Commission believes that markets should be encouraged to innovate. One way of facilitating innovation by exchanges and securities associations, as well as vigorous competition among these markets, would be to enable exchanges and securities associations to establish innovative trading programs, apart from their other operations. For example, an exchange may wish to establish an electronic book for the trading of securities not traded on the exchange's primary system. Such programs could then be subject to similar oversight as that applied to small, start-up alternative trading systems, to the extent appropriate in light of investor protection. Under such an approach, the Commission could exempt pilot programs from rule filing requirements until such time as the program obtained significant volume, was integrated with an exchange's or securities association's other trading mechanisms, or otherwise began to have significant market impact.

Any such proposal would require careful consideration as to the types of programs that might be eligible for exemption, and other conditions that might be appropriate in light of investor protection concerns, national market system goals, and just and equitable principles of trade. As noted above, one reason that Congress required SROs to submit rule filings was to ensure that the interests of investors were considered in SRO actions, and that persons with a significant stake were provided with notice and an opportunity to comment on a proposed rule change. For example, pilot programs that might be eligible for exemption could potentially function as alternatives to trading through a market's primary system. In such circumstances, these programs would affect not only investors whose orders are executed on such systems, but also investors and traders who were not given the opportunity to use the pilot program. Moreover, customers who placed orders in the exchange's main trading system could also be affected, *e.g.*, if their orders did not have an opportunity to interact with orders executed through the pilot program. For these reasons, it may not be appropriate to make a rule filing exemption available for pilot programs that trade the same securities, operate during the same time of day, or have similar trading structures as a market's main trading system or are otherwise linked to a market's primary operations.

In addition, the Commission could consider the appropriate standards for determining whether a particular proposal would qualify as a pilot program. Other issues to be considered would include whether any exemption for pilot programs should be limited in duration, even if the programs did not reach significant volume, and what would be the appropriate measure for determining when a program would have limited volume in light of all relevant factors.[205] Finally, the Commission could consider how SROs would notify the Commission and the SROs' participants prior to implementing a pilot program, and disclose to participants in the pilot program whether the quality or type of execution capabilities of the pilot system differ from those of the exchange's established systems.

Question 90: Would it be feasible for the Commission to expand the scope of rules eligible for expedited treatment pursuant to Section 19(b)(3)(A) without jeopardizing the investor protection and

expedited process. Similarly, in fiscal year 1995, only 12 out of a total of 593 rule changes (2%) were filed under the expanded expedited process. SROs could also facilitate the prompt publication of notices of proposed rule changes by submitting rule filings in such a form that enables the staff to expedite their review. The Commission strongly encourages SROs to evaluate their internal procedures for drafting, reviewing, and submitting rule filings to take greater advantage of expedited procedures and to ensure complete filings that will enable the Commission to respond promptly.

[201] *See* Securities Exchange Act Release No. 36296 (Sept. 28, 1995), 60 FR 52234 (Oct. 5, 1995) (relating to listing and trading of broad-based index warrants on Nasdaq); Securities Exchange Act Release No. 36165 (Aug. 29, 1995), 60 FR 46653 (Sept. 7, 1995) (establishing the NYSE's uniform listing and trading guidelines for stock index, currency, and currency index warrants); Securities Exchange Act Release No. 36166 (Aug. 29, 1995), 60 FR 46660 (Sept. 7, 1995) (establishing PCX's uniform listing and trading guidelines for stock index, currency, and currency index warrants); Securities Exchange Act Release No. 36167 (Aug. 29, 1995), 60 FR 46667 (Sept. 7, 1995) (establishing Phlx's uniform listing and trading guidelines for stock index, currency, and currency index warrants); Securities Exchange Act Release No. 36169 (Aug. 29, 1995), 60 FR 46644 (Sept. 7, 1995) (establishing CBOE's uniform listing and trading guidelines for stock index, currency, and currency index warrants).

[202] *See* Securities Exchange Act Release No. 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991); Securities Exchange Act Release No. 32368 (May 25, 1993), 58 FR 31565 (June 3, 1993).

[203] *See, e.g.*, Securities Exchange Act Release No. 35030 (Nov. 30, 1994), 59 FR 63141 (Dec. 7, 1994) (order approving Chicago Match, an electronic matching system operated by the CHX, which provided for the crossing of orders entered by CHX members and non-members, including institutional customers).

[204] The NYSE's crossing sessions continue to generate volume that is well below that of POSIT and the smallest registered exchange. The CHX determined not to continue operating Chicago Match in 1996. *See* Sarah Gates, *Will Anyone Miss Chicago Match*, Wall Street & Technology, Apr. 1996, at 26.

[205] As discussed above, whether a trading system has enough volume to have significant market impact will differ depending upon, among other things, the size and liquidity of the market for the instruments traded.

market integrity benefits of Commission oversight of exchange and other SRO rule changes? If so, to what types of rule filings should immediate effectiveness, pursuant to Section 19(b)(3)(A), be extended?

Question 91: If the Commission expands the scope of rule filings eligible for treatment under Section 19(b)(3)(A) to include, for example, certain types of new products, what conditions or representations should be required of an SRO to ensure that the proposed rule change is eligible for expedited treatment under Rule 19b–4?

Question 92: Should the Commission exempt markets' proposals to implement new trading systems, separate from their primary trading operations, from rule filing requirements? If so, should SROs be permitted to operate pilot programs under such an exemption if they trade the same securities, operate during the same hours, or utilize similar trading procedures as the SRO's main trading system? Should there be a limit on the number of pilot programs an SRO can operate under an exemption at any one time? What other conditions should apply to such exemption?

B. Surveillance and Enforcement

Technological advances have greatly increased an exchange's ability to fulfill its enforcement obligations under the Exchange Act efficiently and cost effectively. Some sponsors of trading systems have suggested that automated trading activity requires less extensive surveillance, and that markets with fully automated trading should not be required to conduct the same surveillance as non-automated exchanges. This suggestion may be based in part on the view that automation of trading algorithms may make it more difficult for participants to trade in violation of the trading rules embedded in those algorithms. While automation and embedded algorithms alone cannot prevent insider trading or market manipulation,[206] automation may make it easier to detect potential and attempted abuses by providing a full audit trail of trading activity. By circumscribing participant trading activity, automation can also reduce the resources that must be devoted to monitoring trading activities, which, consequently, would reduce the costs of exchange regulation. For example, failures by market makers to fulfill their obligation to honor quotations are easier to detect in a fully automated environment.[207] Accordingly, the Commission is considering whether fully automated markets may be able to fulfill their regulatory obligations in non-traditional ways.

Existing Commission initiatives and SRO plans that coordinate supervision of broker-dealers that are members of more than one SRO (''common members'') could also apply to newly registered exchanges. For example, while exchanges are required to enforce compliance by their members (and persons associated with their members) with applicable laws and rules, the Commission has used its authority under sections 17 and 19 of the Exchange Act to allocate oversight of common members to particular exchanges, and to exempt exchanges from enforcement obligations with respect to persons that are associated with a member, but that are not engaged in the securities business.[208] In order to avoid unnecessary regulatory duplication, the Commission appoints a single SRO as the designated examining authority (''DEA'') to examine common members for compliance with the financial responsibility requirements.[209] When an SRO has been named as a common member's DEA, all other SROs to which the common member belongs are relieved of the responsibility to examine the firm for compliance with applicable financial responsibility rules.[210] Consistent with past Commission action, the Commission could continue to designate one SRO, such as the NASD or the NYSE, as the primary DEA for common members of exchanges. The Commission has also permitted existing SROs to contract with each other to allocate non-financial regulatory responsibilities.[211] For example, the Commission has approved a regulatory plan filed by the Amex, CBOE, NASD, NYSE, PCX, and the Phlx that designates, with respect to each common member, an SRO participating in the plan as a broker-dealer's options examination authority. This designated SRO has sole regulatory responsibility for certain options-related trading matters.[212] An SRO participating in a regulatory plan is relieved of regulatory responsibilities with respect to a broker-dealer member of such an SRO, if those regulatory responsibilities have been designated to another SRO under the regulatory plan. These programs could also be applicable to newly registered exchanges.

These plans permit an SRO to allocate its oversight obligations with respect to certain members' compliance with various requirements. They do not permit an SRO to allocate its oversight obligations with respect to the activities taking place on its market. Currently, enforcement and disciplinary actions for

[206] While automation may reduce the cost and increase the effectiveness of a market's surveillance program, a responsible party must still be able to recognize potentially manipulative activity and, in many cases, review trading records.

[207] *See* NASD 21(a) Report, *supra* note 20, at 28 and 45 for discussion of failures by market makers on the Nasdaq market to honor their quotations or to ''back away,'' and steps that the NASD undertook, as part of its settlement with the Commission, to upgrade its capabilities to detect and prevent such backing away.

[208] *See* 17 CFR 240.17d–2; 17 CFR 240.19g2–1.

[209] With respect to a common member, Section 17(d)(1) of the Exchange Act authorizes the Commission, by rule or order, to relieve an SRO of the responsibility to receive regulatory reports, to examine for and enforce compliance with applicable statutes, rules and regulations, or to perform other specified regulatory functions. 15 U.S.C. 78q(d)(1).

[210] *See* Securities Exchange Act Release No. 23192 (May 1, 1986) 51 FR 17426 (May 12, 1986). Moreover, Section 108 of the 1996 Amendments, *supra* note 68, adds a provision to Section 17 of the Exchange Act that calls for improving coordination of supervision of members and elimination of any unnecessary and burdensome duplication in the examination process.

[211] Rule 17d–2 under the Exchange Act permits SROs to establish joint plans for allocating the regulatory responsibilities imposed by the Exchange Act with respect to common members. Securities Exchange Act Release No. 12935 (Oct. 28, 1976), 41 FR 49093 (Nov. 8, 1976). In addition to the regulatory responsibilities it otherwise has under the Exchange Act, the SRO to which a firm is designated under these plans assumes regulatory responsibilities allocated to it. Under Rule 17d–2(c), the Commission may declare any joint plan effective if, after providing notice and opportunity for comment, it determines that the plan is necessary or appropriate in the public interest and for the protection of investors, to foster cooperation and coordination among the SROs, to remove impediments to and foster the development of a national market system and a national clearance and settlement system, and in conformity with the factors set forth in section 17(d) of the Exchange Act. The Commission has approved plans filed by the equity exchanges and the NASD for the allocation of regulatory responsibilities pursuant to Rule 17d–2. *See, e.g.,* Securities Exchange Act Release No. 13326 (Mar. 3, 1977), 42 FR 13878 (Mar. 14, 1977) (NYSE/Amex); Securities Exchange Act Release No. 13536 (May 12, 1977), 42 FR 26264 (May 23, 1977) (NYSE/BSE); Securities Exchange Act Release No. 14152 (Nov. 9, 1977), 42 FR 59339 (Nov. 16, 1977) (NYSE/CSE); Securities Exchange Act Release No. 13535 (May 12, 1977), 42 FR 26269 (May 23, 1977) (NYSE/CHX); Securities Exchange Act Release No. 13531 (May 12, 1977), 42 FR 26273 (May 23, 1977) (NYSE/PSE); Securities Exchange Act Release No. 14093 (Oct. 25, 1977), 42 FR 57199 (Nov. 1, 1977) (NYSE/Phlx); Securities Exchange Act Release No. 15191 (Sep. 26, 1978), 43 FR 46093 (Oct. 5, 1978) (NASD/BSE, CSE, CHX and PSE); and Securities Exchange Act Release No. 16858 (May 30, 1980), 45 FR 37927 (June 5, 1980) (NASD/BSE, CSE, CHX and PSE).

[212] *See* Securities Exchange Act Release No. 20158 (Sept. 8, 1983), 48 FR 41265 (Sept. 14, 1983). The SRO designated under the plan as a broker-dealer's options examination authority is responsible for conducting options-related sales practice examinations and investigating options-related customer complaints and terminations for cause of associated persons. The designated SRO is also responsible for examining a firm's compliance with the provisions of applicable federal securities laws and the rules and regulations thereunder, its own rules, and the rules of any SRO of which the firm is a member. *Id.*

violations relating to transactions executed in an SRO's market or rules unique to that SRO must be retained by that SRO. Existing exchanges generally employ personnel and establish extensive programs to fulfill this responsibility. Fully automated exchanges, however, might be able to contract with other exchanges to perform these activities while retaining ultimate responsibility for ensuring that these activities are performed. Fully automated exchanges can produce comprehensive, instantaneous automated records that can be monitored remotely. As a result, it may be possible for such an exchange to contract with another exchange to perform its day-to-day enforcement and disciplinary activities. The Commission could consider whether allowing an automated market to do so would be consistent with the public interest.

Another approach would be for fully automated exchanges to form a separate SRO solely for the purpose of overseeing the activities of their markets. This SRO, rather than the automated exchanges, would have the responsibility for bringing enforcement and disciplinary actions for violations relating to transactions executed on those exchanges. The Commission seeks comment on the advisability and feasibility of such an approach.

Question 93: Do differences between automated and non-automated trading require materially different types or degrees of surveillance or enforcement procedures?

Question 94: Which Exchange Act requirements applicable to registered exchanges, if any, could be minimized or eliminated without jeopardizing investor protection and market integrity?

Question 95: If an automated exchange contracts with another SRO to perform its day-to-day enforcement and disciplinary activities, should this affect the exchange's requirement to ensure fair representation of its participants and the public in its governance?

Question 96: If an exchange contracts with another entity to perform its oversight obligations, should that exchange continue to have responsibility under the Exchange Act for ensuring that those obligations are adequately fulfilled?

VI. Costs and Benefits of Revising the Regulation of Domestic Markets

The two alternatives discussed in Section IV could provide significant benefits to U.S. securities markets and market participants. By integrating all significant markets in the market regulatory framework, these proposals would bolster the effectiveness of the national market system by better protecting market participants. For example, if the Commission were to continue to regulate alternative trading systems as broker-dealers, but adopted additional regulations (the first approach discussed in Section IV), the market as a whole would benefit from the additional transparency provided by the public reporting of all orders submitted to alternative trading systems. Moreover, enhancing the surveillance of trading on alternative trading systems would benefit the public by preventing fraud and manipulation. Similarly, by regulating alternative trading systems under a tiered approach to exchange regulation, investors and other market participants could benefit because, as exchanges, significant alternative trading systems would be prohibited from unfairly denying access, taking discriminatory action against participants, imposing unreasonably discriminatory fees, or establishing anticompetitive rules. In addition, because significant alternative trading systems would be required to directly participate in market-wide plans such as the CQS, CTA, OPRA, and ITS, investors could benefit from reductions in misallocations of capital, inefficiency, and trading fragmentation. Moreover, under the proposed reinterpretation of ''exchange,'' investors and the integrity of the market generally could benefit from alternative trading systems sharing SRO responsibilities with currently registered exchanges. In particular, the Commission's ability to prevent fraud and manipulation would be strengthened.

The Commission also recognizes that the proposals discussed in this release would have a substantial impact on the allocation of regulatory costs among market participants. In particular, the additional obligations contemplated under both alternative proposals to revise domestic market regulation could impose costs on alternative trading systems. For example, alternative trading systems could be required to adopt rules to prevent fraud and manipulation, promote just and equitable principles of trade, and not impose any unnecessary or inappropriate burden on competition. Alternative trading systems could also be required to establish mechanisms to assure regulatory oversight of their participants and review their listing procedures. In addition, there would also be costs associated with joining market-wide plans, such as the CQS, CTA, ITS, OPRA, and OTC–UTP. These costs, however, would at least partially be offset because most alternative trading systems would no longer be regulated as broker-dealers. In addition, because alternative trading systems, as exchanges, would share the responsibilities of self-regulation, the regulatory burden carried by currently registered exchanges should be reduced. In contrast, integrating these alternative trading systems into the mechanisms of the national market system through broker-dealer regulation could entail additional costs for the trading systems as well as their supervising SROs.

Question 97: What costs to investors and other market participants are associated with the current regulation of alternative trading systems as broker-dealers? Specifically, what costs are associated with the potential denial of access by an alternative trading system?

Question 98: What costs are associated with each of the alternatives for revising market regulation discussed above? For example, would either of the two principal alternatives discussed in Section IV above impose costs by limiting innovation? Would these costs be greater than those imposed by the current regulatory approach?

Question 99: What regulatory costs can be shared by markets operating simultaneously as self-regulatory organizations, and what regulatory costs must be borne by each market individually? What are the relative magnitudes of these costs (as a proportion of total costs)?

Question 100: Are there innovations or adjustments that can be made to market wide plans such as CQS, CTA and ITS that will lead to lower regulatory costs for exchanges under any of the alternatives for regulating domestic markets?

Question 101: Total regulatory costs vary with a variety of factors (e.g., volume of trade, degree of technology applied in trade). Of these factors, which are most relevant in considering the alternatives discussed above? For example, recognizing that some market mechanisms may rely on some factors more than others, to what extent are regulatory costs greater for particular mechanisms than others?

Question 102: What costs are associated with the responsibilities of an SRO? Will the costs to existing SROs be reduced by registering significant alternative trading systems as exchanges?

Question 103: What regulatory burdens currently inhibit innovation of trading systems? How will the alternatives discussed above change the incentives for innovation?

Question 104: Will the alternatives discussed above impose costs on systems that differ depending on the nature of the trade? For example, will the proposed regulatory revisions change the costs of trades directly between customers relative to the costs of trades between a customer and a dealer?

VII. Regulation of Foreign Market Activities in the United States

A. The Need for a Clear Regulatory Structure to Address U.S. Investors' Electronic Cross-Border Trading

In addition to significantly changing the way domestic markets operate, technology has given U.S. investors new and varied options for accessing foreign markets. The desire of many investors to diversify their portfolios through foreign investment has already resulted in an exponential increase in trading in foreign securities by U.S. persons.[213] The use of advanced technology by broker-dealers, markets, and other entities has the potential to greatly increase institutions' and other U.S. investors' cross-border trading opportunities, to make cross-border trading both more efficient and more affordable, and to promote competition among global markets and intermediaries.

Until recently, in order to obtain current information regarding foreign market activity and to purchase or sell securities on a foreign market, a U.S. investor typically contacted a U.S. broker-dealer by telephone or facsimile. The U.S. broker-dealer would then give the investor current information and transmit the investor's order to a foreign broker-dealer member of the foreign market[214] on which the security was traded. Alternatively, the U.S. investor could contact a foreign broker-dealer member of the foreign market directly. Today, however, it is possible for U.S. investors to obtain real-time information about trading on foreign markets from a number of different sources and to enter and execute their orders on those markets electronically from the United States.

For example, an investor that is not a member of a foreign market can nonetheless trade directly on that market using electronic interfaces, by linking to the market through a member of that market (typically the investor's broker-dealer). The market member provides a direct, automated link between the customer and the foreign market by connecting the customer's computer system directly to its own, which is also connected with the foreign market. This may be accomplished in a variety of ways, including through the use of proprietary software, leased lines or a public network such as the Internet. The member's systems will then automatically distribute market information to the U.S. investor and route the investor's orders directly to the market. Through these types of ''pass-through'' linkages, the non-member customer can enjoy electronic trading capabilities that are equivalent to the trading privileges of a member of the foreign market. From the broker-dealer's and customer's perspectives, this type of ''pass-through'' service enables the investor to send orders through the electronic interface without the broker-dealer having prior knowledge of each order or manually interpositioning itself in the trading process. As a result, orders routed electronically by a customer to the exchange remain under the customer's control until the moment of execution. This is in contrast to traditional brokerage activities involving orders that are routed from a customer to a foreign market member (or its affiliate), and from the member to the exchange. From the perspective of the foreign market, orders sent by a broker-dealer customer through a member's electronic interface may be indistinguishable from orders placed directly by the member.[215] Some broker-dealers have also begun to facilitate trading directly on the facilities of foreign markets in which those broker-dealers are not members, for their U.S. customers or affiliates. This is typically accomplished through agreement or affiliation with a local member of that market.

In addition to allowing investors that are not members to trade directly on foreign markets, technological advances have enabled market members themselves to trade from remote locations outside of particular markets' home countries. Many foreign markets have integrated new technology into their trading processes in recent years, either by using computers in combination with traditional floor trading procedures,[216] or by completely automating their trading facilities.[217] This enhanced technology enables members of those markets to trade without being physically present on a market ''floor'' or establishing a physical

[213] Between 1980 and 1995, the total activity by U.S. persons in foreign securities grew from $53.1 billion to $2,573.6 billion, representing over a 4700% increase. Securities Industry Association, 1996 Securities Industry Fact Book 67 (forthcoming June 1997).

[214] As used in this release, a ''member'' of a foreign market includes any person to which a foreign market provides access for the purpose of effecting transactions on that market. This would include any person that is a full or limited member of a foreign market or that the foreign market allows to electronically access its trading facilities.

[215] Although orders originate from a non-member, they are electronically identified, or ''stamped,'' as coming from the member providing the interface.

[216] For example, in September 1994, the Amsterdam Stock Exchange introduced a new electronic trading system that permits banks and broker-dealers to effect wholesale trades on-screen using the Automatic Interprofessional Dealing System Amsterdam (''AIDA''). This system permits exchange participants to enter bids and offers and to execute trades via a remote computer located in their offices. *The Netherlands,* Institutional Investor, Inc., Sept. 16, 1996, at 11; *The Amsterdam Stock Exchange—An Overview—Amsterdam Stock Exchange,* Business Monitor, Mar. 30, 1995. Similarly, Frankfurt's Deutsche Borse provides remote access in London, Amsterdam, Paris, and Zurich, and has attracted 44 remote members. The number of remote members of the Deutsche Borse is predicted to swell to at least 100 within three to five years. Laura Covill, *Survival of the Fittest,* ABI/INFORM, Aug. 1996, at 60. In addition, the Athens Stock Exchange has installed an electronic trading system that allows members to execute orders via exchange-owned terminals. Internet Site of the Athens Stock Exchange, address: http://www.ase.gr/waser.htm (Dec. 5, 1996).

[217] For example, since 1989, OM Stockholm (formerly the Stockholm Stock Exchange) has been completely electronic, and has remote members in London, Denmark, Norway, Finland, and Switzerland. OMLX, the London Securities & Derivatives Exchange, which is owned by the same company as OM Stockholm, is also a completely electronic trading system. *See* Laura Covill, *Survival of the Fittest,* ABI/INFORM, Aug. 1996, at 60; Hugh Carnegy, *Survey—Swedish Banking; Two Dynamic Exchanges,* Fin. Times, June 20, 1996, at 6. Tradepoint, a London-based electronic stock exchange, started trading in September 1995. *See* Henry Harrington, *Survey of European Stock Exchanges,* Fin. Times, Feb. 16, 1996. The Paris Bourse is now an entirely computerized stock market. Supercac, a system linked to member firms and other intermediaries collecting client orders, went on line in April 1995 and allows for continuous, automated trade execution to take place on the Paris Bourse. *See* Internet Site of The Paris Stock Exchange, address: http://www.bourse-de-paris.fr (Nov. 6, 1996); Henry Harrington, *Survey of European Stock Exchanges,* Fin. Times, Feb. 16, 1996. The purchase by the Toronto Stock Exchange (''TSE'') of the Paris Bourse's Supercac software enabled the TSE to close its floor on April 24, 1997. See *Toronto Stock Exchange Closes its Trading Floor,* The Wall Street J., Apr. 24, 1997, at C15. Other examples of completely automated exchanges include the MEFF Renta Fija and MEFF Renta Variable in Spain, the New Zealand Stock Exchange, the Korean Stock Exchange, the Philippine Stock Exchange, the Singapore Stock Exchange, and the Thailand Stock Exchange. Foreign futures and options markets have also embraced electronic trading systems. For example, the Tokyo International Financial Futures Exchange, the Osaka Futures and Options Exchange, the Swiss Options and Financial Futures Exchange, the Irish Futures and Options Exchange, and the New Zealand Futures and Options Exchanges are completely electronic. *See* Hughes Levecq & Bruce W. Weber, *Electronic Markets and Floor Markets: Competition for Trading Volumes in Futures and Options Exchanges,* Center for Research on Information Systems, Working Paper Series No. IS–95–20, June 15, 1995; Allan D. Grody & Hughes Levecq, *Past, Present and Future: The Evolution and Development of Electronic Financial Markets,* Center for Research on Information Systems, Working Paper Series No. IS–95–21, Nov. 1993.

presence in a market's home country. As a result, several foreign markets have begun to offer their members in non-U.S. jurisdictions ''remote'' access to their trading facilities, typically by installing proprietary market terminals in the members' offices, by providing data feeds or codes for use with software operated through the members' own computers, or by allowing members to access a market's trading facilities through third party service vendors or public networks (such as the Internet). In recent years, several foreign markets have proposed permitting U.S. broker-dealers and institutional investors to become market members through similar remote access arrangements.[218] If this remote access were offered in the United States, U.S. investors would have the ability to trade directly on foreign markets and to bypass broker-dealers.

These are examples of ways in which U.S. investors might access foreign markets. As technology evolves and investor comfort with electronic trading increases, other types of access will likely develop as well, including those that may make greater use of the Internet.

1. The Applicability of the U.S. Regulatory Structure to the Activities of Access Providers Has Not Been Expressly Addressed

When a foreign market, broker-dealer, or other entity provides the type of direct foreign market access described above to investors located in the United States (hereinafter referred to as an ''access provider''), its activities typically differ from both traditional brokerage activities and the activities of exchanges. The Commission to date has not expressly addressed the regulatory status of entities that provide U.S. persons with the ability to trade directly on foreign markets from the United States. While some access providers may be registered as U.S. broker-dealers because of their other activities, the lack of regulatory guidance in this context has discouraged other parties from offering U.S. persons foreign market access. Similarly, foreign markets have been reluctant to permit U.S. persons to become members of their markets without assurances from the Commission that they would not be required to register as national securities exchanges.[219] The Commission therefore is soliciting comment on how best to address U.S. investors' increasing access to foreign markets. Specifically, the Commission requests comment on whether investors could benefit from a clearer regulatory framework for entities that provide U.S. investors with the technological capability to trade directly on foreign markets from the United States.

2. U.S. Investors' Ability to Trade Directly on a Foreign Market And Investor Protection Concerns Under the Federal Securities Laws

In addressing issues raised by cross-border trading, it is important to ensure that investors are provided with certain key protections under the federal securities laws. From an investor's perspective, trading on a foreign market through an access provider is often indistinguishable from trading on a domestic market. These similarities could lead many investors to expect that such trading would be subject to the same protections provided by the U.S. securities laws. There are, however, significant differences in the protections available to investors trading on domestic U.S. markets, and those available to investors trading on foreign markets from the United States. For example, the U.S. securities laws provide significant protections to investors trading on U.S. markets. These protections include assurances that markets and intermediaries will disclose information regarding the rules governing trading operations, as well as requirements regarding transaction reporting and issuer disclosure practices. In addition, U.S. securities laws provide the Commission with the tools to detect and deter fraud and manipulation. Because foreign securities laws are generally not designed to provide these protections to U.S. investors that directly trade on their markets, in the absence of disclosure these differences have the potential to mislead U.S. investors that have come to rely on the U.S. securities laws.

The Commission has been examining alternative regulatory frameworks for addressing these concerns. As an initial matter, the optimal framework for addressing these issues should not impose unnecessary obligations on foreign markets that could effectively preclude U.S. investors from taking advantage of an otherwise efficient, cost-effective investment alternative. Cross-border trading opportunities may raise concerns, however, that U.S. investors may not receive sufficient disclosure about foreign markets or foreign issuers and their securities. As foreign markets are made increasingly accessible to U.S. investors through technological advances, therefore, the Commission should examine how to ensure that investors will receive sufficient information to make informed decisions.

B. Regulating Foreign Market Activities in the United States

The Commission's goal is to initiate a dialogue as to how to develop a consistent, long-term approach that clarifies the application of the U.S. securities laws to the U.S. activities of foreign markets. Any such approach must not impose unnecessary regulatory costs on cross-border trading and, at the same time, must allow the Commission to oversee foreign markets' activities in the United States and protect U.S. investors under the U.S. regulatory framework. There are several ways to achieve these goals. As discussed below, for example, the Commission could (1) rely solely on a foreign market's home country regulator; (2) require all foreign markets to register as national securities exchanges or apply for an exemption from registration; or (3) develop a tailored regulatory scheme designed to regulate the entity that provides U.S. investors with the ability to trade directly on foreign markets, rather than regulating the foreign market itself. The Commission solicits comments on whether any other alternatives could achieve the goals discussed above.

Question 105: What regulatory approaches would best address the concerns raised by the development of automated access to foreign markets? Would these approaches differ if U.S. investors accessed foreign markets in ways other than those described above, such as through the Internet? Are there any other alternative approaches that could be more appropriate?

1. Sole Reliance on Foreign Markets' Home Country Regulation

One option could be for the Commission to rely solely on the laws of the primary regulators of foreign

[218] For example, Deutsche Terminbörse (''DTB''), Germany's electronic futures and options market, installed computer terminals in the United States for trading non-U.S. futures products. *See* Letter from Andrea M. Corcoran, Director, Division of Trading and Markets, Commodity Futures Trading Commission, to Lawrence H. Hunt, Jr., Esq., Sidley & Austin (Feb. 29, 1996) (no-action letter authorizing DTB to install and use computer terminals in the United States in connection with the purchase and sale of certain futures and options contracts). The no-action letter explicitly did not address securities law issues. See also Mark J. Arend, *Securities Trading: How Electronic Markets Empower Institutional Investors,* Global Investment, Dec. 1996, at 30; *The Netherlands,* Institutional Investor, Inc., Sept. 16, 1996, at 11; Laura Covill, *Survival of the Fittest,* ABI/INFORM, Aug. 1996, at 60; *Business, Legal News from Around Europe,* Buraff Publications, May 13, 1996.

[219] Several foreign markets have proposed to provide U.S. investors with direct electronic access to their trading systems. In conjunction with these proposals, the foreign markets have requested certain relief from U.S. exchange and broker-dealer registration requirements.

markets, if those foreign markets are subject to regulation comparable to U.S. securities regulation. Under this approach, the Commission could specify foreign markets that it determines are subject to comparable regulation. In determining whether a foreign market is subject to comparable regulation, the foreign regulatory structure could be viewed as a whole to determine whether it, in its design and implementation, adequately addresses the key protections provided by U.S. securities laws. The Commission could make this determination on a case-by-case basis or it could establish certain standards governing the determination. Under the latter approach, if a foreign market met those enumerated standards, the foreign market could be considered subject to ''comparable'' regulation.[220]

This approach might have several advantages. First, it could provide regulatory certainty to foreign markets entering the United States. Second, it would not impose any additional regulatory costs on foreign markets. As a result, foreign markets would be able to provide their services to U.S. investors at lower cost. Third, this approach would recognize that principles of international comity support reasonable deference to a home country's governance of its own markets, particularly with respect to trading in the securities of home country issuers.

Despite these advantages, an approach that relies solely on foreign regulation has significant drawbacks. As discussed above, a U.S. investor trading on a foreign market through an access provider may incorrectly assume that such trading is subject to the same protections as trading on U.S. markets. Foreign laws, however, may differ significantly from U.S. securities laws.[221] For example, under the federal securities laws, a registered exchange must establish rules that describe its trading processes, file those rules with the Commission (which publishes them for comment), and enforce those rules fairly among its members. These requirements are designed to enable investors to make informed decisions about the risks and benefits of trading in a particular market. U.S. investors rely on the availability and accuracy of the information provided by markets, as well as the information provided by intermediaries, when making their investment decisions. Many foreign markets, however, do not require a similar level of disclosure.

The practices of foreign markets in areas that affect market integrity can also differ significantly from those of U.S. exchanges. For example, some foreign markets are not subject to laws designed to prevent insider trading or other forms of market manipulation that are prohibited in the United States. In addition, U.S. securities laws require market makers and specialists to have firm quotes,[222] and to display certain customer limit orders.[223] They also require U.S. markets and certain participants to report most trades for public dissemination within 90 seconds.[224] On the other hand, many foreign markets do not require market participants to report trading activity as quickly as under U.S. law,[225] and do not publicly disseminate such information as promptly as U.S. markets. Some foreign markets also do not require companies to provide financial and other material information to investors as often or as completely as is required under U.S. law. Moreover, the methods of calculating and reporting financial information that are used on foreign markets often differ from U.S. standards. U.S. investors trading electronically on foreign markets from the United States may not have access to complete information regarding these transaction reporting and issuer disclosure practices so as to evaluate whether published information is current.

Foreign markets also may not be subject to regulations designed to provide regulators with the tools to detect and deter behavior that is prohibited under U.S. securities laws, such as fraud, manipulation, or insider trading. For example, unlike domestic exchanges, which are required to comply with federal securities laws and to enforce compliance with such laws by their members,[226] foreign markets may have less comprehensive surveillance, examination, or enforcement capabilities. In addition, many foreign markets are not required under the laws of their home countries to preserve the trading information that would enable an investigation to be commenced under U.S. law. Without adequate recordkeeping, it could be difficult for the Commission to detect fraudulent or other illegal activity being conducted through access providers.[227]

An equally important component of the Commission's ability to detect and investigate violations of the federal securities laws is *access* to trading information. Even if a foreign market maintains comprehensive trading records, it may be constrained by local law from sharing these records or other market information with U.S. regulators.[228] Unless the Commission has access to trading records, its ability to fully investigate and bring enforcement actions for violations of the U.S. securities laws could be undermined.

U.S. investors may also expect that, because they are trading on foreign markets from the United States, they will be able to file private actions to recover losses arising from trading on those markets. In reality, the foreign nature of such trading may prevent U.S. investors from filing such claims in U.S. courts, from obtaining evidence to support their claims, from serving process on defendants, or from enforcing judgments.

In sum, although relying on foreign market regulation could provide regulatory certainty and allow foreign markets and access providers to provide their services to U.S. investors, it may not provide U.S. investors with certain essential protections they have come to expect. The Commission seeks comment on whether this option is feasible and consistent with the federal securities laws.

Question 106: If the Commission were to rely solely on a foreign market's primary regulator, how could it address the investor protection and enforcement concerns discussed above?

[220] It could be appropriate to permit foreign markets regulated solely under the laws of their home country to trade only foreign securities with U.S. persons. Possible definitions of the term ''foreign securities'' are discussed below.

[221] *See supra* Section VII.A.2.

[222] Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1.

[223] Exchange Act Rule 11Ac1–4, 17 CFR 240.11Ac1–4.

[224] Pursuant to the terms of the CTA Plan, *see supra* notes 166 and 167, it is the responsibility of all participant exchanges and the NASD to report all sales transactions as promptly as possible, and establish collection procedures to ensure that 90% of such last sale reports are provided within 90 seconds of execution. CTA Plan, Section VIII. Market rules also require participants to report trades within 90 seconds after execution or designate them as being late. *See, e.g.,* NASD Rule 4632. A pattern or practice of late reporting without exceptional circumstances may be considered inconsistent with high standards of commercial honor and just and equitable principles of trade in violation of NASD Rule 2110.

[225] Other foreign markets allow market participants to delay reporting of certain trades. For example, the London Stock Exchange allows members to delay publication of certain large block trades for up to 60 minutes.

[226] *See supra* Section II.B.1.

[227] As the Commission staff stated in its 1994 report on the U.S. equity markets, the Commission also has a significant regulatory interest in ensuring that foreign markets are not used by U.S. broker-dealers to circumvent the application of U.S. regulatory requirements to the detriment of U.S. persons complying with those requirements. *See* Market 2000 Study, *supra* note 14, at VII–4.

[228] *See generally* Technical Committee of the International Organization of Securities Commissions (IOSCO), Report on Issues Raised for Securities and Futures Regulators by Under-Regulated and Uncooperative Jurisdictions 5 (Oct. 1994).

2. Requiring Foreign Markets to Register as National Securities Exchanges

A second option could be to require foreign markets with U.S. activities to register as national securities exchanges under the Exchange Act or to satisfy criteria for exemption from exchange registration.[229] Foreign markets that offer their services to U.S. persons would have to comply with the same regulatory obligations as U.S. exchanges. Under this approach, U.S. investors trading on foreign markets would be provided with the same protections they have when trading on U.S. markets. This could address the concern that, because trading on a foreign market may be indistinguishable from trading on a domestic market, investors may be led to expect that such trading would be subject to the same protections provided by the U.S. securities laws. This approach also could ensure that any foreign markets that offer services to U.S. investors would provide the same protections as registered or exempted exchanges, such as disclosure of trading rules, transparency, timely transaction reporting, and T+3 clearance and settlement.

The U.S. regulatory scheme applicable to exchanges, however, is not necessarily designed to accommodate entities that only engage in limited activities in the United States and that are primarily regulated in foreign jurisdictions. It may not be feasible, therefore, to regulate a foreign market's activities under a regulatory scheme that applies to domestic markets, particularly if a foreign market's only activity in the United States is to provide its U.S. members with the ability to trade directly on its facilities or to allow its members to provide U.S. persons with electronic linkages to trade outside of the United States. For example, U.S. exchange regulation could conflict with the regulation to which these markets are already subject in their home countries or could subject these markets to unnecessarily duplicative and expensive obligations. Any approach to regulating the U.S. activities of these foreign markets should attempt to minimize conflict with obligations imposed by their primary regulators. There may also be limits on the Commission's jurisdiction to impose exchange requirements on foreign markets that have remote access arrangements with U.S. persons. The Commission seeks comment on whether this option is feasible and consistent with the federal securities laws.

Question 107: Should the Commission require foreign markets with only limited activities in the United States to register as national securities exchanges or obtain an exemption from such registration? How would this affect U.S. persons trading directly on foreign markets?

3. Regulating Access Providers to Foreign Markets

A third approach could be to regulate the access providers to foreign markets, including broker-dealers, rather than regulating the foreign markets themselves. Entities that provide U.S. investors with the technological capability to trade directly on a foreign market's facilities appear to fall into two basic categories. The first category includes those entities that distribute or publish information regarding transactions on a foreign market, and provide a direct electronic link on behalf of the U.S. *members* of that foreign market. This category of access providers could be regulated as SIPs.[230] Under this approach, foreign markets, information vendors, and other parties that provide U.S. members with the ability to trade directly on foreign markets could either register as SIPs themselves, or could choose instead to have another registered SIP provide this capability to U.S. persons. This approach could also provide a safe harbor from exchange registration for foreign markets regulated abroad that choose to conduct their limited U.S. activities through a registered SIP.

The second category of access providers consists of those U.S. and foreign broker-dealers that provide U.S. persons who are not members of a foreign market with the technological capability to trade directly on a foreign market. Through their own or another broker-dealer's electronic linkage to a foreign market, broker-dealer access providers enable their customers to trade directly on the facilities of those foreign markets.[231] Because this access is provided in a manner that is functionally equivalent to that provided by SIP access providers, it presents the same risks to U.S. investors. Therefore, similar basic requirements, such as recordkeeping, reporting, disclosure, and antifraud requirements, could be applied to both SIP and broker-dealer access providers.

Such an approach, based on the regulation of access providers, might have several advantages over the two alternatives discussed above. First, regulating only the U.S. activities of foreign markets and other entities might reduce the likelihood of conflict with foreign markets' home country regulations. Second, creating a regulatory framework tailored for foreign markets could ensure appropriate protections for U.S. investors and clarify the regulatory status of foreign markets and other entities with only limited activities in the United States. Third, establishing a regulatory structure that focuses on the limited activities occurring in the United States, rather than on the activities that a foreign market or third party conducts primarily in a foreign country, may be more consistent with the Commission's mandate under the Exchange Act.[232] Finally, this approach recognizes that U.S. investors trade directly on foreign markets through a variety of sources, and could permit the Commission to regulate, in a similar manner, all entities that provide this service.

Question 108: How can the Commission best achieve its goal of regulating the U.S. activities of foreign markets? Commenters should take into consideration that foreign markets are regulated abroad, that there is a potential for international conflicts of law, and that the Commission has jurisdictional limits. Given the difficulties of surveilling public networks such as the Internet, would an access provider approach be workable?

a. Access Providers to U.S. Members of Foreign Markets

Entities that provide U.S. members of foreign markets with the technological capability to trade directly on these markets from remote locations could be regulated as SIPs under section 11A of the Exchange Act. Section 11A was enacted by Congress more than twenty years ago to create a statutory framework for the integration of automation into the securities markets.[233] Through this section, Congress sought to ensure that ''the securities markets and the regulations of the securities industry remain strong

[229] Currently, the only available exemption from exchange registration is based on limited volume of transactions. 15 U.S.C. 78(e). As discussed in Section IV.B. above, however, the Commission is soliciting comment on using its exemptive authority under section 36 of the Exchange Act to create a new category of exempted exchanges.

[230] *See infra* note 235 and accompanying text for a discussion of the statutory definition of SIP. Registered SIPs are required to comply with Section 11A of the Exchange Act.

[231] A broker-dealer would not be considered an access provider to a foreign market's trading facilities, however, if it handled the execution of its customer orders on foreign markets as part of its traditional brokerage activities.

[232] *See generally* 15 U.S.C. 78dd(b).

[233] Section 11A of the Exchange Act was adopted as part of the 1975 Amendments. Pub. L. No. 29, 89 Stat. 97 (1975).

and capable of fostering [the] fundamental goals [of the Exchange Act] under changing economic and technological conditions.''[234]

While Congress did not focus on cross-border trading specifically, Section 11A provides a regulatory basis to address changes in the markets that result from the development of a global, electronic marketplace. Section 11A extended the Commission's oversight authority to ''any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security . . . or (ii) distributing or publishing . . . on a current and continuing basis, information with respect to such transactions or quotations.''[235] Congress gave the Commission authority to require such entities—referred to as SIPs—to register with the Commission and to establish rules governing SIP activities. All registered SIPs must carry out their functions in a manner consistent with the Exchange Act and report to the Commission denials or limitations of access to the services they provide. The Commission has the authority to review those decisions in much the same manner as it reviews denials or limitations of access to the services offered by registered U.S. exchanges.

Because information processing and dissemination are critical components of today's automated market, the definition of SIP potentially covers a broad range of entities that facilitate communications among investors, intermediaries, and markets. To date, however, only SIPs that process information exclusively on behalf of a U.S. exchange or securities association (known as ''exclusive processors'')[236] have been required to register with the Commission. Congress exempted non-exclusive SIPs from the Section 11A registration requirements until such time as the Commission, by rule or order, finds that the registration of such non-exclusive SIPs is necessary or appropriate in the public interest, for the protection of investors, or for the achievement of the purposes of section 11A. The Commission has not yet promulgated any such rules or orders.[237]

The Commission could use its authority to register and oversee non-exclusive SIPs in order to establish a regulatory framework that could accommodate U.S. investors' and intermediaries' participation in foreign markets from the United States. For example, any non-exclusive SIP could be required to register with the Commission under section 11A if it met the statutory definition of a SIP with respect to securities traded or approved for trading on a foreign market and if it provided a facility or means through which a U.S. person could transmit orders to a foreign market of which the U.S. person is a member.

This approach may have several advantages. For example, it would clarify the regulatory status of foreign markets that arrange for U.S. investors to be members of their trading facilities from the United States. As discussed above, several foreign markets have been reluctant to provide U.S. persons with direct trading capability without receiving assurances from the Commission that they would not be required to register as national securities exchanges under section 5 of the Exchange Act. If the Commission's concerns regarding the effects of U.S. investors' direct trading on foreign markets could be addressed through SIP regulation, there might be no overriding interest in regulating these limited activities of foreign exchanges in the United States under section 5. The Commission therefore solicits comment on the advantages of this approach. The Commission is also soliciting comment on whether it would be appropriate to create a ''safe harbor'' from exchange registration for *bona fide*[238] foreign markets that conduct all their securities activities in the United States through a registered SIP.

Question 109: What would be the best way for the Commission to regulate the limited U.S. activities of foreign markets that provide remote access to U.S. members?

Question 110: When should an entity be required to register with the Commission as a non-exclusive SIP under section 11A of the Exchange Act? For example, should the activities described above require registration as a SIP?

Question 111: If the SIP approach were adopted, is it likely that U.S. members of foreign markets would wish to transmit their orders to such markets through more than one SIP registered with the Commission? If so, should all but one of those SIPs be exempt from registration?

Question 112: Under the SIP approach, should foreign markets that allow their U.S. members to transmit their orders solely through a registered SIP have a safe harbor from registration as national securities exchanges?

Question 113: What type of activities should a registered SIP be permitted to conduct on behalf of a foreign market without the SIP or the foreign market registering as an exchange?

b. Broker-Dealer Access Providers

A U.S. or foreign broker-dealer that provides U.S. persons with terminals, software, access codes, or other means of directly trading on the facilities of a foreign market through a member's interface with that market, provides those U.S. persons with trading capabilities that are functionally equivalent to those of market members, as described above. These types of arrangements therefore present the same risks to U.S. investors and investor protection concerns as described above. An example of this type of arrangement is where a broker-dealer's customer is provided with the technological capability to direct the execution of its orders by viewing a foreign exchange's central limit order book and then transmitting, modifying, or subsequently cancelling an order based on the information in the limit order book.[239] Although the customer's trading on the foreign exchange may be technically or legally considered to be routed by the foreign market member, the customer has the ability to use the facilities of the exchange as though it were a member. By providing U.S persons with the capability to transmit directly, and to direct the execution of, orders to a foreign market, the broker-dealer is providing services that go

[234] S. Rep. No. 75, *supra* note 22, at 3.

[235] Exchange Act section 3(a)(22), 15 U.S.C. 78c(a)(22).

[236] Exchange Act section 3(a)(22)(B), 15 U.S.C. 78c(a)(22)(B). An ''exclusive processor'' is any securities information processor (which is defined in Section 3(a)(22)(A)) that: ''directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange or registered securities association or, any national securities exchange or registered securities association which engages on an exclusive basis on its own behalf, in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association.'' *Id.*

[237] Exchange Act section 11A(b)(1), 15 U.S.C. 78k–1(b)(1). In 1975, the Commission adopted Rule 11Ab2–1 and Form SIP, which provide that each SIP that is required to be registered pursuant to Section 11A(b)(1) of the Exchange Act (*i.e.*, exclusive SIPs) must file an application for registration on Form SIP. Securities Exchange Act Release No. 11673 (Sept. 23, 1975), 40 FR 45448 (October 2, 1975). Currently, there are five exclusive processors registered under Section 11A: (1) The Consolidated Tape Association, (2) the Consolidated Quotation System, (3) the Securities Industry Automation Corporation, (4) Nasdaq, and (5) the Options Price Reporting Authority.

[238] *See infra* Section VII.B.1.c.(i).

[239] This type of arrangement is commonly referred to in this context as a broker-dealer ''give-up.''

beyond traditional brokerage services.[240] Because these services are a relatively recent development, it appears that only a small number of registered broker-dealers provide this type of direct automated service to their institutional customers.[241] In view of these developments, it may be appropriate to regulate, in the manner just described for SIP access providers, both foreign and U.S. broker-dealers that provide U.S. persons with access to an automated facility or means through which they can directly transmit, and direct the execution of, orders on a foreign market.

In some cases, broker-dealers provide their customers with this type of direct linkage to U.S. exchanges through systems such as the NYSE's SuperDOT system.[242] Although a U.S. exchange has obligations under the federal securities laws and is subject to Commission oversight, a foreign market does not have similar obligations. The ability to trade directly on foreign markets, therefore, may raise investor protection concerns.

U.S. registered broker-dealers are also subject to a panoply of regulations and supervisory requirements intended to protect both the capital markets and investors,[243] and have general agency obligations to their customers under the federal securities laws. Nevertheless, these requirements, in their current form, do not necessarily address concerns raised when broker-dealers provide automated means for U.S. persons to trade directly on foreign markets. Consequently, the Commission could separately regulate the activities of U.S. broker-dealers that act as access providers.

Foreign broker-dealers that engage in activities as broker-dealer access providers are, in most cases, exempt from broker-dealer registration pursuant to Rule 15a–6 under the Exchange Act.[244] These access providers therefore are not subject to the same requirements under the U.S. securities laws as registered broker-dealers. The question thus arises of whether the Commission should require foreign broker-dealers to register as U.S. broker-dealers if they act as access providers to foreign markets on behalf of U.S. persons. Traditional broker-dealer regulation could subject foreign broker-dealers to requirements that are not necessary to address concerns raised by the activities of access providers. Such requirements could include the maintenance of specified capital, and SIPC and SRO membership. Under an approach that applied to broker-dealer access providers, however, the Commission could subject foreign broker-dealers that enable U.S. investors to trade directly on foreign markets to a regulatory framework tailored to their access provider activities.

Question 114: What types of automated broker-dealer systems, both operational and contemplated, would be encompassed within the above description of access providers to foreign markets? How widespread are these activities?

Question 115: Would the above description of broker-dealer access providers adequately and clearly exclude traditional brokerage activities, particularly handling the execution of customer orders on foreign markets? If not, how should such activities be distinguished from traditional brokerage activities, particularly traditional cross-border activities? Should U.S. broker-dealers that provide investors with access to foreign markets be subject to any additional requirements?

Question 116: Should foreign broker-dealers that provide U.S. investors with automated access to foreign markets be required to register as broker-dealers on the basis of that activity?

c. Requirements Applicable to Access Providers

If the Commission were to regulate foreign market access providers, there are a number of conditions that could be applied to these entities. For example, as discussed further below, the Commission could subject registered SIP and broker-dealer access providers to recordkeeping, reporting, disclosure, or antifraud requirements.

Question 117: What types of conditions, if any, should the Commission place on access providers if it were to pursue that approach?

(i) Conditions Relating to the Type of Foreign Market

Any new regulatory approach developed by the Commission to address the unique concerns raised by access providers would not be intended as an alternative regulatory scheme for U.S. exchanges. Accordingly, any such approach would be applicable only to *bona fide* foreign markets. There are a variety of ways the Commission could define a *bona fide* foreign market. For example, a *bona fide* foreign market could be any entity that meets the definition of an exchange under Section 3(a)(1) of the Exchange Act or that otherwise conducts the business of an exchange, but that is organized and has its principal place of business outside of the United States. Any national securities exchange, national securities association, or exchange exempt from registration pursuant to a Commission rule or order would not be considered a *bona fide* foreign market. The Commission could also exclude from the definition of a *bona fide* foreign market an exchange that operates a trading facility or provides terminals in the United States.

Another issue is whether SIP and broker-dealer access providers should be permitted to transmit orders for U.S. persons only to foreign markets that would be able to share information with the Commission in connection with an investigation. As discussed above, the ability to access trading and other market information is an essential component of the Commission's ability to detect and deter fraud. Therefore, the Commission could require a level of information sharing that could ensure that the Commission has the ability to obtain necessary information from a foreign regulatory authority and to obtain meaningful assistance in the case of fraud or manipulation involving U.S. persons and a foreign market's participants.[245] For example, the Commission could require access providers to enter into private contractual agreements with foreign markets to which orders are transmitted, under which foreign markets represent

[240] This type of electronic ''pass-through'' arrangement would not encompass customer orders executed on foreign markets by broker-dealers on behalf of their customers as part of a broker-dealers' traditional brokerage activities.

[241] The principal additional requirement with which registered broker-dealers that are access providers to foreign markets would have to comply under this type of approach, would be disclosure of the specific risks relating to the trading on foreign markets. Registered broker-dealers are already subject to most of the recordkeeping, reporting, and antifraud requirements discussed in Section VII.B.1.c.(iii).

[242] *See supra* note 16.

[243] For example, a broker-dealer is required to register with the Commission, become a member of an SRO and SIPC, maintain certain minimum levels of net capital, segregate customer funds, maintain certain books and records, and make periodic reports to the Commission. In addition, broker-dealers are subject to statutory disqualification standards and the Commission's disciplinary authority. *See* Exchange Act section 15, 15 U.S.C. 78o; Securities Investor Protection Act of 1970, 15 U.S.C. 78aaa. *See also* 17 CFR 240.15a–6.

[244] This release does not address any issues that may be raised regarding the applicability of Rule 15a–6 under the Exchange Act or a foreign broker-dealer's obligations thereunder. 17 CFR 240.15a–6.

[245] Some U.S. exchanges that trade derivative products based on securities primarily traded on foreign markets already have surveillance sharing agreements in place. These surveillance sharing agreements typically require signatories to provide to each other, upon reasonable request, information about market trading activity, clearing activity, and, in some instances, the identities of the purchasers and sellers of securities.

that they are not prohibited by local law from sharing information with the Commission and, as a condition of registration, agree to provide information to the Commission upon request. Alternatively, the Commission could designate certain foreign markets that, in its experience, are able to share information with the Commission.

Question 118: If the Commission decides to regulate access providers to foreign markets, what criteria should the Commission use in determining whether an exchange is a *bona fide* foreign market? Should a market be required to have at least a majority of foreign members in order to be a *bona fide* foreign market? Should the Commission exclude exchanges that provide terminals in the United States?

Question 119: Should the Commission regulate as a U.S. exchange any market that, although organized and having its principal place of business outside of the United States, is under common control with or controlled by U.S. persons, or whose decisions regarding trading rules, practices, or procedures are made by U.S. persons?

Question 120: What factors should the Commission use in determining whether an exchange is operating a trading facility in the United States and is not a *bona fide* foreign market? If exchange-owned terminals are located in the United States, should this constitute operating a trading facility in the United States?

Question 121: What effect would a reinterpretation of the term ''exchange'' under section 3(a)(1) of the Exchange Act have on any Commission proposal to regulate SIP and broker-dealer access providers?

Question 122: If the Commission decides to regulate access providers to foreign markets, should the Commission require access providers to transmit orders only to foreign markets that are willing to share, and capable of sharing, information with the Commission in connection with investigations involving violations of U.S. securities laws? If so, what standard should the Commission use in determining whether a foreign market would provide meaningful assistance to the Commission? If commenters believe that SIP and/or broker-dealer access providers should be permitted to transmit orders to any foreign market, indicate how the Commission could ensure that it has the ability to enforce the applicable provisions of the federal securities laws.

Question 123: Should the Commission require access providers to transmit orders only to foreign markets that are located in countries that have entered into arrangements with the Commission to provide enforcement and information sharing assistance?

(ii) Conditions Relating to Type of Persons and Securities

Access providers could be limited to providing their services only to certain sophisticated U.S. institutional investors. Another alternative could be to permit broker-dealer access providers to provide their services to all U.S. investors, but restrict the type of investors to which SIP access providers could provide their services. The Commission is soliciting comment on whether both SIP and broker-dealer access providers should provide their services only to certain sophisticated U.S. institutional investors. In addition, the Commission solicits comment on whether the additional customer protection requirements to which registered broker-dealers are subject should mean that broker-dealer access providers should be allowed to provide their services to all U.S. investors.

Another issue to be considered is whether it would be appropriate to permit SIP and broker-dealer access providers to transmit orders from U.S. persons to foreign markets only for foreign securities. On the whole, transactions in securities of domestic issuers have a greater potential to affect the U.S. securities markets than transactions in securities of non-U.S. issuers, where the primary market is typically overseas. Moreover, when a U.S. access provider is used to trade the securities of domestic issuers on a foreign market, the foreign market could be required to register as a U.S. exchange under section 5 of the Exchange Act.[246]

Question 124: If the Commission regulated access providers through the approach described above, should SIP access providers be limited to providing their services to sophisticated institutions or should they be allowed to provide any U.S. investor with the capability of directly trading on foreign markets as members? If so, should broker-dealer access providers be subject to similar requirements?

Question 125: If the Commission permits SIP access providers to offer their services only to broker-dealers and certain sophisticated institutions, how should this category of sophisticated institutions be defined?

Question 126: Should the Commission permit SIP and broker-dealer access providers to transmit orders to foreign markets for the securities of U.S. issuers or only for the securities of non-U.S. issuers?

Question 127: Should the Commission limit the ability of SIP and broker-dealer access providers to transmit orders to foreign markets for the securities of non-U.S. issuers if the ''principal market'' for those securities is located in the United States? If so, how should the Commission determine when the ''principal market'' of a non-U.S. security is located in the United States?

Question 128: If the Commission permits SIP and broker-dealer access providers to transmit orders to foreign markets only for securities of non-U.S. issuers, how should the Commission distinguish between U.S. and non-U.S. issuers?

(iii) Recordkeeping, Reporting, Disclosure, and Antifraud Requirements

Recordkeeping and reporting requirements, generally, are an important component of the Commission's oversight role. Adequate trading records are invaluable to the Commission's efforts to enforce the antifraud provisions of the Exchange Act. Without adequate records and reports, the Commission would be unable to effectively monitor, evaluate, and examine the activities of registered SIP and broker-dealer access providers.

If the Commission decides to adopt a regulatory framework for access providers, such recordkeeping and reporting requirements could be crucial elements in enhancing Commission oversight of their activities, and in identifying areas where surveillance is needed to detect fraudulent, deceptive, and manipulative practices. Records and periodic reports could also assist the Commission in gaining an understanding of the effects of foreign markets' activities in the United States and with U.S. persons. For example, these recordkeeping and reporting requirements could be similar to the requirements currently imposed on broker-dealers under Exchange Act Rule 17a–23.[247] Specifically, the Commission could require access providers to keep (i) records regarding the identity of their

[246] U.S. courts have interpreted the extraterritorial application of the Exchange Act more expansively when the securities that are the subject of the transaction are issued by a U.S. corporation. *See* ITT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); ITT v. Vencap, Ltd., 519 F.2d 1001, 1017 (2d Cir. 1975) (''We believe that Congress intended the Exchange Act to have extraterritorial application in order . . . to protect the domestic securities market from the effects of improper foreign transactions in American securities.'') (quoting Schoenbaum v. Firstbrook, 405 F.2d 215, 206 (2d Cir. 1968)).

[247] 17 CFR 240.17a–23. To the extent that an access provider that is a U.S. broker-dealer is already subject to Rule 17a–23, that access provider would not be subject to duplicative requirements.

U.S. users; (ii) records regarding daily summaries of trading and time-sequenced records of each transaction effected through the access provider; (iii) information disseminated to U.S. investors, such as quotation and transaction information regarding foreign securities traded on foreign markets; and (iv) copies of the membership standards used by each foreign market to which the SIP provides the U.S. members of the market with the ability to trade directly.

In addition, access providers could be required to file periodic reports. Such periodic reports could contain information regarding (i) the types of securities for which orders are transmitted; (ii) the names of users of the access provider; and (iii) certain transaction information, such as the total volume, number, and monetary value of transactions for each foreign market to which orders are transmitted.

If certain entities that provide U.S. investors with the ability to trade directly on foreign markets were required to register as SIPs, they would, by operation of section 11A of the Exchange Act, be required to notify the Commission, and the Commission would be required to review, any limitations or prohibitions of access to the services offered by such SIPs.[248] Pursuant to Section 11A, the Commission would be required to set aside any action only if it determined that such action was unfairly exclusionary.

In addition to recordkeeping and reporting requirements, the Commission is soliciting comment on whether access providers could be required to make certain disclosures to U.S. investors. Disclosure has always been a cornerstone of the Commission's efforts to protect investors. The question becomes what types of specific disclosures are needed to ensure that U.S. persons have sufficient information regarding foreign securities traded on a particular foreign market through an access provider. For example, SIP and broker-dealer access providers could be required to disclose information about the material risks of trading on foreign markets, as well as the risks of using their own facilities. Such disclosure could include information about trading priorities on a foreign market and notification that the nature and timeliness of pre-trade and post-trade information provided by a foreign market differs from that provided by U.S. registered securities exchanges. In addition, access providers could be required to disclose that there is no guarantee under U.S. law that clearance or settlement of securities trades will occur. SIP and broker-dealer access providers could also be required to disclose system-related risks, including limitations affecting the access providers' capacity to disseminate timely information or to handle users' orders during peak periods.

The Commission could also consider specific antimanipulation rules for registered SIP and broker-dealer access providers in order to clarify the obligations imposed upon these entities under the antifraud provisions of the federal securities laws. The Commission has promulgated rules applicable specifically to registered broker-dealers that prohibit them from engaging in manipulative, deceptive, or other fraudulent activities.[249] It would initially appear that SIP and broker-dealer access providers should be similarly prohibited from engaging in fraudulent, deceptive, or manipulative activities. For this reason, the Commission could consider the need for rules supplementing the general prohibition against fraud in section 10(b) of the Exchange Act, and Rule 10b–5 thereunder.[250] For example, it could specifically prohibit access providers from distributing or publishing information that they have reasonable grounds to believe is fraudulent, deceptive, or manipulative, or from colluding to promote certain stocks without the knowledge of U.S. investors.

Question 129: If the Commission decides to regulate access providers to foreign markets, should they be required to make and keep records? What records should registered SIP and broker-dealer access providers be required to maintain?

Question 130: Should access providers be required to file periodic reports? If so, what information should those contain?

Question 131: Should broker-dealer access providers be required to keep records of denials of access to their services? Should they be required to notify the Commission of such denials of access?

Question 132: What types of risks should be disclosed to users of SIP and broker-dealer access providers? For example, should SIP and broker-dealer access providers be required to disclose the listing and maintenance standards of foreign markets to which they transmit orders on behalf of U.S. persons? What would be the costs associated with such a requirement?

Question 133: Should access providers be required to make disclosures to sophisticated institutions?

Question 134: What market information should SIP and broker-dealer access providers be required to provide to the users of their services?

C. Addressing the Differences Between U.S. and Foreign Markets' Listed Company Disclosure Standards

As the Commission develops an approach to the appropriate regulation of the U.S. activities of foreign markets, it must also address the issues that arise because most securities traded on foreign markets are not registered under the Securities Act or the Exchange Act, and the issuers of those securities do not file reports with the Commission. Section 5 of the Securities Act makes it unlawful for any person, through the use of interstate commerce or the mails, to offer or sell a security in a public distribution prior to the effective date of the registration statement.[251] Unless an exemption applies, securities offered or sold in the United States by issuers (whether domestic or foreign) must be registered with the Commission pursuant to section 5 of the Securities Act.[252] In some cases, foreign securities issued abroad, but later sold in the United States, may be eligible for the exemption under section 4(1) of the Securities Act for ''transactions by any person, other than an issuer, underwriter or dealer.'' [253] However, to the extent that a foreign issuer effects a distribution over the facilities of a foreign market, SIP access providers to that market could be required to ensure that U.S. investors may not purchase

[248] Exchange Act section 11A(b)(5), 15 U.S.C. 78k–1(b)(5). The Senate Committee on Banking, Housing and Urban Affairs report on the Securities Acts Amendments of 1975 indicates that one of the purposes of expanding the Commission's regulatory authority over the processors and distributors of market information was ''to assure that these communications networks are not controlled or dominated by any particular market center, to guarantee fair access to such systems * * * and to prevent any competitive restriction on their operation not justified by the purposes of the Exchange Act.'' S. Rep. No. 75, 94th Cong., 1st Sess. 9 (1975). Under Section 11A(b)(5)(A) of the Exchange Act, registered SIPs are required to file notices of denial or limitation of access with the Commission. 15 U.S.C. 78k–1(b)(5)(A).

[249] *See* 17 CFR 240.15c1–2 through 240.15c1–9.

[250] 15 U.S.C. 78j(b); 17 CFR 240.10b–5.

[251] Securities Act section 5, 15 U.S.C. 77e.

[252] For example, section 3(a) of the Securities Act enumerates 12 categories of exempted securities to which the registration requirements of section 5 do not apply, including securities issued by the U.S. Government, religious and benevolent organizations, savings and loan associations, and cooperative banks. 15 U.S.C. 77c(a). Securities of foreign private and sovereign issuers are not exempted securities. In addition, section 4 of the Securities Act sets forth a number of exempted transactions. 15 U.S.C. 77d.

[253] Securities Act section 4(1), 15 U.S.C. 77d(1).

that security during the distribution, absent registration or an available exemption under the Securities Act. Similarly, the Commission requests comment on whether broker-dealer access providers should be required to ensure that U.S. investors do not purchase the securities of a foreign issuer effecting a distribution on a foreign market, unless there is an effective registration statement or an applicable exemption.

As noted, U.S. investors historically have been able to purchase unregistered securities traded on foreign markets by placing orders through one or more domestic and foreign broker intermediaries, which in turn have direct or indirect access to the foreign exchange or market. U.S. and foreign broker-dealers are today providing certain U.S. investors with automated links to foreign markets. As technology facilitates the ability of U.S. investors to conduct transactions directly on foreign securities exchanges and markets, the distinctions between the domestic and foreign trading markets may quickly disappear.

In the Exchange Act, Congress has set the threshold for requiring registration and reporting either upon a company's listing on a U.S. exchange [254] or, in the case of a class of equity securities, upon having at least 500 record holders (in the case of foreign issuers, 300 of which are in the United States) and assets over a specified dollar amount.[255] These disclosure requirements provide transparency with respect to the business, management, operating results and financial condition of the issuers of the traded securities. This is different from the market transparency provided by the Commission's regulatory and disclosure requirements applicable to markets and their members.

The Commission has accommodated the legitimate interest of foreign issuers whose shares come to be held in the United States by providing an exemption from registration under Exchange Act Rule 12g3–2(b) [256] if those shares are not listed on a U.S. exchange or quoted on Nasdaq and if the issuer has not registered an offering of securities under the Securities Act. These issuers need not register so long as they provide the Commission with the information that they make available to their securityholders in their home countries. The exemption is grounded in the jurisdictional and comity concerns that the Commission could not require a foreign company to register and file reports if the company has not affirmatively taken steps to enter our markets, regardless of the level of interest by U.S. investors in the company's securities.

These concerns directly relate to issues raised by the extensive trading in this country of unregistered foreign securities in the U.S. over-the-counter markets, bulletin boards, and alternative trading systems. Despite the extensive U.S. ownership and trading in these foreign securities, registration under the Exchange Act is not required by virtue of the Rule 12g3–2(b) exemption.

As noted in Section IV.B., if the Commission decides to regulate certain domestic alternative trading systems as exchanges, foreign securities traded on those exchanges would have to be registered. By excluding foreign markets from the definition of exchange, however, absent Commission action, Rule 12g3–2(b) would continue to provide an exemption for the foreign issuers of the securities traded on those markets from registration under the Exchange Act. By facilitating U.S. investor access to foreign markets, the SIP or broker-dealer approach described above could promote a real time market in the United States for the securities of potentially thousands of foreign companies without those companies meeting U.S. disclosure and accounting standards. The question thus becomes whether the access provided by SIPs to trading in foreign markets should be limited to securities that are registered with the Commission pursuant to section 12 of the Exchange Act. In addition, there is a question as to whether the Commission should also limit broker-dealer access providers to providing U.S. investors with access to securities trading in foreign markets that are registered under section 12, or whether a distinction should be made between SIP access providers and broker-dealer access providers. The Commission is soliciting comment on whether the approach described above adequately protects the interests of U.S. investors.

Question 135: Should direct trading in foreign listed companies be limited to those that satisfy U.S. disclosure standards in order to better protect U.S. investors?

Question 136: Is it sufficient to merely disclose to investors that the information available about a foreign security may significantly differ from the information that would be available about U.S. securities? Do public policy concerns dictate that the Commission make distinctions based on whether investors receive adequate information?

Question 137: Are there circumstances under which unregistered foreign securities should be permitted to trade on foreign markets through an access provider? For example, should the Commission establish some *de minimis* threshold for a foreign security based on the dollar value of the U.S. float or trading volume in that security, or on the relative percentage of U.S. float or trading volume compared to that of the home or worldwide markets?

Question 138: Should the exemption from registration under Exchange Act Rule 12g3–2(b) be available if a significant portion of an issuer's float is traded in the United States?

Question 139: Given that broker-dealers currently trade unregistered securities for customers, should the Commission reconsider its approach to securities registration requirements in this context? Are there other viable alternatives that would ensure adequate disclosure to U.S. investors trading on foreign markets?

Question 140: Is trading in unregistered foreign securities through an access provider to a foreign market appropriate if access is limited to sophisticated investors? For example, should access providers be permitted to transmit orders for unregistered foreign securities to a foreign market on behalf of qualified institutional buyers as defined in Rule 144A of the Securities Act?

Question 141: Are there uniform procedures that the Commission should impose on foreign markets or on access providers to assure that securities are not sold to U.S. investors in circumstances that result in a public distribution of securities in the United States that are not registered under the Securities Act?

Question 142: What are the consequences to SEC reporting companies if unregistered foreign securities listed on foreign markets are available to be purchased or sold through access providers?

D. Costs and Benefits of Revising Regulation of Foreign Market Activities in the United States

Direct U.S. investor access to foreign markets could provide significant benefits to U.S. investors. Such access may provide these investors with entirely new investment opportunities, and may significantly reduce their transaction costs. The Commission generally solicits comment on the expected costs and benefits of the three alternative approaches to regulating the

[254] Section 12(a) of the Exchange Act.

[255] Section 12(g) of the Exchange Act, 15 U.S.C. 78*l*(g), and Rules 12g–1 and 12g3–2(a), 17 CFR 240.12g–1 and 240.12g3–2(a).

[256] 17 CFR 240.12g3–2(b).

activities of foreign markets in the United States, as discussed above.

E. Conclusion

The increasing globalization of the securities markets has created new opportunities for U.S. investors. The establishment of new securities markets coupled with the enhancement of corporate disclosure and trade transparency in many stock exchanges throughout the world has dramatically increased their range of viable investment opportunities. At the same time, advancements in technology have made foreign investment opportunities more accessible and affordable to U.S. investors. Although these are positive developments, they also raise concerns that the activities of foreign markets in the United States could adversely affect not only U.S. investors, but also the U.S. securities markets.

The Commission believes it is critical to address the regulatory issues raised by U.S. investors' use of technology to trade directly on foreign markets. The Commission hopes to develop a consistent, long-term approach to address these issues, while ensuring that key protections for U.S. investors, as well as U.S. markets, are in place. Discussed above are three alternatives. The Commission is seeking comment on each of these alternatives, along with commenters' ideas about other viable alternatives.

Question 143: Would any of the approaches described above provide an effective means of addressing the issues raised by foreign market activities in the United States, including providing key protections for U.S. investors? What would be the benefits of each approach? What would be the drawbacks of each approach?

VIII. Summary of Requests for Comment

Following receipt and review of comments, the Commission will determine whether rulemaking or other action is appropriate. Commenters are invited to discuss the broad range of concepts and approaches described in this release concerning the Commission's registration and oversight of national securities exchanges, alternative trading systems, and foreign market activities in the United States. In addition to responding to the specific questions presented in this release, the Commission encourages commenters to provide any information to supplement the information and assumptions contained herein regarding the functioning of secondary markets, the roles of market participants, the advantages and disadvantages of the suggested reforms, the expectations of investors, and cross-border trading. The Commission also invites commenters to provide views and data as to the cost and benefits associated with possible changes discussed above in comparison to the costs and benefits of the existing statutory framework. In order for the Commission to assess the impact of changes to the Exchange Act's regulatory scheme, comment is solicited, without limitation, from investors, broker-dealers, exchanges, and other persons involved in the securities markets. In sum, the Commission requests comment on the following questions:

Question 1: The Commission seeks comment on the concerns identified above and invites commenters to identify other issues raised by the current approach to regulating alternative trading systems.

Question 2: Are the concerns raised in this release with regard to the operation of alternative trading systems under the current regulatory approach unique to such systems? To what extent could these concerns be raised by broker-dealers that do not operate alternative trading systems, such as a broker-dealer that matches customer orders internally and routes them to an exchange for execution or a broker-dealer that arranges for other broker-dealers to route their customer orders to it for automated execution?

Question 3: What regulatory approaches would best address the concerns raised by the growth of alternative trading systems and the needs of the market? Is the current approach the most appropriate one?

Question 4: What should be the objectives of market regulation? Are the goals and regulatory structure incorporated by Congress in the Exchange Act appropriate in light of technological changes? Are business incentives adequate to accomplish these goals?

Question 5: Are the regulatory categories defined in the Exchange Act sufficiently flexible to accommodate changes in market structure? If not, what other categories would be appropriate? How should such categories be defined?

Question 6: Can the Commission regulate markets effectively through standard-oriented regulation of the type described above?

Question 7: How could the Commission enforce compliance with the Exchange Act under such a standard-oriented approach?

Question 8: Is the current regulatory framework an effective form of oversight, in light of technological changes? Are there other regulatory techniques that would be comparably effective? If so, would the implementation of such techniques be consistent with congressional goals reflected in the Exchange Act?

Question 9: Are there viable alternatives within the existing Exchange Act structure, other than those discussed below, that would address the concerns raised by the growth of alternative trading systems and congressional goals in adopting the Exchange Act?

Question 10: What types of alternative trading systems would it be appropriate to regulate in this manner?

Question 11: If the Commission decided to further integrate alternative trading systems into the NMS through broker-dealer regulation, should it require alternative trading systems to submit all orders displayed in their systems into the public quotation system? If not, how should the Commission ensure adequate transparency?

Question 12: If the Commission requires alternative trading systems to submit all orders displayed in their systems into the public quotation system, how can duplicate reporting by alternative trading systems and their participant broker-dealers be prevented?

Question 13: Are there other methods for integrating all orders submitted into alternative trading systems into the public quotation system?

Question 14: Are there any reasons that orders available in alternative trading systems should not be available to the public?

Question 15: If the Commission requires alternative trading systems to allow non-participants to execute against orders of system participants, how should it ensure that non-participants are granted equivalent access?

Question 16: If the Commission requires alternative trading systems to allow non-participants to execute against orders of system participants, how should it determine whether the fees charged to non-participants by such systems are reasonable and do not have the effect of denying access to orders?

Question 17: Are there any reasons that non-participants should not be able to execute against orders of participants in alternative trading systems?

Question 18: Should the Commission require alternative trading systems to provide additional information (such as identifying counterparties) to their SRO in order to enhance the SRO's audit trail and surveillance capabilities?

Question 19: What other methods could the Commission use to enhance

market surveillance of activities on alternative trading systems?

Question 20: Should SROs be required to surveil trading by their members in securities that are not listed or quoted on the market operated by that SRO?

Question 21: Should alternative trading systems be required to follow guidelines regarding the capacity and integrity of their systems? If not, how should the Commission address systemic risk concerns associated with potentially inadequate capacity of alternative trading systems, particularly those systems with significant volume?

Question 22: With what types of standards regarding computer security, capacity, and auditing of systems, should alternative trading systems be required to comply?

Question 23: To what extent would complying with systems guidelines similar to those implemented by exchanges and other SROs require modification to the current procedures of alternative trading systems? What costs would be associated with such modifications? How much time would be required to implement the necessary modifications and systems enhancements? Please provide a basis for these estimates.

Question 24: Is access to alternative trading systems an important goal that the Commission should consider in regulating such systems? If so, are there circumstances in which alternative trading systems should be able to limit access to their systems (for example, should the Commission be concerned about access to an alternative trading system that has arranged for its quotes to be displayed as part of the public quotation system)?

Question 25: If alternative trading systems were to continue to be regulated as broker-dealers and were subject to a fair access requirement, should the Commission consider denial of access claims brought by participants and non-participants in alternative trading systems? If not, are there other methods that could adequately address such claims?

Question 26: Are commenters aware of any unfair denials of access by broker-dealers operating alternative trading systems, where there were no alternative trading venues available to the entities denied access?

Question 27: Would enhanced surveillance of alternative trading systems by their SROs raise competitive concerns that could not be addressed through separation of the market and regulatory functions of the SROs?

Question 28: If alternative trading systems continue to be regulated as broker-dealers, are there other ways to integrate the surveillance of trading on alternative trading systems?

Question 29: What is the feasibility of establishing an SRO solely for the purpose of surveilling the trading activities of broker-dealer operated alternative trading systems, that does not also operate a competing market?

Question 30: If alternative trading systems continue to be regulated as broker-dealers, how can the Commission address anticompetitive practices by such systems?

Question 31: Would this approach be an effective means of addressing the issues raised by the growth of alternative trading systems? What would be the benefits of such an approach? What would be the drawbacks of such an approach?

Question 32: If the Commission reinterpreted the term ''exchange,'' are the factors described above (*i.e.*, (1) consolidating orders of multiple parties and (2) providing a facility through which, or setting conditions under which, participants entering such orders may agree to the terms of a trade) sufficient to include the alternative trading systems described above?

Question 33: Is broadening the Commission's interpretation of ''exchange'' to cover diverse markets, and then exempting all but the most significant of these new exchanges from registration, the most appropriate way to address the regulatory gaps discussed above and provide the Commission with sufficient flexibility to oversee changing market structures?

Question 34: Are there any other categories of alternative trading systems that have sufficiently minimal effects on the public secondary market that they should be treated as exempted exchanges?

Question 35: Should low impact markets be regulated as exempted exchanges, rather than as broker-dealers?

Question 36: What measure or measures should be used in determining whether a market has a low impact? What is the level above which an alternative trading system should not be considered to have a low impact on the market? At what level should an already registered exchange be able to deregister?

Question 37: Should an alternative trading system be considered to have a low impact on the market and be treated as an exempted exchange if it trades a significant portion of the volume of one security, even if the trading system's overall volume is low in comparison to the market as a whole?

Question 38: In determining whether an alternative trading system has a low impact, what factors other than volume should the Commission consider? Should this determination be affected if the operator of an alternative trading system was the issuer of securities traded on that system?

Question 39: Should passive markets be regulated as exempted exchanges, rather than as broker-dealers?

Question 40: Are the requirements described above appropriate to ensure the integrity of secondary market oversight?

Question 41: Should any other requirements be imposed upon exempted exchanges, such as requirements that an exempted exchange provide fair access or establish procedures to ensure adequate system capacity, integrity, and confidentiality?

Question 42: Should requirements vary with the type of alternative trading system (*e.g.*, should passive systems be subject to different conditions than systems exempted on the basis of low impact)?

Question 43: Should the Commission require that securities traded on exempted exchanges be registered under section 12 of the Exchange Act? Should different disclosure standards be applicable to such securities if they are only traded on such exchanges?

Question 44: Should the Commission allow institutions to be participants on registered exchanges to the same extent as registered broker-dealers? If so, should the Commission adopt rules allowing registered exchanges to have institutional participants, or should the Commission issue exemptive orders on a case-by-case basis, upon application for relief by registered exchanges?

Question 45: Should the Commission allow exchanges to provide services exclusively to institutions?

Question 46: If the Commission allows institutions to participate in exchange trading, should the Commission view all entities that have electronic access to exchange facilities as ''members'' under the Exchange Act and then exempt exchanges from section 6(c)(1)?

Question 47: Is it foreseeable that exchanges will wish to permit retail investors to be participants in their markets? If so, should the Commission allow retail participation on registered exchanges to the same extent as registered broker-dealers?

Question 48: Should the Commission allow registered exchanges to provide services exclusively to retail investors?

Question 49: Could exchanges have various classes of participants, as long as admission criteria and means of

access are applied and allocated fairly? Would it be in the public interest if new or existing exchanges sought to operate primarily or exclusively on a retail basis? What would be the advantages and disadvantages if new or existing exchanges were to admit as participants only highly capitalized institutions or only highly capitalized institutions and broker-dealers?

Question 50: Should non-membership exchanges (including alternative trading systems that may register as exchanges) be exempt from fair representation requirements?

Question 51: Should all exchanges be required to comply with section 6(b)(3) by having a board of directors that includes participant representation?

Question 52: If not, are there alternative structures that would provide independent, fair representation for all of an exchange's constituencies (including the public)?

Question 53: Would the revised interpretation of ''exchange'' being considered by the Commission adequately and clearly include alternative trading systems that operate open limit order execution systems (even those that also provide brokerage functions)?

Question 54: In light of the decreasing differentiation between market maker quotes and customer orders in trading, should the Commission consider an ''order'' to include any firm trading interest, including both limit orders and market maker quotes?

Question 55: What should the Commission consider to be ''material conditions'' under which participants entering orders may agree to the terms of a trade? For example, should an alternative trading system be considered to be setting ''material conditions'' when it standardizes the material terms of instruments traded on the market, such as standardizing option terms or requiring participants that display quotes to execute orders for a minimum size or to give priority to certain types of orders?

Question 56: Is it appropriate for the Commission to consider the activities described above as broker-dealer activities?

Question 57: How should a revised interpretation of exchange adequately and clearly distinguish broker-dealer activities, such as block trading and internal execution systems, from market activities?

Question 58: Are the distinctions discussed above accurate reflections of exchange and broker-dealer activities? Are there other factors that may better distinguish a broker-dealer from an exchange?

Question 59: How should a revised interpretation of the term ''exchange'' adequately and clearly distinguish broker-dealer activities, such as block trading and internal execution systems, from market activities?

Question 60: What factors should the Commission consider in determining whether an organization of dealers is sufficiently ''organized'' to require exchange registration?

Question 61: Does the revised interpretation of ''exchange'' described above clearly exclude information vendors, bulletin boards, and other entities whose activities are limited to the provision of trading information? How should the Commission distinguish between information vendors, bulletin boards, and exchanges?

Question 62: If the Commission expands its interpretation of ''exchange,'' should the Commission exempt interdealer brokers that deal only in exempted securities from the application of exchange registration and other requirements?

Question 63: How could the Commission define interdealer brokers in a way that would implement congressional intent not to regulate traditional interdealer brokers as exchanges, without unintentionally exempting other alternative trading systems operated by brokers?

Question 64: How could the Commission foster the continued trading of all securities currently traded on alternative trading systems if these systems are classified as exchanges under the interpretation described above and some of these systems are required to register as national securities exchanges? For example, what would be the effect on alternative trading systems that wish to trade securities exempted from registration under Rule 144A if those systems are required to register as national securities exchanges?

Question 65: How would the requirement to have rules in place for trading unlisted securities affect the viability of alternative trading systems that are required to register as national securities exchanges?

Question 66: Would the specifications in the OTC–UTP plan relating to the trading of Nasdaq/NM securities pose particular problems for systems that are required to register as national securities exchanges?

Question 67: Should the Commission extend UTP to securities other than NM securities, such as Nasdaq SmallCap securities? What effect would an inability to trade Nasdaq SmallCap and other non-Nasdaq/NM securities have upon alternative trading systems that are required to register as national securities exchanges?

Question 68: What effect would the prohibition on UTP trading of newly listed stock until the day following an initial public offering have upon systems that are required to register as national securities exchanges?

Question 69: How should existing exchange rules designed to limit members from effecting OTC transactions in exchange-listed stock be applied, if the Commission's interpretation of exchange were expanded to include alternative trading systems and organized dealer markets? What customer protection and competitive reasons might there be to preserve these rules if alternative trading systems are classified as exchanges?

Question 70: What effects would linking alternative trading systems to NMS mechanisms have on those systems? For example, how would such linkages affect the ability of alternative trading systems to operate with trading and fee structures that differ from those of existing exchanges or to alter their structures? To what extent could revision of the NMS plans alleviate these effects?

Question 71: Are there any insurmountable technical barriers to admission of alternative trading systems into the CTA, CQS, OPRA, or OTC–UTP plans?

Question 72: What costs are associated with the admission of new applicants to these plans?

Question 73: Are there any CTA, CQS, OPRA, or OTC–UTP plan rules that would prevent newly registered national securities exchanges from obtaining fair and equal representation on these entities?

Question 74: What effect would the admission of newly registered national securities exchanges to the CTA, CQS, OPRA, and OTC–UTP plans have upon the governance and administration of those plans?

Question 75: Do admissions fees for new participants required by the terms of the plans present a barrier to admission to the plans? Do the plans' provisions that all participants are eligible to share in the revenues generated through the sale of data affect commenters' views on this issue?

Question 76: What effect would the admission of new, highly automated participants have upon the operation of the ITS?

Question 77: How would compliance with the current ITS rules and policies affect trading on alternative systems that may be regulated as exchanges? How

appropriate are these rules and policies for alternative trading systems?

Question 78: What costs would be associated with newly registered exchanges joining ITS? Would those costs represent a barrier for newly registered exchanges to join ITS?

Question 79: Are there any ITS plan rules or practices that would prevent newly registered national securities exchanges from obtaining fair and equal representation on the ITS?

Question 80: What effect would the admission of newly registered national securities exchanges to the ITS plan have upon the governance and administration of the plan?

Question 81: What effect would the requirements to impose trading halts or circuit breakers in some circumstances have upon alternative trading systems if such systems were regulated as exchanges?

Question 82: What impact would registration of an alternative trading system as an exchange have on the institutional participants of that trading system, including registered investment companies?

Question 83: If the Commission allows institutions to effect transactions on exchanges without the services of a broker, to what extent should an exchange's obligations to surveil its market and enforce its rules and the federal securities laws apply to such institutions?

Question 84: How could an exchange adequately supervise institutions that effect transactions on an exchange without the services of a broker?

Question 85: What, if any, accommodations should be made with respect to an exchange's surveillance, enforcement, and other SRO obligations with respect to institutions that transact business on that exchange?

Question 86: How could institutions that directly access exchanges be integrated into existing systems for clearance and settlement?

Question 87: Under what conditions should an entity be subject to both exchange and broker-dealer regulation?

Question 88: Should a dually registered entity be required to formally separate its exchange operations from its broker-dealer operations (*e.g.*, through use of separate subsidiaries)?

Question 89: Would this approach be an effective means of addressing the issues raised by the growth alternative trading systems? What would be the benefits of such an approach? What would be the drawbacks of such an approach?

Question 90: Would it be feasible for the Commission to expand the scope of rules eligible for expedited treatment pursuant to section 19(b)(3)(A) without jeopardizing the investor protection and market integrity benefits of Commission oversight of exchange and other SRO rule changes? If so, to what types of rule filings should immediate effectiveness, pursuant to section 19(b)(3)(A), be extended?

Question 91: If the Commission expands the scope of rule filings eligible for treatment under section 19(b)(3)(A) to include, for example, certain types of new products, what conditions or representations should be required of an SRO to ensure that the proposed rule change is eligible for expedited treatment under Rule 19b–4?

Question 92: Should the Commission exempt markets' proposals to implement new trading systems, separate from their primary trading operations, from rule filing requirements? If so, should SROs be permitted to operate pilot programs under such an exemption if they trade the same securities, operate during the same hours, or utilize similar trading procedures as the SRO's main trading system? Should there be a limit on the number of pilot programs an SRO can operate under an exemption at any one time? What other conditions should apply to such exemption?

Question 93: Do differences between automated and non-automated trading require materially different types or degrees of surveillance or enforcement procedures?

Question 94: Which Exchange Act requirements applicable to registered exchanges, if any, could be minimized or eliminated without jeopardizing investor protection and market integrity?

Question 95: If an automated exchange contracts with another SRO to perform its day-to-day enforcement and disciplinary activities, should this affect the exchange's requirement to ensure fair representation of its participants and the public in its governance?

Question 96: If an exchange contracts with another entity to perform its oversight obligations, should that exchange continue to have responsibility under the Exchange Act for ensuring that those obligations are adequately fulfilled?

Question 97: What costs to investors and other market participants are associated with the current regulation of alternative trading systems as broker-dealers? Specifically, what costs are associated with the potential denial of access by an alternative trading system?

Question 98: What costs are associated with each of the alternatives for revising market regulation discussed above? For example, would either of the two principal alternatives discussed in section IV above impose costs by limiting innovation? Would these costs be greater than those imposed by the current regulatory approach?

Question 99: What regulatory costs can be shared by markets operating simultaneously as self-regulatory organizations, and what regulatory costs must be borne by each market individually? What are the relative magnitudes of these costs (as a proportion of total costs)?

Question 100: Are there innovations or adjustments that can be made to market wide plans such as CQS, CTA and ITS that will lead to lower regulatory costs for exchanges under any of the alternatives for regulating domestic markets?

Question 101: Total regulatory costs vary with a variety of factors (e.g., volume of trade, degree of technology applied in trade). Of these factors, which are most relevant in considering the alternatives discussed above? For example, recognizing that some market mechanisms may rely on some factors more than others, to what extent are regulatory costs greater for particular mechanisms than others?

Question 102: What costs are associated with the responsibilities of an SRO? Will the costs to existing SROs be reduced by registering significant alternative trading systems as exchanges?

Question 103: What regulatory burdens currently inhibit innovation of trading systems? How will the alternatives discussed above change the incentives for innovation?

Question 104: Will the alternatives discussed above impose costs on systems that differ depending on the nature of the trade? For example, will the proposed regulatory revisions change the costs of trades directly between customers relative to the costs of trades between a customer and a dealer?

Question 105: What regulatory approaches would best address the concerns raised by the development of automated access to foreign markets? Would these approaches differ if U.S. investors accessed foreign markets in ways other than those described above, such as through the Internet? Are there any other alternative approaches that could be more appropriate?

Question 106: If the Commission were to rely solely on a foreign market's primary regulator, how could it address the investor protection and enforcement concerns discussed above?

Question 107: Should the Commission require foreign markets with only limited activities in the

United States to register as national securities exchanges or obtain an exemption from such registration? How would this affect U.S. persons trading directly on foreign markets?

Question 108: How can the Commission best achieve its goal of regulating the U.S. activities of foreign markets? Commenters should take into consideration that foreign markets are regulated abroad, that there is a potential for international conflicts of law, and that the Commission has jurisdictional limits. Given the difficulties of surveilling public networks such as the Internet, would an access provider approach be workable?

Question 109: What would be the best way for the Commission to regulate the limited U.S. activities of foreign markets that provide remote access to U.S. members?

Question 110: When should an entity be required to register with the Commission as a non-exclusive SIP under section 11A of the Exchange Act? For example, should the activities described above require registration as a SIP?

Question 111: If the SIP approach were adopted, is it likely that U.S. members of foreign markets would wish to transmit their orders to such markets through more than one SIP registered with the Commission? If so, should all but one of those SIPs be exempt from registration?

Question 112: Under the SIP approach, should foreign markets that allow their U.S. members to transmit their orders solely through a registered SIP have a safe harbor from registration as national securities exchanges?

Question 113: What type of activities should a registered SIP be permitted to conduct on behalf of a foreign market without the SIP or the foreign market registering as an exchange?

Question 114: What types of automated broker-dealer systems, both operational and contemplated, would be encompassed within the above description of access providers to foreign markets? How widespread are these activities?

Question 115: Would the above description of broker-dealer access providers adequately and clearly exclude traditional brokerage activities, particularly handling the execution of customer orders on foreign markets? If not, how should such activities be distinguished from traditional brokerage activities, particularly traditional cross-border activities? Should U.S. broker-dealers that provide investors with access to foreign markets be subject to any additional requirements?

Question 116: Should foreign broker-dealers that provide U.S. investors with automated access to foreign markets be required to register as broker-dealers on the basis of that activity?

Question 117: What types of conditions, if any, should the Commission place on access providers if it were to pursue that approach?

Question 118: If the Commission decides to regulate access providers to foreign markets, what criteria should the Commission use in determining whether an exchange is a *bona fide* foreign market? Should a market be required to have at least a majority of foreign members in order to be a *bona fide* foreign market? Should the Commission exclude exchanges that provide terminals in the United States?

Question 119: Should the Commission regulate as a U.S. exchange any market that, although organized and having its principal place of business outside of the United States, is under common control with or controlled by U.S. persons, or whose decisions regarding trading rules, practices, or procedures are made by U.S. persons?

Question 120: What factors should the Commission use in determining whether an exchange is operating a trading facility in the United States and is not a *bona fide* foreign market? If exchange-owned terminals are located in the United States, should this constitute operating a trading facility in the United States?

Question 121: What effect would a reinterpretation of the term ''exchange'' under section 3(a)(1) of the Exchange Act have on any Commission proposal to regulate SIP and broker-dealer access providers?

Question 122: If the Commission decides to regulate access providers to foreign markets, should the Commission require access providers to transmit orders only to foreign markets that are willing to share, and capable of sharing, information with the Commission in connection with investigations involving violations of U.S. securities laws? If so, what standard should the Commission use in determining whether a foreign market would provide meaningful assistance to the Commission? If commenters believe that SIP and/or broker-dealer access providers should be permitted to transmit orders to any foreign market, indicate how the Commission could ensure that it has the ability to enforce the applicable provisions of the federal securities laws.

Question 123: Should the Commission require access providers to transmit orders only to foreign markets that are located in countries that have entered into arrangements with the Commission to provide enforcement and information sharing assistance?

Question 124: If the Commission regulated access providers through the approach described above, should SIP access providers be limited to providing their services to sophisticated institutions or should they be allowed to provide any U.S. investor with the capability of directly trading on foreign markets as members? If so, should broker-dealer access providers be subject to similar requirements?

Question 125: If the Commission permits SIP access providers to offer their services only to broker-dealers and certain sophisticated institutions, how should this category of sophisticated institutions be defined?

Question 126: Should the Commission permit SIP and broker-dealer access providers to transmit orders to foreign markets for the securities of U.S. issuers or only for the securities of non-U.S. issuers?

Question 127: Should the Commission limit the ability of SIP and broker-dealer access providers to transmit orders to foreign markets for the securities of non-U.S. issuers if the ''principal market'' for those securities is located in the United States? If so, how should the Commission determine when the ''principal market'' of a non-U.S. security is located in the United States?

Question 128: If the Commission permits SIP and broker-dealer access providers to transmit orders to foreign markets only for securities of non-U.S. issuers, how should the Commission distinguish between U.S. and non-U.S. issuers?

Question 129: If the Commission decides to regulate access providers to foreign markets, should they be required to make and keep records? What records should registered SIP and broker-dealer access providers be required to maintain?

Question 130: Should access providers be required to file periodic reports? If so, what information should those contain?

Question 131: Should broker-dealer access providers be required to keep records of denials of access to their services? Should they be required to notify the Commission of such denials of access?

Question 132: What types of risks should be disclosed to users of SIP and broker-dealer access providers? For example, should SIP and broker-dealer access providers be required to disclose the listing and maintenance standards of foreign markets to which they transmit orders on behalf of U.S. persons? What

would be the costs associated with such a requirement?

Question 133: Should access providers be required to make disclosures to sophisticated institutions?

Question 134: What market information should SIP and broker-dealer access providers be required to provide to the users of their services?

Question 135: Should direct trading in foreign listed companies be limited to those that satisfy U.S. disclosure standards in order to better protect U.S. investors?

Question 136: Is it sufficient to merely disclose to investors that the information available about a foreign security may significantly differ from the information that would be available about U.S. securities? Do public policy concerns dictate that the Commission make distinctions based on whether investors receive adequate information?

Question 137: Are there circumstances under which unregistered foreign securities should be permitted to trade on foreign markets through an access provider? For example, should the Commission establish some *de minimis* threshold for a foreign security based on the dollar value of the U.S. float or trading volume in that security, or on the relative percentage of U.S. float or trading volume compared to that of the home or worldwide markets?

Question 138: Should the exemption from registration under Exchange Act Rule 12g3–2(b) be available if a significant portion of an issuer's float is traded in the United States?

Question 139: Given that broker-dealers currently trade unregistered securities for customers, should the Commission reconsider its approach to securities registration requirements in this context? Are there other viable alternatives that would ensure adequate disclosure to U.S. investors trading on foreign markets?

Question 140: Is trading in unregistered foreign securities through an access provider to a foreign market appropriate if access is limited to sophisticated investors? For example, should access providers be permitted to transmit orders for unregistered foreign securities to a foreign market on behalf of qualified institutional buyers as defined in Rule 144A of the Securities Act?

Question 141: Are there uniform procedures that the Commission should impose on foreign markets or on access providers to assure that securities are not sold to U.S. investors in circumstances that result in a public distribution of securities in the United States that are not registered under the Securities Act?

Question 142: What are the consequences to SEC reporting companies if unregistered foreign securities listed on foreign markets are available to be purchased or sold through access providers?

Question 143: Would any of the approaches described above provide an effective means of addressing the issues raised by foreign market activities in the United States, including providing key protections for U.S. investors? What would be the benefits of each approach? What would be the drawbacks of each approach?

Dated: May 23, 1997.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 97–14284 Filed 6–3–97; 8:45 am]

BILLING CODE 8010–01–P

DEPARTMENT OF THE INTERIOR

Office of Surface Mining Reclamation and Enforcement

30 CFR Part 916

[SPATS No. KS–017–FOR]

Kansas Regulatory Program and Abandoned Mine Land Reclamation Plan

AGENCY: Office of Surface Mining Reclamation and Enforcement (OSM), Interior.

ACTION Proposed rule; public comment period and opportunity for public hearing.

SUMMARY: OSM is announcing receipt of a proposed amendment to the Kansas program and Abandoned Mine Land Reclamation Plan (hereinafter the ''Kansas program'') under the Surface Mining Control and Reclamation Act of 1977 (SMCRA). The proposed amendment consists of revisions to Kansas' regulations for its regulatory program and abandoned mine land reclamation plan pertaining to communications, petitions to initiate rulemaking, notice of citizen suits, preparation and submission of reports by the permittee, definitions, permit applications, administrative hearing procedures, civil penalties, permit review, permit revision, permit renewals, permit transfers, assignments, and sales, permit conditions, permit suspension or revocation, termination of jurisdiction, exemption for coal extraction incident to government-financed highway or other construction, exemption for coal extraction incidental to the extraction of other minerals, coal exploration, bonding procedures, performance standards, revegetation, interim performance standards, underground mining, small operator assistance program, lands unsuitable for surface mining, training, certification, and responsibilities of blasters and operators, employee financial interest, inspection and enforcement, eligible lands and water, reclamation project evaluation, consent to entry, liens, appraisals, contractor responsibility, exclusion of certain noncoal reclamation sites, and abandoned mine land reclamation plan reports. The amendment is intended to revise the Kansas program to be consistent with the corresponding Federal regulations.

This document sets forth the times and locations that the Kansas program and proposed amendment to that program are available for public inspection, the comment period during which interested persons may submit written comments on the proposed amendment, and the procedures that will be followed regarding the public hearing, if one is requested.

DATES: Written comments must be received by 4:00 p.m., c.d.t., July 7, 1997. If requested, a public hearing on the proposed amendment will be held on June 30, 1997. Requests to speak at the hearing must be received by 4:00 p.m., c.d.t. on June 19, 1997.

ADDRESSES: Written comments and requests to speak at the hearing should be mailed or hand delivered to Russell W. Frum, Mid-Continent Regional Coordinating Center, at the address listed below.

Copies of the Kansas program, the proposed amendment, a listing of any scheduled public hearings, and all written comments received in response to this document will be available for public review at the addresses listed below during normal business hours, Monday through Friday, excluding holidays. Each requester may receive one free copy of the proposed amendment by contacting OSM's Mid-Continent Regional Coordinating Center.

Russell W. Frum, Mid-Continent Regional Coordinating Center, Office of Surface Mining Reclamation and Enforcement, Alton Federal Building, 501 Belle Street, Alton, Illinois, 62002, Telephone: (618) 463–6460.

Kansas Department of Health and Environment, Surface Mining Section, 4033 Parkview Drive, Frontenac, Kansas 66763, Telephone (316) 231–8540.

FOR FURTHER INFORMATION CONTACT: Russell W. Frum, Mid-Continent