SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 202, 240, 242 and 249

[Release No. 34–40760; File No. S7–12–98]

RIN 3235–AH41

Regulation of Exchanges and Alternative Trading Systems

AGENCY: Securities and Exchange Commission.

ACTION: Final rules.

SUMMARY: The Securities and Exchange Commission today is adopting new rules and rule amendments to allow alternative trading systems to choose whether to register as national securities exchanges, or to register as broker-dealers and comply with additional requirements under Regulation ATS, depending on their activities and trading volume. The Commission is also adopting amendments to rules regarding registration as a national securities exchange, repealing Rule 17a–23, and amending the books and records rules by transferring the recordkeeping requirements from Rule 17a–23 to Rules 17a–3 and 17a–4 as they apply to broker-dealer internal trading systems. Finally, the Commission is excluding from the rule filing requirements for self-regulatory organizations certain pilot trading systems operated by national securities exchanges and national securities associations. These rules will more effectively integrate the growing number of alternative trading systems into the national market system, accommodate the registration of proprietary alternative trading systems as exchanges, and provide an opportunity for registered exchanges to better compete with alternative trading systems.

DATES: *Effective Date:* April 21, 1999, except §§ 242.301(b)(5)(i)(D) and (E) and §§ 242.301(b)(6)(i) (D) and (E), which shall become effective on April 1, 2000.

Compliance Date: Prior to April 21, 1999, the Commission will publish a schedule of those securities with respect to which alternative trading systems must comply with § 242.301(b)(3) on April 21, 1999 and those securities with respect to which alternative trading systems must comply with § 242.301(b)(3) on August 30, 1999. See Section VIII of this release.

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I. Introduction

Today the Securities and Exchange Commission (''Commission'' or ''SEC'') is adopting a regulatory framework for alternative trading systems,[1] to strengthen the public markets for securities, while encouraging innovative new markets. During the past three years, the Commission has undertaken a reevaluation of its regulatory framework for markets because of substantial changes in the way securities are traded. Market participants have incorporated technology into their businesses to provide investors with an increasing array of services, and to furnish these services more efficiently, and often at lower prices. The current regulatory framework, however, designed more than six decades ago, did not envision many of these trading and business functions. In particular, market participants have developed a variety of alternative trading systems that furnish services traditionally provided solely by registered exchanges.

To better understand the questions raised by technological developments in the U.S. markets, in May 1997, the Commission published a concept release exploring ways to respond to the rapid technological developments affecting securities markets and, in particular, the growing significance of alternative trading systems (''Concept Release'').[2] After taking into consideration the comments submitted in response to the Concept Release, in April 1998, the Commission proposed a new regulatory framework for alternative trading systems (''Proposing Release'').[3]

Alternative trading systems now handle more than twenty percent of the orders in securities listed on The Nasdaq Stock Market (''Nasdaq''), and almost four percent of orders in exchange listed securities. These systems operate markets similar to the registered exchanges and Nasdaq. Over time, an alternative trading system may become the primary market for some securities. Yet these markets are private, available only to chosen subscribers, and are regulated as broker-dealers, not in the way registered exchanges and Nasdaq are regulated. This creates disparities that affect investor protection and the operation of the markets as a whole.

Our national market system, as it has evolved since 1975, has sought the benefits of both market centralization—deep, liquid markets—and competition. To achieve these benefits, the national market system has maintained equally regulated, individual markets, which are linked together to make their best prices publicly known and accessible. Alternative trading systems have remained largely outside the national market system. For example, the evidence in the Commission's report on the National Association of Securities Dealers, Inc. (''NASD'') and Nasdaq suggested that widespread use of Instinet by market makers as a private market had a significant impact on public investors and the operation of the Nasdaq market.[4] Through Instinet, market makers were able to quote prices better than those made available to public investors. This private market developed only because the activity on alternative trading systems is not fully disclosed, or accessible, to public investors. Moreover, these trading systems have no obligation to provide investors a fair opportunity to participate in their systems or to treat their participants fairly. These systems may also not be adequately surveilled for market manipulation and fraud. In fact, market participants can manipulate the prices in the public securities markets through the use of alternative trading systems.[5] In addition, alternative trading systems have no obligation to ensure that their systems are sufficient to handle rapid increases in trading volume as occurs in times of market volatility, and at times they have failed to do so. Because of the increasingly important role of alternative trading systems, these differences are inconsistent with the national market system goals set forth

[1] The term ''alternative trading system'' is defined in Rule 300(a), 17 CFR 242.300(a). This term encompasses some systems that previous Commission releases called proprietary trading systems, broker-dealer trading systems, and electronic communication networks.

[2] Securities Exchange Act Release No. 38672 (May 23, 1997), 62 FR 30485 (June 4, 1997). The comment letters to the Concept Release and a summary of these comments have been placed in Public File S7–16–97, which is available for inspection in the Commission's Public Reference Room.

[3] Securities Exchange Act Release No. 39884 (Apr. 17, 1998), 63 FR 23504 (Apr. 29, 1998). The comment letters to the Proposing Release and a summary of those comments received as of August 25, 1998 have been placed in Public File S7–12–98, which is available for inspection in the Commission's Public Reference Room.

[4] *See* SEC, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market (1996) (''NASD 21(a) Report'').

[5] See In the Matter of Ian and Lawrence Fishman, Securities Exchange Act Release No. 40115 (June 24, 1998) (finding that the Fishman brothers manipulated the national best bid and offer in violation of Section 10(b) and Rule 10b–5 under the Exchange Act by coordinating the entry of orders routed to alternative trading systems).

by Congress in the 1975 amendments to the Securities Exchange Act of 1934 (''1975 Amendments'')[6] and call into question the fairness of current regulatory requirements.

In 1996, Congress provided the Commission with greater flexibility to regulate new trading systems by giving the Commission broad authority to exempt any person from any of the provisions of the Securities Exchange Act of 1934 (''Exchange Act'') and impose appropriate conditions on their operation.[7] This new exemptive authority, combined with the ability to facilitate a national market system, provides the Commission with the tools it needs to adopt a regulatory framework that addresses its concerns about alternative trading systems without jeopardizing the commercial viability of these markets. In the Proposing Release, the Commission proposed ways to use these tools to adopt new rules and rule amendments designed to resolve many of the concerns raised by alternative trading systems, better integrate these systems into our national market system structure, and make the benefits of these systems available to more investors.

In response to its Proposing Release,[8] the Commission received seventy comment letters.[9] Commenters generally supported the Commission's proposals and welcomed the regulatory flexibility these proposals offered.[10] Many commenters agreed with the Commission that the regulatory structure needs to be modernized to better integrate alternative trading systems into the national market system.[11] For example, several commenters expressed the view that, on balance, the proposed regulatory framework for alternative trading systems represented a preferable alternative to the current regulation of these systems as broker-dealers, which is not only inadequate for many alternative trading systems, but also results in disparate regulatory treatment of exchange markets and their alternative trading system competitors.[12] Other commenters believed that the Commission's proposal was a step in the right direction, both from a competitive business perspective and from an investor protection and fair regulation perspective. While some commenters thought that the Commission should continue the present framework for alternative trading systems,[13] most believed that the proposal provided a framework that could maintain a competitive balance among the markets offering services to investors.[14] Other commenters were pleased by the Commission's determination to allow market participants to engage in business decisions regarding how to register with the Commission.[15] Commenters also generally supported the Commission's proposal to allow for-profit exchanges,[16] and generally supported the proposed temporary exemption for pilot trading systems.[17]

The Commission believes that its regulation of markets should both accommodate traditional market structures and provide sufficient flexibility to ensure that new markets promote fairness, efficiency, and transparency. In adopting a new regulatory framework for alternative trading systems today, the Commission has incorporated suggestions and responded to requests for clarification made by commenters. The Commission believes that this regulatory approach effectively addresses commenters' concerns while carefully tailoring a regulatory framework that is flexible enough to accommodate the evolving technology of, and benefits provided by, alternative trading systems.

While the revised regulatory scheme implemented today is designed to address changes in the way securities are traded, the Commission's assessment of the *impact* that these systems may have on the trading of unregistered securities (*i.e.* of both domestic and foreign issuers), and of the appropriate regulatory posture to these developments, is still ongoing. This matter and the broader issues involving recent trends and initiatives that give U.S. investors greater and more instantaneous access to foreign securities markets create tensions between competing Commission goals. The Commission, for example, wishes to foster developments that enable U.S. investors to execute securities trades more efficiently, but it also desires that foreign securities traded in U.S. markets have full and fair disclosure. These tensions and issues will be addressed by the Commission in the future.

II. Executive Summary of Final Rules

The final rules seek to establish a regulatory framework that makes sense both for current and future securities

[6] Pub. L. 29, 89 Stat. 97 (1975). Congress granted to the Commission authority in 1975 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. *See* S. Rep. No. 75, 94th Cong., 1st Sess. 8 (1975); H.R. Rep. No. 229, 94th Cong., 1st Sess 92 (1975). *See also* section 11A(a)(1) of the Exchange Act, 15 U.S.C. 78k-1(a)(1).

[7] Section 36 of the Exchange Act, 15 U.S.C. 78mm, was enacted as part of the National Securities Markets Improvement Act of 1996, Pub. L. 104–290 (''NSMIA''). *See infra* Section VII.D.1.

[8] *See supra* note 3.

[9] This is the number of comment letters received by the Commission as of the close of business on December 1, 1998.

[10] Some commenters, however, suggested that the better approach would be for the Commission to retain its present regulatory framework for alternative trading systems. *See, e.g.,* Letter from Robin Roger, Principal and Counsel, Morgan Stanley Dean Witter to Jonathan G. Katz, Secretary, SEC, dated Sept. 11, 1998 (''MSDW Letter'') at 3–4; Letter from Christopher J. Carroll and W. Hal Hinkle, Co-Chairs, ATS Task Force, The Bond Market Association to Jonathan G. Katz, Secretary, SEC, dated July 28, 1998 (''TBMA Letter'') at 2, 8–12; Letter from Lee B. Spencer, Jr., Chairman, SIA Federal Regulation Committee and Perry L. Taylor, Jr., Chairman, SIA Alternative Trading System Subcommittee, Securities Industry Association to Jonathan G. Katz, Secretary, SEC, dated July 31, 1998 (''SIA Letter'') at 2, 5. Another commenter suggested that the Commission solicit comment again on the broader issues discussed in the Concept Release. *See* Letter from Louis C. Magill, President, Corporate Capital Securities, Inc. to Jonathan G. Katz, Secretary, SEC, dated July 27, 1998 (''Corporate Capital Letter'') at 4.

[11] *See, e.g.,* Letter from Joanne Moffic-Silver, Secretary and General Counsel, Chicago Board Options Exchange to Jonathan G. Katz, Secretary, SEC, dated July 28, 1998 (''CBOE Letter'') at 3; Letter from John C. Katovich, Senior Vice President and General Counsel, OptiMark Technologies Inc. to Jonathan G. Katz, Secretary, SEC, dated Aug. 13, 1998 (''OptiMark Letter'') at 1.

[12] *See, e.g.,* CBOE Letter at 3.

[13] *See, e.g.,* SIA Letter at 1, 5–6.

[14] *See, e.g.,* Letter from Joan C. Conley, Corporate Secretary, National Association of Securities Dealers, Inc. to Jonathan G. Katz, Secretary, SEC, dated Aug. 10, 1998 (''NASD Letter'') at 1–2.

[15] *See, e.g.,* Letter from Douglas M. Atkin, Chief Executive Officer, Instinet International to Jonathan G. Katz, Secretary, SEC, dated Aug. 3, 1998 (''Instinet Letter'') at 1, 7; Letter from Frederic W. Rittereiser, President and Chief Executive Officer and William W. Uchimoto, Executive Vice President and General Counsel, Ashton Technology Group, Inc. to Jonathan G. Katz, Secretary, SEC, dated July 28, 1998 (''Ashton Letter'') at 1; Letter from Mary Sue Fisher, Managing Director, Legal and Compliance, Chicago Board Brokerage, LLC to Jonathan G. Katz, Secretary, SEC, dated July 29, 1998 (''CBB Letter'') at 1–2.

[16] *See, e.g.,* TBMA Letter at 4; Letter from Larry E. Fondren, President, Integrated Bond Exchange, Inc. to Jonathan G. Katz, Secretary, SEC, dated July 27, 1998 (''IBEX Letter'') at 13.

[17] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute to Jonathan G. Katz, Secretary, SEC, dated July 28, 1998 (''7/28/98 ICI Letter'') at 5; Letter from James E. Buck, Senior Vice President and Secretary, New York Stock Exchange, Inc. to Jonathan G. Katz, Secretary, SEC, dated July 28, 1998 (''NYSE Letter'') at 9; Letter from Robert H. Forney, President and Chief Executive Officer, Chicago Stock Exchange to Jonathan G. Katz, Secretary, SEC, dated July 30, 1998 (''CHX Letter'') at 11; Letter from T. Eric Kilcollin, President and Chief Executive Officer, Chicago Mercantile Exchange to Jonathan G. Katz, Secretary, SEC, dated Aug. 5, 1998 (''CME Letter'') at 4; Letter from James F. Duffy, Executive Vice President and General Counsel, Legal and Regulatory Policy, American Stock Exchange, Inc. to Jonathan G. Katz, Secretary, SEC, dated Aug. 18, 1998 (''Amex Letter'') at 1; Ashton Letter at 2; CBOE Letter at 3, 8–9. *See infra* Section VI for a discussion of the temporary exemption for pilot trading systems.

markets. This regulatory framework should encourage market innovation while ensuring basic investor protections. The Commission continues to believe that the approach outlined in the Proposing Release will accomplish these goals. In general, this approach gives securities markets a choice to register as exchanges, or to register as broker-dealers and comply with Regulation ATS.[18] The Commission believes the framework it is adopting meets the varying needs and structures of market participants and is flexible enough to accommodate the business objectives of, and the benefits provided by, alternative trading systems. The principal components of this new framework are discussed below.

A. New Interpretation of "Exchange"

A fundamental component of the new regulatory framework is new Rule 3b–16. This rule interprets key language in the statutory definition of "exchange" under section 3(a)(1) of the Exchange Act.[19] Rule 3b–16 reflects a more comprehensive and meaningful interpretation of what an exchange is in light of today's markets. Until now, the Commission's interpretation of the exchange definition reflected relatively rigid regulatory requirements and classifications for "exchange" and "broker-dealers." Advancing technology has increasingly blurred these distinctions, and alternative trading systems today are used by market participants as functional equivalents of exchanges. Accordingly, the Commission's new interpretation of exchange contained in Rule 3b–16[20] encompasses these equivalent markets and the Commission's new general exemptive authority enables it to craft a new regulatory framework.

The statutory definition of "exchange" includes 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."[21] In response to commenters' concerns and suggestions, the Commission has carefully revised Rule 3b–16 to define these terms to mean *any organization, association, or group of persons that: (1) Brings together the orders of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.*[22]

Rule 3b–16 explicitly excludes those systems that the Commission believes perform only traditional broker-dealer activities. The Commission modified these exclusions to address issues raised by commenters. Rule 3b–16 now expressly excludes the following systems from the revised interpretation of "exchange": (1) Systems that merely route orders to other facilities for execution; (2) systems operated by a single registered market maker to display its own bids and offers and the limit orders of its customers, and to execute trades against such orders; and (3) systems that allow persons to enter orders for execution against the bids and offers of a single dealer.[23]

B. Exemption for Regulated Alternative Trading Systems

The framework the Commission adopts today uses the Commission's new exemptive authority to allow most alternative trading systems to choose to be regulated either as exchanges or as broker-dealers. Rule 3a1–1 exempts most alternative trading systems from the definition of "exchange," and therefore the requirement to register as an exchange, if they comply with Regulation ATS. However, any system exercising self-regulatory powers, such as regulating its members' or subscribers' conduct when engaged in activities outside of that trading system, must register as an exchange or be operated by a national securities association. This is because self-regulatory activities in the securities markets must be subject to Commission oversight under Section 19 of the Exchange Act.[24] Thus any system exercising self-regulatory powers will not be permitted the option of registering as a broker-dealer.

In addition, the Commission can determine that a dominant alternative trading system should be registered as an exchange. An alternative trading system would first have to exceed certain volume levels and the Commission, after notice and an opportunity for the alternative trading system to respond, would have to determine that an exemption from exchange regulation is not necessary or appropriate in the public interest or consistent with the protection of investors, taking into account the requirements of exchange registration and the objectives of the national market system.[25] At this time, however, the Commission does not believe that it is necessary or appropriate under this provision that any alternative trading system register as an exchange.

C. Regulation ATS

The Commission is adopting new Regulation ATS, substantially in the form proposed, to impose essential elements of market-oriented regulation on alternative trading systems. This new regulation addresses the concerns raised by the market activities of alternative trading systems that choose to register as broker-dealers. To allow new markets to start, without disproportionate burdens, a system with less than five percent of the trading volume in all securities it trades is required only to: (1) File with the Commission a notice of operation and quarterly reports; (2) maintain records, including an audit trail of transactions; and (3) refrain from using the words "exchange," "stock market," or similar terms in its name.

If, however, an alternative trading system with five percent or more of the trading volume in any national market system security chooses to register as a broker-dealer—instead of as an exchange—the Commission believes it is in the public interest to integrate its activities into the national market system. In addition to the requirements for smaller alternative trading systems, Regulation ATS requires alternative trading systems that trade five percent or more of the volume in national market system securities to be linked with a registered market in order to disseminate the best priced orders in those national market system securities displayed in their systems (including institutional orders) into the public quote stream.[26] Such alternative trading systems must also comply with the same market rules governing execution priorities and obligations that apply to members of the registered exchange or national securities association to which the alternative trading system is linked.[27]

[18] 17 CFR 242.300–303.

[19] 15 U.S.C. 78c(a)(1).

[20] 17 CFR 240.3b–16.

[21] 15 U.S.C. 78c(a)(1).

[22] Rule 3b–16(a), 17 CFR 240.3b–16(a).

[23] Rule 3b–16(b), 17 CFR 240.3b–16(b).

[24] 15 U.S.C. 78s.

[25] Rule 3a1–1(b)(1), 17 CFR 240.3a1–1(b)(1).

[26] Rule 301(b)(3), 17 CFR 240.301(b)(3). Alternative trading systems will only have to comply with this rule for fifty percent of securities on April 21, 1999. By August 30, 1999, alternative trading systems will have to comply with this rule for all securities. Prior to April 21, 1999, the Commission will publish a schedule of those individual securities for which alternative trading systems must comply with Rule 301(b)(3) on April 21, 1999. *See infra* notes 192–193–and 216–217– and accompanying text.

[27] This linkage requirement would not apply to alternative trading systems that do not display participant orders to anyone, including other system participants. In addition, this requirement would not apply to alternative trading systems to

Continued

In addition, alternative trading systems with twenty percent or more of the trading volume in any single security, whether equity or debt, would be required to: (1) Grant or deny access based on objective standards established by the trading system and applied in a non-discriminatory manner; and (2) establish procedures to ensure adequate systems capacity, integrity, and contingency planning. The Commission believes that these requirements will better integrate those significant alternative trading systems into national market system mechanisms. Moreover, because alternative trading systems that choose to register as broker-dealers are not required to surveil activities on their markets, the Commission intends to work with the self-regulatory organizations (''SROs'') to ensure that they can operate ongoing, real-time surveillance for market manipulation and fraud and develop surveillance and examination procedures specifically targeted to alternative trading systems they oversee.

D. For-Profit Exchanges

In this release, the Commission also expresses its view that registered exchanges may structure themselves as for-profit organizations. This will allow alternative trading systems, which are typically proprietary, to choose to register as exchanges without changing their organizational structure. In addition, currently registered exchanges—which are all membership organizations—could choose to demutualize. This release provides guidance on ways for proprietary markets to meet their fair representation requirements as non-membership national securities exchanges.[28]

E. Temporary Exemption From Rule Filing Requirements for SROs' Pilot Trading Systems

To help reduce competitive impediments to innovation by SROs, the Commission is allowing them to start new trading systems without preapproval by the Commission. The Commission is adopting Rule 19b-5 to permit SROs, without filing for approval with the Commission, to operate new pilot trading systems for up to two years. These pilot trading systems will be subject to specific conditions, including limitations on their trading volumes.[29]

the extent that they trade securities other than national market system securities. *See infra* Section IV.A.2.c.(ii).

[28] *See infra* Section IV.B.2.

[29] *See infra* Section VI. The purpose of this new rule is to provide registered exchanges and national securities associations with a greater opportunity to compete with alternative trading systems registered as broker-dealers and with foreign markets.

III. Rule 3b–16 Under the Exchange Act

The Commission today is adopting new Rule 3b–16 under the Exchange Act. This rule defines terms used in the statutory definition of ''exchange,'' found in section 3(a)(1) of the Exchange Act.[30] The statutory definition of ''exchange'' includes 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.'' The new rule interprets these terms to include *any organization, association, or group of persons that: (1) Brings together the orders of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.*[31] This rule revises the current interpretation of the term ''exchange,'' as set forth in the *Delta Release*.[32]

New Rule 3b–16 is an important element of the Commission's new regulatory framework for alternative trading systems. As discussed above, the rapid growth and technological advancements of alternative trading systems have eroded the distinctions between the roles played by alternative trading systems and by traditional exchanges. Alternative trading systems today provide services more akin to exchange functions than broker-dealer functions, such as matching counterparties' orders, executing trades, operating limit order books, and facilitating active price discovery. For many of these systems, regulation as a market more appropriately fits their economic functions. Rule 3b–16 defines terms in the statutory definition of exchange to include markets that engage in activities functionally equivalent to markets currently registered as national securities exchanges. Moreover, because in some cases exchange regulation may better meet these systems' business objectives, the Commission believes that alternative trading systems should have the option to register as national securities exchanges.[33] The rule helps modernize the Commission's approach to these systems because it adapts the concept of what is ''generally understood'' to be an exchange to reflect changes in the markets brought about by automated trading. In addition, in light of recent technological developments, Rule 3b–16 more closely reflects the statutory concept of ''bringing together'' buying and selling interests.

The Proposing Release sought comment on whether the proposed definition captures the fundamental features of an exchange as that term is generally understood today. The Commission received several comments supportive of its proposed revision to the interpretation of ''exchange.'' For example, the NASD commented that this new definition ''is not inappropriate, particularly with the express exclusion for internal broker-dealer systems.''[34] Other commenters also supported broadening the Commission's interpretation of what constitutes an exchange and agreed that the proposed rule accurately identified the fundamental features of a securities ''exchange.''[35] On the other hand, some commenters questioned the basis and need for the Commission to move away from its interpretation in *Delta*. The

[30] 15 U.S.C. 78c(a)(1).

[31] Rule 3b–16(a), 17 CFR 240.3b–16(a). In the Proposing Release, the Commission proposed to define the terms in the definition of ''exchange'' to be ''any organization, association, or group of persons that: (1) Consolidates orders of multiple parties; and (2) sets non-discretionary material conditions (whether by providing a trading facility or by setting rules) under which parties entering such orders agree to the terms of a trade.'' *See* Proposing Release, *supra* note 3.

[32] See Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 FR 1980, 1900 (Jan. 19, 1990) *(''Delta Release''). See infra* Section VII for a further discussion of the *Delta Release* and the basis and purpose of the revised interpretation.

[33] *See infra* Section IV.B. (discussing registration as a national securities exchange). Under Section 5 of the Exchange Act, an exemption may be granted to an exchange from registration as a national securities exchange on the basis of low volume, or expected low volume. Currently, there is only one exchange, the Arizona Stock Exchange (''AZX''), that is operating under a limited volume exemption. *See* Securities Exchange Act Release No. 28899 (Feb. 20, 1991), 56 FR 8377 (Feb. 28, 1991). In addition, the Commission solicited comment on whether Tradepoint Financial Networks, plc should be granted a limited volume exemption. *See* Securities Exchange Act Release No. 40161 (July 2, 1998), 45 FR 41920 (July 9, 1998).

The Commission believes that the low volume exemption continues to be appropriate for some exchanges, such as an exchange that, for example, disciplines its members (other than by excluding them or limiting them from trading based on objective criteria, such as creditworthiness), or has other self-regulatory attributes that exclude it from the definition of alternative trading system, Rule 300(a), and therefore preclude it from making the choice to register as a broker-dealer. Any exchange seeking a low volume exemption would, of course, have to have low volume. The Commission believes that the low volume exemption would be inappropriate for any alternative trading system that can register as a broker-dealer and comply with Regulation ATS, and that the conditions under Regulation ATS should generally be met by any alternative trading system falling within Rule 3b–16, including an alternative trading system that, for other reasons, seeks a low volume exemption.

[34] NASD Letter at 3, n.4.

[35] *See* CME Letter at 2; IBEX Letter at 4.

Commission responds to these comments below in Section VII.

Finally, one commenter expressed concern that the proposed revision to the Commission's interpretation of ''exchange'' would encompass every market participant providing electronic or other technologically advanced trading service.[36] The Commission does not intend for the distinction between exchanges and broker-dealers to turn on automation, and does not believe that its revised interpretation of ''exchange'' has this effect. In particular, the Commission notes that paragraph (a) of new Rule 3b–16 does not contain the word automation, but is instead descriptive of those activities the Commission considers to be the activities of a ''market'' where buyers and sellers meet and includes purely floor-based exchanges, as well as fully automated ones. Moreover, paragraph (b) clearly excludes certain systems that—even though automated—are not exchanges, such as automated single dealer systems.

The language of Rule 3b–16 the Commission is adopting today modifies the language the Commission proposed in response to commenters' suggestions and concerns, and their requests for clarification. The discussion below is intended to further explain how the Commission envisions that its new interpretation of ''exchange'' will be applied and responds to specific requests for clarification by commenters.

A. Brings Together the Orders of Multiple Buyers and Sellers

In order to be covered by the definition in Rule 3b–16, a system must satisfy the first part of Rule 3b–16(a)—*brings together the orders of multiple buyers and sellers.* This emphasizes the concept of ''bringing together purchasers and sellers of securities'' set forth in the definition of ''exchange'' in section 3(a)(1) of the Exchange Act. While the intent is the same, the language in Rule 3b–16(a)(1) has been modified from the proposal to address the concerns of some of the commenters who requested that the definition be clarified.

1. To Bring Together

The Commission is adopting the language ''brings together'' in Rule 3b–16, rather than ''consolidates'' as originally proposed. While the Commission believes that ''consolidates'' and ''brings together'' have the same meaning, the latter more closely mirrors the language in the statute and is a plainer use of language.

A system brings together orders if it displays, or otherwise represents, trading interests entered on the system to system users. These systems include consolidated quote screens, such as the system operated by Nasdaq. A system also brings together orders if it receives subscribers' orders centrally for future processing and execution. For example, a limit order matching book that allows subscribers to display buy and sell orders in particular securities and to obtain execution against matching orders contemporaneously entered or stored in the system ''brings together orders.'' These activities are currently performed by systems that bring together orders internally for crossing[37] or matching,[38] as well as floor-based markets that impose trading rules. In addition, interdealer brokers (''IDBs'')[39] bring together orders, regardless of their level of automation.[40] Accordingly, a system ''brings together orders'' when orders entered in the system for a given security have the opportunity to interact with other orders entered into the system for the same security.

2. Multiple Buyers and Sellers

In addition, to satisfy paragraph (a)(1) of Rule 3b–16, a system must bring together orders of multiple buyers and multiple sellers. The Commission proposed to use the term ''multiple parties'' in paragraph (a)(1) of Rule 3b–16, rather than the term ''multiple buyers and sellers.'' The Commission believes that this modification to the language proposed in Rule 3b–16 addresses the concerns of those commenters who requested that the Commission clarify that systems in which there is only a single seller, such as systems that permit issuers to sell their own securities to investors, would not be included within Rule 3b–16. While such systems have multiple buyers (*i.e.*, investors), they have only one seller for each security (*i.e.*, issuers) and, therefore, do not meet the multiple buyers and sellers test. An example of this type of system is CP Direct in which an issuer can offer to sell its commercial paper to the customers of CS First Boston.[41] Another example of systems that do not meet the multiple buyers and sellers criteria are systems in which securities are offered by a single seller at successively lower prices. In addition, systems designed for the purpose of executing orders against a single counterparty, such as the dealer operating a system, would not be considered to have multiple buyers and sellers. Thus a single counterparty that buys *and* sells securities through a system, where other parties entering orders only execute against the single designated counterparty, would not meet the requirements of the first part of Rule 3b–16.[42] However, the mere interpositioning of a designated counterparty as riskless principal for settlement purposes after the purchasing and selling counterparties to a trade have been matched would not, by itself, mean that the system does not have multiple buyers and sellers.

3. Definition of ''Order''

Finally, the rule makes clear that, to be included within the definition in Rule 3b–16(a), a system must bring together participants' ''orders.'' The term ''order'' is defined in paragraph (c) of Rule 3b–16 to include any firm indication of a willingness to buy or sell a security, whether made on a principal

[36] Instinet Letter at 7.

[37] A crossing system is, typically, one that allows participants to enter unpriced orders to buy and sell securities. Orders are crossed at specified times at a price derived from another market.

[38] Matching systems allow participants to enter priced limit orders and match those orders with other orders in the system. Participants are able to view unmatched limit orders in the system's book. The sponsor of a matching system typically acts as riskless principal or a dealer firm on behalf of the system acts as riskless principal, with respect to matched orders, or contracts with another broker-dealer to perform this function.

[39] Currently, debt markets are not centrally organized by a single entity, but are nonetheless informally organized around interdealer brokers. Interdealer brokers (also called blind brokers and brokers' brokers) display, on an anonymous basis, the offers to buy and sell securities that are placed with them by subscribers. In order to place a bid or offer, a subscriber typically telephones the interdealer broker, which enters the order into its system and displays it to other subscribers. Some interdealer brokers display all bids and offers; others display only the best bid and offer. To execute against an offer displayed on the computer screen, a subscriber telephones the interdealer broker, although sometimes execution may be electronic. The identities of the counterparties are, generally, kept confidential through clearance and settlement of the trade. Some interdealer brokers, however, reveal the names of each counterparty after execution. Traditionally interdealer brokers facilitated trading only between dealers. Increasingly, however, interdealer brokers are permitting non-dealers to participate in their systems.

[40] *But see infra* notes 123–130 and accompanying text (discussing the exclusion from Regulation ATS for alternative trading systems that trade exclusively government, and other related, securities).

[41] *See* Bruce Rule, *PSA Panels Embrace Internet for Institutional Trading; and Regulators Love the Audit Trail,* Investment Dealers' Digest, Nov. 18, 1996 (discussing CP Direct). The converse situation—*i.e.*, where there is one buyer and multiple sellers for a given instrument—would also not meet the ''multiple buyers and sellers'' requirement. The Commission, however, is not aware of any system that currently operates this way.

[42] This type of system would also be expressly excluded from Rule 3b–16 under paragraph (b)(2). *See infra* Section III.C.2.

or agency basis.[43] Firm indications of buying or selling interest specifically include bid or offer quotations, market orders, limit orders, and any other priced order.

Several commenters requested that the Commission clarify the proposed definition of ''order.'' One commenter expressed concern that the proposed definition of ''order'' was too broad and recommended that the revised interpretation of ''exchange'' be clarified to exclude trading systems that broadcast non-executable indicative quotations, and noted that IDBs frequently communicate an indicative price to a customer, which is merely a starting point for a negotiation of the final transaction price.[44] The Commission notes that the term ''order'' is defined as ''any *firm* indication of a willingness to buy or sell a security, * * * including any bid or offer quotation, market order, limit order, or other priced order.''[45] Whether or not an indication of interest is ''firm'' will depend on what actually takes place between the buyer and seller.

The label put on an order—''firm'' or ''not firm''—is not dispositive. For example, a system claiming it displays only ''indications of interest'' that are not orders, may be covered by the new interpretation of ''exchange'' if those indications are, in fact, firm in practice. In general, the Commission intends to read the definition of ''order'' broadly and will not consider systems to fall outside the definition in Rule 3b–16 based solely on a system's labeling of indications of interest as ''not firm.'' Instead, what actually takes place between the buyers and sellers interacting in a particular system will determine whether indications of interest are ''firm'' or not. At a minimum, an indication of interest will be considered firm if it can be executed without the further agreement of the person entering the indication. Even if the person must give its subsequent assent to an execution, however, the indication will still be considered firm if this subsequent agreement is always, or almost always, granted so that the agreement is largely a formality. For instance, indications of interest where there is a clear or prevailing presumption that a trade will take place at the indicated price, based on understandings or past dealings, will be viewed as orders.

Generally, however, a system that displays *bona fide*, non-firm indications of interest—including, but not limited to, indications of interest to buy or sell a particular security without either prices or quantities associated with those indications—will not be displaying ''orders'' and, therefore, not fall within Rule 3b–16.

Nevertheless, the price or size of an indication of interest may be either explicit or may be inferred from the facts and circumstances accompanying the indication. For example, an indication of interest will be considered to include a price if the system in which the indication of interest is entered defaults automatically to a price pegged to another market, index, rate, or other variable, or if the person entering such indication indicates that such person is interested in trading at a price pegged to another market, index, rate, or other variable, which includes ''market'' orders.

The same commenter expressed concern that the proposed definition of order could have the effect of including markets within the definition of ''exchange'' that quote prices over the telephone for a potential transaction.[46] As discussed above, whether or not a particular system is an exchange does not turn solely on the level of automation used: ''orders'' can be given over the telephone, as well as electronically.

The Commission emphasizes that merely because a system ''brings together orders of multiple buyers and sellers,'' does not mean that the system is an exchange. In order to fall within Rule 3b–16, a system must also satisfy the requirements in paragraph (a)(2). Thus, whether or not an ''order'' is part of a system that falls within the new interpretation of ''exchange'' depends upon the activities of that system taken as a whole. For example, a system could display subscribers' ''orders'' to other market participants, but would not be encompassed by Rule 3b–16 if subscribers contacted each other and agreed to the terms of their trades outside of the system.[47] Unless a system also establishes rules or operates a trading facility under which subscribers can agree to the terms of their trades, the system will not be included within Rule 3b–16, even if it brings together ''orders.''

Finally, the NYSE commented that the Commission's definition of ''order'' appeared to cover trading interest that, in the Order approving the Pacific Exchange (''PCX'') Application of the OptiMark System (''OptiMark Order''), the Commission did not consider to be an order. In the OptiMark Order, the Commission took the position that the profiles entered into OptiMark are not bids or offers under Rule 11Ac1–1 (''Firm Quote Rule'').[48] The Commission's definition of ''order'' in paragraph (c) of Rule 3b–16 is intended to be broader than the terms bid and offer in the Firm Quote Rule.[49] Therefore, it is possible for an indication of interest to be an ''order'' under Rule 3b–16, without being a bid or offer under the Firm Quote Rule.

B. Established, Non-Discretionary Methods

In addition to bringing together the orders of multiple parties, to be included within Rule 3b–16, a system would have to use *established, non-discretionary methods * * * under which such orders interact with each other and the buyers and sellers entering orders agree to the terms of the trade.* A system uses established non-discretionary methods either by providing a trading facility or by setting rules governing trading among subscribers. The Commission intends for ''established, non-discretionary methods'' to include any methods that dictate the terms of trading among the multiple buyers and sellers entering orders into the system. Such methods include those that set procedures or priorities under which open terms of a trade may be determined. For example, traditional exchanges' rules of priority, parity, and precedence are ''established, non-discretionary methods,'' as are the trading algorithms of electronic systems. Similarly, systems that determine the trading price at some designated future date on the basis of pre-established

[43] Rule 3b–16(c), 17 CFR 240.3b–16(c).

[44] TBMA Letter at 15–16 (stating that the bids and offers associated with telephone-based IDBs are generally ''subject,'' *i.e.*, the broker must check back with the dealer client before finalizing the transaction).

[45]: Rule 3b–16(c), 17 CFR 240.3b–16(c).

[46] TBMA Letter at 15.

[47] These bulletin board types of systems were described in no-action letters from the staff. See Letter dated June 24, 1996 from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, Jack W. Murphy, Chief Counsel, Division of Investment Management, SEC, and Martin P. Dunn, Chief Counsel, Division of Corporate Finance, SEC to Barry Reder, Coblentz, Cahen, McCabe and Breyer, LLP (counsel to Real Goods Trading Corporation); Letter dated Aug. 5, 1996 from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC to: Bruce D. Stuart, Esq. (counsel to PerfectData Corporation); and Letter dated April 17, 1996 from Abigail Arms, Associate Director, Division of Corporate Finance, SEC, and Catherine McGuire, Associate Director, Division of Market Regulation, SEC to Andrew Klein (President and Chief Executive Officer of Spring Street Brewing Company).

[48] *See* Securities Exchange Act Release No. 39086 (Sept. 17, 1997), 62 FR 50036 (Sept. 24, 1997). In approving OptiMark, the Commission stated that OptiMark's unique design warrants a non-traditional approach in determining whether to require the dissemination of trading interest expressed through operation of OptiMark.

[49] *See* Rule 11Ac1–1(c), 17 CFR 240.11Ac1–1(c).

criteria (such as the weighted average trading price for the security on the specified date in a specified market or markets) are using established, non-discretionary methods. A requirement that the trade subsequently be ratified does not avoid this element. For example, a system that trades limited partnership units might use established, non-discretionary methods even though approval from the general partner is required prior to settlement. Rules that merely supply the means of communication with a system (for example, software or hardware tools that subscribers may use in accessing a system), however, do not satisfy this element of Rule 3b–16.

In general, where customers of a broker-dealer exercise control over their own orders in a trading system operated by the broker-dealer, that broker-dealer is unlikely to be viewed as using discretionary methods in handling the order. An example of systems that the Commission believes do not use established, non-discretionary methods are traditional block trading desks. Block trading desks generally retain some discretion in determining how to execute a customer's order, and frequently commit capital to satisfy their customers' needs. For example, a block positioner may ''shop'' the order around in an attempt to find a contra-side interest with another investor. In some cases, the block positioner may take the other side of the order, keeping the block as a proprietary position. While block trading desks do cross customers' orders, these crosses are not done according to fixed non-discretionary methods, but instead are based on the block trading desks' ability to find a contra-side to the order. It may cross two customer orders, or it may assemble a block of several customer orders with completion dependent on its willingness to take a proprietary position for part of the block. Execution prices, size of the proprietary position and agency compensation may all be part of a single negotiated deal. Consequently, the Commission would not consider traditional block trading desks to be using established, non-discretionary methods and, therefore, they would not fall within Rule 3b–16.

In addition, systems that merely provide information to subscribers about other subscribers' trading interest, without facilities for execution, do not fall within paragraph (a) of Rule 3b–16. One commenter asked the Commission to clarify that such systems would not be viewed as exchanges.[50] While such vendors may allow buyers and sellers to find each other, they do not provide a facility or set rules under which those orders interact with each other. Accordingly, the Commission agrees with this commenter that such systems are not exchanges.

In contrast, when a customer gives a broker-dealer flexibility in how to handle an order, it relinquishes a degree of control over that order. The Commission recognizes that broker-dealers exercising discretion or judgment over customer orders may use internal systems to trade and manage these orders. The mere use of these systems does not make a broker an exchange, unless those systems themselves predetermine the handling and execution practices for the order, replacing the broker-dealer's judgment and flexibility in working the order.

One commenter suggested that the lack of display of customer orders outside the broker-dealer should be determinative of whether the system was an exchange.[51] The Commission notes that it is possible for a system to use established, non-discretionary methods even if orders are not displayed. For example, the OptiMark System—by design—does not display participants' indications of interest. There is, however, no discretion exercised by the operator of the OptiMark System; the trade optimization calculations are established, non-discretionary methods.

Finally, the Commission proposed to explicitly exclude from the revised interpretation of ''exchange'' trading systems that allow a single broker-dealer to internally manage its customers' orders.[52] The Commission was concerned that such systems might technically be covered by paragraph (a) of Rule 3b–16 if they occasionally crossed or matched customer orders. Because the Commission believes that these systems have generally automated traditional brokerage functions, it proposed to clearly exclude them from the revised interpretation of ''exchange.'' Several commenters noted their agreement with the Commission's proposed exclusion of these internal broker-dealer systems from its reinterpretation of ''exchange,''[53] but requested that the Commission clarify it. In particular, the Securities Industry Association (''SIA'') and The Bond Market Association (''TBMA'') requested that the Commission clarify the intended meaning of the terms ''predetermined procedures'' and ''communicated to customers'' as used in the proposed exclusion.[54]

The Commission intended to exclude a number of different types of systems under this proposed exclusion. First, this exclusion was intended to cover internal systems operated by market makers to automate the management of their customer orders, including the display of customer limit orders, and to match those displayed orders with other customer orders. The Commission is now adopting a more specific exclusion to cover these types of systems.

In addition, in large part, the Commission intended to exclude systems that automate the management of customer orders that require a broker-dealer to use its discretion. These types of systems would not be included within paragraph (a) of Rule 3b–16 because—like traditional block trading desks—they do not use established, non-discretionary methods. The purpose of the proposed exclusion for internal broker-dealer systems was to exclude traditional internal systems created to increase efficiency rather than to provide a non-discretionary trading system for customers. In light of the comments on the proposed exclusion for internal broker-dealer systems and the difficulty of distinguishing among internal systems on this basis, the Commission now believes it is better not to attempt to set specific requirements that internal broker-dealer systems must meet in order to be excluded from Rule 3b–16. Instead, the Commission is clarifying that trading systems that do not use established, non-discretionary methods fail to meet the two-part test in paragraph (a) and are, therefore, not included within the revised interpretation of ''exchange.''

1. Established, Non-Discretionary Methods Provided by a Trading Facility

As stated previously, a trading system that uses established, non-discretionary methods would include a traditional exchange floor where specialists are responsible for executing orders. It would also include a computer system (whether comprised of software, hardware, protocols, or any combination thereof) through which orders interact, or any other trading mechanism that provides a means or location for the bringing together and execution of orders. For example, the Commission considers the use of an algorithm by an electronic trading system that sets trading procedures and priorities to be a trading facility that uses established, non-discretionary methods.

[50] MSDW Letter at 11.

[51] MSDW Letter, pp. 7–8.

[52] Proposed Rule 3b–12(b)(2).

[53] *See* NASD Letter at 3, n.4; TBMA Letter at 3, 14; SIA Letter at 3, 10; MSDW Letter at 5–6.

[54] *See* TBMA Letter at 3, 14–15; SIA Letter at 3, 10–11.

The Commission will attribute the activities of a trading facility to a system if that facility is offered by the system directly or indirectly (such as where a system arranges for a third party or parties to offer the trading facility). Thus, if a system that brings together the orders of multiple parties arranges for a third party vendor to distribute software that establishes non-discretionary methods under which orders interact, that system will fall within Rule 3b–16. Similarly, if a bulletin board operator contracted with another party to provide execution facilities for the bulletin board users, the bulletin board will be deemed to have established a trading facility because it took affirmative steps to arrange for the necessary exchange functions for its users.[55] In addition, if an organization arranges for separate entities to provide different pieces of a trading system, which together meet the definition contained in paragraph (a) of Rule 3b–16, the organization responsible for arranging the collective efforts will be deemed to have established a trading facility. For example, the arrangement between the Delta Government Options Corporation (''Delta''), RMJ Options Trading Corporation, and Security Pacific National Trust Company, as described in a 1990 Commission release,[56] would together meet the definition set forth in Rule 3b–16. Moreover, a trading system that falls within the Commission's interpretation of ''exchange'' in Rule 3b–16 will still be considered an ''exchange,'' even if it matches two trades and routes them to another system or exchange for execution. Whether or not the actual execution of the order takes place on the system is not a determining factor of whether the system falls under Rule 3b–16.

2. Established, Non-Discretionary Methods Provided by Setting Rules

Alternatively, a system may use established, non-discretionary methods through the imposition of rules under which parties entering orders on the system agree to the terms of a trade. For example, if a system imposes affirmative quote obligations on its subscribers, such as obligations to post two-sided quotations or to post quotations no worse than the quotes subscribers post on other systems, the Commission will consider it to be using established, non-discretionary methods.

In addition, rules imposing execution priorities, such as time and price priority rules, would be ''established, non-discretionary methods.'' Similarly, a system that standardizes the material terms of instruments traded on the system, such as the system operated by Delta at the time the Commission published the *Delta Release*,[57] will be considered to use established, non-discretionary methods.

Similarly, Nasdaq's use of established, non-discretionary methods bring it within the revised interpretation of ''exchange'' in Rule 3b–16. The NASD imposes basic rules by which securities are traded on Nasdaq. Specifically, it imposes affirmative obligations on market makers in Nasdaq National Market (''Nasdaq NM'') and SmallCap securities, including obligations to post firm and two-sided quotes. It also operates the Small Order Execution System (''SOES'') and SelectNet systems, requiring market makers to accept executions or orders for execution in these securities. Through Nasdaq, market participants act in concert to centralize and disseminate trading interest and establish the basic rules by which securities are traded. The Commission believes that Nasdaq performs what today is generally understood to be the functions commonly performed by a stock exchange. Nasdaq, however, is currently registered as a securities information processor under section 11A of the Exchange Act[58] and is operated by the NASD, a registered securities association under Section 15A of the Exchange Act.[59] Because the requirements currently applicable to a registered securities association are virtually identical to the requirements applicable to registered exchanges, the Commission does not believe it is necessary or appropriate in the public interest to require Nasdaq to register as an exchange.[60] Under the rules the Commission is adopting today, however, Nasdaq could choose to register under section 6 of the Exchange Act as a national securities exchange.[61]

C. Systems Excluded From Rule 3b–16

The Proposing Release specifically excluded from the proposed, revised interpretation of ''exchange'' several types of activities that could be considered traditional brokerage activities: order routing systems, dealer quotation systems, and internal broker-dealer order management and execution systems. Commenters widely agreed that automated broker-dealer functions should not be encompassed in the meaning of ''exchange.''[62] The Commission agrees. Commenters did, however, ask for clarification about the application of the exclusions in paragraph (b). In particular, some commenters appeared to misunderstand Rule 3b–16 as requiring that a system fall within one of the exclusions in paragraph (b) in order to be outside of the revised interpretation of ''exchange.'' This was not the Commission's intent. A system is not included within the revised interpretation of ''exchange'' if: (1) It fails to meet the two-part test in paragraph (a) of Rule 3b–16; *or* (2) it falls within one of the exclusions in paragraph (b).

The Commission has included paragraph (b) of Rule 3b–16 to explicitly exclude some systems that the Commission believes are not exchanges. Paragraph (b) of Rule 3b–16 expressly excludes: (1) Systems that merely route orders to other execution facilities; and (2) systems that allow persons to enter orders for execution against the bids and offers of a single dealer, and systems that automate the activities of registered market markers.

Two commenters asked the Commission to exclude from the revised interpretation of ''exchange'' all correspondent clearing relationships, as well as agreements among broker-dealers to handle their respective order flow.[63] The Commission has excluded routing systems under Rule 3b–16(b)(1). Whether or not correspondent clearing

[55] Whether or not a bulletin board will be considered an exchange under the rule will also depend on whether it meets the other elements of the definition.

[56] *See Delta Release, supra* note 32. The Commission notes that the arrangement between these entities no longer exists, and that Delta, in its current form, would not fit the new interpretation of the definition of exchange.

[57] *See id.*, at 1897.

[58] 15 U.S.C. 78k–1.

[59] 15 U.S.C. 78*o*–3. The NASD, parent of Nasdaq, is the self-regulatory organization. The NASD delegates to NASD Regulation, Inc. (''NASDR''), the wholly owned regulatory subsidiary of the NASD, its SRO responsibilities to surveil trading conducted on Nasdaq and the OTC Bulletin Boards, and to enforce compliance by its members (and persons associated with its members) with applicable laws and rules. Nasdaq also surveils trading conducted on its market and refers potential violations to NASDR. *See also infra* note 342.

[60] *See infra* notes 93–94 and accompanying text (discussing Rule 3a1–1(a)(1), which explicitly exempts any system operated by a national securities association from the definition of the term ''exchange'').

[61] 15 U.S.C. 78f. If Nasdaq registered as an exchange, it would have its own SRO responsibilities, but the Commission does not expect this to increase Nasdaq's current burden. In view of the NASD's SRO status the Commission could use its authority under Sections 17 and 19 of the Exchange Act, 15 U.S.C. 78q and 78s, to delegate any obligations Nasdaq would have as a registered exchange to enforce compliance by its members (and persons associated with its members) with the federal securities laws to NASDR.

[62] *See* SIA Letter at 3, 10–11; DBSI Letter at 3; NASD Letter at 4; TBMA Letter at 3, 14.

[63] *See* TBMA Letter at 14, n.26; SIA Letter at 10–11, n.18.

relationships are excluded, however, depends on the nature of the systems used in that relationship. The Commission does not believe that systems operated by clearing firms should be excluded simply because their correspondents participate in them. The Commission believes that such an exclusion would be overly broad.

One commenter questioned whether IDBs are the functional equivalent of internal broker-dealer systems and, therefore, should be excluded from Rule 3b–16.[64] The Commission believes that most screen-based IDBs function by displaying, on an anonymous basis, the offers to buy and sell securities that are placed with them by subscribers. While typically a subscriber uses a telephone to place the orders and ordinarily use the telephone to request execution, multiple buyers and sellers are involved, and generally customers view some or all orders on screens. Thus, IDBs bring together the orders of multiple buyers and sellers. Where an IDB has set procedures under which it executes subscriber orders against displayed or retained orders in a predetermined fashion, the methods by which these orders are brought together likely would be established and non-discretionary. The Commission believes that IDBs that function in this fashion are covered by Rule 3b–16. If an IDB does not display orders or communicate them verbally to customers, and does not execute orders according to pre-determined, well-understood rules, it may not be covered by the rules the Commission is adopting today. As a general matter, however, the Commission believes that most IDBs would be covered by the definition in Rule 3b–16(a) and not excluded by any of its exclusions.

In addition, one commenter recommended that any entity that has the discretion to commit capital to a trade be excluded from Rule 3b–16, because broker-dealers commit capital, but exchanges do not.[65] The Commission generally views the willingness to predictably commit capital as a traditional broker-dealer activity. For this reason it is explicitly excluding registered market maker and single dealer systems, which commit capital in all—or almost all—trades. In addition, broker-dealers frequently commit capital as part of their block trading desk activities. As discussed above, the Commission does not believe that traditional block trading desks are covered under paragraph (a) of Rule 3b–16. However, the Commission does not believe that a system engaging in activities as a market should be excluded from the scope of Rule 3b–16 simply because the broker-dealer operating the system may participate as a dealer in that system.

Finally, one commenter asserted that ''passive systems,'' such as POSIT,[66] should be excluded from the Commission's revised interpretation of ''exchange,'' because they do not have a traditional price discovery mechanism.[67] The Commission, however, does not agree that systems like POSIT are simply an automation of traditional brokerage functions, but believes they are markets. Like other markets, ''passive'' or derivative pricing systems bring together the orders of multiple buyers and sellers. All subscribers enter orders,[68] which interact at pre-specified times. In addition, ''passive systems'' establish non-discretionary methods under which subscribers agree to the terms of the trade. Such systems cross orders at pre-established times during the day according to specified priorities, such as time priority. While these orders are traded at a price that is not known at the time a subscriber enters an order, the parameters under which such price will be determined are established and not subject to discretion by the operator of the ''passive system.'' While these systems do not themselves have traditional price discovery mechanisms, they have the potential to—and frequently do—affect the markets from which their prices are derived.[69] The Commission, however, agrees with this commenter that these systems do not raise the same concerns as alternative trading systems with price discovery mechanisms and, therefore, even if such systems have significant trading volume, if they choose to register as broker-dealers they are not required to meet the fair access and systems capacity requirements.[70] The Commission, however, will monitor the activities of these passive systems and if concerns arise with regard to their activities will reconsider whether these requirements should apply.

1. Order Routing Systems

The Commission proposed to exclude from proposed Rule 3b–16 those trading systems that merely route orders to an exchange or broker-dealer for execution. The only commenter to address this provision was the SIA, which expressed its support for this exclusion.[71] The Commission is adopting the exclusion as proposed in Rule 3b–16(b)(1). Examples of such systems include the New York Stock Exchange's (''NYSE's'') and the American Stock Exchange's (''Amex's'') Common Message Switch[72] and BRASS.[73] Nasdaq, however, is not *merely* a routing system. In addition to SelectNet's routing capabilities, Nasdaq is a quotation facility, permits executions through its SOES system, and establishes rules for its members regarding the firmness of their bids and offers and how members deal with each other.

The Commission does not believe that these routing systems meet the two-part test in paragraph (a) of Rule 3b–16 because they do not bring together orders of multiple buyers and sellers.

[64] TBMA Letter at 14, n.25 (suggesting that the Commission expressly recognize the possibility that some IDBs may be able to rely on the exclusion for internal broker-dealer systems).

[65] SIA Letter at 3–4, 6–7, 9.

[66] POSIT is an alternative trading system operated by ITG Inc. Broker-dealers and institutions enter unpriced orders to buy and sell exchange listed and Nasdaq securities into POSIT at any time prior to a pre-selected crossing time. At the crossing time, buy orders in the system for each security are crossed, where possible, with sell orders and crossed orders are executed at a price derived from the primary market where the security trades.

[67] Letter from Timothy H. Hosking, General Counsel, ITG Inc., to Jonathan G. Katz, Secretary, SEC dated Nov. 20, 1998 (''ITG Letter'') at 2–3.

[68] The indications of interest entered into ''passive'' or derivative pricing systems are ''orders,'' under Rule 3b–16(c). While the orders are entered without a specified price, subscribers agree to trade at a price based on the primary market, such as the mid-point of the bid and ask at the time orders are matched or at the primary market's opening price.

[69] In addition, there exists the incentive for subscribers to these ''passive systems'' to manipulate the price in the market from which the ''passive system'' derives its price in order to obtain a favorable execution on the passive system.

[70] *See* Rules 301(b)(5)(iii) and 301(b)(6)(iii), 17 CFR 242.301(b)(5)(iii) and 242.301(b)(6)(iii). *See infra* notes 248, 278, 241–291 and accompanying text. Further, the Commission did not propose, nor is it adopting, a requirement that alternative trading systems that register as broker-dealers publicly display any orders that are not displayed to that system's subscribers. Thus, alternative trading systems—like most ''passive'' systems—that do not display subscriber orders at all, are not subject to the public display requirement if they register as broker-dealers under Regulation ATS.

[71] SIA Letter at 10.

[72] A similar system, also operated by the Amex, is Automated Post Execution Reporting System, or AutoPERS.

[73] BRASS is an order routing system operated by Automated Securities Clearance, Ltd. (''ASC''). ASC provides system users with software and hardware that enables users to enter orders into the system which are then routed to an exchange or Nasdaq for execution. BRASS software enables a market maker to execute orders against its inventory at the market maker's quoted price, monitor compliance with the Commission's Limit Order Display Rule, *infra* note 76, route an order to another market maker or market, report executed transactions, and monitor, among other things, trading positions, and profit/loss margins. Separately, an entity affiliated with ASC, the BRASS Utility, LLC (''BRUT''), operates an electronic communications network (''ECN'') to which orders can be routed through the use of BRASS software. *See infra* note 178.

Instead, all orders entered into a routing system are sent to another execution facility. In addition, routing systems do not establish non-discretionary methods under which parties entering orders interact with each other.

2. Dealer Systems

In the Proposing Release, the Commission discussed the application of proposed Rule 3b–16 to single dealer systems. 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. Because single market maker systems merely provide a more efficient means of executing the trading interest of separate customers with one dealer, the Commission stated that they should not be considered exchanges. Accordingly, the Commission proposed to explicitly exclude from proposed Rule 3b–16 those trading systems that display the quotations of a single dealer and allow persons to enter orders for execution against the dealer's proprietary account, usually at the dealer's quote. This exclusion was intended to encompass systems operated by third market makers,[74] as well as those systems operated by dealers, primarily in debt securities, who display their own quotations to customers and other broker-dealers on proprietary or vendor screens.

The Commission is today adopting paragraph (b)(2) of Rule 3b–16 to exclude systems that display quotes of a single dealer and allow persons to enter orders for execution against the bids and offers of a single dealer. If a market maker executes a customer order at the National Best Bid or Offer (''NBBO''), rather than at its displayed bid or offer, the Commission will consider the NBBO as the market maker's quote for purposes of that trade. As in the proposal, paragraph (b)(2) is intended to exclude from Rule 3b–16 all dealers, including third market makers.

The Commission received two comment letters asking the Commission to reconsider its proposed exclusion of third market makers.[75] These commenters disagreed with the Commission's distinction between third market makers and exchanges, and stated that these systems compete directly with the regional exchanges for order flow. Consequently, these commenters suggested that the Commission include third market makers within its revised interpretation of ''exchange.'' As discussed in the Proposing Release, however, the Commission does not believe that a single dealer that automates its means of communicating trading interest to customers is a market. Instead, such systems automate functions traditionally performed by dealers.

Accordingly, the exclusion the Commission is adopting today in paragraph (b)(2) of Rule 3b–16 is intended to cover systems operated by third market makers. Because of the Commission's own rules and those of the SROs, a third market maker's quote may not always reflect its own bids and offers, but may—at times—represent a customer limit order. The Limit Order Display Rule[76] requires third market makers (among others) to display customer limit orders in a security that are at a price that would improve the bid or offer of such market maker in that security. The Commission does not believe that a market maker engaging principally in the business of trading for its own account should be included within Rule 3b–16 solely because it is complying with the Limit Order Display Rule. Consequently, in the Proposing Release the Commission stated that, for purposes of this exclusion, if a dealer displayed a customer order to comply with a Commission or SRO rule, that customer order would be considered to be the ''dealer's quote.''[77] To ensure that Rule 3b–16 clearly excludes such dealers, the Commission is adopting paragraph (b)(2)(ii) of Rule 3b–16. Paragraph (b)(2)(ii) excludes a registered market maker that displays its own quotes and customer limit orders, and allows its customers and other broker-dealers to enter orders for execution against the displayed orders. The exclusion also allows such a registered market maker, as an incidental activity resulting from its market maker status, to match or cross orders for securities in which it makes a market, even if those orders are not displayed.[78]

Two other commenters expressed their support for the single dealer exclusion.[79] One of these commenters, however, suggested that the Commission modify the exclusion so that trading systems that display the quotes of a dealer *and its affiliates* and allow persons to execute against those quotes be excluded from Rule 3b–16.[80] The Commission is adopting the exclusion from Rule 3b–16 for single dealer systems, but does not agree with this commenter that a dealer's affiliates should be included in the exclusion.

In addition, one commenter requested that the Commission clarify whether the exclusion for dealer quotation systems would apply to systems that allow other broker-dealers to execute against a single dealer's quotations.[81] The Commission intends for this exclusion to cover dealer quotation systems that permit other broker-dealers to execute against the dealer's quotations and realizes that its use of the term ''customer'' in the proposal would preclude this. Accordingly, the Commission is adopting the exclusion in paragraph (b)(2) so that it encompasses single dealer systems that allow any person to enter orders for execution against that dealer's quotes.[82] A single dealer system could also match orders that are not displayed to any person other than the dealer and its employees, provided this matching is only incidental to its primary activity as a dealer.[83]

D. Examples of Systems Illustrating Application of Rule 3b–16

The following examples are provided to illustrate various applications of Rule 3b–16.[84] While these examples are intended to provide guidance, the application of Rule 3b–16 will be fact-specific.

1. Examples of Systems Included Within Rule 3b–16

a. System A is a trading floor that maintains a continuous two-sided auction market under a unitary specialist system. Through the use of an electronic communication system, orders are transmitted from member firms to the floor and execution reports are transmitted from the floor to the member firms. System A also has an automated routing and small order execution system. Price discovery occurs through the interaction of bids and offers of market participants under the application of System A's rules of priority, parity, and precedence. The specialist's dealings are subject to compliance obligations established by System A. System A is included under Rule 3b–16.

[74] Third market firms are NASD member firms that execute orders for exchange-listed securities.

[75] *See* Letter from David E. Rosedahl, Executive Vice President and Chief Regulatory Officer, Pacific Exchange, Inc. to Jonathan G. Katz, Secretary, SEC, dated Aug. 20, 1998 (''PCX Letter'') at 2–6; CHX Letter at 3–4.

[76] Rule 11Ac1–4(b)(1)(i), 17 CFR 240.11Ac1–4(b)(1)(i).

[77] Proposing Release, *supra note* 3, at n.9.

[78] Rule 3b–16(b)(2)(ii), 17 CFR 240.3b–16(b)(2)(ii).

[79] *See* SIA Letter at 10; DBSI Letter at 3.

[80] DBSI Letter at 3.

[81] SIA Letter at 11.

[82] Rule 3b–16(b)(4), 17 CFR 240.3b–16(b)(4).

[83] Rule 3b–16(b)(2)(i), 17 CFR 240.3b–16(b)(2)(i).

[84] These systems may also implicate other provisions of the federal securities laws.

b. System B allows participants to enter, replace, or cancel limit orders prior to a pre-established auction cutoff time. Bids and offers (including price and size) are displayed in the System B's order book, which participants can view on their screens. After the cutoff time, the system reviews all orders with respect to each security and determines the price at which the volume of buying interest is closest to the volume of selling interest. That price is the ''auction price.'' Participants that have entered bids at or above, and offers at or below, the auction price receive an execution at the auction price on the basis of time priority up to the available size. Matched orders are executed by a registered broker-dealer. System B is included under Rule 3b–16.

c. System C allows participants to enter limit orders and matches those orders with other orders in System C based on internal parameters. System C displays unmatched limit orders in the system's book on an anonymous basis to all participants. The broker-dealer operating System C acts as a riskless principal in executing all matched orders. System C is included under Rule 3b–16.

d. System D limits participation to institutional investors that trade illiquid restricted securities. To offer a security, a seller notifies System D as to the security, the price and the amount offered. After System D accepts an order, it enters it into the system where it is posted anonymously. Prospective purchasers may accept a posted order or seek to negotiate a transaction by contacting System D. System D facilitates the purchase and sale of securities through the system on an agency basis. Participants enter a bid or offer by calling a dedicated telephone number at System D. Once each side of the transaction agrees to the terms of the trade, System D obtains necessary documentation from the participants and reviews all the documentation. Once all the documentation has been processed, System D notifies the parties setting the transfer and settlement date, at which time System D will coordinate the transfer of funds and the issuer is notified to effect the transfer on its books. System D is included under Rule 3b–16.

e. System E allows participants to enter orders for securities by computer, facsimile, or telephone. Those orders are not displayed to other participants. System E crosses orders at specified times at a price derived from another market such as the closing price, a volume weighted average price, or the midpoint between the closing bid and ask on the primary market. System E is included under Rule 3b–16, but would be exempt from the requirements of Regulation ATS under Rule 301(a)(5) if it is registered as a broker-dealer.

f. System F displays, on an anonymous basis, firm offers to buy and sell securities from its participants. Participants typically telephone an employee of System F to place a bid or offer, which the employee enters into the system for display to other participants. To execute against a bid or offer displayed on the computer screen, a participant telephones an employee at System F. The employee is required to execute the participant's order against the displayed order if it matches. System F is included under Rule 3b–16. If System F allowed subscribers to execute against a displayed order by sending a message electronically, it would also be included under Rule 3b–16.

g. System G permits competing market makers to post continuous two-sided quotes in certain securities. Quotes are consolidated and disseminated to subscribers electronically. System G maintains and enforces rules setting standards for the posting of quotes and executions. Trades are executed by subscribers calling market makers outside the system and executing trades based on quotes displayed in the system. System G is included under Rule 3b–16.

h. System H is owned and operated by a bank. System H permits registered broker-dealers to place orders to buy or sell securities at specified prices and sizes and have those orders displayed to all users on an anonymous basis. Registered broker-dealers may trade both for their own account or on an agency basis on behalf of their customers. System H automatically executes an order if it matches an existing order. If no match is immediately available, System H displays the order on the system on an anonymous basis to all users. System H is included under Rule 3b–16.

i. System I permits participants to enter a range of ranked contingent buy and sell orders at which they are willing to trade securities. These orders are matched based on a mathematical algorithm whose priorities are designed to achieve the participants' objectives. System I does not display orders to any participants. System I is included under Rule 3b–16.

2. Examples of Systems Not Included Within Rule 3b–16

a. System J routes orders from broker-dealers to registered exchanges or to other broker-dealers for execution. System J also routes execution reports back to the broker-dealers that entered the orders. System J provides no facility for execution, but rather only acts as a communications system for the transmission of orders and execution reports. System J falls within the exclusion in paragraph (b)(1) of Rule 3b–16.

b. System K displays a registered market maker's quotes in exchange-listed securities and permits subscribers to submit orders for those securities to the market maker. Limit orders are displayed in the market maker's quote pursuant to requirements under the Commission's order execution rules. Market orders are executed against the market maker's quote or at the NBBO or at a price better than the NBBO. Limit orders are held until marketable. System K falls within the exclusion in paragraph (b)(2) of Rule 3b–16.

c. System L allows a dealer to disseminate its proprietary quotations to its customers and permits customers to transmit orders to buy from or sell to that dealer at those quoted prices. System L is not included under Rule 3b–16 because it falls within the exclusion in paragraph (b)(2) of Rule 3b–16.

d. System M is operated by a broker-dealer that makes markets in Nasdaq securities. System M permits the broker-dealer's customers, as well as other broker-dealers (including correspondent broker-dealers with whom it has a clearing arrangement) to send orders electronically or by telephone to the broker-dealer. An order transmitted electronically goes directly to the system server. An order transmitted by phone is received by an employee of the broker-dealer, who enters it into the System M. If it is a market order for a Nasdaq security in which the broker-dealer makes a market, System M checks to see if the order can be crossed against a customer limit order held by the broker-dealer. If two customer orders cannot be crossed, System M automatically executes the market order against the firm's inventory if the order size is at or below certain parameters. If the order size exceeds those parameters, the market order will be routed to a trader for manual execution against the firm's inventory, or other handling as the trader determines. If the order is for a security in which the broker-dealer does not make a market, System M sends the order to a market maker in the security or to another market for execution. System M falls within the exclusions in paragraph (b)(1) and (b)(2) of Rule 3b–16.

e. System N allows participants to post the names of securities they wish to buy or sell. Other participants view

this ''bids wanted list'' or ''offers wanted list'' and place bids or offers for the specified securities during a defined auction period. The participant who posted the security on the ''bids wanted list'' or ''offers wanted list'' may either accept or reject the best bid or offer at the close of the auction. System N is not included under Rule 3b–16 because there is only one seller.

f. System O permits correspondent firms of a broker-dealer to send orders electronically to that broker-dealer. The broker-dealer executes the orders against its own inventory. System O falls within the exclusion in paragraph (b)(2)(i) of Rule 3b–16.

g. System P is an Internet web site set up by an issuer. Through this web site, the issuer provides information to prospective buyers and sellers of its common stock. Prospective buyers and sellers post their identities, contact information, and the number of shares offered or sought at a given price. The issuer makes that information, along with the date the information was submitted, available to prospective buyers and sellers. The participants contact each other outside of the web site to execute trades. System P is not included under Rule 3b–16 because it does not establish non-discretionary methods under which buyers and sellers interact.

h. System Q is a screen-based system on which broker-dealers post indications of interest to institutional customers in the securities the broker-dealers wish to trade and advertise trades they have recently conducted. System R sets no requirements and provides no procedures regarding whether or how posted quantities and prices of securities can be executed. System Q is not included under Rule 3b–16 because it does not establish non-discretionary methods under which buyers and sellers interact.

i. System R is an internal system operated by a broker-dealer to display only to its registered representatives the prices and sizes of securities offered for sale by the firm in its capacity as a dealer. A registered representative can enter a buy order, specifying price and size, on behalf of its customer. If the terms of the customer's order match the dealer's posted offer, System R automatically executes the order. If the terms are different, System R places the customer's order on the screen for later matching. Assuming the matches of customer orders are merely incidental relative to the dealer's own trades, System R falls within the exclusion in paragraph (b)(2)(i) of Rule 3b–16.

j. System S permits an issuer to post prices to sell its own securities to a broker-dealer's customers. The issuer is under no obligation to post prices on the system and may choose to do so at any time. If a customer accepts the posted price and size, System S routes the order to the issuer who retains discretion to accept or reject the trade. If the posted price or size is not accepted as posted, System S automatically alerts the issuer that further negotiation is necessary. System S is not included under Rule 3b–16 because it has only one seller and, therefore, fails to meet the ''multiple buyers and sellers requirement.''

k. System T facilitates the clearance and settlement of securities products. Participating IDBs disseminate and match trading interest through their own proprietary trading screens to their own customers. The participating IDBs then submit matched transactions between their customers to System T for clearance and settlement. The IDBs' screens are not linked together and the IDBs interact only with those dealers using the system. The customers' orders interact only with the quote of the IDB of which they are a customer and do not interact with the other customer orders of that IDB. Dissemination and execution of orders by the IDBs is governed solely by their rules and not by System T.[85] System T is not included under Rule 3b–16.

E. Exemption From the Definition of ''Exchange''

Section 36 of the Exchange Act[86] gives the Commission broad authority to exempt any person, security, or transaction from provisions of the Exchange Act and the rules thereunder. Such an exemption may be subject to conditions. Using this authority, the Commission is adopting Rule 3a1–1.[87] This rule exempts from the definition of ''exchange'': (1) Any alternative trading system that compies with Regulations ATS[88] (2) any alternative trading system that under Rule 301(a) of Regulation ATS is not required to comply with regulation ATS and alternative trading system operated by a national securities association,[89] and (3) any alternative trading system operated by a national securities association.[90] Finally, as described more fully below,[91] paragraph (b)(1) of Rule 3a1–1 also conditions an alternative trading system's exemption on the absence of a Commission determination that the exemption in a particular case is not ''necessary or appropriate in the public interest or consistent with the protection of investors.''[92]

The Commission has determined that this exemption is in the public interest and will promote efficiency, competition, and capital formation because it has the effect of providing alternative trading systems with the option of positioning themselves in the marketplace as either registered exchanges or as broker-dealers. The Commission believes that allowing alternative trading systems to make a business decision about how to register with the Commission will continue to encourage the development of new and innovative trading facilities. The Commission has also determined that this exemption is consistent with the protection of investors because investors will benefit from conditions governing an alternative trading system, in particular Regulation ATS's enhanced transparency, market access, system integrity, and audit trail provisions.

Moreover, because national securities associations are subject to requirements virtually identical to those applicable to national securities exchanges,[93] Rule 3a1–1 also exempts from the definition of ''exchange'' any alternative trading system operated by a national securities association.[94] The Commission believes that the regulation of alternative trading systems operated by a national securities association is adequate, and therefore, that such systems should not be required to register either as exchanges, or as broker-dealers and comply with Regulation ATS. Consequently, trading systems operated by national securities associations may continue to operate as they do now.

Finally, in response to a commenter's request that the Commission clarify that the exemption from the definition of ''exchange'' provided in Rule 3a1–1(a)(2) includes broker-dealers that are excluded from the scope of Regulation ATS by Rule 301(a),[95] the Commission is adding paragraph (a)(3) to Rule 3a1–

[85] In some cases, however, the systems operated by the interdealer brokers may fall within Rule 3b–16. See supra System F.

[86] 15 U.S.C. 78mm.

[87] 17 CFR 240.3a1–1.

[88] 17 CFR 240.3a1–1(a)(2). *See infra* note and accompanying text for the definition of an alternative trading system.

[89] 17 CFR 240.3a1–1(a)(3). *See* notes—and accompanying text.

[90] 17 CFR 240.3a1–1(a)(1).

[91] *See infra* Section III.F.

[92] Rule 3a1–1(b), 17 CFR 240.3a1–1(b).

[93] Registration as a national securities association under section 15A of the Exchange Act is voluntary. 15 U.S.C. 78*o*–3. Currently the only national securities association is the NASD, which operates Nasdaq.

[94] Rule 3a1–1(a)(1). *See also* Rule 301(a)(3) (excluding alternative trading systems operated by a national securities association from the scope of proposed Regulation ATS).

[95] Instinet Letter at 8, n.11.

1. The Commission intended for broker-dealers that perform only activities delineated in Rule 301(a) to be exempt from the definition of exchange under Rule 3a1–1, and is making this clear by adding this new paragraph.[96]

The Commission intends for the exemption provided by Rule 3a1–1 to make clear that alternative trading systems that register as broker-dealers and comply with Regulation ATS not be regulated as national securities exchanges. The Commission believes that the requirements in Regulation ATS as adopted will address the market-like functions of alternative trading systems without imposing requirements applicable to exchanges that might not fit comfortably with certain alternative trading systems' structures and businesses.

In the Proposing Release, the Commission requested comment on whether an exclusion from the definition in Rule 3b–16 for alternative trading systems that register as broker-dealers and comply with the provisions of Regulation ATS would be preferable to the exemption under Rule 3a1–1. Several commenters expressed a preference for an exclusion, rather than an exemption.[97] Most of these commenters were concerned that foreign regulators would view these systems, currently registered as broker-dealers, as exchanges if they were now exempted from the definition of exchange rather than excluded from it. The Commission believes that its new framework being adopted today represents a carefully balanced approach to the regulation of markets that is grounded in the particular statutory structure of the Exchange Act. First, the Commission notes that its exemption for alternative trading systems applies to the definition of an exchange. By exempting alternative trading systems from this definition, the Commission is making clear its view that these systems should not be treated as exchanges under the Exchange Act or in any other context. Moreover, the Commission does not intend its interpretation of exchange to be used outside of the Exchange Act context. The Commission strongly cautions against applying this interpretation in other contexts where its effects will differ from those under the Exchange Act. The Commission also believes that application in another context of only one element of the structure adopted today would be inappropriate and would seriously call into question the validity of the interpretation in that context.

Another concern raised by at least one commenter was that investors could be influenced in how they view a trading system, if such trading system is included within the Commission's interpretation of ''exchange.''[98] The Commission believes that investors' views of systems are shaped more by the functions those systems perform than by the way they are classified. The Commission also believes that the enhanced regulation of alternative trading systems that choose to remain registered as broker-dealers that is provided by Regulation ATS provides more protection for the investors who use these systems.

In the Proposing Release, the Commission also requested comment on the scope, form, and conditions of the exemption in Rule 3a1–1. Commenters generally approved of the Commission's proposal to allow alternative trading systems the choice to register as exchanges or be exempt from the definition of ''exchange'' by registering as broker-dealers and complying with Regulation ATS.[99] One commenter questioned whether national securities exchanges would have the choice to register as alternative trading systems, in effect ceasing to act as SROs and electing instead to be regulated as a broker-dealer under Regulation ATS.[100] The Commission believes that, as a general matter, national securities exchanges do have this choice under the rules the Commission is adopting today.[101] Any national securities exchange making this choice would, of course, be required to give up its SRO functions and privileges, and to register as a broker-dealer and become a member of a national securities association or other SRO.[102] That organization would then act as the SRO for this alternative trading system. If a national securities exchange chose, as part of this restructuring, to allow its members to form their own national securities association to operate this new alternative trading system, that alternative trading system would be run directly by a national securities association, and, as stated above, would be regulated in a manner that was equivalent to being regulated as a national securities exchange.[103]

F. Commission's Authority To Require Registration as an Exchange

Rule 3a1–1(b) contains an exception to the exemption from the exchange definition. Under this exception, the Commission effectively may require a trading system that is a substantial market (as set forth in the rule) to register as a national securities exchange if it finds in a particular case that it is necessary or appropriate in the public interest or consistent with the protection of investors.[104] In particular, the Commission could deny or withhold exemptive status from a trading system that otherwise meets the exemptive conditions under Rule 3a1–1(a). Although the standard for denying or withholding the exemption is based on objective factors, the Commission has discretion whether to initiate any process to consider whether to revoke a

[96] 17 CFR 240.3a1–1(a)(3).

[97] *See* TBMA Letter at 12–13 (expressing concern that foreign regulators might be influenced by the Commission's categorization of a system as an ''exchange,'' even if that system chose to be regulated in the U.S. as a broker-dealer); Instinet Letter at 3, 6–7, 13–14 and 6–7, n.9 (stating that classifying a securities firm as an exchange in the U.S. could significantly impair a firm's ability to participate in foreign markets * * * because a number of foreign regulators may regard all broker-dealers covered by the expanded 'exchange' definition as 'exchanges'). *See also* CBB Letter at 3.

[98] TBMA Letter at 12.

[99] *See* Letter from Mike Cormack, Manager, Equity Trading, American Century to Jonathan G. Katz, Secretary, SEC, dated Aug. 12, 1998 (''American Century Letter'') at 1–2 (supporting the Commission's proposal to permit alternative trading systems to register as exchanges because it would provide an option for innovators, and noting alternative trading systems' objection to the NASD's proposed central limit order book based on the belief that an SRO regulating alternative trading systems should not operate a competing system); NASD Letter at 3 (commenting that both registration as an exchange and Regulation ATS ''generally appear to ensure that alternative trading systems operate with the appropriate levels of investor protection, while affording alternative trading systems the necessary flexibility to choose between different models of regulation''); CME Letter at 3 (generally supporting the additional requirements for alternative trading systems because they will improve investor protection and lessen the regulatory disparity that currently exists between alternative trading systems and traditional exchanges); Instinet Letter at 7, n.10 (stating that the Commission should modify the exemption in Rule 3a1–1 from exchange registration so that alternative trading systems that, while acting in good faith, fail to comply fully with each of the technical requirements of Regulation ATS do not violate Sections 5 and 6 of the Exchange Act); ICI Letter at 2; IBEX Letter at 4.

[100] CHX Letter at 6 (questioning why traditional exchanges should not have the opportunity to make the same choice as alternative trading systems, and commenting that SROs should be permitted to form subsidiaries that were alternative trading systems registered as broker-dealers).

[101] In making this significant decision, a national securities exchange would have to follow its constitution and by-laws (including provisions concerning membership votes), and any applicable state law requirements.

[102] Section 15(b)(8) of the Exchange Act requires any broker-dealer engaging in transactions other than solely on a national securities exchange of which it is a member, to become a member of a national securities association. 15 U.S.C. 78o(b)(8).

[103] The Commission does not mean to imply that national securities exchanges cannot make this choice. The Commission is merely pointing out that if a national securities exchange does so, it cannot continue to act as its own SRO.

[104] Rule 3a1–1(b), 17 CFR 240.3a1–1(b)(1).

particular entity's exemption under the rule.

Specifically, under Rule 3a1–1(b), if an organization, association, or group of persons meets certain, specified volume levels, the Commission could consider whether registration as an exchange is necessary. The Commission will not consider making an assessment whether a particular system should register as an exchange unless that system, during three of preceding four calendar quarters had: (1) Fifty percent or more of the average daily dollar trading volume in any security and five percent or more of the average daily dollar trading volume in any class of security; or (2) Forty percent or more of the average daily dollar trading volume in any class of securities. The Commission would also provide such a system with notice and an opportunity to respond before determining that exemption from registration as an exchange is not appropriate in the public interest. In making that determination, the Commission would take into account the requirements for exchange registration under section 6 of the Exchange Act and the objectives of the national market system under section 11A of the Exchange Act. For example, it may not be consistent with the protection of investors or in the public interest for a trading system that is the dominant market, in some important segment of the securities market, to be exempt from registration as an exchange if competition cannot be relied upon to ensure fair and efficient trading structures in that case. In that case it may be necessary for the Commission's greater oversight authority over registered exchanges to apply.[105] As another example, if the Commission believed that an exemption under Rule 3a1–1 for a particular trading system that meets the volume thresholds would create systemic risk or lead to instability in the securities markets' infrastructure, it could determine that an exemption from registration as an exchange was not appropriate in the public interest or consistent with the protection of investors.

The Commission believes that there are alternative trading systems operating today that exceed the volume levels in paragraph (b)(1) of Rule 3a1–1. However, the Commission does not believe at this time that there are any alternative trading systems—given their current operations—for which the exemption from the definition of exchange in paragraph (a) of Rule 3a1–1 is not appropriate.

In addition, under section 19(c)(3) of the Exchange Act,[106] the Commission has the authority to promulgate rules for the de-registration of an exchange. In order to ensure a smooth transition for exchanges that wish to de-register and become registered broker-dealers subject to Regulation ATS, the Commission will consider promulgating de-registration rules. Such rules would also give the Commission the opportunity to formally consider whether certain exchanges should be prohibited from de-registering, just as Rule 3a1–1(b) gives the Commission the opportunity to consider whether certain alternative trading systems registered as broker-dealers should be compelled to register as exchanges.

IV. Regulation of Alternative Trading Systems

Securities markets have become increasingly interdependent. The use of technology permits market participants to link products, implement complex hedging strategies across markets and across products, and trade on multiple markets simultaneously. While these opportunities benefit many investors, they may also create misallocations of capital, widespread inefficiency, and trading fragmentation if markets are not coordinated. In addition, a lack of coordination among markets has the potential to increase system-wide risks. Congress adopted the 1975 Amendments, in part, to address these negative effects of potentially fragmented markets.[107] The Commission believes that it is consistent with Congress' goals to integrate significant alternative trading systems into the national market system.

In the 1975 Amendments, Congress specifically endorsed the development of an national market system, and sought to clarify and strengthen the Commission's authority to promote the achievement of such a system.[108] Because of uncertainty as to how technological and economic changes would affect the securities markets, Congress explicitly rejected mandating specific components of an national market system.[109] Instead, Congress recognized that the securities markets dynamically change and, accordingly, granted the Commission broad authority to oversee the implementation, operation, and regulation of the national market system in accordance with Congressional goals and objectives.[110]

Congress identified two paramount objectives in the development of an national market system: the maintenance of stable and orderly markets with maximum capacity, and the centralization of all buying and selling interest so that each investor has the opportunity for the best possible execution of his or her order, regardless of where the investor places the order.[111] In addition, Congress directed the Commission to remove present and future competitive restrictions on access to market information and order systems, and to assure the equal regulation of markets, exchange members, and broker-dealers effecting transactions in the national market system.[112] In particular, Congress found that it was in the public interest to assure ''fair competition * * * between exchange markets and markets other than exchange markets.'' [113]

To further national market system goals, Congress granted the Commission broad authority to make rules, including those to: (1) Prevent the use and publication of deceptive trade and order information; (2) assure the prompt, accurate, and reliable distribution of quotation and transaction information; (3) enable non-discriminatory access to such information; and (4) assure that all broker-dealers transmit and direct orders for securities in a manner consistent with the operation of a national market system.[114] Moreover, Congress recognized that in order to implement national market system goals, the Commission would need to classify markets, firms, and securities and facilitate the development of

[105] The Commission does not mean to imply that the NASD will be required to register Nasdaq as a national securities exchange. As stated above, because Nasdaq is operated by a national securities association, it is currently subject to requirements virtually identical to those applicable to national securities exchanges. Any alternative trading system, however, currently operated by a national securities association could choose to register as an exchange.

[106] 15 U.S.C. 78s(c)(3).

[107] *See* S. Rep. No. 75, 94th Cong., 1st Sess. 8 (1975) at 2, 8; H.R. Rep. No. 229, 94th Cong., 1st Sess 92 (1975).

[108] *See supra* note 6.

[109] *See* S. Rep. No. 75. *supra* note 107. ''(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.'' *Id.* at 3.

[110] S. Rep. No. 75 *supra* note 107, at 8–9.

[111] S. Rep. No. 75 *supra* note 107, at 7; *see* Section 11A(a)(1)(C) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(C).

[112] *See* S. Rep. No. 75 *supra* note 107, at 104–05.

[113] Section 11A(a)(1)(C)(ii) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(C)(ii). A fundamental goal of a national market system was to ''achieve a market characterized by economically efficient executions, fair competition, (and the) broad dissemination of basic market information.'' S. Rep. No. 75 *supra* note 107, at 101.

[114] *See* Section 11A(c)(1) of the Exchange Act, 15 U.S.C. 78k–1(c)(1).

''subsystems within the national market system.'' [115]

The Commission believes the rules it is adopting today advance national market system goals. At present, alternative trading systems are not fully integrated into the national market system, leaving gaps in market access and fairness, systems capacity, transparency, and surveillance. These concerns, together with the increasing significance of alternative trading systems, call into question the fairness of current regulatory requirements, the effectiveness of existing national market system mechanisms, and the quality of public secondary markets. Under the rules the Commission is adopting today, alternative trading systems that have the most significant effect on our markets will be required to integrate their trading into national market system mechanisms. Alternative trading systems may choose to register either as national securities exchanges or as broker-dealers. Systems that elect broker-dealer regulation will be integrated into the national market system under Regulation ATS if they have significant trading volume.[116] Discussed in Section IV.A. below are the requirements for alternative trading systems that choose to register as broker-dealers and comply with Regulation ATS. Any alternative trading system that registers as a national securities exchange will be obligated—as currently registered exchanges are—to participate in the national market system mechanisms. Section IV.B. contains a discussion of the requirements applicable to alternative trading systems that choose to register as exchanges.

A. Regulation ATS

1. Scope of Regulation ATS

a. Definition of Alternative Trading System

The Commission proposed to define the term ''alternative trading system'' as any system that: (1) Constitutes, maintains, or provides a marketplace 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 under Exchange Act Rule 3b–16; [117] and (2) does not set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system, or discipline subscribers other than by exclusion from trading.[118] This proposed definition would have the effect of precluding any trading system that performs self-regulatory functions from opting to register as a broker-dealer, rather than as an exchange. Such a system would consequently be required to register as an exchange or be operated by a national securities association. Nothing, however, would prevent a registered exchange from giving up its self-regulatory functions and choosing instead to comply with Regulation ATS.[119]

The Commission received only one comment on this proposed definition. This commenter suggested that the proposed definition for alternative trading systems was too complex and should instead, simply be defined as an exchange that does not set conduct rules or discipline subscribers.[120] Under the framework the Commission is adopting today, an alternative trading system is exempt from the definition of an exchange if it registers as a broker-dealer and complies with Regulation ATS.[121]

Because the Commission continues to believe that any system that uses its market power to regulate its participants should be regulated as an SRO, the Commission is adopting the definition of alternative trading system as proposed. The Commission would consider a trading system to be ''governing the conduct of subscribers'' outside the trading system if it imposed on subscribers, as conditions of participation in trading, any requirements for which the trading system had to examine subscribers for compliance. In addition, if a trading system imposed as conditions of participation, directly or indirectly, restrictions on subscribers' activities outside of the trading system, the Commission believes that such a trading system should be a registered exchange or operated by a national securities association. For example, the Commission would not consider a trading system to be an alternative trading system, as defined in Rule 300(a), if that trading system prohibited subscribers from placing orders on its system at prices inferior to those subscribers place on other systems. The Commission believes such rules should only be imposed and enforced by regulatory bodies because of the potential that they may be applied for anti-competitive purposes. The Commission does not intend for this limitation to preclude an alternative trading system from imposing credit conditions on subscribers or requiring subscribers to submit financial information to the alternative trading system.

b. Exclusion of Trading Systems Registered as Exchanges or Operated by a National Securities Association

The Commission proposed to exclude from the scope of Regulation ATS certain alternative trading systems that are subject to other appropriate regulations. In particular, Rule 301(a) would exclude alternative trading systems (1) registered as exchanges, (2) exempt from exchange registration based on limited volume,[122] or (3) operated by a national securities association. These systems are subject to regulation as markets under other provisions of the Exchange Act. The Commission is adopting these exclusions as proposed.

c. Exclusion of Alternative Trading Systems Trading Solely Government and Related Securities

(i) Discussion

In addition, the Commission proposed that any alternative trading system that trades only government securities,[123] Brady Bonds, and repurchase and reverse repurchase agreements involving government securities or Brady Bonds be excluded from the scope of Regulation ATS, as long as the alternative trading system is registered as a broker-dealer. The Commission believes that alternative trading systems trading only government securities raise several of the structural issues raised by alternative trading systems trading equity and other debt securities. Nevertheless, the Commission recognizes that government securities are subject to other forms of regulation that help to ensure that those markets are fair and orderly. In particular,

[115] S. Rep. No. 75 *supra* note 107, at 7.

[116] In addition to its authority under section 11A of the Exchange Act, 15 U.S.C. 78k–1, the Commission is adopting Regulation ATS pursuant to its rulemaking power under other parts of the Exchange Act, including sections 3(b) (power to define terms), 15(b)(1) (registration and regulation of broker-dealers), 15(c)(2) (prescribing means reasonably designed to prevent fraud), 17(a) (books and records requirements), 17(b) (inspection of records), 23(a)(1) (general power to make rules and classify persons, securities, and other matters), and 36 (general exemptive authority). 15 U.S.C. 78c(b), 78*o*(b)(1), 78*o*(c)(2), 78q(a), 78q(b), 78w(a)(1), and 78mm, respectively. For a discussion on the general exemptive authority in section 36 of the Exchange Act, 15 U.S.C. 78mm, *see infra* Section VII.D.1.

[117] *See supra* Section III (discussing Rule 3b–16).

[118] Rule 300(a), 17 CFR 242.300(a).

[119] *See supra* note and accompanying text. The Commission has the authority to require significant markets to remain registered as exchanges. *See supra* Section III.F.

[120] PCX Letter at 3.

[121] Rule 3a1–1(a)(2), 17 CFR 240.3a1–1(a)(2).

[122] *See supra* note 33.

[123] The term ''government security'' is defined in section 3(a)(42) of the Exchange Act, 15 U.S.C. 78c(a)(42).

government securities broker-dealers are currently regulated jointly by the Commission, U.S. Department of the Treasury (''Treasury''), and federal banking regulators, under the Exchange Act (particularly the provisions of the Government Securities Act of 1986) and the federal banking laws.[124] Unlike surveillance of trading in equities and other instruments traded primarily on registered exchanges,[125] surveillance of trading in government securities is coordinated among the Treasury, the Commission, and the Board of Governors of the Federal Reserve System.

The Commission is adopting this proposed exclusion from Regulation ATS with some modifications.[126] Specifically, the Commission is eliminating Brady Bonds from the types of securities an alternative trading system can trade and fall within this exclusion. The Commission received no comments specifically addressing the trading of Brady Bonds by alternative trading systems. Based on information the Commission has available about trading on alternative trading systems, however, the Commission is not aware of any systems trading Brady Bonds that do not also trade other non-government securities, most typically other emerging market debt. Accordingly, no alternative trading systems trading Brady Bonds would have been exempt under the proposals. Further, the Commission does not treat Brady Bonds in the same manner as government securities in other contexts. Moreover, the significance of Brady Bonds in the market is diminishing.

In addition, the Commission is expanding the exclusion in two respects. First, the Commission is adding commercial paper[127] and certain options on government securities[128] to the types of securities alternative trading systems may trade without being subject to Regulation ATS. The Commission believes this expansion is appropriate because commercial paper does not require registration even as a broker-dealer, and because the term ''government securities'' includes certain options on government securities for purposes of sections 15C and 17A of the Exchange Act.[129] Second, the Commission is expanding this exclusion from Regulation ATS to include alternative trading systems that are banks and that trade solely government securities, repurchase and reverse repurchase agreements on government securities, certain options of government securities, and commercial paper because of banks' traditional role in the government securities market.[130]

(ii) Response to Commenters

The Commission solicited comment on whether it was appropriate to exclude from the regulatory framework for alternative trading systems those alternative trading systems trading solely government and other related securities. Of those commenters who addressed this issue, most were in favor of excluding such systems. Most of these commenters agreed with the Commission that alternative trading systems trading government securities are subject to their own specialized oversight structure and, therefore, were appropriately excluded from the scope of the Commission's proposal.[131] Only one commenter opposed the proposed exclusion of alternative trading systems that trade government securities.[132]

One commenter suggested that the Commission exclude alternative trading systems that trade government securities from the definition in Rule 3b–16, rather than exclude them from Regulation ATS. This commenter stated that if these alternative trading systems were classified as exchanges that fact would be cited by proponents of a narrow interpretation of the Treasury Amendment to the Commodity Exchange Act, potentially resulting in a broad definition of ''board of trade'' beyond its intended meaning as a traditional organized exchange.[133] As stated earlier, the Commission believes that it would be inappropriate and

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[124] *See generally* Department of the Treasury, Securities and Exchange Commission, and Board of Governors of the Federal Reserve System, Joint Study of the Regulatory System for Government Securities (March 1998); Department of the Treasury, Report of the Secretary of the Treasury on Specialized Government Securities Brokers and Dealers (July 1995) (''1995 Treasury Report'').

The Government Securities Act of 1986 (''GSA'') amended the Exchange Act to incorporate new section 15C, which, among other things, established registration and notice requirements for government securities brokers and dealers. Section 15C generally requires government securities brokers and dealers (*i.e.*, 15C firms or specialized government securities brokers and dealers) to register with the Commission and to become members of an SRO (twenty-two firms as of March 1998). Firms that are registered with the Commission as general securities brokers or dealers (*i.e.*, traditional broker-dealers registered under section 15(b) of the Exchange Act) are required to file notice with the Commission of their government securities business (3,023 firms as of April 1998). In addition, financial institutions that engage in government securities broker or dealer activities are required to file notice of such activities with their appropriate regulatory agency (120 institutions as of March 1998).

Under the regulatory structure established by the GSA, the Treasury was granted authority to adopt regulations for all government securities brokers and dealers concerning financial responsibility, protection of investors' funds and securities, recordkeeping, reporting, and audit requirements, and to adopt regulations governing the custody of government securities held by depository institutions. The Government Securities Act Amendments of 1993 (''GSAA'') expanded the authority of the federal regulators and the SROs over government securities transactions. The GSAA, among other things, reauthorized the Treasury's rulemaking responsibilities, granted the Treasury authority to prescribe large position recordkeeping and reporting rules, extended the Commission's antifraud and antimanipulation authority to all government securities brokers and dealers, required government securities brokers and dealers to provide to the Commission on request records of government securities transactions to reconstruct trading in the course of a particular inquiry or investigation, removed the statutory restrictions on the authority of the NASD to extend sales practice rules to its members' transactions in government securities, and provided the bank regulatory agencies with the authority to issue sales practice rules for financial institutions engaged in government securities broker or dealer activities.

The GSA also strengthened the ability of federal regulators to examine, and to bring enforcement actions against, government securities brokers and dealers. The Commission and the SROs have examination and enforcement authority over government securities brokers and dealers registered under section 15C and over the government securities activities of general securities brokers and dealers. The Commission's enforcement authority includes the power to censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of the entity. For financial institutions that are government securities brokers or dealers, the institution's appropriate regulatory agency has examination and enforcement authority over the institution. The appropriate regulatory agency must notify the Commission of any sanctions imposed on such institutions, and the Commission must maintain a record of the sanctions.

[125] 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* 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).

[126] In other words, these systems are not required to register as either an exchange or to comply with the requirements of Regulation ATS. Rule 301(a)(4), 17 CFR 242.301(a)(4).

[127] Rule 301(a)(4)(ii)(E), 17 CFR 242.301(a)(4)(ii)(E). The term ''commercial paper'' is defined in Rule 300(m), 17 CFR 242.300(m). This definition is based on the definition of commercial paper as set forth in 12 CFR 541.5, an Office of Thrift Supervision regulation that defines commercial paper, and section 3(a)(3) of the Securities Act of 1933, which uses identical language to identify these securities as one category of exempted securities.

[128] Rule 301(a)(4)(D), 17 CFR 242.301(a)(4)(D).

[129] Section 3(a)(42) of the Exchange Act, 15 U.S.C. 78c(a)(42).

[130] Rule 301(a)(4), 17 CFR 242.301(a)(4).

[131] *See, e.g.*, TBMA Letter at 17–18 (also urging the Commission to clarify the application of proposed Regulation ATS where a trading system trades government securities, as well as non-government securities); CBB Letter at 3 (but requesting guidance from the Commission on whether an ATS trading government securities and relying on such an exemption would be precluded from trading products other than securities); SIA Letter at 3, 11.

[132] IBEX Letter at 4–5.

[133] TBMA Letter at 13, n.21.

without a reasoned basis to transfer part or all of its determination regarding regulation to other statutory contexts.[134] The Commission's reinterpretation of ''exchange'' is grounded on its decision to use its exemptive authority to allow alternative trading systems to choose to be regulated as broker-dealers. The Commission's reinterpretation of exchange should not be relied upon by other regulators to interpret other, potentially more restrictive statutory schemes.

In addition, this same commenter encouraged the Commission to consider the effects of the proposed rules on banks that operate alternative trading systems. In particular, this commenter noted that the exclusion for alternative trading systems that trade government securities applied only if the alternative trading system registered as a broker-dealer, not if the alternative trading system were a bank.[135] The Commission did not intend to require banks trading government securities to register as broker-dealers and, therefore, Rule 301(a)(4), as adopted, excludes from Regulation ATS alternative trading systems that trade government securities if these systems are registered as broker-dealers *or are banks.*

Several commenters raised questions about the application of Regulation ATS to alternative trading systems that trade not only government securities, but also other types of securities.[136] One commenter asked the Commission to extend the proposed exemption for alternative trading systems that trade only government securities and other related securities to all trading in those securities. This commenter stated that broker-dealers that trade government securities, as well as other securities and financial instruments, should not be required to restructure their operations to avail themselves of an exclusion for government securities activities.[137]

The Commission does not believe that an alternative trading systems' government securities trading will be subject to more burdensome regulation if it is conducted in the same system as trading in other securities, than if it is conducted in a separate and, therefore, excluded system. Accordingly, the exclusion applies to systems that only trade government and other related securities.

Government securities are not ''covered securities'' [138] and, therefore, are not subject to the transparency requirements of Regulation ATS. In addition, an alternative trading system is only required to comply with the fair access requirements for those securities (or categories of securities) in which it represents twenty percent or more of the total volume. The fair access requirement does not apply to government securities regardless of whether government securities trading is conducted in the same alternative trading system as securities subject to the fair access requirements or in a separate alternative trading system. Finally, the capacity, integrity, and security requirements would never be triggered by an alternative trading system's government securities trading. If, however, the trading in other securities on that same system exceeds the twenty percent threshold, an alternative trading system in which government securities are traded would have to meet the capacity, integrity, and security standards. Nevertheless, it seems unlikely that an alternative trading system would choose to create a separate alternative trading system for its government securities trading solely for the privilege of trading government securities on a system with lesser capacity, integrity, and security than the system on which other securities are traded. Therefore, the Commission does not believe that it will be necessary, as a practical matter, for an alternative trading system to restructure its system to avail itself of the government securities exclusion.

Another commenter asked that the Commission expressly confirm that the exclusion from the scope of Regulation ATS for systems trading government and related securities does not preclude such an alternative trading system from offering services involving products other than securities.[139] In response, the Commission has clarified that to be excluded from the scope of Regulation ATS an alternative trading system need only limit its *securities* activities to government securities, Brady Bonds, repurchase and reverse repurchase agreements on such instruments, and commercial paper.

Finally, this commenter suggested that the Commission adopt rules to permit government securities alternative trading systems to trade other fixed income securities on a limited pilot basis. This commenter argued that, without such a limited exemption, Regulation ATS would have a chilling effect on the ability of government securities alternative trading systems to introduce technological innovation, and that such a provision would raise no significant investor protection concerns.[140] The Commission, however, does not believe that allowing one category of alternative trading systems (*i.e.,* those trading government securities) to trade other types of fixed income securities where the regulation and surveillance is different, without complying with Regulation ATS is appropriate. The notice and recordkeeping requirements under Regulation ATS are limited and should not interfere with market participants' ability to test new, innovative systems.

d. Alternative Trading Systems Trading Non-Government Debt Securities

(i) Discussion

The Commission proposed that alternative trading systems that trade debt securities (other than those trading government and other related securities) be subject to Regulation ATS, if they choose not to register as exchanges. Under Regulation ATS, these systems would be required to file a notice with the Commission, maintain an audit trail, periodically report certain information to the Commission, and ensure that they have adequate safeguards to protect subscribers' confidential trading information. In addition, alternative trading systems with twenty percent or more of the trading volume in a particular category of debt would have to meet the fair access and systems capacity, integrity, and security standards.[141] The Commission solicited comment on what categories of debt would be appropriate for this purpose and what sources of debt transaction volume information is available. Specifically, the Commission solicited comment on whether the following categories would be appropriate: mortgage and asset-backed securities, municipal securities, corporate debt securities, foreign corporate debt securities, and sovereign debt securities.

The Commission is adopting the proposal to include alternative trading systems that trade fixed income securities within its new regulatory framework. With respect to the fair access and systems capacity, integrity and security requirement, the rules as adopted require alternative trading systems with twenty percent or more of the volume in municipal securities, investment grade corporate debt securities, and non-investment grade corporate debt securities to comply with the fair access and systems capacity,

[134] *See supra* note 97 and accompanying text.

[135] TBMA Letter at 17.

[136] *See* TBMA Letter at 17; Instinet Letter at 8, n.11; CBB Letter at 3–4.

[137] Instinet Letter at 8, n.11.

[138] *See infra* note 180 and accompanying text for the definition of ''covered security.''

[139] CBB Letter at 3.

[140] CBB Letter at 3–4.

[141] The proposal would not require an alternative trading system to publicly display its best orders in fixed income securities.

integrity, and security requirements. Accordingly, the Commission is adopting rules to define these three categories of debt securities. The Commission is deferring any action on requiring alternative trading systems that trade foreign corporate debt or foreign sovereign debt to comply with the fair access and systems capacity, integrity, and security requirements.

For municipals, the Commission is incorporating into Regulation ATS the definition of municipal securities in section 3(a)(29) of the Exchange Act.[142] A debt security (other than an exempted security) with a fixed maturity of at least one year will be considered investment grade corporate debt if it is rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization,[143] and will be considered non-investment grade corporate debt if it is not so rated.[144] The Commission believes that these categories are widely recognized as relatively distinct markets within the debt market as a whole and, while not encompassing all forms of debt securities, will ensure that alternative trading systems that provide markets for significant segments of the debt market take adequate measures for systems capacity, integrity, and security, as well as provide fair access.

While the Commission is adopting rules to establish the appropriate categories for debt securities, the volume-based rules with respect to all categories, except municipal securities, will not become effective until volume information is available in a format that will enable alternative trading systems to determine their relative volume. Volume data for municipal securities is available and being published through the Municipal Securities Rulemaking Board's (''MSRB'') Daily Volume Price Reports. On August 24, 1998, the MSRB started producing a Combined Daily Report to summarize both intra-dealer and customer transactions of municipal securities that are traded four or more times per day pursuant to Rule G–14. This report is made available through data vendors, such as Bloomberg, by approximately 6:00 am each business day.[145] Among other information, the Combined Daily Report provides total volume data against which alternative trading systems that trade municipal securities can measure their compliance obligations under Regulation ATS.

Volume data for the remaining two categories—investment grade and non-investment grade corporate debt—, however, is not currently compiled or published so that alternative trading systems can determine their obligations under Regulation ATS. In order to allow time for logistical arrangements to make such data available, the Commission will not make these fair access and systems capacity, integrity and security provisions of Regulation ATS effective until April 1, 2000.[146]

(ii) Response to Commenters

Some commenters thought that the Commission should exclude debt securities entirely from Regulation ATS.[147] On the other hand, several commenters supported the Commission's proposal to include alternative trading systems that trade debt securities.[148] The Commission believes that many of the same concerns about the trading of equity securities on alternative trading systems apply equally to the trading of fixed income securities on alternative trading systems. Specifically, it is important that markets with significant portions of the volume in particular instruments have adequate systems capacity, integrity, and security, regardless of whether those instruments are equity securities or debt securities. Similarly, as electronic systems for debt grow, it will become increasingly important for the fair operation of our markets for market participants to have fair access to significant market centers in debt securities. One of the consequences of the growing role of alternative trading systems in the securities markets generally is that debt securities are increasingly being traded on these systems, similar to the way equity securities are traded. This change in the market requires appropriate measures for markets for debt.

Two commenters suggested that the Commission exempt or exclude alternative trading systems trading municipal securities for the same reasons that it proposed to exclude alternative trading systems that trade government securities.[149] For example, one commenter asserted that the municipal securities market is overseen not only by securities regulators, but also by the federal banking regulators. This commenter also pointed out that the Commission had proposed excluding municipal securities in the Concept Release and stated that the Commission should have maintained this approach in the Proposing Release.[150] Although the Commission did solicit comment in the Concept Release on whether alternative trading systems trading municipal securities should be excluded from any proposed new regulatory framework, the Commission has concluded that it would not be appropriate to do so.

There are substantial differences between the oversight of the government securities market and the municipal securities markets, and between government securities instruments and municipal securities instruments. For example, municipal securities are far more varied products than government securities. While traditional general obligation bonds issued by municipalities are more akin to government securities in that they are backed by the full faith and credit of the issuing taxing authority, revenue bonds, which bear greater resemblance to privately issued bonds due to their ties to specific revenue sources, are riskier products.[151] Most municipal bonds are rarely traded. The market for government securities, on the other hand, is deep and liquid.[152] Therefore, alternative trading systems that may develop for municipal securities may have widely different qualities than those for government securities. Moreover, regulation of the government

[142] 15 U.S.C. 78c(a)(29).

[143] Rule 300(l), 17 CFR 242.300(l).

[144] Rule 300(m), 17 CFR 242.300(m).

[145] An initiative by TBMA would also make the MSRB data available on TBMA's web site <http://www.investinginbonds.com>. *See* Robert Whalen, *Investor Aids: TBMA's Internet-Based Price Reporting Aims to Increase Market Transparency*, The Bond Buyer, Nov. 25, 1998, at 28.

[146] Due to the Commission's concerns regarding the Year 2000 computer technology conversion process, no new Commission rules requiring major computer reprogramming will be made effective between June 1, 1999 and March 31, 2000. *See* Securities Exchange Act Release No. 40377 (Aug. 27, 1998), 63 FR 47501 (Sept. 3, 1998). Accordingly, because the logistical framework for investment grade and non-investment grade corporate debt data has not been fully developed, the Commission is not making Rules 301(b)(5)(D) and (E) and Rules 301(b)(6)(D) and (E) effective until after the moratorium is lifted.

[147] *See* TBMA Letter at 3, MSDW Letter at 13; SIA Letter at 11; DBSI Letter at 1 (adopting TBMA Letter).

[148] *See* NYSE Letter at 6 (supporting regulation of alternative trading systems that trade debt securities as important for investor protection); IBEX Letter at 2–3 (also generally urging the Commission to take steps to increase transparency, access to best priced orders, and other investor protections in the debt markets, *e.g.*, insider trading and front running rules).

[149] *See* TBMA Letter at 18–20; SIA Letter at 3, 11.

[150] TBMA Letter at 19–20.

[151] *See* Robert Zipf, How the Bond Market Works 86–87 (1997) (noting characteristics of general obligation and revenue bonds and the heightened risk of revenue bonds relative to general obligation bonds).

[152] As of June 30, 1998, there was approximately $3.4 trillion of U.S. Treasury debt securities outstanding with average daily trading volume of over $200 billion. By comparison, there was approximately $1.4 trillion of municipal debt securities outstanding with average daily trading volume of approximately $1 billion. The Bond Market Association, *Research Quarterly* (August 1998) <http://www.bondmarkets.com/research/9808rschq.pdf>.

securities market is shared by the Federal Reserve Board, the Treasury Department and the Commission and other bank regulators, while oversight of the municipal securities market is assigned to the Commission and the MSRB. For these reasons, the Commission believes it would not be appropriate to exempt alternative trading systems that trade municipal securities from Regulation ATS.

Only one commenter directly addressed the Commission's request for comment on possible categories of debt. Although TBMA encouraged the Commission to exclude alternative trading systems trading debt securities from Rule 3b–16,[153] it stated that, if the Commission chose to go forward with the proposal, it ''believes that the proposed categories reflect a reasonable indication of how market participants view and trade debt securities.'' [154]

Several commenters recommended that the Commission consider the clearing agencies as a source of information on the trading volume in the debt market.[155] One commenter also noted that for municipal securities, the MSRB's transaction reporting requirements could be a good source for volume information.[156] As discussed above, the Commission plans to use the MSRB's transaction reporting program as a basis for volume in the municipal securities market.

e. Exemptions From Certain Requirements of Regulation ATS Pursuant to Application to the Commission

The Commission today is also adopting a provision to allow the Commission, upon application by an alternative trading system, to exempt by order such alternative trading system from one or more of the requirements of Regulation ATS.[157] The Commission expects to issue such an order only under unusual circumstances, and only after determining that such an order is consistent with the public interest, the protection of investors and the removal of impediments to, and the perfection of the mechanisms of, a national market system.

While the Commission believes that the requirements it is adopting under Regulation ATS are appropriate for all alternative trading systems operating today, the Commission is aware that a system may develop in the future to which these requirements may not be appropriate, and they could hinder the development of specialized trading systems. For example, the Commission could consider exempting an alternative trading system that limited participation only to investment companies with similar investment strategies, such as index funds, from the transparency requirements.[158]

2. Requirements for Alternative Trading Systems Subject to Regulation ATS

Discussed below are the requirements for alternative trading systems subject to Regulation ATS.

a. Membership in an SRO

Because alternative trading systems that choose to register as broker-dealers will not themselves have self-regulatory responsibilities, the Commission believes it is important for such systems to be members of an SRO. For this reason, the Commission proposed to require alternative trading systems subject to Regulation ATS to be members of an SRO.

Most alternative trading systems are currently registered as broker-dealers and, therefore, are also members of an SRO.[159] The Commission understands some alternative trading systems may have concerns about SROs abusing their regulatory authority for competitive reasons. While the Commission understands that SROs operate competing markets and, therefore, have potential conflicts of interest in overseeing alternative trading systems, the Commission believes these conflicts can be minimized using the Commission's oversight.[160] The Commission considers it part of its own oversight responsibility over SROs to prevent and take the necessary steps to address any such actions by SROs.[161] Further, an alternative trading system that wishes to avoid potential conflicts of interest altogether may choose to register as an exchange. The Commission also notes that section 15A of the Exchange Act would permit an association of brokers and dealers to establish an SRO that does not operate a market.[162] Such a national securities association could be established solely for purposes of overseeing the activities of alternative trading systems. Of course, this association must be able to effectively conduct its SRO responsibilities.

The Commission expects SROs to effectively surveil trading that occurs on alternative trading systems by integrating alternative trading system trading data into the SRO's existing surveillance systems. SROs should also incorporate relevant information regarding the entities trading on such systems into their existing surveillance programs. The enhanced recordkeeping requirements for alternative trading systems will aid SRO oversight considerably in this regard.[163]

The Commission believes it is appropriate to continue to require alternative trading systems that register as broker-dealers to be SRO members and is, therefore, adopting this requirement as proposed.[164]

b. Notice of Operation as an Alternative Trading System and Amendments

The Commission proposed to require an alternative trading system registered as a broker-dealer to file a notice with the Commission before commencing operation, amendments to this notice in the event of material changes, and a notice when an alternative trading system ceases operation. The Commission is adopting these requirements as proposed.

More specifically, under Regulation ATS, alternative trading systems are required to file an initial operation report with the Commission on Form ATS at least twenty days prior to commencing operation.[165] Alternative trading systems operating currently must file Form ATS within twenty days of the effective date of these final rules.[166] Form ATS requests information about the alternative trading system, including a detailed description of how it will operate, its prospective subscribers, and the securities it intends to trade. In addition, the alternative trading system is required to describe its existing procedures for reviewing systems capacity, security, and contingency planning. Alternative trading systems are currently required to

[153] TBMA Letter at 6–7, 21.

[154] TBMA Letter at 24.

[155] *See* TBMA Letter at 23–25; IBEX Letter at 12. IBEX also suggested reactivating the SIA practice of publishing the average daily trading volume of corporate and other bonds on a monthly basis which was discontinued in 1994. IBEX Letter at 12.

[156] TBMA Letter at 23–25.

[157] Rule 301(a)(5), 17 CFR 242.301(a)(5).

[158] The transparency requirements are discussed *infra* Section IV.A.2.c.

[159] Section 15(b)(8) of the Exchange Act, 15 U.S.C. 78*o*(b)(8).

[160] For example, the structural reforms undertaken by the NASD since August 1996 should aid in ensuring the independence of NASDR and insulating its staff from the commercial interests of Nasdaq.

[161] *See supra* note 4.

[162] Section 15A of the Exchange Act, 15 U.S.C. 78*o*–3.

[163] *See* Rule 301(b)(8), 17 CFR 242.301(b)(8).

[164] Rule 301(b)(1), 17 CFR 242.301(b)(1).

[165] Rule 301(b)(2)(i) and Form ATS, 17 CFR 242.301(b)(2)(i) and 17 CFR 249.637.

[166] Most currently operating alternative trading systems have filed Part 1 of Form 17A–23. To avail themselves of the exemption in Rule 3a1–1(a)(2), these systems must file Form ATS within 20 days of the effective date of these rules. Internal broker-dealer systems, 17 CFR 240.17a–3(a)(16)(ii)(A), which may also have previously filed Part I of Form 17A–23, do not have to file Form ATS.

report most of this information on Part I of Form 17A–23, which the Commission proposed to repeal.[167] Form ATS is not an application and the Commission would not ''approve'' an alternative trading system before it began to operate. Form ATS is, instead, a notice to the Commission.

An alternative trading system is also required to notify the Commission of material changes to its operation by filing an amendment to Form ATS at least twenty calendar days prior to implementing such changes.[168] One commenter requested that the Commission provide more specific guidance as to what would be considered a ''material change.''[169] As discussed in the Proposing Release, material changes to an alternative trading system include any change to: the operating platform, the types of securities traded, or the types of subscribers. The Commission notes that currently all alternative trading systems implicitly make materiality decisions in determining when to notify their subscribers of changes.

In addition to reporting material changes at least twenty days before implementation, alternative trading systems are required to notify the Commission in quarterly amendments of *any* changes to the information in the initial operation report that have not been reported in a previous amendment.[170] Finally, if an alternative trading system ceases operations, it is required to promptly file a notice with the Commission.[171] Under Regulation ATS, the initial operation report, any amendments, and the report filed when an alternative trading system ceases operation will be kept confidential.

In the Proposing Release,[172] the Commission requested comment on the notice requirements and Form ATS. The Commission specifically requested comment on whether such requirements would be burdensome for alternative trading systems, and if so, whether the burden is inappropriate. The Commission also sought comment on the frequency of filings and whether more or less frequent filings would be preferable. Finally, the Commission sought comment on whether it would be appropriate to permit or to require electronic filing of Form ATS and all subsequent amendments.

Most of the commenters did not comment directly on the notice requirements or Form ATS. One commenter recommended that the Commission allow for filing of the initial operation report on Form ATS within twenty days after commencing operation, rather than twenty days before commencing operation as proposed.[173] This commenter stated that such a change would ease the regulatory burden on new systems that often have uncertain timelines and would avoid the possibility that a new trading system would be prevented from operating solely because of the need to wait for a twenty-day regulatory time period to run.

The Commission, however, believes that twenty days is a short enough period of time that alternative trading systems would not be inconvenienced by the requirement. If a system were only required to provide notice after it commenced operations, the Commission would have no notice of potential problems that might impact investors before the system begins to operate. The Commission also notes that currently broker-dealer trading systems have an identical requirement to file Form 17A–23 with the Commission twenty days prior to commencing operation. The Commission knows of no broker-dealer trading system that was unable to start operating because of the twenty day period. Consequently, the Commission believes the Rule, as adopted, is a reasonable means for the Commission to carry out its functions and imposes no unnecessary burdens on respondents.

The Commission also requested comment on whether the information in Form ATS should remain confidential. Two commenters supported the Commission's proposal to keep confidential the information contained in Form ATS,[174] and one commenter encouraged the public availability of filed information.[175] The Commission continues to believe that notice reports filed with the Commission and the alternative trading system's SRO pursuant to Regulation ATS should be kept confidential. Information required on Form ATS may be proprietary and disclosure of such information could place alternative trading systems in a disadvantageous competitive position. Further, because the Commission wishes to encourage candid and complete filings in order to make informed decisions and track market changes, preserving confidentiality provides respondents with the necessary comfort to make full and complete filings. Finally, based on the Commission's experience with Rule 17a–23 filings, the Commission believes that confidentiality is appropriate.

Finally, the Commission solicited comment on the possibility of permitting Form ATS to be filed electronically. Several commenters supported the acceptance of electronic filings by the Commission as a way to reduce the regulatory burden of filing Form ATS and in light of the technological nature of alternative trading systems.[176] The Commission agrees that electronic filing is an important goal and plans to work toward it. Currently, however, legal and technological limitations—primarily relating to security and authentication—make an electronic filing system infeasible. At this time, the Commission is capable of, and plans to, provide alternative trading systems with the ability to access Form ATS and Form ATS–R on-line, through the Commission's web site, so that the form can be downloaded. Alternative trading systems would then have to submit these forms to the Commission by mail or facsimile. Ultimately, the Commission anticipates that current technological barriers will be overcome, and a system able to electronically accept Forms ATS and ATS–R will be available.

c. Market Transparency

(i) Importance of Market Transparency

In 1997, the Commission implemented rules that require a market maker or specialist to make publicly available any superior prices that it privately offers through certain types of alternative trading systems known as ECNs.[177] The rules permit an ECN to fulfill these obligations on behalf of market makers or specialists using its system, by submitting the ECN's best priced market maker or specialist quotations to an SRO for inclusion into

[167] 17 CFR 240.17a–23. *See infra* Section V.

[168] Rule 301(b)(2)(ii), 17 CFR 242.301(b)(2)(ii).

[169] SIA Letter at 17–18.

[170] Rule 301(b)(2)(iii), 17 CFR 242.301(b)(2)(iii). Alternative trading systems would also be required to file an amendment to Form ATS to correct any previously filed information that has been discovered to have been inaccurate when filed. Rule 301(b)(2)(iv), 17 CFR 242.301(b)(2)(iv).

[171] Rule 301(b)(2)(v), 17 CFR 301(b)(2)(v). An alternative trading system is required to provide a duplicate of each of these filings to surveillance personnel designated by the SRO of which it is a member. Rule 301(b)(2)(vii), 17 CFR 301(b)(2)(vii).

[172] *See supra* note 3.

[173] SIA Letter at 17–18.

[174] *See* SIA Letter at 17–18; American Century Letter at 6.

[175] IBEX Letter at 5.

[176] *See* IBEX Letter at 5; SIA Letter at 18; American Century Letter at 6.

[177] 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. Rule 11Ac–1–1, 17 CFR 240.11Ac1–1. *See also* Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (''Order Handling Rules Adopting Release'').

public quotation displays (''ECN Display Alternative'').[178]

Since the Order Handling Rules were implemented, the spread between bids and offers in covered securities has narrowed dramatically.[179] This has benefited investors, including retail investors, who have enjoyed significant cost savings when trading covered securities.[180]

These rules, however, were not intended to fully coordinate trading on alternative trading systems with public market trading.[181] While these rules have helped integrate orders on certain alternative trading systems into the public quotation system, they only disclose the orders market makers and specialists enter into ECNs, unless the system voluntarily undertakes to disclose institutional prices.[182] In many cases, institutional orders, as well as other non-market maker orders, remain undisclosed to the public.[183] Moreover, it is voluntary for an ECN to reflect the best priced quotations in the public quotation system on behalf of market makers and specialists that participate in its system.

Because certain 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-five years ago when it noted that an essential purpose of a national market system:

> [I]s 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.[184]

(ii) Integration of Orders Into the Public Quotation System

Alternative trading systems are becoming increasingly popular venues for trading securities. Because these systems are not registered exchanges and do not participate in the national market system, there is a possibility that our securities markets could become less transparent over time.[185] The Commission believes that it is inconsistent with congressional goals for a national market system if the best trading opportunities are made accessible only to those market participants who, due to their size or sophistication, can avail themselves of prices in alternative trading systems. The vast majority of investors may not be aware that better prices are disseminated to alternative trading system subscribers and many do not qualify for direct access to these systems and do not have the ability to route their orders, directly or indirectly, to such systems. As a result, many customers, both institutional and retail, do not always obtain the benefit of the better prices entered into an alternative trading system. As the American Association of Individual Investors pointed out, ''(s)imply stated, investors benefit, as do markets, from knowing the full array of best-priced orders from all sources * * * It is in the best interests of individual investors that alternative trading systems disseminate best-priced orders into quotation systems that are available to the public.'' [186]

(A) New Requirements for Alternative Trading Systems

The Commission is adopting Exchange Act Rule 301(b)(3) to further enhance transparency of orders displayed on alternative trading systems, and to ensure that publicly displayed prices better reflect market-wide supply and demand. Specifically, this rule requires alternative trading systems with five percent or more of the trading volume in any ''covered security'' [187] to publicly disseminate their best priced orders in those securities. These orders will then be included in the quotation data made available to quotation vendors by national securities exchanges and national securities associations.[188] Only those orders that are displayed to more than one alternative trading system subscriber would be subject to the

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[178] Presently, nine alternative trading systems have elected to display quotes under the ECN Display Alternative. *See* Letters dated Jan. 17, 1997 from Richard R. Lindsey, Director, Division of Market Regulation, 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). *See also* Letter dated October 6, 1997 from Richard R. Lindsey, Director, Division of Market Regulation, SEC to Matthew G. Maloney, Dickstein Shapiro Morin & Oshinsky LLP (counsel to Spear, Leeds & Kellogg) (recognizing the REDI System as an ECN); Letter dated February 4, 1998 from Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC, to Linda Lerner, General Counsel, All-Tech Investment Group, Inc. (recognizing the Attain System as an ECN); Letter dated April 21, 1998 from Richard R. Lindsey, Director, Division of Market Regulation, SEC to Mark Dorsey, Fried, Frank, Harris, Shriver & Jacobsen (counsel to The Brass Utility, LLC) (recognizing BRUT as an ECN); and Letters dated Nov. 13, 1998 from Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC to: Lloyd H. Feller, Morgan, Lewis & Bockius LLP (counsel to Strike Technologies LLC) (recognizing the Strike System as an ECN); John M. Schaible, PIM Global Equities, Inc. (recognizing the Trading System as an ECN).

[179] Quoted spreads, which measure the difference between the inside ask and the inside bid, have declined by forty-one percent. The effective spread, which takes into account that trades may occur inside or outside the quoted spread, declined by twenty-four percent. The lower decline in the effective spread is due to a decline in trading inside the spread. *See* NASD Economic Research, Market Quality Monitoring: Overview of 1997 Market Changes (Mar. 17, 1998).

[180] A covered security is defined in the same way as it is under Rule 11Ac1–1(a)(6), 17 CFR 240.11Ac1–1. Specifically, a ''covered security'' is any security reported by an effective transaction reporting plan and any other security for which a transaction report, last sale data, or quotation information is disseminated through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Exchange Act, 15 U.S.C. 78c(a)(51)(A)(ii). *See* Rule 300(g). Accordingly, a covered security includes all exchange-listed securities, Nasdaq NM securities, and Nasdaq SmallCap securities.

[181] *See* Order Handling Rules Adopting Release, *supra* note 177, at 87–96.

[182] There is 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. Several of the nine ECNs that are currently linked to Nasdaq display to the public the best prices of any orders entered into their systems (including both market makers and institutions).

[183] Because such trading interest frequently 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 disclosed to the public, the Commission believes it would result in improved price opportunities for public investors.

[184] *See* 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) (emphasis added).

[185] In the Concept Release, *supra* note 2, the Commission considered whether to require certain alternative trading systems to register as exchanges. This approach would have addressed the Commission's concerns about lack of transparency by requiring certain significant alternative trading systems to participate directly in the national market system plans. Commenters to the Concept Release, however, expressed concerns about requiring alternative trading systems to register as exchanges, and that a much more workable and realistic approach would be to enhance the system of broker-dealer regulation under which alternative trading systems are currently regulated. For example, in recommending that the Commission consider allowing alternative trading systems to continue to be regulated as broker-dealers, the SIA commented that ''additional steps to integrate aggregate trading interest on alternative trading systems to public view would be a sensible way of addressing concerns that may exist in the aftermath of the Order Handling Rules.'' See letter from A. B. Krongard, Chairman, Securities Industry Association Task Force on Alternative Trading System Concept Release to Jonathan G. Katz, Secretary, SEC, received Oct. 6, 1997.

[186] Letter from John Markese, President, American Association of Individual Investors, to Jonathan G. Katz, Secretary, SEC, dated Nov. 24, 1998 (''AAII Letter'') at 1.

[187] *See supra* note 180.

[188] 17 CFR 240.11Ac1–1.

public display requirement. As discussed in Section IV.A.2.c.iii. below, alternative trading systems are also required to provide all registered broker-dealers with access to these displayed orders.

Importantly, the public display requirement in Rule 301(b)(3) applies only to orders in ''covered securities.'' The term ''covered securities'' includes only exchange-listed, Nasdaq NM, and Nasdaq SmallCap securities. Accordingly, alternative trading systems trading equity securities not included within the definition of ''covered security,'' or debt securities, would not be subject to the public display requirement under Regulation ATS.

In the Proposing Release, the Commission proposed a public display requirement substantially similar to the one it is adopting today. The proposal, however, would have only required alternative trading systems to publicly display their best priced orders in a covered security when the system represents ten percent of the trading volume in that security. The Commission decided instead to adopt a five percent threshold in light of the comment letters, many of which supported the public display requirement and recommended that the volume threshold be lower than ten percent.

In the Proposing Release, the Commission proposed that the display requirement be applied on a security-by-security basis and would not have required an alternative trading system to publicly display orders for any securities in which its trading volume accounted for less than ten percent of the total volume for such security. The Commission, however, requested comment on whether an alternative trading system should be required to display the best priced orders in *all* securities traded in its system, if it reaches the volume threshold in a specified number or percentage of the securities it trades.

After considering the comments on the issue, the Commission is adopting the security-by-security approach as proposed. Although a system that trades more than the volume threshold in a substantial number of securities could be considered a significant market whose best prices in all securities should be transparent, for now the Commission has decided to take the security-by-security approach with a lower volume threshold (five percent) than proposed. The security-by-security approach, among other things, will more readily enable the phase-in of securities subject to the transparency requirements as discussed below.

The Commission emphasizes that, as proposed, Rule 301(b)(3) only requires alternative trading systems to publicly display subscribers' orders that are displayed to more than one other system subscriber. Thus, if an alternative trading system, like some crossing systems, by its design does not display orders to other subscribers, the rules do not require those orders to be integrated into the public quote stream.[189] Similarly, if a portion of a subscriber's order is not displayed to other alternative trading system subscribers, that hidden portion is not subject to the public display requirement in Rule 301(b)(3). Thus, the Commission's rules allow institutions and non-market makers to guard the full size of their orders by using the ''reserve size'' features offered by some alternative trading systems, which allow subscribers to display orders incrementally. For example, a subscriber that wishes to sell 100,000 shares of a given security could place its order in an alternative trading system and specify that only 10,000 shares are to be displayed to other alternative trading system subscribers at a time. In this instance, Rule 301(b)(3) requires that only 10,000 shares be reflected in the public quote. The ability to continue to control how much of their own orders to reveal was a concern of several institutions who commented.[190] Finally, alternative trading systems are not required to provide to the public quote stream orders displayed to only one other alternative trading system subscriber, such as through use of a negotiation feature.

The Commission believes that in light of the significant trading volume on some alternative trading systems, integration of institutional and non-market maker broker-dealer orders into the national market system is essential to prevent the development of a two-tiered market. Trading anonymity will be preserved because an alternative trading system will comply with any public display requirement by identifying itself, rather than the subscriber that placed the order. Thus, the Commission's proposal, much like the ECN Display Alternative, is designed to preserve the benefits associated with anonymity. Moreover, the Commission believes that the continued ability of institutions to retain their anonymity and to use features within alternative trading systems to shield the full size of their orders gives institutions the ability to keep their full trading interest private. The Commission recognizes that anonymity is often important to institutional investors so that when they are unwinding or building security holdings they do not signal their trading strategy and negatively impact their own market position.[191]

Requiring alternative trading systems to furnish to the public quotation system the full size of the best displayed buy and sell orders will ensure that the public quote better reflects true trading interest in a particular security. Furthermore, the Commission believes that institutional investors' orders entered into alternative trading systems provide valuable liquidity, and that displaying such trading interest will substantially strengthen the national market system. Moreover, this public display requirement levels the playing field between market makers—who, when they send customer limit orders to ECNs, the ECN must publicly display that order—and those ECNs, who do not have to display customer limit orders sent directly to the ECN.

In order to monitor the effects of the public display requirement, however, the rules will permit affected alternative trading systems to phase-in institutional orders in covered securities.[192] Before April 21, 1999, the Commission will publish a schedule for the phase-in of individual securities. Fifty percent of the securities subject to the transparency requirement will be phased-in on April 21, 1999 and the remainder of the securities will be phased-in on August 30, 1999.[193]

(B) Response to Comments

The Commission requested comment on whether a ten percent volume

[189] One commenter (who does not internally display orders) expressed its support for this aspect of the proposed transparency requirement, stating that, while exchanges and broker-dealers should be subject to the same public display requirement, if an alternative trading system did not display any orders to subscribers, it should not be required to publicly display those orders to non-subscribers through the public quotation stream. *See* OptiMark Letter at 4.

[190] *See infra* notes 206–207 and accompanying text.

[191] The Commission plans to monitor the effects of the reserve function on market liquidity and transparency.

[192] In addition to phasing in the transparency requirements for institutional orders, affected alternative trading systems may also choose to phase-in the access requirements for the covered securities. *See infra* notes 216–217 and accompanying text.

[193] The Commission notes that the later date will fall within the moratorium to facilitate Year 2000 conversion. Securities Exchange Act Release No. 40377 (Aug. 27, 1998), 63 FR 47051 (Sept. 3, 1998). The Commission believes that the phase-in will not require major reprogramming, however, and consequently is not subject to the moratorium. In addition, alternative trading systems may voluntarily publicly display all non-market maker broker-dealer and institutional orders covered by the requirement on or before April 21, 1999.

threshold would effectively ensure that alternative trading systems comprising a significant percentage of the market are subject to basic market transparency requirements. The commenters that responded to this issue were split on whether a ten percent volume threshold was too high or too low, although most felt it was too high and should be lowered.[194] A few commenters, however, stated that they believed the volume thresholds were too low.[195]

As discussed above, the transparency requirement the Commission is adopting in Rule 301(b)(3) obligates an alternative trading system to disseminate into the public quote the best priced orders in each covered security in which the trading on such system represents more than five percent of total trading volume. The Commission is persuaded by commenters that stated that a ten percent threshold would exclude trading on too many alternative trading systems. The Commission believes that lowering the threshold to five percent will provide more benefits to investors, promote additional market integration, and further discourage two-tier markets. At the same time, the Commission believes that those alternative trading systems with less than five percent of the volume would not add sufficiently to transparency to justify the costs associated with linking to a market.

The Commission requested comment on whether an alternative trading system should be required to display the best priced orders in all securities traded in its system, if it reaches the volume threshold in a specified number or percentage of the securities it trades. Of those commenters addressing this issue, most were in favor of display of the best priced orders in *all* securities traded on an alternative trading system once that alternative trading system exceeded the volume threshold in some fixed number of securities.[196] The NYSE stated that if an alternative trading system developed a ''general presence'' in the market, for example by reaching the volume threshold in ten or more securities, that alternative trading system should display the best priced orders in all securities it trades. One commenter, however, specifically opposed the display of all securities traded on an alternative trading system rather than mandating display on a security-by-security basis.[197] This commenter also noted that even display on a security-by-security basis may capture a system that trades a significant amount of one security, despite the fact that that security was a minor part of the overall trading in the system. As discussed above, however, the Commission is adopting the rule as proposed.

The Commission also requested comment on whether alternative trading systems should be required to display the full size of the best priced order, even if the full size is hidden from alternative trading system subscribers through use of a ''reserve size'' or similar feature. All commenters directly addressing this issue[198] stated that the reserve feature should be maintained, especially if the Commission's rules as adopted required displayed institutional orders to be integrated into the public quotation stream. The Commission agrees that the reserve features are critical to institutions' ability to minimize the market impact of their orders. Further, when orders are not displayed to anyone, the Commission's concerns about a two-tiered market—where some market participants have information others do not—are absent. Accordingly, Rule 301(b)(3) only requires alternative trading systems to publicly disseminate the best priced orders that are displayed to other alternative trading system subscribers.

The Commission requested comment on whether it would be more appropriate to adopt an alternative to Rule 301(b)(3) that would permit, but not require, the public display of the best-priced institutional orders displayed in a high volume alternative trading system. Under this alternative, an alternative trading system meeting the requirements of Rule 301(b)(3)(i) would only be required to provide to a national securities exchange or national securities association the best-priced orders in covered securities displayed in the alternative trading system by any broker or dealer and by any other subscriber that elects to make its orders available for public display. The

[194] *See* AAII Letter at 1 (suggesting that the volume threshold be much lower than ten percent), NYSE Letter at 5 (stating that it believed a more appropriate level would be five percent of the aggregate daily volume in a security in any two of the three most recent months, because very few registered markets (exchanges and associations) accounted for more than ten percent of the volume in any security); CHX Letter at 8 (suggesting that the Commission require all alternative trading systems to display their best orders regardless of trading volume); NASD Letter at 1 (suggesting a volume threshold of one percent); American Century Letter at 5 (stating opposition to any volume threshold, as volume in any alternative trading system may be sporadic over time). *See also* ICI Letter at 3; IBEX Letter at 7–8; Ashton Letter at 4; TBMA Letter pp. 21–22 (stating that it concurred that display of equity securities trading on alternative trading systems was beneficial to the market as a whole).

[195] *See* SIA Letter at 12 (stating that a volume level of ten percent had the potential to capture insignificant market players and therefore recommending that the Commission consider a level of twenty percent).

[196] *See* ICI Letter at 2, n.5 (stating that the display requirement should apply to all securities and to all alternative trading systems, regardless of volume. The ICI stated that this would avoid the practice of routing to a particular system simply to avoid display); NYSE Letter at 5 (stating that if an alternative trading system developed a ''general presence'' in the market, for example by reaching the volume threshold in ten or more securities, that alternative trading system should display the best priced orders in all securities it traded); Ashton Letter at 4 (stating that once an alternative trading system achieved one percent in a given ''category'' of securities over a six month period, the system should be required to display its best orders in all the securities in that category); CHX Letter at 8 (stating that any volume threshold should be applied on an alternative trading system as a whole, not on a security-by-security basis, because of the burden of tracking security-by-security); American Century Letter at 5 (commenting that a rule requiring public display of all orders displayed in an alternative trading system was preferable). *See also* IBEX Letter at 8; NASD Letter at 11. *But see* SIA Letter at 12.

[197] *See* SIA Letter at 13–14 (supporting display of orders on a security-by-security basis and recommending that the volume threshold be raised to twenty percent of the trading volume in that security nationwide; also stating that no orders should be required to be displayed in the public quotation stream unless the trading volume in that security on the alternative trading system exceeded twenty percent of the alternative trading system's overall trading activity). Of course, the Commission assumes that those commenters who opposed display of non-market maker orders generally would also oppose the display of all securities as well, rather than only those above a certain volume threshold. *See infra* notes 204–205.

[198] *See* ICI Letter at 3 (stating that the ICI supports display of institutional orders provided that the reserve size feature is retained, and provided that orders are displayed in the public quotation system under the name of the alternative trading system, and not the name of the subscriber placing the order, thereby preserving anonymity); IBEX Letter at 8–9 (stating that the ''reserve size'' feature permitted alternative trading system subscribers to avoid adverse market impact and negotiate a larger transaction with a single counter-party, two features IBEX believes to be of considerable value. IBEX stated, however, that reserve size availability to subscribers to an alternative trading system should be contingent on an initial increment being publicly displayed; non-subscribers being able to execute against the reserve size; and the full size and price of each increment being immediately reported, as executed, to the public quotation system); Ashton Letter at 6 (stating that all orders up to 10,000 shares should be displayed, and that orders in excess of 10,000 shares, should have a minimum of 10,000 shares publicly displayed; also stating that negotiation and reserve size features should be available to non-subscribers, as well as subscribers); American Century Letter at 5 (stating that it was ''imperative'' that the reserve feature be maintained, because it provided depth of supply and demand at a price, while protecting the order from being used as a ''free option'' by other participants in the market). *See also* Instinet Letter at 11–13 (arguing against total pre-trade transparency); Bloomberg Letter at 19 n.32 (noting reserve feature in the Tradebook System); Letter from Daniel G. Weaver, Associate Professor of Finance, Zicklin School of Business, Barauch College to Jonathan G. Katz, Secretary, SEC, dated Nov. 23, 1998 (''Weaver Letter'') (stating that institutions will move their trading upstairs even if the full size of their orders is hidden from alternative trading system subscribers through their use of a ''reserve size'' feature).

Commission requested comment on whether such an alternative would sufficiently address the Commission's concerns with transparency and fragmentation in the markets. The Commission is concerned, however, that this alternative could exacerbate the competitive disparities between broker-dealers and ECNs. Under the Order Handling Rules, different order display requirements are imposed on limit orders received by a market maker and forwarded to an ECN, than are imposed on orders entered directly into an ECN. One commenter expressed concern that this differential treatment could serve as a disincentive for customers to place orders with a broker-dealer that acts as a market maker in a security.[199]

Most commenters that expressed support for the display of institutional and non-market maker broker-dealer orders did so because the display of these orders would increase transparency and liquidity in the market. The Investment Company Institute (''ICI'') stated that it would support the display of institutional orders because it believed display of those orders would improve the overall transparency and liquidity of the market. This support, however, was contingent upon the continued availability of the ''reserve'' feature offered by some alternative trading systems.[200] Another commenter, similarly, supported disclosure of institutional orders because displayed orders ''are good for markets,'' and stated that there was no cause for concern that requiring institutions to display in the public quotation stream would lead to a decrease in orders displayed through alternative trading systems. In fact, this commenter stated its belief that the opposite would occur, and pointed to the proliferation of ECNs as evidence.[201] The NYSE also commented that requiring display of institutional orders in the market would add transparency and liquidity. The NYSE added that it strongly believes all orders of high volume alternative trading systems, including orders of 10,000 shares or more, should be required to be publicly displayed.[202] Ashton suggested that orders of up to 10,000 shares on all alternative trading systems should be fully displayed, and orders exceeding 10,000 shares should have at least 10,000 shares publicly displayed. Ashton stated that it believed this would strike the appropriate balance between displaying such orders and minimizing their market impact.[203]

The commenters who opposed display of non-market maker broker-dealer and institutional orders did so because of the market impact they felt such orders would have if displayed. Instinet stated that requiring the display of institutional orders would have several negative effects on the market. In particular, Instinet claimed that public display of institutional orders could have a ''significant negative impact'' on the price and volatility of a security, would divert this order flow to entities not subject to Regulation ATS or to offshore markets, and would curtail the ability of institutions to manage the securities transactions of the individual investors for whom they act as proxy.[204] Instinet also stated that institutional and other non-market maker investors do not perform specialized market functions, and therefore should not be subject to mandatory display in the public quotation system. Finally, Instinet stated it believed that customers should be able to determine the transparency of their orders whether they were placed with a ''traditional brokerage firm'' or a firm ''that offers both traditional and electronic execution opportunities.''[205]

The Commission is not persuaded by commenters that suggest that institutions currently willing to use alternative trading systems to display their orders to other alternative trading system subscribers, including other institutions, market-makers, and broker-dealers, will be less willing to use alternative trading systems that must display those orders to the public market. Our reasons are as follows. The primary group of market participants that will benefit from the public display of institutional orders is retail investors. Retail investors are not currently alternative trading system subscribers. To avoid market impact, institutions try to avoid signaling other institutions and market professionals, not retail investors. Almost all market professionals and a significant number of institutions already subscribe to alternative trading systems. Thus, the Commission believes that the additional exposure to the market should not affect institutions' behavior in their use of alternative trading systems. Moreover, to the extent that institutions want to display small sized orders in the public market, rather than their entire order, they will still be able to make use of an alternative trading system's ''reserve size'' feature. This will enable institutions to avoid exposing the total size of their order to the public market.

The Commission also received numerous comment letters from institutions who expressed similar concerns. Some of these commenters appeared to be concerned that they might be forced to display all orders sent to alternative trading systems, even those orders, or those portions of orders, that are not displayed to any other alternative trading system subscribers.[206] To the extent that these letters are concerned with ''full disclosure,'' that concern is misplaced. Instead, the Commission proposed, and is adopting, a public display requirement that applies only to those orders (or those portions of orders) that alternative trading system subscribers

[199] *See* Letter from Wessels, Arnold & Henderson, LLC to Jonathan G. Katz, Secretary, SEC, dated Nov. 12, 1997 (commenting on the Concept Release).

[200] 7/28/98 ICI Letter at 2–3. In a later letter, the ICI requested clarification of whether certain orders the ICI described as ''non-firm'' would be subject to display under the Commission's rules. *See* Letter from Craig S. Tyle, General Counsel, ICI, to Jonathan G. Katz, dated November 13, 1998 (''11/13/98 ICI Letter''). *See also* the discussion *supra* at Section III.A.3.

[201] American Century Letter at 4–5.

[202] NYSE Letter at 6.

[203] Ashton Letter at 6.

[204] Instinet Letter at 3, 12, and 14.

[205] *Id.* at n.18 and n.23. *See also* Letter from David K. Whitcomb, Professor of Finance and Economics, Rutgers University to Jonathan G. Katz, Secretary, SEC, dated July 27, 1998 (''Whitcomb Letter'') at 2–3 (stating that institutions may, in some instances, feel strongly that displaying their orders more widely than to other participants in the alternative trading system is undesirable, and that, as a result, institutions may be induced to spread their business among firms on the basis of whether the alternative trading system has reached the volume threshold for public display of orders, rather than on the basis of quality of service.); Letter from Ruben Lee, Oxford Finance Group to Jonathan G. Katz, Secretary, SEC, dated July 28, 1998 (''Lee Letter'') at 2–3 (stating that while mandatory transparency might help retail investors monitor the quality of their executions and reduce the inequality in access to information that retail investors face, it could compromise efficiency and liquidity).

[206] *See* 7/28/98 ICI Letter; 11/13/98 ICI Letter; Letter from Rick Dahl, Chief Investment Officer, Missouri State Employees' Retirement System to Jonathan G. Katz, Secretary, SEC, dated Nov. 12, 1998 (''Mosers Letter''); Letter from Russell Rhoads, Director of Equity Trading, and Michael B. Orkin, Chairman and CEO, Caldwell & Orkin, Inc. to Jonathan G. Katz, Secretary, SEC, dated Nov. 20, 1998 (''Caldwell Letter''); Letter from Todd M. Sheridan, Senior Portfolio Manager, Caterpillar Investment Management Ltd. to Jonathan G. Katz, Secretary, SEC, dated Nov. 19, 1998; Letter from Praveen K. Gottipalli, Director of Investments, Symphony Asset Management to Jonathan G. Katz, Secretary, SEC, dated Nov. 20, 1998 (''Symphony Letter''); Letter from Cinda A. Carmer, Senior Securities Trader, Heartland Capital Management, Inc. to Jonathan G. Katz, Secretary, SEC, dated Nov. 17, 1998; Letter from Patrick J. McCloskey, Senior Vice President, Wellington Management Company, LLP to Jonathan G. Katz, Secretary, SEC, dated Nov. 23, 1998 (''Wellington Letter''); Letter from Carrie Canter, Principal, Equity Trading, Barrow, Hanley, Mewhinney & Strauss, Inc. to Jonathan G. Katz, Secretary, SEC, dated Nov. 12, 1998 (''Barrow Letter''). *See also* Weaver Letter (stating that if the Commission required institutions to display the full size of their orders, even if the full size is hidden from alternative trading system subscribers through their use of a ''reserve size'' feature, institutions will move their trading upstairs).

have already decided to display to the large number of other alternative trading system subscribers. Institutions will remain free to use a reserve feature, if an alternative trading system has one, to not display full size of their orders to other alternative trading system subscribers. That non-display of total order size will also apply if that order is displayed in the public quote.

Other commenters generally expressed concerns similar to those expressed by Instinet, emphasizing concerns about best execution for institutional orders, and expressing concern about increased market volatility.[207] The Commission believes that display of institutional orders in the public quote stream will not harm best execution—if anything—best execution will be enhanced as all market participants will have an opportunity to execute against these orders. The Commission also believes that the experience with display of market maker orders under the Order Handling Rules suggests that display of institutional orders will not lead to increased market volatility. Many of the largest market participants already have access to alternative trading system institutional orders; therefore, their display in the public quote stream should not necessarily lead to increased market volatility. It will, however, allow those market participants who do not have access to these alternative trading systems to have the opportunity to execute against these orders.

Some of the letters the Commission has received since the beginning of November also express a concern that if institutional orders were publicly displayed, institutions would lose their anonymity.[208] The Commission did not propose, nor is it adopting, any requirement that would jeopardize an institution's anonymity. Similar to the way in which ECNs currently display orders in the public quote, alternative trading systems would display their best priced orders in the public quote, but would not indicate which of their subscribers had entered the order.

In addition, a number of institutional commenters suggested if Nasdaq had implemented its proposed limit order file, they would not oppose a requirement that alternative trading systems publicly display institutional orders, if those orders represent the best priced order in the alternative trading system they use.[209] Unfortunately, none of these commenters explained why they would be willing to publicly display their orders through a Nasdaq sponsored central limit order file, but not publicly display orders they have chosen to display to other alternative trading system subscribers.

Finally, one commenter expressed concern that the order display rule would mean that retail investors would increasingly observe trades taking place below the bid and above the ask, and would be frustrated by their lack of access to these trades.[210] Because certain institutions' orders will now be displayed in the public quote, however, retail investors will have access to them. The lack of access retail investors currently have to alternative trading systems is one of the reasons the Commission believes that the display of institutional orders in the public quote stream is particularly important. In addition, this commenter stated that requiring public display of institutional orders would tilt the playing field in favor of dealers who do not have to display institutional orders.[211] Under the Order Handling Rules, however market makers are required to display all customer limit orders that improve their quote.

For these reasons, the Commission agrees with those commenters who believe that institutional orders that are displayed to subscribers of an alternative trading system should be integrated into the public quotation system if they represent the top of the book in the alternative trading system.[212] The Commission believes that any market impact that results from such display will be vitiated by the retention of the reserve feature, as discussed above. The Commission notes that such institutional orders are currently displayed to the subscribers of alternative trading systems, who may number in the thousands. These subscribers are often the market makers and other active traders in the security. As a result, prices displayed only on alternative trading systems are immediately known to key market players who can adjust their trading to take advantage of their information advantage. Moreover, the Commission believes that these orders will provide enhanced transparency and liquidity when integrated into the public quotation stream, and will further curtail the development of a two-tiered market.

Nonetheless, the Commission is concerned about commenters' statements that institutions may react to the transparency requirement by shipping more orders upstairs or overseas. The Commission intends to closely monitor the impact of this requirement, and will modify it if harm appears to result.

(iii) Access to Publicly Displayed Orders

(A) Application of Access Requirements Under Regulation ATS

The Commission believes that in addition to the display of better alternative trading system prices in the public quotation system, the availability of such trading interest to public investors is an essential element of the national market system. Therefore, the Commission proposed that alternative trading systems afford all non-subscriber broker-dealers equivalent access to the alternative trading system orders displayed in the public quote, similar to the manner in which ECNs currently comply with the ECN Display

[207] *See* Letter from Gary E. Shugrue, General Partner, Argos Partners Ltd., to Jonathan G. Katz, Secretary, SEC, dated Nov. 11, 1998 (''Argos Letter''); Letter from Stacey Matthews, Chelsey Capital, to Jonathan G. Katz, Secretary, SEC, dated Nov. 16, 1998, (''Chelsey Letter''); Letter from John D. Race, Partner, DePrince, Race & Zollo, Inc., to Jonathan G. Katz, Secretary, SEC, dated Nov. 16, 1998, (''DePrince Letter''); Letter from Michael W. Masters, Portfolio Manager, Masters Capital Investments, LLC, to Jonathan G. Katz, Secretary, SEC, dated Nov. 16, 1998, (''Masters Letter''); Letter from Denise O'Brien, Head of Equity Trading, Wanger Asset Management, LP, to Jonathan G. Katz, Secretary, SEC, received Nov. 19, 1998, (''Wanger Letter''); Letter from Gerald N. Brown, Becker Capital Management, to Jonathan G. Katz, Secretary, SEC, received Nov. 19, 1998 (''Becker Letter''); Letter from Della L. Hood-Laster, V.P. Equity Trading, Loomis Sayles & Company, LP, to Jonathan G. Katz, Secretary SEC, dated Nov. 12, 1998, (''Loomis Letter''). *See also* Barrow Letter and Mosers Letter.

[208] *See* Letter from Susan Ellis, Vice President, Trading, Granahan Investment Management, Inc. to Jonathan G. Katz, Secretary, SEC dated Nov. 16, 1998; Letter from Genrald N. Brown, Becker Capital Management to Jonathan G. Katz, Secretary, SEC received Nov. 19, 1998; Letter from Teresa M. Brandt, Head Equity Trader, Advantus Capital Management, Inc. to Jonathan G. Katz, Secretary, SEC dated Nov. 19, 1998; Letter from Kristen Straubel, Head Trader and Robert T. Lutts, President, Cabot Money Management, Inc. to Jonathan G. Katz dated Nov. 20, 1998; Letter from Tracy Altebrando, Senior Equity Trader, Metropolitan Capital Advisors, Inc. to Jonathan G. Katz, Secretary, SEC, dated Nov. 25, 1998. *See also* Wanger Letter, Caldwell Letter, Symphony Letter, Wellington Letter.

[209] *See, e.g.*, Loomis Letter, Chelsey Letter.

[210] Letter from Ed Restrepo, Head Trader, VanWagoner Capital Management to Jonathan G. Katz, Secretary, SEC, dated Nov. 16, 1998 (''VanWagoner Letter'').

[211] *See* VanWagoner Letter. *See also* Letter from Stacey Carter Fleece, Chief Financial Officer, Brookhaven Capital Management to Jonathan G. Katz, Secretary, SEC dated Nov. 18, 1998 (stating that institutional orders submitted to dealers do not have to be published); Letter from John D. Robinson, Head Trader, Longwood Asset Management to Jonathan G. Katz, Secretary, SEC, dated Nov. 25, 1998.

[212] Under Rule 301(b)(3), non-market maker broker-dealer orders entered into alternative trading systems must also be displayed. 17 CFR 242.302(b)(3).

Alternative under the Quote Rule.[213] The Commission agrees with those commenters who stressed the importance of equivalent access for non-participants and who stated that simply requiring alternative trading systems to display prices in the public quotation system does not go far enough to facilitate the best execution of customer orders without a mechanism to access orders at those prices.[214] Accordingly, the Commission is adopting the requirement as proposed.[215] Specifically, with respect to any security in which an alternative trading system is required to publicly display its best priced orders because it has five percent or more of all trading in that security, such alternative trading system must provide for members of the SRO with which it is linked the ability to effect a transaction with those orders. As discussed above, the Commission is phasing in the public display requirement.[216] In addition, alternative trading systems are not required to provide access to a security until the public display requirement is effective for that security.[217]

The Commission believes that non-subscribing broker-dealers should be able to execute against those alternative trading system orders that are publicly displayed to the same extent as if that price had been reflected in the public quote by a national securities exchange or national securities association. Thus, an alternative trading system should respond to orders entered by non-participants no slower than it responds to orders entered directly by subscribers. The Commission believes that, under current NASD rules, any alternative trading system that allows non-subscribing broker-dealers to execute against publicly displayed alternative trading system orders in the same manner as ECNs linked to the Nasdaq market currently do would comply with this requirement. The NASD does not currently require ECNs to automatically execute orders sent to the ECN through the NASD's SelectNet linkage with the ECN. Any SRO to which alternative trading systems may be linked, may determine that it is necessary for the fair and orderly operation of its market to require that publicly displayed alternative trading system orders be subject to automatic execution. Any such proposed rule change, of course, would have to be filed with the Commission by the SRO, published for comment, and approved by the Commission. The Commission would not approve any such SRO rule unless it finds that such rule is consistent with the Exchange Act.

(B) Response to Comments

The Commission asked for comment on whether alternative trading systems should be required to provide non-subscribers with equivalent access to displayed orders. Several commenters responded to this issue. Most of these commenters stated that non-subscribers should be given equivalent access.[218] Only one commenter cautioned against granting such access. This commenter argued that alternative trading systems and traditional broker-dealers engage in the same business and, therefore, it would impede innovation as well as be unfair to require fair access to trading opportunities on alternative trading systems when the Commission is not proposing to require such access to more traditional broker-dealers.[219] The Commission does not believe that alternative trading systems and traditional broker-dealers engage in the same business.[220] As discussed above, the Commission believes that the public display of orders on alternative trading systems that are currently displayed only to the subscribers of those alternative trading systems will improve the public securities markets. Without a mechanism to access these orders, any public display requirement is insufficient. Accordingly, the Commission is adopting the fair access requirement.

In the Proposing Release, the Commission also stated that it believes that for an alternative trading system to comply with this equivalent execution access requirement, the publicly displayed alternative trading system orders would need to be subject to automatic execution through small order execution systems operated by the SRO to which the alternative trading system is linked. One commenter strongly urged the Commission to eliminate the automatic execution access requirements from its proposal. This commenter was opposed to such a linkage, because it believed it would effectively eliminate pure agency brokers from markets in covered securities, because brokers would be required to commit capital if automatic execution resulted in multiple executions against client orders. This commenter also noted that the Commission's Order Handling Rules do not require automatic execution, but require only that response times for non-subscriber trade requests are no slower than response times for subscribers, and believed this to be a more balanced approach to execution access issues.[221] Similarly, American Century, while supporting equivalent access to non-subscribers, stated that automatic execution access requirements were risky as well, because of the possibility of double execution.[222] The Commission does not expect—by operation of its rules alone—that alternative trading systems will be subject to automatic execution through SROs' small order execution systems. Nevertheless, the Commission believes that an SRO to which an alternative trading system is linked should be able to establish rules regarding how that alternative trading system is integrated into its market. The Commission notes that any change to SRO rules regarding automatic execution would have to be approved by the Commission after notice and the opportunity for the public to comment, and subject to Commission review for competitive fairness and consistency with the Exchange Act.

In addition, the Commission asked if there was a feasible way to allow market-wide interaction without linkage to SRO order execution systems, and whether there was a feasible way to grant equivalent non-subscriber access to institutions that are not broker-dealers.

(iv) Execution Access Fees

(A) Limitations on Alternative Trading System Fees Charged to Non-Subscribers

In the Proposing Release, the Commission stated that an alternative trading system's fee schedules should not be used to circumvent the ability of non-participants to access a system's publicly displayed orders.[223] Because reasonable fees are a component of equal access, the rules the Commission is adopting today prohibit an alternative trading system from setting fees that are inconsistent with the principle of equivalent access to the alternative trading system quotes by members of the SRO to which the alternative trading

[213] Rule 11Ac1–1(c)(5)(ii), 17 CFR 240.11Ac1–1(c)(5)(ii) (''Quote Rule''). *See also* Order Handling Rules Adopting Release, *supra* note 177.

[214] *See infra* note 218 and accompanying text.

[215] Rule 301(b)(5), 17 CFR 242.301(b)(5).

[216] *See supra* notes 192–193 and accompanying text.

[217] The Commission emphasizes that, as with the transparency phase-in, alternative trading systems may voluntarily provide access to non-subscribers on or before April 21, 1999 in all securities covered by the rule.

[218] *See* ICI Letter at 3; IBEX Letter at 9–10; Ashton Letter at 6; American Century Letter at 2; OptiMark Letter at 4.

[219] Instinet Letter at 10.

[220] *See supra* notes 205–212 and accompanying text.

[221] Instinet Letter at 16–17.

[222] American Century Letter at 2.

[223] *See* Proposing Release, *supra* note 3, at n. 108.

system is linked. The rules also require an alternative trading system to comply with the rules or standards governing fees established by the national securities exchange or national securities association through which non-subscribers have access.[224]

The Commission believes that fees charged by an alternative trading system would be inconsistent with equivalent access if they have the effect of creating barriers to access for non-subscribers. As the Commission stated in adopting the Order Handling Rules, any ECN fees should be similar to the communications or systems charges imposed by various markets.[225] In addition, the Commission believes that the national securities exchange or national securities association to which the alternative trading system provides the prices and sizes of its best priced orders should have further authority to assure that fees charged by alternative trading systems to non-subscribers are disclosed or otherwise consistent with fees typically charged by the members of the exchange or association for access to displayed orders. There are a number of ways the exchange or association could address the issue of fees charged by alternative trading systems. For example, subject to Commission review and approval, an exchange or association could establish a standard for what constitutes a fair and reasonable fee for non-subscriber access to an alternative trading system, consistent with the effective operation of the self regulatory organization's market and the Commission's equivalent access requirement. The exchange or association may also require alternative trading system fees to be charged in a manner consistent with the exchange's or association's market, such as requiring the fee to be incorporated in the displayed quote.

At such time as quotations in the national market system are reflected in decimals rather than in fractions, the Commission will reconsider the rule's limitation on alternative trading systems charging fees only as permitted by the national securities exchange or national securities association to which they are linked. At that time, the Commission will also consider whether alternative trading systems should be permitted or required to reflect any fee charged in their quotations.

Any rules the exchange or association develops will of course need to be consistent with the goals of promoting competition and protecting investors. The Commission encourages SROs that accept alternative trading system quotes to work with alternative trading systems to develop uniform standards regarding display and execution access by SRO members to alternative trading systems linked to the SRO.[226] In addition, to foster equivalent access to alternative trading systems for exchange-listed securities, the Commission expects Intermarket Trading System (''ITS'') participants to modify ITS Plan requirements where necessary to accommodate alternative trading system participation in the markets of ITS participants, and access to those alternative trading systems through ITS. If the SROs and ITS participants cannot come to terms with affected alternative trading systems within a reasonable time, the Commission will consider exercising its authority to mandate the necessary linkages.

(B) Response to Comments

The Commission requested comment on the fees that alternative trading systems should be permitted to charge non-subscribers under the proposed rules. In addition, the Commission requested comment on whether there were alternatives for assuring fair execution access for non-subscribers other than limiting fees, or another test for determining whether non-subscriber fees assure equal access.

Ten comment letters addressed the issue of fees charged by alternative trading systems for access by non-subscribers. Of these, seven were generally in favor of permitting alternative trading systems to charge some fee to non-subscribers,[227] two were opposed,[228] and one felt the issue needed to be addressed in a separate release by the Commission.[229]

Most of the commenters who were in favor of allowing fees stated that fees should be ''reasonable,'' or should not exceed the fees typically charged to subscriber broker-dealers. The NASD, while not opposing such fees, stated that the Commission should reconsider the benchmark for an alternative trading system's fees, because it believed that for many alternative trading systems, non-subscriber orders were of primary importance. Because of this, the NASD stated that any fees should be set at the low end of the threshold, rather than at the level that a ''substantial proportion'' of an alternative trading system's broker-dealer customers were paying. The NASD supported permitting SROs to regulate fees, so that such issues could be discussed at the SRO level. The NASD also recommended that the Commission discuss ''the practical issues related to billing disputes and refusals to trade,'' because billing disputes have led to locked and crossed markets.[230] Finally, the NASD asked the Commission to address the best execution obligations of market participants when a fee is not included in the publicly displayed price of an order. A broker-dealer's duty of best execution requires it to seek the most favorable terms reasonably available under the circumstances for a customer's transaction. While price is the predominant element of best execution, the traditional non-price factors of executions should also be considered.[231]

Instinet commented that market forces should determine the appropriate fees that broker-dealers can charge for their services. Consequently, Instinet opposed any proposal to limit (or eliminate entirely) access fees charged by a broker-dealer subject to Regulation ATS if the rules of the national securities exchange or association to which the broker-dealer is linked limits (or prohibits) such fees. The Commission will, of course, review any proposed SRO rules relating to access fees. To be approved by the Commission, any such rules must be necessary to maintain consistency within the SRO's market, as well as being designed to promote just and equitable principles of trade, to promote fair competition, to facilitate transactions in securities, and, in general, to protect investors and the public interest.[232] Instinet also stated,

[224] Rule 301(b)(4), 17 CFR 242.301(b)(4).

[225] *See* Order Handling Rules Adopting Release, *supra* note 177, at n.272.

[226] *See, e.g.,* NASD Rule 4623. Securities Exchange Act Release Nos. 38156 (Jan. 10, 1997), 62 FR 2415 (Jan. 16, 1997); 38008 (Dec. 2, 1996), 61 FR 64550 (Dec. 5, 1996).

[227] *See* ICI Letter at 3; Instinet Letter at 17–18; NASD Letter at 12; American Century Letter at 2; OptiMark Letter at 5. *See also* IBEX Letter at 11 (opposing allowing SROs to dictate a fee schedule for alternative trading systems, in which fees charged non-subscribers are lower than those charged subscribers), Ashton Letter at 6, n.7 (opposed to the idea that non-subscribers be linked through an SRO execution system only).

[228] *See* NYSE Letter at 7; CHX Letter at 8–10.

[229] SIA Letter at 17 (stating that fees imposed by alternative trading systems raised a number of procedural, structural and policy issues, and recommending that the Commission make these the subject of a separate release).

[230] NASD Letter at 12. *See also* ICI Letter at 3 (recommending that alternative trading systems be required to comply with any SRO rules limiting fees).

[231] *See* Order Handling Rules Adopting Release, *supra* note 177, at nn.347–65 and accompanying text; Division of Market Regulation, Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments App V (1994) (''Market 2000 Study'').

[232] While SRO proposed rule changes relating to fees imposed by the SRO are eligible to become effective upon filing under section 19(b)(3)(A)(ii) of

Continued

however, that it would urge the Commission to ensure that all public execution access fee requirements were handled in such a way that all orders integrated into the public quote stream were treated consistently, and so that all broker-dealers were able to set appropriate fees for the services they performed, subject to SRO rules.[233]

American Century stated that all market participants who posted bids and offers, not just alternative trading systems, should be permitted to charge fees. American Century recommended that participants who provide liquidity be permitted to charge a fee for that liquidity, and that those who took liquidity should pay fees.[234] OptiMark stated that the Commission should consider what economic incentive it would be creating by permitting alternative trading systems that register as broker-dealers to charge fees, but not permitting those that register as exchanges to do so.[235]

The Commission also requested comment on whether fees should be included in the price of an order quoted to the public, particularly once orders are quoted in decimals. In this regard, the NYSE and the Chicago Stock Exchange (''CHX'') stated that fees made it difficult to determine the true cost of executing an order and indicated that this would change if fees could be included in the quote.[236] As discussed above, when quotations in the national market system are reflected in decimals rather than fractions, the Commission will reconsider whether alternative trading systems should reflect any fees charged in their quote, and if so, whether they should be subject to SRO requirements.

(v) Amendment to Rule 11Ac1–1 Under the Exchange Act

The Commission also proposed an amendment to Rule 11Ac1–1 under the Exchange Act.[237] The amendment would expand the ECN Display Alternative to allow alternative trading systems that display orders and provide equal execution access to those orders under Rule 301(b)(3) of Regulation ATS to fulfill market makers' and specialists' obligations under the Quote Rule. Only two comment letters addressed the proposed amendment to the Quote Rule, both of which supported it.[238]

The Commission is adopting the amendment to the Quote Rule as proposed.[239] The Quote Rule currently requires all market makers and specialists to make publicly available any superior prices that it privately offers through ECNs. The ECN Display Alternative in the Quote Rule permits an ECN to fulfill these obligations on behalf of market makers and specialists using its system by submitting the ECN's best market maker or specialist priced quotation to an SRO for inclusion into the public quotation.[240] Today's amendment to the Quote Rule is intended to expand the ECN Display Alternative to allow alternative trading systems that display orders and provide equal execution access to those orders under Rule 301(b)(3) of proposed Regulation ATS to fulfill market makers' and specialists' obligations under the Quote Rule.

d. Fair Access

(i) Importance of Fair Access

The Exchange Act requires registered exchanges and national securities associations to consider the public interest in administering their markets and to establish rules designed to admit members fairly.[241] These requirements are intended to ensure that markets treat investors and other market participants fairly.[242] Alternative trading systems that choose to register as exchanges will be subject to these requirements. Under the current regulatory approach, however, there is no mechanism to prevent unfair denials or limitations of access by alternative trading systems or regulatory oversight of such denials or limitations of access. Access to alternative trading systems may not be critical 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 a significantly large percentage of the volume of trading, unfairly discriminatory actions hurt investors lacking access to the system.

Fair treatment by alternative trading systems of potential and current subscribers is particularly important when an alternative trading system captures a large percentage of trading volume in a security, because viable alternatives to trading on such a system are limited. Although the Commission is adopting rules to require alternative trading systems with significant trading volume to publicly display their best bid and offer and provide equal access to those orders,[243] direct participation in alternative trading systems offers benefits in addition to execution against the best bid and offer. For example, participants can enter limit orders into the system, rather than just execute against existing orders on a fill-or-kill basis. Participants in an alternative trading system can view all orders, not just the best bid or offer, which provides important information about the depth of interest in a particular security. Participants also have access to unique features of alternative trading systems, such as ''negotiation'' features, whereby one participant can send orders to another participant proposing specific terms to a trade, without either participant revealing its identity. Some alternative trading systems also allow participants to enter ''reserve'' orders which hide the full size of an order from view. Because of these advantages to participants in an alternative trading system, access to the best bid and offer through an SRO is an incomplete substitute. Therefore, the rules the Commission is adopting today require most alternative trading systems that are registered as broker-dealers and that have a significant percentage of overall trading volume in a particular security to comply with fair access standards, as described in more detail below.[244]

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the Exchange Act, and Rule 19b–4(e)(2) of the Exchange Act, the Commission continues to require SROs to file proposed rule changes regarding fees applicable to non-members or non-participants under section 19(b)(2) for full notice and comment. *See* Securities Exchange Act Release No. 35123 (Dec. 20, 1994), 59 FR 66692 (Dec. 28, 1994). Thus, a proposed SRO rule relating to fees that alternative trading systems charge would not be eligible to become effective upon filing.

[233] Instinet Letter at 17–18 (also stating that the SRO to which an alternative trading system belonged should not be authorized to set fees).

[234] American Century Letter at 2 (also agreeing that decimalization will provide a more valid framework for this pricing structure). *See also* ICI Letter at 3, n.8 (stating that market makers should be able to assess liquidity fees when their quotes are ''hit'').

[235] OptiMark Letter at 4–5.

[236] NYSE Letter at 7 (stating that such fees could make it impossible for market participants to determine the true cost of executing orders, but indicating that if fees were included in the disseminated quotation that would be acceptable); CHX Letter at 8–10 (alternatively, CHX suggested the Commission allow firms to ignore alternative trading system quotes at the NBBO if the next price available after payment of the access fee is worse than the next best available execution). *But see* IBEX Letter at 11 (opposing including fees in the public quote).

[237] *See supra* note 213.

[238] *See* Ashton Letter at 6 (suggesting that the Commission consider amending the Quote Rule to require all exchanges, over-the-counter dealers, and alternative trading systems to disseminate to the public quote the actual size behind the best bid and offer quotations). *See also* IBEX Letter at 11.

[239] Rule 11Ac1–1(c)(5)(ii)(A) and (B), 17 CFR 11Ac1–1(c)(5)(ii)(A) and (B).

[240] *See supra* notes 177–183 and accompanying text.

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

[242] ''Restraints 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).

[243] *See supra* Section IV.A.2.c.(ii).

[244] Rule 301(b)(5), 17 CFR 242.301(b)(5). Alternative trading systems that derive their prices

(ii) Fair Access Requirement

The Commission is adopting Exchange Act Rule 301(b)(5) to ensure that qualified market participants have fair access to the nation's securities markets. As the Commission proposed, an alternative trading system registered as a broker-dealer and subject to Regulation ATS will be required to establish standards for access to its system and apply those standards fairly to all prospective subscribers, if the alternative trading system, during four of the preceding six months, accounts for twenty percent or more of the trading volume.[245] This twenty percent volume threshold will be applied on a security-by-security basis for equity securities.[246] Accordingly, if an alternative trading system accounted for twenty percent or more of the share volume in any equity security, it must comply with the fair access requirements in granting access to trading in that security.

For debt securities, the Commission proposed that if an alternative trading system accounted for twenty percent or more of the volume in any category of debt security, the alternative trading system would be subject to the fair access requirements in granting access to trading in securities in that category. The Commission solicited comment on the appropriate categories of debt securities. Specifically, the Commission asked whether categories such as mortgage and asset-backed securities, municipal securities, corporate debt securities, foreign corporate debt securities, and foreign sovereign debt securities would be appropriate. After considering the comments, the Commission is adopting rules that require alternative trading systems with twenty percent or more of the volume in municipal securities, investment grade corporate debt securities, and non-investment grade corporate debt securities to meet the fair access requirements with respect to that category. The Municipal Securities Rulemaking Board's transaction reporting plan now provides information on the aggregate trading in municipal securities.[247] The fair access requirement will be effective for alternative trading systems with twenty percent or more of the volume in municipal securities on April 21, 1999.

Because similar information for investment grade and non-investment grade corporate debt, however, is not currently available, the fair access requirements in Rule 301(b)(5)(D) and (E) will not be made effective until April 1, 2000 with the expectation that further information will be available at that time.[248] The Commission is deferring action on the fair access standards for alternative trading systems trading a substantial portion of the market in foreign corporate debt and foreign sovereign debt until such time as reliable data is available by which alternative trading systems may determine their relative portion of the market.

The Commission is excluding from the fair access requirement those alternative trading systems that match customer orders for securities with other customer orders, at prices for those same securities established outside such system.[249] Thus, regardless of their trading volume, systems that, for example, match customer orders prior to the market opening and then execute those orders at the opening price for the securities are not required to comply with the fair access requirement. In addition, systems that match unpriced orders at the mid-point of the bid and ask, or at a value weighted average or prices on another market are not subject to the fair access requirements. The Commission, however, would not consider an alternative trading system to be excluded from the fair access requirements in paragraph (b)(5) of Rule 301 if that system priced any security traded on that system using prices established outside such system for instruments other than the particular security being executed. Therefore, a system would not be excluded if it traded options or other derivatives based on prices established on the primary market for the underlying security.

Alternative trading systems subject to this fair access requirement must comply with the requirements in paragraph (b)(5)(ii) of Rule 302. Specifically, these alternative trading systems must establish standards for granting access to trading on their systems,[250] and maintain these standards in their records.[251] An alternative trading system must apply these standards fairly and is prohibited from unreasonably prohibiting or limiting any person with respect to trading in any equity securities, or in certain categories of debt securities, when that trading exceeds the twenty percent volume threshold. For example, the Commission will consider it a denial of access by an alternative trading system if the alternative trading system refuses to open an account for a customer, thereby denying that customer the use of its trading facilities.[252] In addition, if an alternative trading system grants, denies or limits access to trading to any person, the alternative trading system is required to keep records of each action, including the reasons for such action.[253] Each alternative trading system will also be required to provide a list of all grants, denials or limitations of access to the Commission on Form ATS–R each quarter. For each grant, denial or limitation of access, alternative trading systems must provide the name of the person, nature and effective date of the decision, and any other information that the alternative trading system deems relevant. For denials or limitations of access, alternative trading systems must provide information describing the reasons for the decision.[254] For example, if an applicant has a relevant disciplinary history, has insufficient financial resources, or refuses to agree to abide by the rules of the alternative trading system, an alternative trading

for securities from prices for those same securities on another market are not subject to this requirement.

[245] The Commission notes that this twenty percent volume threshold is based on current market conditions. If there is a change in these market conditions, or if the Commission believes that alternative trading systems with less than twenty percent of the trading volume are engaging in inappropriate exclusionary practices or in anticompetitive conduct, the Commission may revisit these fair access thresholds. The Commission intends to monitor the impact and effect of these fair access rules, as well as the practices of alternative trading systems, and will consider changing these rules if necessary to prevent anticompetitive behavior and ensure that qualified investors have access to significant sources of liquidity in the securities markets.

[246] The term "equity security" is defined in section 3(a)(11) of the Exchange Act, 15 U.S.C. 78c(a)(11) and Rule 3a1–1, 17 CFR 240.3a1–1. Options and limited partnerships are included within the definition of an equity security.

[247] *See supra* Section IV.A.1.d.

[248] *See supra* note 146 (discussing the April 1, 2000 effective date).

[249] Rule 301(b)(5)(iii), 17 CFR 242.301(b)(5)(iii).

[250] Several commenters agreed with the Commission that an alternative trading system should be required to establish standards for granting access to trading in its system. *See* IBEX Letter at 12; Ashton Letter at 6; SIA Letter at 4, 14.

[251] Rule 303(a)(1)(iii), 17 CFR 242.303(a)(1)(iii). The Commission expects an alternative trading system to maintain a record of its standards at each point in time. If the alternative trading system amends or modifies its access standards, the records kept should reflect historic standards, as well as current standards.

[252] Moreover, if an alternative trading system requires subscribers to open an account with another broker-dealer with which the alternative trading system has a clearing arrangement, the alternative trading system is responsible for ensuring that the clearing broker-dealer does not unfairly deny access to any person. Thus, the alternative trading system—as part of its agreement with the clearing firm—must ensure that the clearing firm establishes standards for customers opening an account and that notices are sent to any prospective customer denied an account.

[253] Rule 301(b)(5)(ii), 17 CFR 242.301(b)(5)(ii).

[254] Rule 301(b)(5)(ii)(D), 17 CFR 242.301(b)(5)(ii)(D).

system should include such reasons in its filing with the Commission. The Commission intends to enforce the fair access rules by reviewing these reports and investigating any possible violations of the rule.[255]

The fair access requirements the Commission is adopting today are based on the principle that qualified market participants should have fair access to the nation's securities markets. Alternative trading systems remain free to have reasonable standards for access. Such standards should act to prohibit *unreasonably* discriminatory denials of access. A denial of access is reasonable if it is based on objective standards. For example, an alternative trading system may establish minimum capital or credit requirements for subscribers.[256] Similarly, an alternative trading system may reasonably deny access to investors based on a relevant, unfavorable disciplinary history. In addition, an alternative trading system could allow institutional subscribers the option of refusing to trade with broker-dealer subscribers, as long as the alternative trading system grants this option to subscribers based on objective and fairly applied standards. Provided that these or other standards were applied consistently to all subscribers, an alternative trading system would be considered to be granting and denying access fairly. A denial of access might be unreasonable, however, if it were discriminatorily applied among similar subscribers or if it were based solely on the trading strategy of a potential participant.

The proposed rules included a right of appeal to the Commission of any denial or limitation of access, as well as a requirement that an alternative trading system notify a person denied or limited access of their right of appeal. The Commission has decided not to adopt these provisions. The Commission is concerned that such a right of appeal would prove burdensome to the alternative trading system, the party denied or limited access, and Commission staff. In addition, commenters generally approved of the goals of fair access, but were not supportive of providing a right of appeal to the Commission.

(iii) Response to Comments

Commenters who addressed the proposed fair access requirement generally agreed with the Commission's goal of ensuring that alternative trading systems with significant volume establish criteria for fairly determining access.[257] Two commenters, for various reasons, did not believe that a requirement ensuring fair access by alternative trading systems was necessary.[258] Another commenter argued that alternative trading systems that do not display to subscribers should not be required to grant access to non-subscribers.[259]

The Commission solicited comment on the level of volume at which fair access requirements should be applied. Of those commenters who addressed the Commission's proposed threshold of twenty percent, three believed that the level should be raised,[260] two believed it should be lowered,[261] and one believed twenty percent was appropriate.[262] One of the commenters that recommended the Commission lower the threshold from twenty percent stated that fair access should be ensured regardless of volume, because volume levels are subject to variation over time, and because unfair denials of access by even small systems could make access to quotes in illiquid securities particularly difficult.[263]

The Commission agrees with this commenter that fair access is an important element of fair markets. Nevertheless, in balancing the need for fair access with the costs that may be associated with such a requirement, the Commission believes that a twenty percent threshold strikes the right balance. As discussed above, the rules the Commission is adopting today require that an alternative trading system subject to Regulation ATS comply with fair access requirements if, during at least four of the preceding six months, the alternative trading system accounted for twenty percent or more of the average daily share volume in any equity security or certain categories of debt.[264]

The Commission also requested comment on whether persons denied access to an alternative trading system should have the right to appeal this action to the Commission, what form the appeal should take, and what the appropriate standard for Commission review should be. Five comment letters directly addressed the issue of appeal to the Commission of denials of access.

One commenter favored a right to appeal a denial of access, but stated that the appeal process should begin at the SRO level.[265] This commenter stated that appeal to the Commission should occur only if the SRO fails to resolve the dispute. Another commenter, similarly, stated that it believes denials or limitations of access should be handled through current SRO complaint and disciplinary procedures, rather than through procedures used to appeal SRO determinations to the Commission. This commenter stated that it believes formal Commission procedures could blur the allocation of supervisory authority over broker-dealers and could lead to duplicative or inconsistent review proceedings in some cases. Moreover, this commenter was concerned that a

[255] Rule 301(b)(9), 17 CFR 242.301(b)(9); Form ATS–R, 17 CFR 249.638.

[256] For example, the Commission has recognized that the creditworthiness of a counterparty is a legitimate concern of market participants. *See* Letter from Richard R. Lindsey, Director, Division of Market Regulation, SEC, to Richard Grasso, Chairman and Chief Executive Officer, NYSE, dated Nov. 22, 1996 at 17. The Commission also requested comment on what might be appropriate reasons for an alternative trading system to deny market participants access. Most commenters also stated that objective standards, such as creditworthiness, would be appropriate, provided that these standards were applied in a non-discriminatory manner. *See* IBEX Letter at 12 (stating that credit-worthiness would be the most significant standard); ICI Letter at 4 (requesting that the Commission clarify that the standards for access can take into account factors that are relevant to credit or other forms of counterparty risk); SIA Letter at 14 (recommending that the Commission allow alternative trading systems to limit access to any category of its choosing, provided that the standands are not applied in a discriminatory manner, and stating that an alternative trading system should be permitted to select its standards, publish them, and apply them as stated in a non-discriminatory manner); TBMA Letter at 26 (requesting that the Commission clarify that an alternative trading system would still be allowed to set standards describing the customers with whom it wishes to do business, provided its standards are applied in a non-discriminatory manner). *See also* OptiMark Letter at 4, n.8 (stating that non-subscribers who wished to become subscribers should not be ''unreasonably denied'').

[257] *See, e.g.*, IBEX Letter at 12 (stating that reasonable credit or capital requirements or past bad faith dealings should be the only basis for denying access); Ashton Letter at 6 (arguing that alternative trading systems should be required to provide equivalent access through nondiscriminatory system fees).

[258] *See* TBMA Letter at 26 (stating that it would support a fair access requirement for exchanges, but not for alternative trading systems); ICI Letter at 4 (stating that it was not aware of any material barriers to entry to the existing ECNs, and so did not believe that the fair access requirement was necessary).

[259] OptiMark Letter at 4.

[260] *See* TBMA Letter at 22–23 (recommending that the threshold level be raised to thirty-five percent to avoid capturing insignificant market participants, particularly in regard to the bond market); SIA Letter at 3–4 (recommending that the threshold level be raised to forty percent); ICI Letter at 4 (recommending raising the threshold level to fifty percent).

[261] *See* IBEX Letter at 12 (recommending that the threshold level be lowered to ten percent); American Century Letter at 3.

[262] NASD Letter at 12 (stating that twenty percent is an appropriate level).

[263] American Century Letter at 3.

[264] Rule 301(b)(5)(i), 17 CFR 242.301(b)(5)(i).

[265] IBEX Letter at 13. *See also* ICI Letter at 4 (stating that the Commission should not provide a right to appeal denial of access, but that complaints should be handled as any other complaint against broker-dealers were handled: through the appropriate SRO or the Commission).

right to appeal to the Commission could lead to the frequent filing of frivolous or vexatious complaints against the broker-dealer, thereby impeding its ability to screen out potentially unqualified customers.[266] As discussed above, the Commission has decided not to adopt the proposed right of appeal to the Commission.

One commenter opposed a right to appeal denial of access, on the basis that there was no need for it. If, however, the Commission did implement its proposal to provide those denied access with the right to appeal to the Commission, this commenter recommended that the Commission ensure that this process did not become a means to dictate with whom a proprietary system may contract and that the allowable relief not be so expansive as to allow the Commission to alter the alternative trading system's published access standards.[267]

e. Capacity, Integrity, and Security Standards

As discussed in the Proposing Release,[268] in November 1989 and May 1991, the Commission published two policy statements regarding the use of technology in the securities markets.[269] These policy statements established the automation review program and called for the SROs to establish, on a voluntary basis, comprehensive planning, testing, and assessment programs to determine systems' capacity and vulnerability. The Commission recommended that SROs: (1) establish current and future capacity estimates; (2) conduct capacity stress tests; and (3) obtain annual independent assessments of systems to determine whether they can perform adequately.[270] In addition, the Commission staff conducts oversight reviews of the SROs' systems operations. All SROs currently participate in the Commission's automation review program, which has been a significant force in stimulating the SROs to upgrade their systems technology.[271]

The automation review program was established because of ''the impact that systems failures have on public investors, broker-dealer risk exposure, and market efficiency.'' [272] While this program did not directly apply to alternative trading systems, the Commission noted that all broker-dealers should engage in systems testing and use the policy statement as a guideline.[273] Because some alternative trading systems now account for a significant share of trading in the U.S. securities markets, failures of their automated systems have as much of a potential to disrupt the securities markets as failures of SROs' automated systems. For this reason, the Commission proposed to require alternative trading systems with significant volume to meet certain systems capacity, integrity, and security standards.[274] The proposed requirements were similar to those standards SROs currently follow under the automation review program.

(i) Application of Capacity, Integrity, and Security Standards

The Commission is adopting Exchange Act Rule 301(b)(6) to reduce the likelihood that alternative trading systems that play a significant role in our national market system will disrupt the securities markets due to failures of their automated systems. This rule requires alternative trading systems trading twenty percent or more of the volume in any equity security or in certain categories of debt securities [275] to comply with standards regarding the capacity, integrity, and security of their automated systems. As for the fair access requirements discussed above, the volume thresholds are on a security-by-security basis for equity securities. Accordingly, if any one equity security traded on an alternative trading system accounts for more than twenty percent of the total share volume in that security during four of the preceding six months, the alternative trading system is required to meet the capacity, integrity, and security requirements for that security, although in practice this may cause compliance with the standards for all securities traded in that system. With respect to debt securities, an alternative trading system is required to meet the systems capacity, integrity, and security standards if it trades twenty percent or more of the volume during four of the preceding six months in any of the following categories: municipal securities, non-investment grade corporate debt, and investment grade corporate debt.[276]

The Municipal Securities Rulemaking Board's transaction reporting plan now provides information on the aggregate trading in municipal securities.[277] Because similar information for investment grade and non-investment grade corporate debt, however, is not currently available, the system capacity, integrity, and security requirements in Rule 301(b)(6)(D) and (E) will not be made effective until April 1, 2000.[278] The Commission is deferring action on the system reliability standards for alternative trading systems trading a substantial portion of the market in foreign corporate debt and foreign

[266] Instinet Letter at 19.

[267] SIA Letter at 14–15. *See also* TBMA Letter at 26.

[268] See Proposing Release, *supra* note 3, at Section III.A.2.e.

[269] Securities Exchange Act Release No. 27445 (Nov. 16, 1989), 54 FR 48704 (''ARP I''); Securities Exchange Act Release No. 29185 (May 9, 1991), 56 FR 22489 (''ARP II''). ARP I and ARP II were published in response to operational difficulties experienced by SRO automated systems during the October 1987 market break. These releases predicted future capacity requirements, emphasized the need to maintain accurate trade and quote information, and discussed the degree to which computer automation has become, and is likely to increase as, an integral part of securities trading.

[270] ARP II, *supra* note 269, set forth guidance concerning the nature of these independent reviews.

[271] The Commission notes that the United States General Accounting Office (''GAO'') has conducted several studies on the subject of computer systems and their role in the financial markets. Generally, the GAO has recommended that the Commission take steps to improve systems capacity, integrity, and security, *See* GAO, Stronger System Controls and Oversight Needed to Prevent NASD Computer Outage (Dec. 1994) (regarding Nasdaq system outages); GAO, Stock Markets: Information Vendors Need SEC Oversight to Control Automation Risks (Jan. 1992) (regarding risk assessments of automated operations of stock market information dissemination vendors); GAO, Computer Security Controls at Five Stock Exchanges Ned Strengthening (Aug. 1991) (regarding systems related risks at stock markets); GAO, Active Oversight of Market Automation by SEC and CFTC Needed (Apr. 1991) (regarding automation risks of the securities and futures markets); GAO, Tighter Computer Security Needed (Jan. 1990) (regarding the Common Message Switch System and the Intermarket Trading System operated by the Securities Industry Automation Corporation and the Nasdaq system operated by the NASD).

[272] ARP I, *supra* note 269, 54 FR at 48705; ARP II, *supra* note 269, 56 FR at 22490.

[273] *See* ARP I, *supra* note 269, 54 FR at 48706, at n.17; ARP II, *supra* note 269, 56 FR at 22493, at n.15.

[274] With regards to system capacity, integrity, and security standards, the Commission notes that during the past year, Instinet, Island, Bloomberg, and Archipelago (operated by Terra Nova) have all experienced system outages due to problems with their automated systems. On a number of occasions, ECNs have had to stop disseminating market maker quotations in order to keep from closing altogether, including during the market decline of October 1997 when one significant ECN withdrew its quotes from Nasdaq because of lack of capacity. Similarly, a major interdealer broker in non-exempt securities experienced serious capacity problems in processing the large number of transactions in October 1997 and had to close down temporarily. As a result, the Commission believes that the volume thresholds discussed above are necessary to ensure that trading systems have developed systems capacity, integrity, and security standards that are adequate to prevent such system outages.

[275] Rule 301(b)(6) applies to the same categories of debt securities as Rule 301(b)(5), discussed *supra* note 248 and accompanying text. Specifically, the categories are investment grade corporate debt securities, non-investment grade corporate debt securities, and municipal securities. 17 CFR 242.301(b)(6).

[276] *See supra* Section IV.A.2.d.

[277] *See supra* Section IV.A.1.e.

[278] *See supra* note 146 (discussing the April 1, 2000 effective date).

sovereign debt until such time as reliable data is available by which alternative trading systems may determine their relative portion of the market.

As for the fair access requirement, the Commission is excluding from the systems capacity, integrity, and security requirement those alternative trading systems that match customer orders for securities with other customer orders, at prices for those same securities established outside such system.[279] Thus, regardless of their trading volume, systems that, for example, match customer orders prior to the market opening and then execute those orders at the opening price for the securities are not required to comply with these systems reliability requirements. In addition, systems that match unpriced orders at the mid-point of the bid and ask, or at a value weighted average or prices on another market are not subject to the fair access requirements. The Commission, however, would not consider an alternative trading system to be excluded from the requirements in paragraph (b)(6) of Rule 301 if that system priced any security traded on that system using prices established outside such system for instruments other than the particular security being executed. Therefore, a system would not be excluded if it traded options or other derivatives based on prices established on the primary market for the underlying security.

An alternative trading system that meets these volume thresholds will be required to: (1) Establish reasonable current and future capacity estimates; (2) conduct periodic capacity stress tests of critical systems to determine such system's ability to process transactions in an accurate, timely, and efficient manner; (3) develop and implement reasonable procedures to monitor system development and testing methodology; (4) review the vulnerability of its systems and data center computer operations to internal and external threats, physical hazards, and natural disasters; and (5) establish adequate contingency and disaster recovery plans. An alternative trading system is required to meet these proposed standards with respect to all its systems that support order entry, order handling, execution, order routing, transaction reporting, and trade comparison in the particular security.[280] In addition, alternative trading systems subject to this provision are required to notify the Commission staff of material systems outages and material systems changes.[281] This information will enable Commission staff to better understand the operation of the alternative trading system and to identify potential problems and trends that may require attention.

Finally, under Regulation ATS, alternative trading systems that meet the volume levels set forth above are required to perform an annual independent review of the systems that support order entry, order handling, execution, order routing, transaction reporting and trade comparison.[282] As discussed in greater detail in the Commission's May 1991 Policy Statement,[283] an independent review should be performed by competent, independent audit personnel following established audit procedures and standards. If internal auditors are used by an alternative trading system to complete the review, these auditors should comply with the standards of the Institute of Internal Auditors and the Electronic Data Processing Auditors Association (''EDPAA''). If external auditors are used, they should comply with the standards of the American Institute of Certified Public Accountants (''AICPA'') and the EDPAA.

(ii) Response to Comments

In the Proposing Release,[284] the Commission requested comment on its proposal to require significant alternative trading systems to satisfy systems capacity, integrity, and security standards. While most commenters did not specifically address this proposed requirement, those that did comment generally supported it.[285]

The Commission asked whether the twenty percent volume threshold proposed was appropriate. In this regard, the NASD supported the twenty percent proposed volume threshold.[286] Two other commenters, however, suggested that the Commission's proposed threshold was too low.[287] Specifically, one of these commenters argued that the Commission should raise the volume threshold from twenty percent to thirty-five percent to avoid including debt market participants with no significant role in price discovery. This commenter stated that, given the decentralized and fungible nature of the debt markets, an alternative trading system trading debt securities would need twenty percent or more of the relevant market to materially affect the markets in the manner in which the Commission is concerned.[288] Another commenter, similarly, suggested that these requirements not be imposed until an alternative trading system had forty percent of the market in any security. In addition, before the capacity, integrity, and security requirements are triggered, this commenter recommended that any security (or category of debt) in which the alternative trading system reached forty percent of aggregate daily volume also represent twenty percent or more of the alternative trading system's overall trading activity.[289] One commenter, however, argued that the Commission's proposed threshold was too high, and that it should instead be applicable to alternative trading systems with one percent of the consolidated volume in a category of equity securities, such as listed or Nasdaq securities.[290]

In addition, while the ICI stated its belief that competitive pressures will generally suffice to ensure that alternative trading systems have the capacity to execute trades in a timely manner, the ICI also stated that it would not oppose such requirements as long as the Commission applied them in a flexible manner and did not dictate how alternative trading systems structure their operations.[291]

The Commission believes that alternative trading systems that have a significant role in the marketplace should be able to handle reasonably foreseeable volume surges and be prepared for reasonably anticipated future volume increases. As a result, the Commission continues to believe that the volume thresholds above are appropriate. Investors and other market participants increasingly rely on alternative trading systems to buy and sell securities. The ability of these markets to meet the demands of market participants is directly related to the reliability of their automated systems. The Commission realizes that alternative trading systems have significant business incentives to ensure that their systems have adequate capacity so that participants' orders do not experience unnecessary delays. The

[279] Rule 301(b)(6)(iii), 17 CFR 242.301(b)(6)(iii).

[280] Rule 301(b)(6)(ii)(A)–(F), 17 CFR 242.301(b)(6)(ii)(A)–(F).

[281] Rule 301(b)(6)(ii)(G), 17 CFR 242.301(b)(6)(ii)(G).

[282] Rule 301(b)(6), 17 CFR 242.301(b)(6). Regulation ATS also requires alternative trading systems to preserve documentation relating to their efforts to meet the requirements of this rule. *See* Rule 303(a)(1)(iv), 17 CFR 242.303(a)(iv).

[283] *See* ARP II, *supra* note 269.

[284] *See* Proposing Release, *supra* note 3, at Section III.A.2.e.

[285] *See* Ashton Letter at 5; NASD Letter at 11; TBMA Letter at 27 (but only if a system plays some role in price discovery such as a traditional exchange does).

[286] NASD Letter at 11.

[287] *See* TBMA Letter at 22–23; SIA Letter at 13.

[288] *See* TBMA Letter at 22–23.

[289] SIA Letter at 13.

[290] Ashton Letter at 5.

[291] ICI Letter at 4.

systems capacity, integrity, and security rules are intended as a back-up to ensure that alternative trading systems that have a significant role in the market maintain sufficient systems and procedures to minimize the effects of potential systems problems in the secondary markets.

f. Examination, Inspection, and Investigations of Subscribers

The Commission proposed that an alternative trading system be required to cooperate with the Commission's or an SRO's inspection, examination, or investigation of the alternative trading system or any of the alternative trading system's subscribers. Presently, the Commission has the authority to inspect and examine any member of any national securities exchange or any national securities association directly. This is because all such members are broker-dealers. Alternative trading systems, however, also could have certain other subscribers, such as institutions or individuals, to which the Commission's inspection authority does not extend. Because alternative trading systems could be used by subscribers to manipulate the market in a security,[292] it is imperative that alternative trading systems cooperate in all inspections, examinations, and investigations. Although neither the Commission nor the SROs has the authority to directly inspect non-broker-dealer subscribers of alternative trading systems, any relevant trading information involving such subscribers would be maintained by the alternative trading system under its recordkeeping requirements, and would be required to be made available upon request to its SRO or the Commission. Under the rules the Commission is adopting today, an alternative trading system's exemption from exchange registration is conditioned on it cooperating with the Commission's or an SRO's inspection, examination, or investigation of the alternative trading system or any of its subscribers.[293]

g. Recordkeeping

The Commission proposed that alternative trading systems be required to keep certain records. The Commission is adopting these recordkeeping requirements as proposed. As adopted, Regulation ATS requires alternative trading systems to make and keep the records necessary to create a meaningful audit trail.[294] Specifically, alternative trading systems are required to maintain daily summaries of trading and time-sequenced records of order information, including the date and time the order was received, the date, time, and price at which the order was executed, and the identity of the parties to the transaction. In addition, alternative trading systems are required to maintain a record of subscribers and any affiliations between subscribers and the alternative trading system.[295] While some of the information that is required by the Regulation ATS will also be required under the NASD's Order Audit Trail System (''OATS''),[296] OATS is an NASD rule and does not cover all securities traded through alternative trading systems.

These recordkeeping requirements also require alternative trading systems to keep records of all notices provided to subscribers, including notices addressing hours of operation, system malfunctions, changes to system procedures, and instructions pertaining to access to the alternative trading system.[297] In addition, alternative trading systems are required to keep documents made (if any) in the course of complying with the systems capacity, integrity, and security standards in Rule 301(b)(6). These documents include all reports to an alternative trading system's senior management, and records concerning current and future capacity estimates, the results of any stress tests conducted, procedures used to evaluate the anticipated impact of new systems when integrated with existing systems, and records relating to arrangements made with a service bureau to operate any automated systems. These records will allow the Commission to examine whether alternative trading systems are complying with the requirements under Proposed Rule 301(b)(6). Finally, an alternative trading system subject to the fair access requirements discussed above is required to keep a record of its access standards.[298]

Regulation ATS requires that these records be kept for at least three years, the first two years in an easily accessible place. Some records, such as partnership articles and articles of incorporation, must be kept for the life of the alternative trading system.[299] Alternative trading systems are permitted to keep records in any form broker-dealers are permitted to keep records under Rule 17a–4(f) under the Exchange Act.[300]

The Commission recognizes that alternative trading systems subject to Regulation ATS are subject to the recordkeeping requirements for broker-dealers under Rules 17a–3 and 17a–4 of the Exchange Act,[301] which may require that some of the same records be made and kept. Regulation ATS does not require an alternative trading system to duplicate trading records maintained in the course of its normal recordkeeping operations, provided that the alternative trading system can sort and retrieve system records separately upon request. In addition, as broker-dealers are currently permitted to do,[302] Regulation ATS permits an alternative trading system to retain a service bureau, depository, or other recordkeeping service to maintain required records on behalf of the alternative trading system as long as the designated party agrees to make the records available to the Commission upon request.[303]

The Commission solicited comment on these recordkeeping requirements. In general, the comments received on this provision were mixed. Two commenters supported requiring alternative trading systems to keep the records necessary to create a meaningful audit trail.[304] On the other hand, one commenter expressed concern that the Commission's proposal would impose the same recordkeeping requirements on both small and large alternative trading systems. Instead, this commenter argued that smaller systems should be subject to none or only minimal regulation generally, and that even the recordkeeping requirements may serve as a significant barrier to market entry and innovation.[305]

The Commission believes that, for the most part, the records it is requiring alternative trading systems to make and keep are records that alternative trading

[292] The Commission is aware of several incidents involving the manipulation of quotations through alternative trading systems. The participants who engaged in the manipulation were able to profit as a result. *See supra* note 5.

[293] Rule 301(b)(7), 17 CFR 242.301(b)(7).

[294] Rule 301(b)(8), 17 CFR 242.301(b)(8).

[295] Rule 302(a), 17 CFR 242.302(a).

[296] Securities Exchange Act Release No. 39729 (Mar. 6, 1998), 63 FR 12559 (Mar. 13, 1998).

[297] Rule 303(a)(1)(ii), 17 CFR 242.303(a)(1)(ii).

[298] *See supra* Section IV.A.2.d.

[299] Rule 303(a)(2), 17 CFR 242.303(a)(2).

[300] Rule 303(b), 17 CFR 242.303(b). Rule 17a–4(f) provides for the maintenance of records on microfilm, microfiche, or electronic storage media. The Commission recognizes that alternative trading systems may generate much of the information in electronic form and generally may wish to keep records in electronic format. 17 CFR 240.17a–4(f).

[301] 17 CFR 240.17a–3 and 17 CFR 240.17a–4.

[302] 17 CFR 240.17a–4(i).

[303] Rule 303(d), 17 CFR 242.303(d).

[304] *See* ICI Letter at 4; Ashton Letter p. 5.

[305] TBMA Letter at 16. TBMA suggested exempting alternative trading systems that do not exceed fifteen percent of the relevant market from Regulation ATS and, thus, from the recordkeeping requirements. TBMA stated that the additional recordkeeping requirements would not provide the Commission significant new information beyond what is currently included within broker-dealer recordkeeping requirements. *Id*.

systems would otherwise keep as part of their business, and that therefore these requirements will not place undue burdens upon alternative trading systems. In addition, the Commission believes that the highly automated nature of alternative trading systems will help facilitate the construction and maintenance of an audit trail. The Commission also believes that these recordkeeping requirements are necessary to permit surveillance and examination to help assure fair and orderly markets.

One commenter recommended that an alternative trading system's records and reports only be available to an alternative trading system's SRO on a confidential, need-to-know basis.[306] Regulation ATS provides that alternative trading systems are required to permit inspections and examinations of their records by the Commission or the SRO of which they are a member.[307] The Commission noted in the Proposing Release that, while potential conflicts of interest in overseeing alternative trading systems may arise, the Commission believes these conflicts can be managed using the Commission's oversight authority. The Commission also recognized that some market participants might be concerned that SROs could abuse their regulatory authority, but noted that the Commission has oversight responsibility over SROs to prevent such activity. In this regard, the Commission expects SROs to carefully assess, and revise where necessary, their internal policies and procedures for protecting the confidentiality of sensitive information obtained in the course of fulfilling their SRO regulatory responsibilities.[308]

Finally, one commenter asked that the Commission consider the relationship of any new recordkeeping requirements with applicable SRO recordkeeping rules, such as the NASD's recently-adopted OATS.[309] The Commission notes that, while some of the information required by Regulation ATS will also be required by SRO rules, such rules do not have the same scope and are not designed to meet the same goals. Moreover, SRO rules may not apply to all alternative trading system activities. In addition, the Commission is only requiring that records of certain information be made and kept, but is not dictating in what form those records are maintained. This means that alternative trading systems have flexibility in how they comply with SRO and Commission rules. Further, if duplicative rules exist, the same alternative trading system practices should serve to satisfy both sets of rules.

h. Reporting and Form ATS–R

The Commission proposed that alternative trading systems be required to periodically report certain information about their activities. The Commission is adopting these requirements as proposed. Regulation ATS, as adopted, requires alternative trading systems to file with the Commission transaction reports within 30 calendar days of the end of each calendar quarter on Form ATS–R.[310] Specifically, Form ATS–R requires alternative trading systems to report total volume in terms of number of units traded and dollar value for the following categories of securities: (1) Listed equity securities, (2) Nasdaq NM securities, (3) Nasdaq SmallCap securities, (4) equity securities that are eligible for resale pursuant to Rule 144A under the Securities Act of 1933,[311] (5) penny stocks, (6) equity securities not included in (1)–(5), (7) rights and warrants, (8) listed options, and (9) unlisted options. In addition, alternative trading systems are required to report the total settlement value in U.S. dollars for: (1) Corporate debt securities (separately for investment grade and non-investment grade), (2) government securities, (3) municipal securities, (4) mortgage related securities, and (5) debt securities not included in (1)–(4). Alternative trading systems are required to file after-hours trading information in listed equity, Nasdaq NM, and Nasdaq Small Cap securities, as well as listed options. This information will permit the Commission to monitor the trading on alternative trading systems. In addition, alternative trading systems subject to the fair access requirements in Rule 301(b)(5), as discussed above,[312] must report quarterly on Form ATS–R the persons to whom they grant, deny or limit access to the alternative trading systems, as well as the date of the action, the effective date of the action, and the nature of the denials or limitations of access.

Because Rule 17a–23[313] will be eliminated, data filed by alternative trading systems on Form ATS–R will replace the information currently filed on Form 17A–23 by broker-dealers operating trading systems. Unlike Part II of Form 17A–23, Form ATS provides a template on which alternative trading systems are required to file the requested information with the Commission. This template should allow alternative trading systems to file the required information in a more uniform format that will be more useful to the Commission. For example, the Commission anticipates using this information to develop examination modules for the inspection of alternative trading systems. The Commission also expects to use the information to further understand the effect of alternative trading systems on the securities markets.

Another difference between Part II of Form 17A–23 and Form ATS is that Form ATS requires alternative trading systems to provide information about the volume of particular types of securities that are not listed on an exchange or traded on Nasdaq. These new reporting requirements on Form ATS–R will improve the quality of the data that the Commission has available to consider the effectiveness of its regulatory program. Due to the highly automated nature of alternative trading system operations and the experiences with Rule 17a–23, the Commission does not anticipate that gathering and submitting the data required on Form ATS–R will be overly burdensome. Alternative trading systems are also required to make reports on Form ATS–R available to surveillance personnel of any SRO of which they are a member.[314]

The Commission solicited comment on the transaction reporting requirements and Form ATS–R. In particular, the Commission solicited comment on the frequency and scope of transaction reporting requirements

[306] Ashton Letter at 5. Ashton pointed out that, because SRO-sponsored systems compete directly with alternative trading systems, SROs should not be able to gain confidential information through the regulatory reporting process. *Id.*

[307] Rule 301(b)(7), 17 CFR 242.301(b)(7).

[308] *See also* Securities Exchange Act Release No. 35124 (Dec. 20, 1994), 59 FR 66702 (Dec. 28, 1994) (addressing similar concerns in the context of Rule 17a–23).

[309] Instinet Letter at 20–21. Instinet stated that the Commission should work with SROs to establish recordkeeping requirements that minimize duplication and inconsistency as well as providing alternative trading systems substantial flexibility in structuring their recordkeeping operations. *Id.*

[310] Rule 301(b)(9), 17 CFR 242.301(b)(9).

[311] 17 CFR 230.144A. Brokers and others who use alternative trading systems to trade Rule 144A eligible securities and other types of restricted securities should ensure those systems are structured to permit the traders' compliance with their obligations under Rule 144A and under the Securities Act of 1933.

[312] *See supra* notes 253–255 and accompanying text.

[313] *See infra* Section V. 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 information 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).

[314] Rule 301(b)(2)(vii), 17 CFR 242.301(b)(2).

proposed in Regulation ATS. No commenters responded to the Commission's request for comments on the information requested on Form ATS–R.

The Commission received no comments opposing the proposed reporting requirements. Several commenters generally supported the Commission's proposal to require alternative trading systems to report their trading volume.[315] One commenter, however, commented that the Commission should require monthly reporting instead of the proposed quarterly reporting requirement.[316] The Commission believes that quarterly reporting under Regulation ATS, as adopted, will provide sufficiently frequent reporting to the Commission. In view of the Commission's desire to minimize respondent reporting burdens, the Commission believes that more frequent reporting would not provide materially improved investor protections. Based on the Commission's experience with reporting requirements under Rule 17a–23, the Commission believes that a quarterly filing requirement of Form ATS–R is appropriate.

The Commission also requested comment on the appropriateness of permitting Form ATS–R to be filed electronically. Two commenters thought that if the Commission were to accept filings electronically it would be faster and less expensive.[317]

Finally, one commenter recommended that an alternative trading system's records and reports only be available to an alternative trading system's SRO on a confidential, need-to-know basis.[318] As described above with respect to the recordkeeping requirements,[319] the Commission believes that the separation between the market and regulatory functions of an SRO and the Commission's oversight of SROs are sufficient to maintain an appropriate level of confidentiality of, and access to, alternative trading system information. The Commission believes that SROs need to have access to relevant information in order to carry out their oversight responsibilities. The Commission expects that SROs will maintain and enforce appropriate internal policies and procedures to protect against misuse of such information.

i. Procedures To Ensure Confidential Treatment of Trading Information

The Commission requested comment on proposed Rule 301(b)(10) requiring alternative trading systems to have in place safeguards and procedures to protect trading information and to separate alternative trading system functions from other broker-dealer functions, including proprietary and customer trading. The Commission did not propose specific procedures, but encouraged commenters to express their views on the requirements, including how to prevent the misuse by alternative trading systems of confidential customer information. The Commission received only three comment letters which directly addressed this issue. All supported the Commission's proposal, although one also requested clarification on what the confidentiality provisions covered.[320]

The rules the Commission is adopting today require alternative trading systems to have in place safeguards and procedures to protect trading information and to separate alternative trading system functions from other broker-dealer functions, including proprietary and customer trading. The Commission believes that the sensitive nature of the trading information subscribers send to alternative trading systems requires such systems to take certain steps to ensure the confidentiality of such information. For example, unless subscribers consent, registered representatives of alternative trading systems should not disclose information regarding trading activities of such subscribers to other subscribers that could not be ascertained from viewing the alternative trading system's screens directly at the time the information is conveyed.

The Commission's concern regarding confidentiality grew out of its inspections of some ECNs, during which the Commission staff found that some of the broker-dealers operating ECNs used the same personnel to operate the ECN as they did for more traditional broker-dealer activities, such as handling customer orders that were received by telephone. These types of situations create the potential for misuse of the confidential trading information in the ECN, such as customers' orders receiving preferential treatment, or customers receiving material confidential information about orders in the ECN. The rules concerning confidentiality that the Commission is adopting today are designed to eliminate the potential for abuse of the confidential trading information that subscribers send to alternative trading systems. The Commission recognizes that some alternative trading systems provide traditional brokerage services as well as access to their alternative trading systems. The proposed rules are not intended to preclude these services; rather, they are designed to prevent the misuse of private customer information in the system for the benefit of other customers, the alternative trading system operator, or its employees.

Therefore, the Commission is adopting rules which require that: (1) Information, such as the identity of subscribers and their orders, be available only to those employees of the alternative trading system who operate the system or are responsible for its compliance with the proposed rules; (2) the alternative trading system has in place procedures to ensure that all its employees are unable to use any confidential information for proprietary or customer trading, unless the customer agrees; and (3) procedures exist to ensure that employees of the alternative trading system cannot use such information for trading in their own accounts.[321]

The Commission intends the rules to prevent the disclosure or the use of information about a customer's trading orders. Many of the alternative trading systems operating today are anonymous; one of the reasons ECNs are popular with investors is that they permit wide dissemination of orders but provide anonymity. The broker-dealers operating these systems, under the rules the Commission is adopting today, cannot disclose any confidential customer information (including the identity of the subscriber entering an order) to other customers, or use that information for proprietary or agency trades.

The Commission expects that existing alternative trading systems will

[315] *See* ICI Letter at 4 (supporting the proposal to require reports quarterly); Ashton Letter at 5; IBEX Letter at 5.

[316] Ashton Letter at 5.

[317] *See* IBEX Letter at 5; American Century Letter at 6.

[318] Ashton Letter at 5. Ashton pointed out that, because SRO-sponsored systems compete directly with alternative trading systems, SROs should not be able to gain confidential information through the regulatory reporting process. *Id.*

[319] *See supra* Section IV.A.2.g.

[320] *See* ICI Letter at 4–5 (stating that it agreed that the failure to keep trading information confidential created the potential for abuse); Instinet Letter at 21 (requesting that the Commission clarify whether or not the proposed confidentiality provisions would prohibit registered representatives from providing customers with information (other than confidential customer information) regarding the trading activity of the alternative trading system); American Century Letter at 1–2 (stating that agency broker-dealer functions should be separate from intermediated broker-dealer functions that allow an alternative trading system employee to ''work'' an order on behalf of customers, and that these employees should not have access to the orders of customers who choose to work their orders without the assistance of employees of the alternative trading system).

[321] Rule 301(b)(10), 17 CFR 242.301(b)(10).

implement procedures such as these as quickly as possible, if they do not already have them in place. These procedures should be clear and unambiguous and presented to all employees, regardless of whether they have direct responsibility for the operation of the alternative trading system. Presently, many broker-dealers employ various means to ensure that sensitive information does not flow from one division to another. These methods include physical separation, written procedures, separate personnel, and restricted access. The Commission believes that firewalls such as these could be used by broker-dealers that operate alternative trading systems to ensure that sensitive information regarding the alternative trading system is contained in the proper unit of the broker-dealer.

The Commission is not adopting specific procedures because it believes that the broker-dealers who operate the alternative trading systems are in the best position to know what procedures would best prevent abuses. Experience has demonstrated, however, potential for abuse and the Commission regards these procedures as important.

B. Registration as a National Securities Exchange

Trading systems that fall within Rule 3b–16 are only required to comply with Regulation ATS if they wish to be exempt from the definition of ''exchange.'' Such systems may choose instead to register as national securities exchanges. The Commission expects that some trading systems will find that registration as a national securities exchange provides attractive benefits that make this option more suitable to their business objectives. In particular, registered exchanges enjoy more autonomy in their daily operations than do broker-dealers that are members of SROs. Because any trading system that registers as an exchange would be an SRO, it would not be subject to oversight by a competing national securities exchange or national securities association.[322] Similarly, as a national securities exchange, a trading system would be able to establish its own rules of conduct, trading rules, and fee structures for access. An alternative trading system registered as a broker-dealer, on the other hand, would have to comply with the rules of the SRO to which it belongs, including any rules regarding fees or the automatic execution of orders.

In addition, systems that elect to register as exchanges may benefit from the added prestige and investor confidence associated with status as a registered exchange. Registered exchanges are also able to establish listing standards, which may promote investor confidence in the quality of the securities traded on the exchange. Registered exchanges may also become direct participants in the national market system mechanisms, such as the ITS, Consolidated Tape Association (''CTA''), and the Consolidated Quotation System (''CQS''). Direct participation in these systems may provide a higher degree of transparency and execution opportunities for subscribers to a trading system. As direct participants in the national market system mechanisms, registered exchanges are also entitled to share in the revenues generated by the national market system systems, such as revenue from CTA fees. Moreover, as the Commission noted in the Proposing Release, only registered exchanges are eligible to be participants of the Options Clearing Corporation (''OCC'').[323] Consequently, any trading system that wants to trade standardized options issued by the OCC would have to register as an exchange and become a member of the OCC.

Finally, if a trading system chooses to register as an exchange, it could allow broker-dealers that are members of exchanges with off-board trading restrictions to trade certain securities on the trading system pursuant to unlisted trading privileges. The Commission believes that if a trading system is registered and regulated as an exchange, it should be considered to be an exchange, rather than an over-the-counter market, for purposes of exchange off-board trading.[324]

As discussed in the Proposing Release, the Commission views certain obligations of exchanges as fundamental to fair and efficient operation in the marketplace and critical for the protection of investors. The Commission did not propose any relief from the current obligations of registered exchanges under the Exchange Act. Nevertheless, the Commission requested comment on whether any exemptions from exchange regulatory provisions would be necessary or appropriate to enable alternative trading systems to register as exchanges. Commenters, however, generally thought that any trading system that chooses to register as an exchange should be subject to the same requirements as currently registered exchanges and cautioned the Commission against relieving registered exchanges from any requirements because of their for-profit structure. Consequently, at this time the Commission has determined that those trading systems choosing to register as exchanges should satisfy all requirements that apply to national securities exchanges under the Exchange Act.[325]

Many, if not all, alternative trading systems currently operating are proprietary, rather than not-for-profit entities. The Commission does not believe that there is any overriding regulatory reason to require exchanges to be not-for-profit membership organizations, and believes that alternative trading systems may retain their proprietary structure even if they choose to register as exchanges. The Exchange Act does not require national securities exchanges to be not-for-profit organizations. As the Commission stated in the Proposing Release, it believes that Congress clearly intended the 1975 Amendments to encourage innovation by exchanges and recognized that future exchanges may adopt diverse structures.[326] The Commission believes that it is possible for a for-profit exchange to meet the standards set forth in section 6(b) of the Exchange Act.

Any system meeting the definition set forth in Rule 3b–16 may apply for registration as a national securities exchange by filing an application with the Commission on Form 1.[327] The Commission, in Rule 6a–1, set forth the procedure for filing such an application.[328] All Exhibits must accompany Form 1, including audited

[322] Alternative trading systems that continue to be regulated as broker-dealers would remain subject to oversight by national securities exchanges and the NASD, in their self-regulatory capacities. *See supra* Section IV.A.2.a.

[323] Options Clearing Corporation By-laws, Art. VII, Sections 1 and 4. Registered exchanges that are members of the OCC determine such matters as listing, registration, clearance, issuance and exercise of options contracts. Exchange members of the OCC are also able to use registration and disclosure materials tailored for standardized options.

[324] The Commission has the authority to review final disciplinary sanctions imposed by SROs on members or associated persons of members, including sanctions imposed for violations of SRO rules. The Commission may only affirm a sanction imposed by an SRO on one of its members, participants or associated persons of its members for a violation an SRO's rules, if the Commission finds that: (1) The member, participant, or associated person of the member engaged in the acts or practices that the SRO found were engaged in; (2) such acts or practices are in violation of the SRO's rules; and (3) the SRO's rules, and the application by the SRO of its rules, are consistent with the purposes of the Exchange Act. Sections 19(d)(2) and 19(e) of the Exchange Act, 15 U.S.C. 78s(d)(2) and 78s(e).

[325] 15 U.S.C. 78f.

[326] *See* S. Rep. No. 75, *supra* note 107.

[327] Section 6(a) of the Exchange Act, 15 U.S.C. 78f(a).

[328] 17 CFR 240.6a–1.

financial statements prepared in accordance with United States Generally Accepted Accounting Principles.

The Commission has adopted an amendment to its rules of practice regarding the processing of filings. Applications for registration as a national securities exchange, as well as applications for exemption from registration due to the limited volume of transactions, will not be considered filed until all necessary information, including financial statements and other required documents, have been furnished in the proper form.[329] Further, under section 6(b) of the Exchange Act, the Commission must make certain determinations before registering an exchange.[330] In reviewing applications for registration as a national securities exchange, the Commission will not register an exchange unless it is satisfied that the exchange meets the requirements discussed below.

1. Self-Regulatory Responsibilities

As a prerequisite for the Commission's approval of an exchange's application for registration, the exchange must be organized and have the capacity to carry out the purposes of the Exchange Act. Specifically, an exchange must be able to enforce compliance by its members, and persons associated with its members, with the federal securities laws and the rules of the exchange.[331] The Commission believes that the self-regulatory role of registered exchanges is fundamental to the enforcement of the federal securities laws. Congress has delegated to the SROs certain quasi-governmental functions and responsibilities, and has charged the Commission with overseeing the SROs to make sure they have the ability and resources to comply with those obligations. In this regard, the Commission believes that persons responsible for operating an SRO should not have a disciplinary history, and will seriously question the ability of an exchange to carry out its SRO functions if the founders or prospective managers of an applicant for registration as a national securities exchange are subject to a statutory disqualification, as that term is defined in section 3(a)(39) of the Exchange Act.[332] The Commission believes that persons who, for example, have willfully violated the federal securities laws or have been convicted within the past ten years of a felony or misdemeanor involving misappropriation of funds, or securities fraud, larceny, theft, robbery, extortion, or other related crimes would be inappropriate selections to fill the role of director, officer, or manager of an exchange.

An alternative trading system wishing to register as a national securities exchange may choose to set listing standards for its system. If an applicant chooses to set listing standards, it must have written listing and maintenance standards, as well as an adequate regulatory staff to apply those standards.[333] The applicant must also have rules restricting the listing of securities issued in a limited partnership rollup transaction.[334] The ability to carry out these functions must be adequately represented on an exchange's application for registration before the Commission will register the exchange.

An applicant for registration as an exchange must also 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 burdens on competition, among other things.[335] For example, an exchange must maintain procedures to surveil for securities law violations, such as insider trading and manipulation on the exchange. The Commission understands that surveillance procedures can vary and will depend on the nature of, and types of securities traded, on a particular exchange. Thus, while the Commission will require all applicants for registration as an exchange to have adequate measures in place, they will not have to use the same procedures. The Commission will also require an applicant for registration as a national securities exchange to show that it has sufficient resources, including both staff expertise and capital, to support its surveillance function.[336] Consistent with these requirements, an applicant should, at a minimum, demonstrate that the officers charged with day-to-day management of the exchange are familiar with the federal securities laws and the role of a registered exchange as an SRO. In addition, an applicant for registration as a national securities exchange must demonstrate that it has the capability to maintain an audit trail of the transactions on its system. Furthermore, an applicant must establish rules providing for the allocation of fees for the use of its system.[337]

An exchange must also have general conflict of interest rules regarding, for example, trading on the exchange by its employees, owners, or exchange officials. Moreover, an exchange must have rules that ensure that no member's order is unfairly disadvantaged. For example, if an exchange has priority rules, those rules need to treat all exchange members fairly. Finally, an exchange must have rules establishing procedures for the clearance and settlement of trades effected on the exchange. Alternatively, an exchange must have rules requiring members to make their own arrangements for clearance and settlement of trades.

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 to particular SROs oversight of broker-dealers that are members of more than one SRO (''common members'').[338] For example, 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.[339] 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

[329] 17 CFR 202.3(b)(2). The Commission is not required to propose changes to its Rules of Practice prior to adoption. *See* 5 U.S.C. 553(b)(3)(A).

[330] Section 6(b) of the Exchange Act, 15 U.S.C. 78f(b).

[331] Section 6(b)(1) of the Exchange Act, 15 U.S.C. 78f(b)(1).

[332] 15 U.S.C. 78c(a)(39). *See also* 15 U.S.C. 78o(b).

[333] *See* Section 12(d) of the Exchange Act, 15 U.S.C. 78l(d); Rule 12d2–2, 17 CFR 240.12d2–2 (requiring national securities exchanges to file an application with the Commission to strike a security from listing and registration).

[334] *See* 15 U.S.C. 78f(b)(9).

[335] Section 6(b)(5) of the Exchange Act, 15 U.S.C. 78f(b)(5). *See also* Section 6(b)(8) of the Exchange Act, 15 U.S.C. 78f(b)(6).

[336] The Commission notes that, according to the audited financial statements for 1997, the NYSE had total assets of $1,174,887,000 and total expenses of $488,811,000; the Amex had total assets of $195,547,000 and total expenses of $173,742,000; the PCX had total assets of $67,622,000 and total expenses of $60,636,000; the CSE had total assets of $13,124,585 and total expenses of $5,343,403; and the Boston Stock Exchange (''BSE'') had total assets of $33,339,961 and total expenses of $16,106,837.

[337] Section 6(b)(4) of the Exchange Act, 15 U.S.C. 78f(b)(4).

[338] 15 U.S.C. 78q and 78s. *See also* 17 CFR 240.17d-2; 17 CFR 240.19g2–1.

[339] 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).

financial responsibility rules.[340] Consistent with past Commission action, the Commission may continue to designate one SRO, such as the NASD or the NYSE, as the primary DEA for common members of exchanges.

In addition, the Commission has previously permitted existing SROs to contract with each other to allocate non-financial regulatory responsibilities.[341] 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.[342] An SRO participating in a regulatory plan is relieved of regulatory responsibilities with respect to a broker-dealer member of such SRO, if those regulatory responsibilities have been designated to another SRO under the regulatory plan. Alternative trading systems registered as exchanges would also be able to establish joint plans with respect to common members.

A registered exchange would also be expected to maintain an audit trail of trading. A fully automated exchange, however, can produce comprehensive, instantaneous automated records that can be monitored remotely. Therefore, fully automated exchanges might be able to contract with other SROs to perform certain oversight activities, while retaining ultimate responsibility for ensuring that these activities are performed.

Further, the Commission also believes that the ultimate responsibility for enforcement and disciplinary actions for violations relating to transactions executed in an SRO's market or rules unique to that SRO should continue to be retained by that SRO. In addition, these exchanges must establish a disciplinary process including appropriate sanctions for violations of the rules and a fair procedure for administering the disciplinary process.[343] Existing exchanges generally employ personnel and establish extensive programs to fulfill this responsibility. However, it may be possible for an exchange to contract with another SRO to perform its day-to-day enforcement and disciplinary activities. Nevertheless, a registered exchange would retain ultimate responsibility for this function.[344] In considering an exchange's application for registration the Commission will consider whether allowing the exchange to contract with another SRO to perform its day-to-day enforcement and disciplinary activities would be consistent with the public interest.

2. Fair Representation

Section 6(b)(3) of the Exchange Act requires that registered exchanges 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.'' [345]

(i) Public Directors

Congress adopted the requirement that at least one director be representative of issuers and investors because of the public's interest in ensuring the fairness and stability of significant markets.[346] Public representation on an exchange's board of directors helps to achieve this goal. The Commission believes that, under this structure, representation of the public on an oversight body that has substantive authority and decision making ability is 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.[347] Therefore, the Commission would expect alternative trading systems that apply for registration as exchanges to have public representation on their boards of directors.

(ii) Fair Representation of Exchange Members

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, 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, because these actions can have significant and far-reaching ramifications for broker-dealers.

Historically, the fair representation requirement was one of the major obstacles to the regulation of alternative trading systems as exchanges because of the concern that it would be incompatible with their proprietary structures.[348] In the Proposing Release,

[340] *See* Securities Exchange Act Release No. 23192 (May 1, 1986) 51 FR 17426 (May 12, 1986). Moreover, section 108 of NSMIA, *supra* note 7, 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.

[341] For example, the Commission has approved a regulatory plan filed by the Amex, CBOE, NASD, NYSE, PCX, and the Philadelphia Stock Exchange (''Phlx'') that divides the oversight responsibilities among these SROs for common members, by designating each participating SRO as the options examination authority for a portion of the common members. This designated SRO has sole regulatory responsibility for certain options-related trading matters. *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*.

[342] 17 CFR 240.17d–2. 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 Exchange Act section 17(d). 15 U.S.C. 78q(d). 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 Nos. 13326 (Mar. 3, 1977), 42 FR 13878 (Mar. 14, 1977) (NYSE/Amex); 13536 (May 12, 1977), 42 FR 26264 (May 23, 1977) (NYSE/BSE); 14152 (Nov. 9, 1977), 42 FR 59339 (Nov. 16, 1977) (NYSE/CSE); 13535 (May 12, 1977), 42 FR 26269 (May 23, 1977) (NYSE/CHX); 13531 (May 12, 1977), 42 FR 26273 (May 23, 1977) (NYSE/PSE); 14093 (Oct. 25, 1977), 42 FR 57199 (Nov. 1, 1977) (NYSE/Phlx); 15191 (Sept. 26, 1978), 43 FR 46093 (Oct. 5, 1978) (NASD/BSE, CSE, CHX and PSE); and 16858 (May 30, 1980), 45 FR 37927 (June 5, 1980) (NASD/BSE, CSE, CHX and PSE).

[343] *See* section 6(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(6). *See also* section 6(b)(7) of the Exchange Act, 15 U.S.C. 78f(b)(7).

[344] *See, e.g.* section 19 of the Exchange Act, 15 U.S.C. 78s

[345] Section 6(b)(3) of the Exchange Act, 15 U.S.C. 78f(b)(3).

[346] *Id*.

[347] *See* NASD 21(a) Report, *supra* note 4.

[348] *See Delta Release*, *supra* note 32, at 1900. In *Board of Trade of the City of Chicago v. Securities and Exchange Commission*, 923 F.2d 1270 (7th Cir. 1991) (''*Delta II*''), the court 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

however, the Commission proposed to allow non-membership, for-profit alternative trading systems that choose to register as exchanges some flexibility in satisfying this ''fair representation'' requirement.

The Commission notes that it has not, in the past, 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, PCX ''electronic access members'' (''ASAP Members'') do not have voting rights, and therefore are not represented on the board of that exchange.[349]

More recently, the Commission approved the merger between the Amex and the NASD. As a result of the merger, Amex, reorganized as New Amex LLC (''New Amex''), is now a subsidiary of the NASD. In reviewing the merger, the Commission considered several fair representation issues. Specifically, the Commission considered, among other things, Amex member representation on the Board of Governors of New Amex, Amex member representation on the Board of the NASD, the voting rights of the Amex membership, and representation of the Amex membership in the disciplinary process.

The Commission found that the composition of the New Amex Board satisfied the fair representation requirement by providing the Amex membership with the opportunity to nominate four Amex floor governors to the New Amex Board.[350] Further, the Commission found that the inclusion of one New Amex floor governor on the NASD Board [351] helped to fulfill the fair representation requirement by providing for New Amex input on the parent Board.[352] In addition, the Commission believes that the fair representation requirement was furthered by the corporate governance provisions of New Amex's constitution that require the consent of either Amex (through a Membership vote), the Amex Committee (a committee designed specifically to represent the interests of the Amex membership), or both, in situations impacting certain membership interests or material market changes to New Amex. Lastly, the Commission found that the disciplinary procedures of New Amex met the fair representation requirement by providing for review of all disciplinary matters by a committee composed of both Amex members and public representatives. Specifically, the Amex Adjudicatory Council, which is empowered to act for the full New Amex Board in reviewing appeals from disciplinary proceedings, is composed of three Public Members and three Floor Governors, all of whom are nominated by the Amex Nominating Committee (or by petition signed by twenty-five Members) and elected by a full Amex Membership vote.[353]

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.[354] The Commission believes that other structures may also provide independent, fair representation for an exchange's constituencies in its material decision making processes if the exchange is not owned by its participants. For example, a proprietary 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 making rules for the exchange, and ensuring that the governance of such subsidiary equitably represents the exchange's participants.[355] As another possibility, certain directors appointed to the board to represent the interests of trading members or participants could be limited to considering certain topics relating to system use and rules, while consideration of ownership issues could be restricted to board members representing the interests of the owners or stockholders.[356]

Some commenters expressed concern that the flexibility afforded alternative trading systems in complying with their ''fair representation'' requirement not extend so far as to result in unequal regulation of alternative trading systems registered as exchanges and traditional exchanges. In addition, these commenters expressed concern that the efficiency of the markets not be compromised.[357] American Century also expressed its support for structures in which an alternative trading system's board included both owners and participants.[358] On the other hand, several commenters stated that members (or participants) of a proprietary exchange should not have any right to participate in the governance of the exchange and that imposing constraints on the manner in which alternative trading systems are governed may undermine the factors that lead to their efficiency and innovativeness.[359]

The Commission believes alternative trading systems should be required to assure fair representation of their members if they choose to register as exchanges. As discussed above, registered exchanges have special responsibilities under the Exchange Act, regardless of whether they are not-for-profit or for-profit. Accordingly, the Commission continues to believe that exchange participants—including

system to the institutions. The system would be kaput.

Id. at 1272–73.

[349] *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 PCX).

[350] The New Amex Board consists of eighteen total governors. Floor governor nominees will be proposed by either the Amex Nominating Committee (consisting of three floor members and two public members) or a petition signed by twenty five members and will be selected by a plurality of the Amex Regular and Options Principal members voting together as a single class. The Amex membership elects the members of the Amex Nominating Committee.

[351] The Chief Executive Officer of New Amex will also be a governor on the NASD Board.

[352] The New Amex Floor Governor is nominated by the Amex Membership and will be able to directly express the Amex members' viewpoint and concerns within the NASD Board forum. In addition, the Chief Executive Officer of New Amex will be able to provide information about, and communicate the needs of, New Amex to the NASD Board.

[353] *See* Securities Exchange Act Release No. 40622 (Oct. 30, 1998), 63 FR 59819 (Nov. 5, 1998).

[354] 15 U.S.C. 78q–1(b)(3)(c). 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 (Mar. 6, 1978), 43 FR 10288 (Mar. 10, 1978). *See also* Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980).

[355] The proprietary foreign 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.

[356] The Commission in the past has approved exchange rules limiting the voting rights of ''special access'' or non-equity members as consistent with section 6(b)(3) of the Exchange Act, 15 U.S.C. 78f(b)(3). *See, e.g.,* Securities Exchange Act Release No. 22959 (Feb. 28, 1986), 51 FR 8060 (Mar. 7, 1986) (approving rule change by NYSE establishing ''electronic access membership'' with restricted voting rights).

[357] *See* CBOE Letter at 5–6; NASD Letter at 4–5.

[358] American Century Letter at 6.

[359] *See* Ashton Letter at 4 (for-profit exchanges should be afforded considerable flexibility in their formative business stages in meeting fair representation obligations); OptiMark Letter at 3–4 (users of alternative trading systems should be treated fairly, but are not entitled to exercise any formal rights in regard to the management of the system, and are adequately protected through a combination of regulatory safeguards and market forces); Lee Letter at 1–2 (owners of exchanges already have incentives to create suitable governance structures).

participants in a for-profit exchange—need to have substantive input into disciplinary and other key processes to prevent these processes from being conducted in an inequitable, discriminatory, or otherwise inappropriate fashion.

The NASD asked the Commission to provide more specific guidance on the details of the flexibility the Commission proposes to allow alternative trading systems applying for registration as exchanges.[360] The Commission has provided several examples of ways in which fair representation requirements can be met in non-traditional ways and believes that there may be other acceptable ways. The Commission, however, does not believe it is necessary to specify in greater detail what types of structures would be acceptable to it. What constitutes fair representation for a particular exchange will be determined in the context of that system's application for registration under sections 6(a) and 19(a) of the Exchange Act. Under section 19(a) of the Exchange Act, notice of an application for registration as an exchange is published for comment before approval.[361] This will provide interested persons with notice of, and an opportunity to comment on, the manner in which a particular exchange proposes to meet its fair representation obligations.[362]

3. Membership on a National Securities Exchange

An applicant for registration as a national securities exchange must have rules to admit members and persons associated with those members.[363] Section 6(c)(1) of the Exchange Act[364] prohibits exchanges from granting new membership to any person not registered as a broker-dealer, or associated with a broker-dealer. In the Concept Release, the Commission solicited commenters' views on whether to allow institutional membership on national securities exchanges. Because most commenters were opposed to institutional membership on exchanges, the Commission did not propose to exempt registered exchanges from the limitations in section 6(c)(1). Nevertheless, in the Proposing Release, the Commission asked for comment on whether institutions should be permitted to be members of national securities exchanges.

Most commenters expressing a view on institutional membership on registered exchanges agreed that such exchanges should be prohibited from having non-broker-dealer members.[365] One commenter, however, believed that direct institutional access to exchanges is a choice that would benefit market participants by providing lower execution costs for the shareholders of institutional funds. Although this commenter noted the Commission's concerns about the regulatory burden an institution might face if it chose to be a direct member of an exchange, it thought that membership should be a choice available to those institutions that feel they have the economies of scale to warrant direct access or believe that anonymity is worth the regulatory cost of membership.[366]

As discussed in the Proposing Release, the Commission believes that, in order to ensure the central goals of exchange regulation, direct institutional members or participants in exchanges would have to be subject to the majority of rules and regulations to which broker-dealers are currently subject.[367] Moreover, because institutions that were granted exchange membership or direct access to exchanges would likely need to become members in one or more of the national clearance and settlement corporations in order to clear and settle their trades, these institutions would need to demonstrate and maintain financial creditworthiness. Insufficient net capital and incomplete books and records could compromise financial soundness, audit trails, and other general risk management objectives that are critical to sound markets and clearance and settlement systems. Consequently, the Commission would need to require non-broker-dealer institutions to comply with financial responsibility obligations, including the requirements to maintain certain minimum levels of net capital and appropriate books and records.[368] Without such requirements, institutional membership on an exchange may also conflict with an exchange's obligation to have rules that foster the efficient clearance and settlement of securities transactions.

The Commission believes that non-broker-dealer institutions essentially would be required to comply with the same requirements imposed on registered broker-dealers and, therefore, undermine most benefits an institution receives by virtue of not registering as a broker-dealer.[369] Thus, the Commission does not believe that allowing institutional membership on exchanges would be any less costly to an institution than establishing a broker-dealer affiliate, which can become a member in a registered exchange. At the same time, it would impose ad-hoc regulatory burdens on the Commission and the exchanges as they tried to impose critical rules and regulations on institutions. Further, the Commission does not believe that it is currently practical or serves the best interests of investors or the markets generally to allow non-broker-dealers to be members of national securities exchanges, because of the potential lack of regulatory oversight the Commission would have over these entities. Therefore, just as currently registered exchanges are required to limit membership to broker-dealers, alternative trading systems that choose to register as exchanges would be prohibited from extending membership to non-broker-dealers.

Accordingly, the Commission believes that exchange membership should continue to be limited to registered broker-dealers and persons associated with registered broker-dealers in accordance with section 6(c)(1) of the Exchange Act.[370] Institutions, however, would be able to access alternative trading systems registered as exchanges through a registered broker-dealer member of such a trading system, including an affiliate of the institution. Institutions currently have efficient access to the NYSE through SuperDOT

[360] NASD Letter at 4–5.

[361] 15 U.S.C. 78s(a).

[362] 15 U.S.C. 78f(a) and 78s(a). *See* NASD Letter at 4–5 (commenting that the public should have an opportunity to comment on the proposed governance structure of an exchange before the Commission approves its application for registration).

[363] 15 U.S.C. 78f(b)(3)–(4) and 78f(c).

[364] 15 U.S.C. 78f(c)(1). Section 6(c)(1), adopted in 1975, prohibits exchanges from granting new memberships to non-broker-dealers. At the time this Section was adopted, 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.

[365] CBOE Letter at 6 (''it would be difficult, if not impossible, for the Commission to adequately regulate or oversee the array of non-broker-dealer institutions that currently are, or may become, participants on (alternative trading systems)''); NASD Letter at 8 (institutions should not be members of alternative trading systems that register as exchanges); IBEX Letter at 13 (institutional and individual investors should be granted exchange access through the sponsorship of discount or full-service broker-dealers).

[366] American Century Letter at 4.

[367] Sections 6(f) and 15(e) of the Exchange Act, 15 U.S.C. 78f(f) and 78*o*(e), would permit the Commission to subject institutional members to all exchange rules and relevant Exchange Act provisions.

[368] The Commission could adopt such requirements pursuant to its authority under Section 15(c) of the Exchange Act, 15 U.S.C. 78*o*(e).

[369] The Commission notes that institutions currently have the option to establish a broker-dealer affiliate, which can become a member in an exchange. The institution can then direct its order flow through its affiliated entity. Many investment companies already have affiliated broker-dealers.

[370] 15 U.S.C. 78f(c)(1).

terminals given to them by NYSE members,[371] and the OptiMark System[372] will enable institutions to directly enter orders in the OptiMark System through use of an exchange member give-up. Access of this nature should not impose significant costs or burdens on institutions or on broker-dealers providing the access. The Commission believes if institutions continue to have indirect access to exchanges, their needs can be met without compromising important regulatory objectives.

Finally, while the NASD agreed with the Commission's views that institutions should not be ''members'' of registered exchanges, it asked the Commission to provide guidance on whether a registered exchange may set up a broker-dealer subsidiary to provide sponsored access to retail and institutional customers. Further, the NASD asked whether the registered exchange could be the SRO for its broker-dealer subsidiary. The NASD believes that there is an inherent conflict of interest in such an arrangement and that the Commission should explain its views and provide SROs with guidance on the responsibilities for oversight of the broker-dealer in such circumstances.[373]

In this regard, a registered exchange is not explicitly prohibited from establishing a broker-dealer subsidiary through which it can provide sponsored access to its non-broker-dealer customers. Nonetheless, the Commission recognizes concerns about the potential conflict of interest if a registered exchange were the SRO for its subsidiary, and believes that it may be difficult for an exchange to fulfill its obligations under sections 6(b)(6), 6(b)(7), and 19(g) with respect to such a subsidiary.[374]

4. Fair Access

Sections 6(b)(2)[375] and 6(c)[376] of the Exchange Act prohibit registered exchanges from denying access to, or discriminating against, members. The obligation to ensure fair access for members does not, however, restrict the authority of a national securities exchange to maintain reasonable standards for access.[377] The securities industry and the general public need access to exchanges to ensure the best execution of orders. Exchanges are venues for trading that should be open to all qualified persons. The Commission stated in the Proposing Release that alternative trading systems that register as exchanges would be required to comply with section 6(b)(2) and section 6(c) of the Exchange Act. IBEX was the only commenter to express a view on this requirement and its comment was favorable.[378] Thus, the Commission would require any alternative trading system registered as an exchange to ensure the fair access of registered broker-dealers.

In a similar vein, exchanges are prohibited from adopting any anti-competitive rules.[379] To further emphasize the goal of vigorous competition, Congress requires the Commission to consider the competitive effects of exchange rules,[380] as well as the Commission's own rules.[381] The fair access and fair competition requirements in the Exchange Act are intended to ensure that national securities exchanges treat investors and their participants fairly, consistent with the expectations of the investing public. For example, as discussed above, an exchange's rules, including its rules of priority, must treat all members fairly. Accordingly, before granting an application for registration as an exchange, the Commission would review the exchange's rules for compliance with these requirements.

5. Compliance With ARP Guidelines

All national securities exchanges are expected to maintain sufficient systems capacity to handle foreseeable trading volume. Applicants for registration as a national securities exchange must have adequate computer system capacity, integrity and security to support the operation of an exchange. The Commission believes that adequate capacity is vital to the efficient operation of exchanges, particularly during periods of high volume or volatility, such as have been experienced in the past year. To this end, all exchanges and the NASD currently participate in the Commission's automation review program (''ARP'').[382] Given the highly automated nature of most alternative trading systems, the Commission stated in the Proposing Release that it would expect any exchange applying for registration as a national securities exchange to comply with the policies and procedures outlined by the Commission in its policy statements concerning the automation review program, including cooperation with any reviews conducted by the Commission. In this regard, the Commission would consider the resources and ability of an applicant for registration as an exchange to meet the standards set forth in the automation review program. In particular, the Commission would consider whether the applicant had sufficient capital to maintain its automated systems, and staff with technical expertise.

The Commission received one comment letter addressing this issue. The PCX commented that registered exchanges should only have to comply with the ARP guidelines if they reach the threshold level that triggers these requirements for alternative trading systems registered as broker-dealers. The PCX noted that, although many exchanges do not account for twenty percent, or even ten percent, of the trading in ITS eligible equity securities, all exchanges are required to comply with the ARP guidelines. The PCX commented that these regulatory requirements impose substantial costs on exchanges and that there is no basis for imposing these types of requirements on exchanges when such requirements are not imposed on alternative trading systems registered as broker-dealers that have substantially greater trading volume.[383]

The Commission notes that today it is adopting a requirement that alternative trading systems with twenty percent or more of the volume in any equity security, or certain categories of debt, comply with certain systems capacity, integrity, and security requirements. While some registered exchanges may have less than twenty percent of the volume in similar securities, the Commission nevertheless believes that these exchanges' direct participation in the national market system necessitates

[371] Exchange members are subject to regulatory action by the NYSE for violations of NYSE rules by their customers entering orders through the members' SuperDOT terminals.

[372] *See infra* note 452.

[373]:NASD Letter at 8.

[374] 15 U.S.C. 78f(b)(6)–(7) and 15 U.S.C. 78s(g). These provisions require that a registered exchange be able to enforce compliance by its members with the federal securities laws, appropriately discipline its members for violations of such laws, and provide a fair disciplinary procedure. The Commission notes, however, that unless a broker-dealer effects transactions in securities solely on a national securities exchange of which it is a member, it must become a member of a national securities association or another national securities exchange. Section 15(b)(8) of the Exchange Act, 15 U.S.C. 78o(b)(8).

[375] 15 U.S.C. 78f(b)(2).

[376] 15 U.S.C. 78f(c).

[377] A denial of access would be reasonable, for example, if it were based on objective standards, such as capital and credit requirements, and if these standards were applied fairly.

[378] IBEX Letter at 13–14.

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

[380] Section 6(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(6).

[381] Section 23(a) of the Exchange Act, 15 U.S.C. 78w(a).

[382] *See supra* notes 269–273 and accompanying text.

[383] PCX Letter at 7–8.

participation in the automation review program. Moreover, while there are costs associated with capacity planning and testing, contingency planning, stress testing, and independent reviews, as well as ensuring that automated systems have sufficient capacity, these are costs that all highly automated business must bear and not merely regulatory costs.[384] The Commission's ARP guidelines are intended only to ensure that short-term cost cutting by registered exchanges does not jeopardize the operation of the securities markets.

6. Registration of Securities

Under the Exchange Act, securities traded on a national securities exchange must be registered with the Commission and approved for listing on the exchange.[385] In addition, national securities exchanges are permitted to trade securities listed on other exchanges and Nasdaq pursuant to unlisted trading privileges (''UTP'').[386] These requirements ensure that investors have adequate information and that all relevant trading activity in a security is reported to, and surveilled by, the exchange on which it is listed. The Commission discussed in the Proposing Release that an alternative trading system choosing to register as an exchange would be subject to these requirements and would be required to have rules for trading the class or type of securities it seeks to trade pursuant to UTP.[387] Moreover, to trade Nasdaq NM securities, such a system would have to become a signatory to an existing plan governing such trading.[388]

With regard to these securities registration requirements, OptiMark commented that they would preclude, as a practical matter, those alternative trading systems that trade privately placed securities or unregistered foreign securities from choosing to register as exchanges. In addition, the various conditions and limited scope of the Nasdaq/National Market System/Unlisted Trading Privileges (''OTC–UTP'') plan[389] would impair the ability of alternative trading systems that offer competing facilities for securities listed on existing exchanges to register as exchanges. For example, UTP may be extended for Nasdaq NM securities, but this does not include Nasdaq SmallCap securities or other over-the-counter securities. Moreover, formally amending the OTC–UTP plan to admit any new member and to allocate expenses and revenues among competing market centers is a time-consuming process.

Consequently, OptiMark recommended that the Commission exercise its exemptive authority to reduce the differences in regulatory treatment between alternative trading systems registered as exchanges and those registered as broker-dealers. In particular, OptiMark suggested that, regardless of whether they are registered exchanges or broker-dealers, alternative trading systems that limit their screen availability to certain qualified persons be permitted to trade unregistered securities, including private placements and foreign securities. Similarly, OptiMark believed that alternative trading systems that seek to compete for order flow with existing exchanges should be able to do so in *all* securities listed on those exchanges, regardless of the alternative trading system's registration status.[390]

The issue of trading unregistered securities, and in particular unregistered foreign securities, on exchanges raises many difficult issues. Registration of securities provides public information for investors that is prepared in accordance with U.S. accounting and auditing standards. This assures that the issuer's disclosures are consistently presented and can be easily compared to the information provided by other issuers. For this reason, the Exchange Act requires securities to be registered if they trade on national securities exchanges.

The Commission has maintained the current structure in the final rules: continuing to require registered exchanges to trade only registered securities, but not extending this requirement to alternative trading systems not registered as exchanges. The Commission is continuing to review on a broader basis the issuing and trading of unregistered foreign securities in the U.S. and, as part of that review, will specifically consider whether unregistered foreign securities should continue to be freely traded on alternative trading systems that are not registered as exchanges.

7. National Market System Participation

As discussed in the Proposing Release, any alternative trading system that elects to register as a national securities exchange would also be expected to become a participant in the market-wide transaction and quotation reporting plans currently operated by registered exchanges and the NASD. These plans—the CQS,[391] the CTA,[392] the ITS,[393] the Options Price Reporting Authority (''OPRA''),[394] and OTC–

[384] In this regard, those exchanges applying for registration in 1999 should also be prepared to demonstrate that their systems are year 2000 compliant.

[385] 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 has been filed with the Commission and 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. 15 U.S.C. 78*l*(a). Section 12(b) of the Exchange Act, 15 U.S.C. 78*l*(b), contains procedures for the registration of securities on a national securities exchange. Section 12(a) does not apply to an exchange that the Commission has exempted from registration as a national securities exchange. *See, e.g.,* Securities Exchange Act Release No. 28899 (Feb. 20, 1991), 56 FR 8377 (Feb. 29, 1991). *See also* Securities Exchange Act Release No. 37271 (June 3, 1996), 61 FR 29145 (June 7, 1996).

[386] Section 12(f) of the Exchange Act, 15 U.S.C. 78*l*(f). Under section 12(f) of the Exchange Act, 15 U.S.C. 78*l*(f), exchanges cannot trade securities not listed on an exchange or classified as Nasdaq NM securities (such as Nasdaq SmallCap or OTC securities) without Commission action. Section 12(f) of the Exchange Act authorizes the Commission to permit the extension of UTP to any security listed otherwise than on an exchange. The OTC–UTP plan which provides UTP for Nasdaq NM securities, is the only extension to date approved by the Commission. *See* OTC–UTP plan, *infra* note 401. Thus, registered exchanges cannot currently trade Nasdaq SmallCap securities or exempted securities that are not separately listed on the exchange.

[387] Rule 12f–5, 17 CFR 240.12f–5.

[388] *See* OTC–UTP plan, *infra* note 401 and accompanying text.

[389] The OTC–UTP plan provides for the collection, consolidation, and dissemination of quotation and transaction information for Nasdaq NM securities by its participants. Any registered Exchange where Nasdaq NM securities are traded may become a full participant in the OTC–UTP plan. *See infra* note 401. *See also* Securities Exchange Act Release Nos. 24407 (Apr. 27, 1987), 52 FR 17349 (May 7, 1987); 36985 (Mar. 18, 1996), 61 FR 12122 (Mar. 25, 1996).

[390] OptiMark Letter at 3.

[391] The CTA provides vendors and other subscribers (including alternative trading systems) with consolidated last sale information for stocks admitted to dealings on any exchange pursuant to a plan approved by the Commission (''CTA plan''). *See, e.g.,* Securities Exchange Act Release Nos. 10787 (May 10, 1974), 39 FR 17799 (final rules approving CTA plan); 16983 (July 16, 1980), 45 FR 49414 (July 24, 1980); 37191 (May 9, 1996), 61 FR 24842 (May 16, 1996).

[392] The CQS gathers quotations from all market makers in exchange-listed securities and disseminates them to vendors and other subscribers pursuant to a plan approved by the Commission (''CQ plan''). Securities Exchange Act Release No. 16518 (Jan. 22, 1980), 45 FR 6521 (final rules approving CQ plan); 37191 (May 9, 1996), 61 FR 24842 (May 16, 1996).

[393] 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) (CSE/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) (CBOE/ITS linkage).

[394] *See infra* note 401 and accompanying text for a description of the OPRA plan.

UTP[395]—link trading, quotation, and reporting for all registered exchanges and the NASD and are responsible for the transparent, efficient, and fair operation of the securities markets. These plans form the backbone of the national market system and participation in these plans by all registered exchanges is vital to the success of the national market system.

Participation in effective quote and transaction reporting plans and procedures would, therefore, be mandatory for any newly registered exchange, as it is now for currently registered exchanges.[396] The CTA and the CQS, which make quote and transaction information in exchange-listed securities available to the public,[397] both have provisions governing the entry of participants to the plans,[398] and allow any national securities exchange or registered national securities association to become a participant.[399] New participants are required to pay certain entry fees to the existing participants.[400] Participants in these plans share in the income and expenses associated with the plans' operations.[401] Because national securities exchanges are required to participate in an effective quote and transaction reporting plan, the Commission expects the participants of existing plans to include them in the plans under reasonable conditions adapted to the situations of the new exchanges.

In addition to requiring participation by newly registered exchanges in quote and transaction reporting plans, the Commission would expect newly registered exchanges to participate in ITS,[402] or an equivalent system if one were developed. ITS provides trading links between market centers and 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, through the system.[403] The ITS plan requires that the members of participant markets avoid initiating a purchase or sale at a worse price than that available on another ITS participant market (''trade-throughs'').[404] Participation in ITS would give users of these new exchanges access to other ITS participant markets. Moreover, participation in ITS would require new exchanges to adopt rules to comply with other applicable ITS plan provisions and policies on matters such as, for example, trade-throughs, locked markets,[405] and block trades.[406] As with the quote and transaction reporting plans, alternative trading systems that register as exchanges would have to be integrated into ITS, or another system that links markets for trading purposes would have to be created to accomplish full integration of the newly registered exchanges into the national market system.

The Commission solicited comment on what issues were raised by the possible integration of new exchanges into ITS. One commenter strongly believed that the current voting structure of ITS establishes barriers to entry, which leads to barriers to innovation. This commenter was concerned that the network supporting ITS may not be strong enough to handle sharply higher volumes of securities transactions and that, in an environment with multiple exchanges, the failure of these linkages would impede market participants' quest for best prices.[407] Another commenter, similarly, expressed concern that the means of access to, and participation in, the national market system plans more generally was not clearly defined and, therefore, provided the current participants in these plans an opportunity to delay and to set unreasonable terms and conditions for entry of new participants.[408] The Commission realizes that integrating new exchanges into the national market system plans may require amendments to these plans and notes that national market system plans may be amended

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

[396] *See* Rules 11Ac1–1(b)(1) and 11Aa3–2(c), 17 CFR 240.11Ac1–1(b)(1) and 240.11Aa3–2(c).

[397] Both the CTA and the CQS are presently operated by the eight national securities exchanges and the NASD.

[398] 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. Alternative trading systems that do not elect to register as exchanges would be eligible for participation in the CTA plan pursuant to this provision; however, as non-member participants, these systems would neither be obligated to pay the required fees and expenses to the plan, nor able to share in the plan's profits.

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

[400] These fees represent the ''tangible and intangible assets'' provided by the plans to the new participant. *See* Proposing Release, *supra* note 3 at nn.342–43 (discussing entry fees for the CTA, CQS, and ITS plans).

[401] Similar to the CTA and CQ plans, the OTC–UTP plan governing trading of Nasdaq NM securities provides for the collection, consolidation, and dissemination of quotation and transaction information for Nasdaq NM securities by its participants. Any national securities exchange where Nasdaq NM securities are traded may become a full participant of the OTC–UTP plan. The plan also provides that new participants pay a share of development costs, share ongoing operating costs, and are entitled to share in the plan's profits. *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). *See also* Securities Exchange Act Release No. 36985 (Mar. 18, 1996), 61 FR 12122 (Mar. 25, 1996).

The OPRA plan also provides for the collection and dissemination of last sale and quotation information with respect to options that are traded on the participant exchanges. Under the terms of this 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. 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) (''OPRA plan'').

[402] 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 393, at section 3(c).

[403] 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.

[404] 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 20⅛ for an ITS security, the prohibition on trade-throughs would prohibit another ITS participant market from buying that security from a customer at 19⅞ or selling that security to a customer at 20 ½. 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.

[405] 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.

[406] 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).

[407] American Century Letter at 3 (citing instances of downtime on alternative trading systems that are attributable to SelectNet, rather than the alternative trading system).

[408] Ashton Letter at 4 (also stating that the Commission should be sensitive to the ''veiled anti-competitive motives'' of the existing plan participants and be prepared to direct any new qualified exchanges to be accepted into all national market system plans).

either by vote of the participants, or by Commission action.[409]

The Commission also requested comment on whether any changes were necessary to incorporate alternative trading systems registered as exchanges into the national market system plans. In this regard, the Chicago Board Options Exchange (''CBOE'') and the NYSE stated that they did not believe that there would need to be significant changes to these plans, and that any changes that would be necessary to accommodate alternative trading systems registered as exchanges into ITS would be relatively easy to resolve.[410] The CBOE, however, did state that alternative trading systems registered as exchanges should be subject to the same requirements regarding access to the national market system plans as are applicable to traditional exchanges, including payment of participation entry fees.[411]

The NASD suggested that, before the Commission approves an alternative trading system's application for registration as an exchange, the Commission address more completely the manner in which such an alternative trading system registered as an exchange may participate in national market system plans. The NASD noted three areas in which the Proposing Release was silent. First, the Commission did not address what mechanism would be used for access among any new exchange and other exchanges or markets. For example, in the context of Nasdaq securities, the NASD thought it was unclear whether the existing approach to linkage and execution should continue to occur through Nasdaq's SelectNet system or its successor, or whether there should be a new ITS-like entity formed with a completely new approach to access. The NASD expressed a preference for using the current approach to linkages. Second, the NASD noted that the Commission did not address whether alternative trading systems registered as exchanges could continue to charge an access fee, and believed strongly that such alternative trading systems should not be allowed to charge for another market accessing displayed interest. Third, the Commission did not address the intermarket linkage issues raised by access to traditional exchanges by non-broker-dealers that have indirect access to alternative trading systems registered as exchanges.[412]

OptiMark asked the Commission to consider the effect of an alternative trading system's ability to charge an execution fee on its choice to register as an exchange or as a broker-dealer. OptiMark noted that the Proposing Release only contemplated that alternative trading systems operating as broker-dealers would be able to charge a fee to non-subscribers; alternative trading systems registered as exchanges and participating in ITS would not.[413]

Susquehanna Investment Group (''Susquehanna'') expressed concern about potentially integrating many alternative trading systems registered as exchanges into the national market system mechanisms. Susquehanna commented that integrating new exchanges' quotations into the national market system should be done only with careful consideration for the preservation of the ITS trade-through rule.[414] Instinet also stated that in order for an alternative trading system to make a determination about the feasibility of registering as an exchange, the Commission needs to address those unresolved issues relating to ITS, including the rules governing time/price priority within a multiple exchange structure. In addition, Instinet stated that inter-exchange rules need to be set forth for both the listed and over-the-counter securities markets.[415]

The Commission agrees that access to national market system systems is of key importance. It currently has outstanding proposals for incorporation of one linkage into ITS of an alternative trading system—OptiMark—and a traditional exchange—PCX—and has sought comment on organizational and other changes to ITS to make it more responsive to changing conditions.[416] The precise arrangements for inclusion of new exchanges into these plans depends on the structure of these exchanges, and will be addressed when an applicant seeks registration as an exchange.

8. Uniform Trading Standards

In addition to participation in national market system mechanisms, an alternative trading system that registers as an exchange would be required to comply with any Commission-instituted trading halt relating to securities traded on or through its facilities.[417] Newly registered exchanges would be required in some instances to adopt trading halt rules to comply with certain Commission rules.[418] A newly registered exchange would also have the authority and be expected to impose trading halts for individual securities, for classes of securities, and for its system as a whole under the appropriate circumstances.[419] The Commission does not believe that this requirement would present any undue burden for alternative trading systems that elect to register as national securities exchanges because most alternative trading systems are already subject to the imposition of trading halts as members of the NASD.

In addition, to promote the orderly operation of the securities markets in accordance with Section 6 of the Exchange Act,[420] the Commission would expect all newly registered national securities exchanges to implement circuit breaker rules to temporarily halt trading during periods

[409] Securities Exchange Act Release No. 40204 (July 15, 1998), 63 FR 390306 (July 22, 1998) (proposal providing for the linkage of the PCX application of the OptiMark system to the ITS system); Securities Exchange Act Release No. 40260 (July 24, 1998), 63 FR 40748 (July 30, 1998) (proposal expanding the ITS/CAES linkage to all listed securities, including non-Rule 19c-3 securities).

[410] *See* CBOE Letter at 4–5; NYSE Letter at 8–9. The NYSE also stated that consideration of this issue can be better evaluated at the time an alternative trading system registers as an exchange and seeks to become a member of ITS. *Id. But see* CHX Letter at 7 (expressing concern about a for-profit exchange becoming a full participant in the national market system plans because such exchanges would be subject to pressures not to expend significant resources on maintaining surveillance and enforcement capability and would not have the same commitment to the public interest and the investing public as traditional not-for-profit exchanges).

[411] CBOE Letter at 4–5.

[412] NASD Letter at 7.

[413] OptiMark Letter at 4–5 (also asking that the Commission consider how members of exchanges, other than the exchange through which an alternative trading system registered as a broker-dealer disseminates its quotations, could access such alternative trading system's quotes).

[414] Letter from Gerald D. O'Connell, Susquenhanna Investment Group to Jonathan G. Katz, Secretary, SEC, dated July 23, 1998 (''Susquehanna Letter'') at 1–2. *See also* OptiMark Letter at 4 (asking the Commission to clarify that participation in national market system plans is not conditioned on any universal public display requirement).

[415] Instinet Letter at 1–2, 3, 6.

[416] *See supra* note 409.

[417] 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 pursuant to sections 12(k)(1)(A) and (B) of the Exchange Act, 15 U.S.C. 78*l*(k)(1)(A) and (B).

[418] For example, a newly registered exchange would be required under Rule 11Ac1–1, 17 CFR 240.11Ac1–1, to halt trading when neither quotation nor transaction information can be disseminated.

[419] The Commission has found that trading halt rules instituted by a national securities exchange or a national securities association are consistent with the objectives of Section 6(b)(5) of the Exchange Act, 15 U.S.C. 78f(b)(5). *See, e.g.,* Securities Exchange Act Release Nos. 39582 (Jan. 26, 1998), 63 FR 5408 (Feb. 2, 1998); 26198 (Oct. 19, 1988), 53 FR 41637 (Oct. 24, 1988). *See, e.g.,* Amex Rule 117, NASD Rule 4120(a)(3), and NYSE Rules 80B and 717. There is no requirement that exchanges or associations of securities dealers employ identical trading halt rules, and these rules may vary according to the needs of the individual market.

[420] 15 U.S.C. 78f.

of extraordinary market volatility or unusual market declines. The Commission believes that for circuit breakers to be effective, all markets must impose corresponding circuit breakers.[421]

9. Proposed Rule Changes

Under Section 19(b)(1) of the Exchange Act, SROs are required to file all proposed rule changes with the Commission.[422] Thus, once registered as an exchange, an alternative trading system would have to submit copies of any proposed rule changes to the Commission for approval.

C. Application for Registration as an Exchange

The Commission proposed to revise Rules 6a–1, 6a–2 and 6a–3 under the Exchange Act[423] to clarify the requirements for registration as an exchange and to accommodate the registration as exchanges of automated and proprietary trading systems. Additionally, the Commission proposed to revise Form 1, the application used by exchanges to register or to apply for an exemption based on limited volume, and to repeal Form 1–A. After considering the comments, the Commission is adopting the amendments to Rule 6a–1, Rule 6a–2, Rule 6a–3 and Form 1 as proposed.

1. Revisions to and Repeal of Form 1–A

The Commission is adopting the revisions to Form 1 and repealing Form 1–A as proposed. Form 1 is revised by reorganizing and redesignating the Statements and the exhibits. Because the Commission expects most future applicants for registration as an exchange to be fully or partially automated, the Commission revised some of the information requested in Form 1 to be more applicable to automated exchanges. Specifically, the Commission is adding two new exhibits requiring an applicant for registration as an exchange to describe the way any of its electronic trading systems operate, and the criteria used by the exchange in admitting members.[424] In addition, the Commission is adding a new exhibit to Form 1 to reflect the possibility that an exchange is owned by shareholders, rather than members.[425] The Commission is also adopting other changes to the information requested on Form 1 to reflect the fact that a for-profit exchange would have participants or subscribers trading, rather than members.

Both the NYSE and the Amex expressed concern that these new Exhibits would require new and additional information.[426] Exhibits E and L, however, need only accompany the application for registration as an exchange and, therefore, are inapplicable to currently registered exchanges. In addition, Exhibit K applies only to non-member owned exchanges. Therefore, because all currently registered exchanges are member-owned, new Exhibit K does not apply to them. The Commission has clarified that Exhibit K exclusively applies to non-member owned exchanges. If, however, a currently registered, member-owned exchange were to convert to a for-profit structure, it would have to comply with the requirement to update Exhibit K.

Exchanges currently registered with the Commission are required to use amended Form 1 in complying with Rules 6a–2 and 6a–3. The information registered exchanges are required to update under Rules 6a–2 and 6a–3 is not substantially different from what registered exchanges are required to update today. The Commission has provided the chart below to assist currently registered exchanges in complying with the filing obligations under amended Rules 6a–2 and 6a–3.

Amended form 1	Filing requirements under amended rules 6a–2 and 6a–3	Corresponding part of former Form 1 on which information was requested
Questions 1–7 of the Execution Page	File an amendment within 10 days after any action is taken that renders the information previously filed inaccurate (Rule 6a–2((a)(1)).	Questions 1–6 of the Statement.
Exhibit A	File an amendment every three years (Rule 6a–2(c)) or make information available by publication, upon request, or via an Internet Web site (Rule 6a–2(d)).	Exhibit A(1).
Exhibit B	File an amendment every three years (Rule 6a–2(c)) or make information available by publication, upon request, or via an Internet Web site (Rule 6a–2(d)).	Exhibit A(2).
Exhibit C	File an amendment every three years (Rule 6a–2(c)) or make information available by publication, upon request, or via an Internet Web site (Rule 6a–2(d)).	Question 7 of the Statement.
	File an amendment within 10 days after any action is taken that renders the information previously filed inaccurate (Rule 6a–2(a)(2)).	Exhibit A(3) Exhibit H.
Exhibit D	File an annual amendment (Rule 6a–2(b)(1))	Exhibit F.
Exhibit E	No requirement to update; only required on application for registration	
Exhibit F	File an amendment within 10 days after any action is taken that renders the information previously filed inaccurate (Rule 6a–2(a)(2)).	Exhibit B.
Exhibit G	File an amendment within 10 days after any action is taken that renders the information previously filed inaccurate (Rule 6a–2(a)(2)).	Exhibit C.
Exhibit H	File an amendment within 10 days after any action is taken that renders the information previously filed inaccurate (Rule 6a–2(a)(2)).	Exhibit D.
Exhibit I	File an annual amendment (Rule 6a–2(b)(1))	Exhibit E.

[421] If circuit breakers are imposed in one market, but not in another, overall market disruptions caused by trading imbalances can migrate from one market to the next, and efforts to stabilize such imbalances during periods of heavy trading and extreme volatility would be subverted. *See also* Securities Exchange Act Release No. 39846 (Apr. 9, 1998), 63 FR 18477 (Apr. 15, 1998) (approving proposed changes to SRO rules regarding circuit breakers).

[422] Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b).

[423] 17 CFR 240.6a–1, 240.6a–2 and 240.6a–3.

[424] Exhibit E requires an exchange to describe, among other things, the means of access to the electronic trading system, the procedures governing display of quotes and/or orders, execution, reporting, clearance, and settlement. Exhibit L requires an exchange to describe its criteria for membership, conditions under which members may be subject to suspension or termination, and procedures that would be involved in such suspension or termination.

[425] Exhibit K requires non-member owned exchanges to provide a list of direct owners and control persons.

[426] *See* NYSE Letter at 11; Amex Letter at 6.

Amended form 1	Filing requirements under amended rules 6a–2 and 6a–3	Corresponding part of former Form 1 on which information was requested
Exhibit J	File an amendment every three years (Rule 6a–2(c)) or make information available by publication, upon request, or via an Internet Web site (Rule 6a–2(d)). File an amendment within 10 days after any action is taken that renders the information previously filed inaccurate (Rule 6a–2(a)(2)).	Exhibit G.
Exhibit K	Only for-profit exchanges are required to file an annual amendment (Rule 6a–2(b)(2)) or make information available by publication, upon request, or via an Internet Web site (Rule 6a–2(d)), and to file an amendment within 10 days after any action is taken that renders the information previously filed inaccurate (Rule 6a–2(a)(2)).	
Exhibit L	No requirement to update; only required on application for registration as an exchange.	
Exhibit M	File an amendment (Rule 6a–2(b)(2)) or make information available by publication, upon request, or via an Internet Web site (Rule 6a–2(d)).	Question 8 of the Statement.
	File an amendment within 10 days after any action is taken that renders the information previously filed inaccurate (Rule 6a–2(a)(2)).	Question 9(a) of the Statement.
Exhibit N	File an amendment (Rule 6a–2(b)(2)) or make information available by publication, upon request, or via an Internet Web site (Rule 6a–2(d)).	Exhibit I. Exhibit J. Exhibit K. Exhibit L. Exhibit M.
Deleted		Question 9(b) of the Statement.

2. Amendments to Rules 6a–1, 6a–2, and 6a–3 Under the Exchange Act

In order to reduce some of the filing burdens for exchanges and to allow exchanges to comply with the filing requirements by posting information on an Internet web page, the Commission is amending Rules 6a–1, 6a–2, and 6a–3 under the Exchange Act.

a. Rule 6a–1 Application for Registration as an Exchange or Exemption Based on Limited Volume of Transactions

The Commission proposed to amend Rule 6a–1 to clarify that Form 1 should only be used by an exchange to apply for registration as a national securities exchange or for an exemption from registration under section 5 of the Exchange Act based on such exchange's limited volume of transactions. The Commission received no comments on these proposed changes and is adopting them as proposed.

b. Rule 6a–2 Periodic Amendments

Paragraph (a) of amended Rule 6a–2 requires an exchange to file an amendment to Form 1 within 10 days of changes to: (1) Information filed on the Execution Page of Form 1, or amendment thereto; (2) information regarding all affiliates and subsidiaries (Exhibit C); (3) application for membership, participation or subscription to the exchange or for a person associated with a member, participant, or subscriber of the exchange (Exhibit F); (4) financial statements, reports or questionnaires required of members, participants or subscribers (Exhibit G); (5) listing applications, any agreements required to be executed in connection with listing and a schedule of listing fees (Exhibit H); [427] (6) officers, governors, members of all standing committees, or persons performing similar functions, who presently hold or have held their offices or positions during the previous year (Exhibit J); (7) persons with direct ownership and control for non-member owned exchanges (Exhibit K); and (8) any members, participants, subscribers or other users and the information pertaining thereto (Exhibit M).[428] Additionally, rather than exchanges filing these changes in the form of a notice, as is currently required under paragraph (a) of Rule 6a–3, the changes will be filed in the form of an amendment on Form 1.

These amendments to Rule 6a–2 relieve exchanges from some of the filing requirements to which exchanges are currently subject. Specifically, a registered exchange no longer has to file notice within 10 days of changes to: (1) Its constitution, articles of incorporation or association, or by-laws (Exhibit A); (2) written rulings or settled practices of any governing board or committee of the exchange that have the effect of rules or interpretations (Exhibit B); and (3) the schedule of securities listed on the exchange (Exhibit N).

Paragraph (b) of amended Rule 6a–2 requires an exchange to file annually an amendment to Form 1 with the following information: (1) Unconsolidated financial statements for each subsidiary or affiliate or the exchange for latest fiscal year (Exhibit D); (2) audited consolidated financial statements for last fiscal year of the exchange prepared in accordance with, or reconciled to, United States generally accepted accounting principals (Exhibit I); [429] (3) a list of persons with direct ownership and control for non-member exchanges (Exhibit K); (4) a list of all members, participants, subscribers or other users and the information pertaining thereto (Exhibit M); and (5) a schedule of securities listed on the exchange, securities admitted to unlisted trading privileges and securities admitted to trading on the exchange which are exempt from registration under Section 12(a) of the Act (Exhibit N).[430] These amendments remove exchanges' obligations to include the following as part of the annual amendment: (1) The exchange's affiliates and subsidiaries (Exhibit C) and (2) a list of officers, governors, and members of standing committees be

[427] A technical modification was made to the amendments as proposed to include Exhibit H in Rule 6a–2(a)(2).

[428] Rule 6a–2(a), 17 CFR 240.6a–2(a).

[429] A technical modification was made to the amendments as proposed to remove Exhibit I from Rule 6a–2(a)(2) and to include Exhibit I in Rule 6a–2(b)(1).

[430] A technical modification was made to the amendments to include Exhibit N in Rule 6a–2(b)(2).

included as part of an annual amendment (Exhibit J).

Paragraph (c) of amended Rule 6a–2 requires an exchange to file an amendment to Form 1 every three years with the following information: (1) A copy of the constitution, articles or incorporation or association and by-laws (Exhibit A); (2) a copy all written rulings, settled practices having effect of rules and interpretations of any governing board or committee of the exchange (Exhibit B); (3) information regarding all affiliates and subsidiaries (Exhibit C); and (4) a list of officers, governors, members of all standing committees, or persons performing similar functions, who presently hold or have held their offices or positions during the previous year (Exhibit J).[431]

Paragraph (d) of amended Rule 6a–2 provides exchanges with alternatives to the annual filing requirement for Exhibits K, M, and N, and to the three year filing requirement for Exhibits A, B, C, and J. Pursuant to Rule 6a–2(d) exchanges have the following options, in lieu of paper filing: (1) To publish or cooperate in the publication of this information on an annual or more frequent basis, and to certify to the accuracy of the information; (2) to keep the information up to date, and certify that the information is up to date and available to the Commission and the public upon request; or (3) to make the information available continuously on an Internet web site controlled by an exchange, indicate the location of the Internet Web site where such information may be found, and to certify that the information available at such location is accurate as of its date.[432]

Comments from the NYSE and the Amex suggested that the amendments to Rule 6a–2 and Form 1, as adopted, reimpose some of the annual filing requirements previously eliminated.[433] As discussed above, Rule 6a–2 and Form 1, as adopted, relax the current filing burdens without reimposing any filing requirements. The technical modifications to the amendments to Rule 6a–2 clarify the operation of the rule, as adopted.

c. Rule 6a–3 Supplemental Material

Paragraph (b) of Rule 6a–3 currently requires registered exchanges, or exchanges exempt from registration based on their limited volume of transactions, to furnish to the Commission copies of all materials issued or made available to members. The Commission proposed to continue to require exchanges to provide the Commission with the information currently required under the rule. However, as an alternative to filing such information on paper, the Commission proposed to permit exchanges to make the information available on an Internet web site and provide the Commission with the location of the web site. The Commission did not receive comments addressing these proposed changes, and is adopting the amendments to Rules 6a–3(b) as proposed.[434]

D. National Securities Exchanges Operating Alternative Trading Systems

National securities exchanges could, under the rules the Commission is adopting today, form subsidiaries or affiliates that operate alternative trading systems registered as broker-dealers.[435] If a national securities exchange chose to form such a subsidiary or affiliate, the exchange itself could remain registered as a national securities exchange, while the subsidiary or affiliate operated as a broker-dealer. Such subsidiaries or affiliates would of course be required to become members of a national securities association or another national securities exchange.[436] In addition, any subsidiary or affiliate of a registered exchange could not integrate, or otherwise link the alternative trading system with the exchange, including using the premises or property of such exchange for effecting or reporting a transaction, without being considered a ''facility of the exchange.'' [437]

V. Broker-Dealer Recordkeeping and Reporting Obligations

A. Elimination of Rule 17a–23

Under the regulatory framework adopted in this release, alternative trading systems are required to register as exchanges or broker-dealers, and comply with the requirements under Regulation ATS. These systems are currently subject to recordkeeping and reporting requirements under Rule 17a–23 of the Exchange Act.[438] Because these alternative trading systems are now subject to recordkeeping and reporting requirements relating to their operations, either as registered exchanges or as broker-dealers under proposed Regulation ATS, the Commission is eliminating duplicative recordkeeping and reporting obligations for these systems by repealing Rule 17a–23. Only the recordkeeping requirements in Rule 17a–23 as they apply to broker-dealers that are not also alternative trading systems, are being moved to the broker-dealer recordkeeping rules, Rules 17a–3 and 17a–4 under the Exchange Act.

B. Amendments to Rules 17a–3 and 17a–4

Certain trading systems operated by broker-dealers are not alternative trading systems, and therefore are not required to register as exchanges or comply with Regulation ATS under the framework the Commission is adopting today. This group of internal broker-dealer systems [439] will continue to be regulated under the traditional broker-dealer regulatory scheme. The Commission is amending Rules 17a–3 and 17a–4 under the Exchange Act [440] to require broker-dealers to continually make and keep records regarding the activities of internal broker-dealer systems for non-alternative trading systems. These recordkeeping requirements are similar to the recordkeeping requirements under Rule 17a–23, which the Commission today is repealing.[441] The Commission believes that these recordkeeping requirements continue to be valuable to the oversight and inspections of internal broker-dealer systems by the Commission and the SROs.

These amendments ensure that broker-dealers continue to keep records of any of their customers that have access to their internal broker-dealer system, as well as any affiliations between those customers and the

[431] A technical modification was made to the amendments to include Exhibit J in Rule 6a–2(c).

[432] Rule 6a–2(d), 17 CFR 240.6a–2(d).

[433] Securities Exchange Act Release No. 35123 (Dec. 20, 1994), 59 FR 66692 (Dec. 28 1994).

[434] 17 CFR 240.6a–3. This rule is now found at paragraph (c) of Rule 6a–3.

[435] In addition, the owner of the alternative trading system would continue to be liable for securities law violations.

[436] *But see supra* note 374.

[437] Section 3(a)(2) of the Exchange Act, 15 U.S.C. 78c(a)(2). *See also* supra note 48 (discussing the OptiMark System as a facility of the PCX); 35030 (Nov. 30, 1994), 59 FR 63141 (Dec. 7, 1994) (discussing the Chicago Match system as a facility of the CHX); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (discussing the Off-Hours Trading system as a facility of the NYSE).

[438] 17 CFR 240.17a–23.

[439] The term ''internal broker-dealer system'' is defined as ''any facility, other than a national securities exchange, an exchange exempt from registration based on limited volume, or an alternative trading system as defined in Regulation ATS * * * that provides a mechanism, automated in full or in part, for collecting, receiving, disseminating, or displaying system orders and facilitating agreement to the basic terms of a purchase or sale of a security between a customer and the sponsor, or between two customers of the sponsor, through use of the internal broker-dealer system or through the broker or dealer sponsor of such system.'' Rule 17a–3(a)(16)(ii)(A), 17 CFR 240.17a–3(a)(16)(ii)(A).

[440] 17 CFR 240.17a–3 and 240.17a–4.

[441] Only one commenter addressed the Commission's proposal to repeal Rule 17a–23 and amend Rules 17a–3 and 17a–4. This commenter agreed that amended Rules 17a–3 and 17a–4 would impose similar obligations as current Rule 17a–23. TBMA Letter at 25–26.

broker-dealer. Broker-dealers are also required to keep daily trading summaries, including information on the types of securities for which transactions have been executed through the internal broker-dealer system, and transaction volume information.[442] In addition, to clarify the application of Rule 17a–3, the Commission is defining, for the purposes of the rule, the terms ''internal broker-dealer system,'' [443] ''sponsor,'' [444] and ''system order.'' [445]

The Commission is also amending Rule 17a–4 under the Exchange Act to require that the records required under the amendments to Rule 17a–3 be preserved for three years, the first two years in an accessible place.[446] This amendment also requires the preservation of all notices regarding an internal broker-dealer system provided to its participants, whether communicated in writing, through the internal broker-dealer system, or by other automated means. Such notices include notices concerning the internal broker-dealer system's hours of operations, malfunctions, procedural changes, maintenance of hardware and software, and instructions for accessing the system.

VI. Temporary Exemption of Pilot Trading System Rule Filings

A. Introduction

The Commission recognizes that registered exchanges, unlike alternative trading systems registered as broker-dealers, must submit rule filings for Commission approval. In the Concept Release, the Commission generally sought comment on ways to expedite the rule filing process and specifically sought comment on whether the Commission should exempt new SRO trading systems or mechanisms from rule filing requirements.[447] Commenters pointed out that, under the current regulatory structure, registered exchanges and alternative trading systems compete on a ''playing field that is far from level,'' [448] and attributed this, in part, to exchanges' inability to implement new trading systems before submitting a rule filing and receiving Commission approval.[449] In response to commenters' concerns and to make existing markets more competitive, the Commission proposed Rule 19b–5, a temporary exemption for SROs that would defer the rule filing requirements of Section 19(b) under the Exchange Act [450] for pilot trading systems (''pilot trading system rule'').[451]

In formulating the pilot trading system rule, the Commission drew on its prior experience with SROs' attempts to operate new pilot trading systems for their members.[452] In the Proposing Release, the Commission sought comment on whether the proposed pilot trading system rule would provide appropriate regulation and would level the competitive playing field between SROs and alternative trading systems. As an alternative, the Commission sought comment on the benefits and disadvantages of allowing SROs to file proposed rule changes relating to pilot trading systems under an expedited approval process pursuant to section 19(b)(3)(A) of the Exchange Act. Overall, comments on the proposed pilot trading system rule were supportive of it as a way to ease the regulatory disparity between registered exchanges and alternative trading systems.

The Commission received no comments opposing proposed Rule 19b–5. In general, commenters supported the proposal, stating that it would encourage further innovation and reduce some of the regulatory burdens that make it difficult for SROs to compete with broker-dealer operated trading systems. Some commenters, while generally supporting the temporary exemption, suggested modifying proposed Rule 19b–5. These comments focused on the proposed definition of a pilot trading system, the types of securities the Commission proposed to allow SROs to trade on pilot trading systems, and the confidential treatment of information filed by SROs regarding their pilot trading systems.[453] After considering the comments, the Commission is adopting Rule 19b–5 substantially as proposed.

Currently, SROs are required to submit a rule filing to the Commission and undergo a public notice, comment, and approval process before they operate any new trading system.[454] As adopted, the pilot trading system rule permits SROs that develop separate, new systems that qualify as ''pilot trading systems,'' [455] to begin their operation shortly after submitting new Form PILOT to the Commission is merely an informational filing and an SRO does not need to await Commission approval to begin operating its pilot trading system.[456] During the operation of the pilot trading system, the

[442] Rules 17a–3(a)(16)(i)(B) and (C), 17 CFR 240.17a–3(a)(16)(i)(B) and (C).

[443] *See supra* note 439.

[444] The term ''sponsor'' is defined as ''any broker or dealer that organizes, operates, administers, or otherwise directly controls an internal broker-dealer system or, if the operator of the internal broker-dealer system is not a registered broker or dealer, any broker or dealer that, pursuant to contract, affiliation, or other agreement with the system operator, is involved materially on a regular basis with executing transactions in connection with use of the internal broker-dealer system, other than solely for its own account or as a customer with access to the internal broker-dealer system.'' Rule 17a–3(a)(16)(ii)(B), 17 CFR 240.17a–3(a)(16)(ii)(B).

[445] The term ''system order'' is defined as ''any order or other communication or indication submitted by any customer with access to the internal broker-dealer system for entry into a trading system announcing an interest in purchasing or selling a security,'' but specifically excludes ''inquiries or indications of interest that are not entered into the internal broker-dealer system.'' Rule 17a–3(a)(16)(ii)(C), 17 CFR 240.17a–3(a)(16)(ii)(C).

[446] Rules 17a–4(b)(1) and (10), 17 CFR 240.17a–4(b)(1) and (10).

[447] *See* Concept Release, *supra* note 2, 62 FR at 30518–19.

[448] *See* Proposing Release, *supra* note 3 (discussing comments responding to the Concept Release).

[449] *Id.* at n.252.

[450] 15 U.S.C. 78s(b).

[451] The Commission is also adopting measures to relieve SROs of the requirement to file rule changes with the Commission when an SRO wishes to list or trade new derivative securities products. Securities Exchange Act Release No. 40761 (Dec. 8, 1998).

[452] For example, in November 1990, the NYSE submitted a rule filing proposing an after-hours crossing system to automate the execution of single stock orders and baskets of securities and received Commission approval in May 1991. *See* Securities Exchange Act Release Nos. 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991); 32368 (May 25, 1993), 58 FR 31565 (June 3, 1993). In August 1993, the CHX submitted a rule filing to operate the Chicago Match system, an electronic matching system that crossed orders entered by the CHX's members and non-members including institutional customers, and obtained Commission approval in November 1994. *See* Securities Exchange Act Release No. 35030 (Nov. 30, 1994), 59 FR 63141 (Dec. 7, 1994). More recently, in May 1997, the PCX submitted a rule filing for approval of the OptiMark System and received Commission approval in September 1997. *See* Securities Exchange Act Release No. 39086 (Sept. 17, 1997), 62 FR 50036 (Sept. 24, 1997).

[453] *See* ICI Letter at 5; Corporate Capital Letter at 2; CBOE Letter at 8; CHX Letter at 11; NASD Letter at 13; Amex Letter at 1–2; NYSE Letter at 9; American Century Letter at 6. *See also* Ashton Letter at 2; CME Letter at 4; SIA Letter at 15; PCX Letter at 8.

[454] Section 19(b)(1) of the Exchange Act, 15 U.S.C. 78s(b)(1), requires an SRO to file with the Commission any proposed rule or any proposed rule change (''proposed rule change'') accompanied by a concise general statement of the basis and purpose of the proposal. Once a proposed rule change has been filed, the Commission is required to publish notice of it and provide an opportunity for public comment. The proposed rule change may not take effect unless it is approved by the Commission or is otherwise permitted to become effective under Section 19(b) of the Exchange Act. Section 19(b)(2) of the Exchange Act, 15 U.S.C. 78s(b)(2), sets forth the standards and time periods for Commission action either to approve a proposed rule change or to institute and conclude a proceeding to determine whether a proposed rule change should be disapproved. The Commission may also approve a proposed rule change on an accelerated basis if the Commission finds good cause for so doing and publishes its reasons for so finding. Section 19(b)(2) of the Exchange Act, 15 U.S.C. 78s(b)(2)(B).

[455] *See* paragraph (c) of Rule 19b–5, 17 CFR 240.19b–5(c), for the definition of ''pilot trading system.''

[456] 17 CFR 249.821.

sponsoring SRO must submit to the Commission quarterly reports, as well as amendments to Form PILOT concerning any material changes to the pilot trading system. Rule 19b–5 exempts an SRO from the requirement to file rule changes for the pilot trading system with the Commission for two years. Before two years expire, the SRO must submit a rule filing to obtain from the Commission permanent approval of the pilot trading system or must cease operation of the trading system.[457] In addition, the temporary exemption under Rule 19b–5 expires sixty days after a pilot trading system exceeds certain volume levels. A pilot trading system that exceeds these volume levels must file for permanent approval before the two-year period expires.[458]

The Commission believes the pilot trading system rule addresses many of the concerns raised by commenters.[459] Inherent in the rule filing process is public disclosure of SROs' business plans for trading systems prior to their operation. Consequently, SROs' competitors are informed about the proposed pilot trading system and have an avenue to copy, delay, or obstruct implementation of the trading system before it can be tested in the marketplace.[460] The rule filing process also hinders innovation because registered exchanges do not realize the full competitive benefits of their efforts.[461] In contrast, alternative trading systems that offer similarly innovative, start-up services do not have the same rule filing obligations and, thus, have a significant advantage in their flexibility to devise, implement, and modify new pilot trading systems. Comments to the Proposing Release echo these concerns.[462] By deferring the rule filing process, the pilot trading system rule allows SROs to better compete with alternative trading systems, while continuing to ensure that investors are protected and the pilot trading system is operated in a manner consistent with the Exchange Act.

Finally, the Commission recognizes that domestic markets must compete with less regulated foreign markets and broker-dealers. The Commission agrees with commenters that excessive regulation of traditional exchanges, alternative trading systems, or other markets hinders these exchanges' ability to compete and survive in the global arena. The pilot trading system rule responds to SROs' need for a more balanced competitive playing field.

B. Rule 19b–5

The Commission is adopting Rule 19b–5 to provide a temporary exemption from Section 19(b) of the Exchange Act for SRO proposed rule changes concerning the operation of pilot trading systems.

1. Types of Systems Eligible for Exemption Under Rule 19b–5

a. Definition of Pilot Trading System. The Commission is adopting the definition of pilot trading system substantially as proposed. Under paragraph (c) of Rule 19b–5, a trading system operated by an SRO would be a ''pilot trading system'' if it met one of two definitions. First, a trading system would be a ''pilot trading system,'' even if it traded the same securities or operated during the same hours as an SRO's existing trading system, if the SRO operated it for less than two years, and during at least two of the last four consecutive calendar months, it traded no more than one percent of the U.S. average daily trading volume of each security traded on the trading system. In addition, the trading system could not have an aggregate share trading volume of more than twenty percent of the average daily trading volume of all trading systems operated by the SRO.[463] Second, a trading system would also be considered a ''pilot trading system'' if it were independent[464] of any other trading system operated by the SRO, the SRO operated it for less than two years, and, during at least two of the last four consecutive calendar months, it traded no more than five percent of the U.S. average daily trading volume of each security traded on the trading system. In addition, under this second definition, the trading system would have to have aggregate share trading no more than twenty percent of the average daily trading volume of all trading systems operated by the SRO.[465]

If at any time within the two-year period a pilot trading system exceeds the volume thresholds, it would be allowed to continue to operate for 60 more days under this exemption.[466] During this 60 day period, if the SRO intended to continue operating the trading system, it would have to file for permanent approval under Section 19(b) of the Exchange Act of the rules related to the trading system.

The Commission received several comments asking the Commission to relax or eliminate the proposed requirement that, to be a pilot trading system with five percent of the trading volume in a security, the pilot trading system would have to be ''independent.'' As proposed, a pilot trading system would be independent if it trades securities different from the issues of securities traded on any other trading system that is operated by the same SRO and that has been approved by the Commission. A pilot trading system would also be deemed independent if it does not operate during the same trading hours as any other trading system that is operated by the same SRO and that has been approved by the Commission. Finally, a pilot trading system would be deemed independent if no market maker or specialist on any other trading system operated by the SRO trades on the pilot trading system the same securities in which they act as a market maker or specialist.[467] The Commission emphasized that a pilot trading system need only satisfy one of the three criteria to qualify the pilot trading system as independent. After considering the comments, the Commission continues to believe such criteria are not unduly restrictive and are necessary for the protection of investors, and is adopting it as proposed.

b. *Response to Comments on the Proposed Definition of Pilot Trading System.* In its proposed definition of a pilot trading system, the Commission sought to impose limits that were in the public interest and for the protection of investors, while still providing SROs with the flexibility to innovate. The Commission requested comment on this proposed definition, and specifically asked whether the proposed two-year time period, trading volume limits, and independence criteria were appropriate. Commenters were asked to provide specific reasons for any concerns about the proposed definition and to suggest alternatives. Several commenters focused on particular aspects of the proposed pilot trading system definition.

The NYSE commented that the specific provisions of proposed Rule

[457] Rule 19b–5(f)(1) and (f)(2), 17 CFR 240.19b–5(f)(1) and (f)(2). *See also infra* Section VI.C.

[458] Rule 19b–5(c)(3), 17 CFR 240.19b–5(c)(3).

[459] *See infra* Section VI.B.

[460] *See* Proposing Release, *supra* note 3, at ns.256–61 and accompanying text.

[461] *See* Proposing Release, *supra* note 3, at n.261.

[462] *See* Ashton Letter at 2; SIA Letter at 15; CME Letter at 3; Amex Letter at 1; Bloomberg Letter at 6.

[463] Rule 19b–5(c)(2), 17 CFR 240.19b–5(c)(2).

[464] A pilot trading system is ''independent'' of other trading systems if it meets one of the standards set forth in paragraph (d) of Rule 19b–5.

[465] Rule 19b–5(c)(1), 17 CFR 240.19b–5(c)(1).

[466] Rule 19b–5(c)(3), 17 CFR 240.19b–5(c)(3). *See also infra* Section VI.C.

[467] Rule 19b–5(d), 17 CFR 240.19b–5(d). For purposes of the pilot trading system rule, a specialist means any member subject to a requirement of an SRO that such member regularly maintain a market in a particular security. Rule 19b–5(a), 17 CFR 240.19b–5(a).

19b–5 were carefully crafted. In addition, the NYSE agreed with the Commission's proposal to distinguish between systems that are ''independent'' of other SRO trading systems and systems that work together with existing SRO trading systems.[468] The ICI supported the proposed limited exemption for pilot trading systems. The ICI, however, discouraged any further expansion of the criteria that would constitute a pilot trading system and encouraged the Commission to carefully monitor pilot trading systems as they operate under the exemption.[469]

On the other hand, several commenters stated that Rule 19b–5 should be liberalized to provide SROs with a meaningful opportunity to develop pilot trading systems on a comparable basis to alternative trading systems.[470] For example, the CME generally asserted that the numerous proposed restrictions on what would qualify as a pilot trading system would render the proposal of little practical value to exchanges.[471] With regard to the volume thresholds proposed by the Commission, the NASD and the PCX stated that the volume thresholds were too low. [472] The PCX stated that the volume restrictions did not make sense because they limited the ability of registered exchanges to introduce new trading systems—particularly when neither alternative trading systems nor third market makers are subject to similar volume limitations. Instead, the PCX stated that Rule 19b–5 should treat exchange pilot trading systems as though they were alternative trading systems for two years, provided the trading systems did not exceed a fairly high percentage (perhaps ten percent) of total trading volume in any security.[473] Moreover, the Amex said the volume thresholds for individual securities would limit the utility of the exemption for primary markets. In particular, the Amex suggested that the Commission apply only an aggregate volume threshold whereby volume in an SRO pilot trading system could not exceed a specified percentage of total volume in all such SRO's trading systems. This approach, the Amex believed, would eliminate the administrative burden on SROs monitoring the one percent or five percent thresholds and would avoid the potentially adverse impact on the operation and success of a pilot trading system that could occur by removing securities from the system that exceeded a specified threshold.[474]

Other commenters thought the criteria establishing the independence of a pilot trading system from other trading systems operated by the same SRO were too restrictive.[475] In particular, the CBOE and NASD asserted that the independence criteria unnecessarily precluded exchange specialists and market makers from participating in pilot trading systems.[476] Similarly, the CHX stated that it was too limiting to require a pilot trading system to trade different securities or operate during different hours than the sponsoring SRO's other trading systems in order to be ''independent.'' [477]

c. Adopted Definition of Pilot Trading System. The Commission has considered these comments. As discussed above, it believes that, because the proposed definition of a pilot trading system, including the proposed volume thresholds and independence criteria is novel and untried, the criteria are appropriate. The Commission notes that, pursuant to paragraph (b)(5) under section 6 of the Exchange Act, rules of a registered exchange should be designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and, in general, to protect investors and the public interest.[478] The Commission believes that the desire of the registered exchanges to innovate and compete with alternative trading systems must be balanced with their statutory obligations under section 6 of the Exchange Act. Therefore, the volume thresholds and other standards are designed to ensure that once a pilot trading system's activities reach a significant level, the pilot trading system will be subject to the public notice and comment process under section 19(b) of the Exchange Act. The Commission recognizes that the definition of ''pilot trading system'' is more narrow than some SROs would prefer, but notes that this does not prevent registered exchanges from developing trading systems that do not meet the definition of ''pilot trading system'' and filing proposed rule changes relating to those systems under section 19(b) of the Exchange Act.

Similarly, through the independence criteria, the Commission identified characteristics that render pilot trading systems sufficiently distinct from the sponsoring SRO's other trading systems so that a five percent, rather than one percent volume level, is acceptable. ''Independent'' pilot trading systems pose less risk of substantially changing the existing markets in a manner detrimental to investors and, therefore, the Commission believes should be able to operate under the exemption at higher volume thresholds than their ''non-independent'' counterparts before having to submit proposed rule filings under section 19(b) of the Exchange Act.[479] The Commission will monitor use of the pilot trading system exemption, and will consider modifying these criteria in the future based on its experience with SRO's use of the exemption.

2. Scope of Pilot Trading Rule Exemption

The Commission is adopting Rule 19b–5 to provide a temporary exemption from Section 19(b) of the Exchange Act for SRO proposed rule changes concerning the operation of pilot trading systems. This temporary exemption includes all rules related to the operation of pilot trading systems. The Commission defines trading system in paragraph (b) of Rule 19b–5 to include the rules of a self-regulatory organization that: (i) Determine how the orders of multiple buyers and sellers are brought together; and (ii) establish non-discretionary methods under which such orders interact with each other and under which the buyers and sellers entering such orders agree to the terms of trade.[480] The Commission intends this exemption to provide SROs with flexibility to establish and modify the pilot trading system without obtaining prior approval from the Commission. However, this exemption does not include any SRO rules that would fundamentally affect the relationship between an SRO's members and those members' customers, or an SRO's oversight of its members.

The Commission notes that Rule 19b–5 does not relieve SROs from any obligation under the federal securities laws, other than the requirement to file proposed rule changes relating to the operation of a pilot trading system. Rule 19b–5, therefore, does not provide an exemption for SRO rules relating to other requirements imposed under other provisions of the Exchange Act, such as sections 11(a) and 10(a), and Rule 10a–1 thereunder. In addition, an SRO must ensure that securities listed and traded on any pilot trading system comply

[468] NYSE Letter at 9.

[469] ICI Letter at 5.

[470] *See* CBOE Letter at 2, 9; CHX Letter at 11; CME Letter at 4; PCX Letter at 8–10.

[471] *See* CME Letter at 4; PCX Letter at 9–10.

[472] *See* NASD Letter at 13; PCX Letter at 9–10.

[473] PCX Letter at 9–10.

[474] Amex Letter at 1, 3.

[475] *See* CBOE Letter at 9; CHX Letter at 11.

[476] *See* CBOE Letter at 9; NASD Letter at 2, 14.

[477] CHX Letter at 11.

[478] 15 U.S.C. 78f(b)(5).

[479] *See supra* note 467 and accompanying text.

[480] Rule 19b–5(b), 17 CFR 240.19b–5(b).

with, among other things, the registration requirements of the Exchange Act.[481] An SRO also continues to be required to enforce compliance with its own rules and the federal securities laws, including members' compliance with the Order Handling Rules.[482] SROs, similarly, are expected to operate the pilot trading systems in compliance with rules governing market-wide trading halts.

3. SROs' Continuing Obligations Regarding Pilot Trading Systems

In order to ensure that pilot trading systems are operated in a manner consistent with the Exchange Act, the Commission proposed requiring SROs to comply with certain conditions before a pilot trading system would be eligible for the temporary exemption. In particular, the Commission proposed that SROs comply with the following with regard to pilot trading systems: (1) Notify and periodically file information about the pilot trading system with the Commission, (2) implement trading rules and procedures, (3) establish effective surveillance, (4) establish reasonable clearance and settlement procedures, (5) limit the types of securities traded, (6) cooperate with inspections and examinations by the Commission, and (7) have procedures to ensure the confidential treatment of trading information.[483]

The Commission sought comment on whether there were any additional conditions with which SROs should be required to comply in order to be temporarily exempt from the rule filing requirements under Rule 19b–5. Commenters did not recommend any additional conditions. The Commission notes, however, that, as discussed below, it is adding a requirement that SROs make publicly available the rules relating to the operation of the pilot trading system.[484]

In the Proposing Release, the Commission stated that SROs would have to ''ensure'' that these conditions were satisfied in order to rely on the temporary exemption under proposed Rule 19b–5. One commenter raised concerns regarding the requirement that SROs ''ensure'' that the conditions were met in order to rely on the proposed pilot trading system rule. Specifically the CBOE requested that an SRO be allowed to rely on proposed Rule 19b–5 if the SRO acts in good faith in determining that the requirements of the pilot trading system rule have been met.[485] Based upon the Commission's experience with reviewing new pilot trading system proposals submitted by SROs, the Commission continues to believe that SROs operating pilot trading systems should satisfy the proposed requirements in order to operate such systems in a manner consistent with the Exchange Act. Nonetheless, the Commission recognizes that full compliance with some of the conditions may be beyond the SROs' control. The Commission agrees it is not practical to hold SROs strictly liable for the failure of unaffiliated entities to satisfy certain requirements of the proposed pilot trading system rule. Therefore, the Commission will consider an SRO exempt from rule filing requirements under Rule 19b–5 if the SRO acts in good faith in determining that the operation of the pilot trading system meets the conditions set out in paragraph (e) of that rule, and in operating the pilot trading system.

a. Notice and Filings to the Commission. The Commission proposed that SROs be required to provide written notice of, and information about, the operation of a pilot trading system to the Commission on new Form PILOT. On Form PILOT, an SRO would have to provide general information about the pilot trading system, including: (1) The date the SRO expects to commence operation of the pilot trading system; (2) a list of securities to be traded; (3) a list of anticipated members to the pilot trading system; and (4) the names of entities assisting in the operation of the pilot trading system.[486] The SRO could start operation of the pilot trading system twenty days after this filing is complete. If the SRO materially changes its proposed pilot trading system prior to commencing operation, the SRO would be required to file an amendment to Form PILOT and wait twenty days before commencing operation. The Commission is adopting the notice requirement and Form PILOT as proposed.[487]

The twenty day period following an SRO's filing of Form PILOT is intended to provide the Commission with time to review the form for compliance by the SRO with the pilot trading system rule. In addition, after reviewing Form PILOT the Commission may determine, after notice to the SRO and an opportunity for the SRO to respond, that the operation of a particular pilot trading system would not be necessary or appropriate in the public interest or consistent with the protection of investors without the SRO filing proposed rule changes under section 19(b) of the Exchange Act.[488]

The Commission also proposed to require an SRO to file an amendment to Form PILOT at least twenty days before it implements any material change to the operation of the pilot trading system. The Commission would consider a material change to the pilot trading system to include the addition of new types of securities, or a new date for commencing operation of the pilot trading system. The Commission proposed that an SRO also submit quarterly reports on Form PILOT that would include information about the trading volume effected on the pilot trading system during the most recent calendar quarter. The Commission received no comments on these requirements and is adopting them as proposed.[489]

The Commission proposed that all notices and reports filed on Form PILOT be kept confidential. The Commission, however, requested comment on whether all information on Form PILOT should be publicly available or whether, as an alternative, information on Form PILOT should be publicly available, unless an SRO specifically requests confidential treatment. The Commission received several comments on the confidential treatment of information on Form PILOT. The CBOE recommended that all information about a pilot trading system filed quarterly on Form PILOT be deemed confidential.[490] The NYSE suggested only limited confidentiality for filings on Form PILOT, that is, pilot trading system information should be publicly available shortly prior to, or on the date of, launch of a new system.[491] Another commenter offered that the Commission make public only certain information on Form PILOT.[492] One commenter suggested that the confidential treatment of Form PILOT information be at the filer's discretion.[493]

[481] *See supra* notes 504–505 and accompanying text.

[482] *See* Section 6(b)(2) of the Exchange Act, 15 U.S.C. 78f(2). *See also* Order Handling Rules Adopting Release, *supra* note.

[483] The Commission is not adopting the requirement concerning the procedures to ensure the confidential treatment of trading information because SROs are not currently required to do this with regard to their other trading systems.

[484] *See* discussion *infra* VI.B.3.i.

[485] CBOE Letter at 10.

[486] Examples include computer companies that design and maintain systems and clearing agencies.

[487] Rule 19b–5(e)(1), 17 CFR 240.19b–5(e)(1).

[488] Rule 19b–5(g), 17 CFR 240.19b–5(g).

[489] Rule 19b-5(e)(1), 17 CFR 240.19b–5(e)(1). The Commission requires that SROs identify filings made pursuant to Rule 19b–5 by including a file number on Form PILOT that appears as follows: PILOT—name of SRO—year—file number.

[490] CBOE Letter at 9.

[491] NYSE Letter at 9.

[492] Amex Letter, p. 2.

[493] American Century Letter, p. 6.

After considering commenters' suggestions, the Commission has determined that the confidential treatment of Form PILOT information is an important element in reducing the disparate regulatory treatment of SROs and alternative trading systems and that such confidentiality is critical in the period prior to a pilot trading system commencing operations. However, the Commission also considers important the public's interest in having access to accurate information about the pilot trading system. Accordingly, the Commission is modifying proposed Rule 19b–5, so that information reported by an SRO on Form PILOT is confidential until the pilot trading system commences operation.[494] Thereafter, Form PILOT information will be made available to the public. b. Fair Access

b. Fair Access. Because information and access advantages of certain SRO members could subvert the fair and orderly trading of securities on a pilot trading system or the primary market, the Commission is adding a specific condition to the pilot trading system rule requiring that the SRO provide fair access to the pilot trading system to all members of the SRO. The Commission is adding this fair access requirement in order to ensure that markets treat their members fairly.[495] In particular, the SRO shall establish written standards for granting access to the pilot trading system and apply those standards fairly to all members. Fair access does not require an SRO to allow every member to trade on a pilot trading system or to give each member trading on the pilot trading system the same privileges. However, this requirement does prohibit an SRO from unfairly discriminating in the access it does give its members to the pilot trading system. In addition, the SRO must ensure that information regarding orders on the pilot trading system is equally available to all members of the SRO with access to the pilot trading system.[496] However, a specialist may have preferred access to information regarding orders it represents in its capacity as specialist on the pilot trading system.[497] This means that such SRO rules need not require a member acting as a specialist on the pilot trading system to expose its orders to all members, that is maintain an ''open book.'' Such rules established by the SRO will be considered part of the pilot trading system for purposes of the temporary exemption.[498]

c. Trading Rules and Procedures. The Commission proposed to require SROs operating pilot trading systems under Rule 19b–5 to adopt and implement trading rules and procedures necessary to operate the pilot trading system in a manner consistent with the Exchange Act. The Commission received no comments specifically addressing this condition and is adopting it substantially as proposed. As adopted, an SRO must have appropriate trading rules and procedures to promote the fair and orderly trading of securities on the pilot trading system, including: (1) Margin requirements; (2) listing standards; (3) sales practice guidelines, such as rules regarding communications with the public; and (4) disclosure requirements. The trading rules and procedures should be appropriate for, and ensure the fair and orderly trading of, each type of security to be traded on the pilot trading system.[499]

d. Surveillance. Under the proposal, an SRO would have to establish procedures for the effective surveillance of trading activity on a pilot trading system. In the Proposing Release, the Commission noted the importance of an SRO being able to obtain information necessary to detect and deter market manipulation, illegal trading, and other trading abuses. To satisfy this requirement, the Commission proposed that an SRO have to develop and implement internal surveillance procedures to monitor transactions effected on the pilot trading system, and obtain surveillance information from other markets, both domestic and foreign.

Specifically, in the Proposing Release, the Commission discussed its expectation that there be a comprehensive information sharing agreement (''ISA'') in place between the SRO operating a pilot trading system and any other market trading the securities, or trading the underlying securities of derivative securities products, traded on such pilot trading system.[500] Such agreements provide a necessary deterrent to manipulation because they facilitate the availability of information needed to fully investigate a potential manipulation. An SRO operating a pilot trading system trading U.S. securities, or new derivative securities products overlying U.S. securities, would have to continue to ensure that all exchanges on which the U.S. securities trade are members of the Intermarket Surveillance Group (''ISG'').[501] The ISG was formed to coordinate, among other things, effective surveillance and investigative information sharing arrangements in the stock and options markets.

The Commission received no comments specifically addressing the surveillance requirement under the proposed pilot trading system rule. The Commission continues to believe that in order for an SRO to operate a pilot trading system in a manner consistent with the Exchange Act, the SRO must be able to obtain information necessary to detect and deter market manipulation, illegal trading, and other trading abuses. Therefore, the Commission is adopting, as proposed, the requirement that an SRO develop and implement internal surveillance procedures to monitor transactions effected on the pilot trading system, and obtain surveillance information from other markets, both

[494] Rule 19b–5(e)(11), 17 CFR 240.19b–5(e)(11).

[495] The Commission notes that registered exchanges and national securities associations already have obligations to ensure that their markets treat investors and other market participants fairly. The Exchange Act requires registered exchanges and national securities associations to consider the public interest in administering their markets and to establish rules designed to admit members fairly. Sections 6(b)(2) and 6(c) of the Exchange Act, 15 U.S.C. 78f(b)(2) and (c); section 15A(b)(8) of the Exchange Act, 15 U.S.C. 78o–3(b)(8). *See also supra* notes 241–244 and accompanying text.

[496] Rule 19b–5(e)(2)(i), 17 CFR 240.19b–5(e)(2)(i).

[497] Rule 19b–5(e)(2)(ii), 17 CFR 240.19b–5(e)(2)(ii).

[498] Rule 19b–5(e)(2)(iii), 17 CFR 240.19b–5(e)(2)(iii).

[499] Rule 19b–5(e)(3), 17 CFR 240.19b–5(e)(3).

[500] The Commission believes that a comprehensive ISA requires that the parties provide to each other, upon request, information about market trading, clearing activity, and the identity of the ultimate purchasers and sellers of securities. *See* Securities Exchange Act Release No. 31529 (Nov. 27, 1992), 57 FR 57248 (Dec. 3, 1992). Similarly, an SRO that operates a pilot trading system that trades securities, or derivatives of securities that are listed or traded on a foreign market, should have a comprehensive ISA with such foreign markets. In addition, the SRO should ensure there are no blocking or secrecy laws in the foreign country that would prevent or interfere with the transfer of information under the comprehensive ISA. If securing a comprehensive ISA is not possible, the SRO should contact the Commission. In such instances, the Commission may determine that it is appropriate instead to rely on a Memorandum of Understanding (''MOU'') between the Commission and the foreign regulator. Generally, the Commission has permitted an SRO to rely on an MOU in the absence of a comprehensive ISA only if the SRO receives an assurance from the Commission that such an MOU can be relied on for surveillance purposes and includes, at a minimum, the transaction, clearing, and customer information necessary to conduct an investigation. *See* Securities Exchange Act Release No. 35184 (Dec. 30, 1994), 60 FR 2616 (Jan. 10, 1995). In addition, an SRO should endeavor to develop comprehensive ISAs with foreign exchanges even if the SRO receives prior Commission approval to rely on an MOU in place of a comprehensive ISA.

[501] *See* ISG Agreement, dated July 14, 1983, amended Jan. 29, 1990. The ISG members are: Amex, BSE, CBOE, CHX, NASD, NYSE, PCX, and Phlx. The major stock index futures exchanges joined the ISG as affiliate members in 1990.

domestic and foreign by means of an ISA.[502]

e. *Clearance and Settlement.* In the Proposing Release, the Commission observed that the integrity of the trading markets depends on the prompt and accurate clearance and settlement of securities transactions. For this reason, the Commission proposed that, as a condition of the exemption under Rule 19b–5, an SRO establish reasonable clearance and settlement procedures for transactions effected on the pilot trading system. For example, to ensure that adequate linkages have been formed, part of the user agreement should, at a minimum, request information about the name of the clearing agency member through which the user will clear its trades. The Commission received no comments specifically addressing the clearance and settlement requirement under the proposed pilot trading system rule. Therefore, the Commission is adopting as proposed, the requirement that an SRO operating a pilot trading system ensure that the necessary linkages to clearing agencies exist for all pilot trading system users.[503]

f. *Types of Securities.* The Commission proposed to limit the types of securities an SRO could trade on a pilot trading system. Two separate limitations were proposed. First, under the proposal a pilot trading system would only be permitted to trade securities listed on a national securities exchange or to which unlisted trading privileges was extended pursuant to a rule, regulation, or order of the Commission under section 12(f) of the Exchange Act. In general, section 12 of the Exchange Act requires an exchange to trade only those securities that the exchange lists, except that section 12(f) of the Exchange Act provides UTP under certain circumstances.[504] For example, under the OTC–UTP plan, exchanges are permitted to trade certain over-the-counter securities pursuant to a Commission order.[505] As proposed, a pilot trading system operated by a registered exchange or a national securities association would be limited to trading listed securities or securities to which UTP has been extended under section 12(f) of the Exchange Act. Because national securities associations currently trade securities that are neither exchange listed or subject to UTP, this provision was unnecessarily restrictive. Consequently, the Commission is modifying the limitation on the types of securities a pilot trading system may trade from that proposed. In particular, Rule 19b–5(e)(6), as adopted, only restricts pilot trading systems by requiring that securities traded be registered under section 12 of the Exchange Act.[506] Registered exchanges will still be required to comply with sections 12(a) and 12(f) of the Exchange Act, and therefore, can only trade securities listed on that exchange, or securities it is permitted to trade under the OTC–UTP Plan.

g. *Activities of Specialists.* As proposed, an SRO's pilot trading system would not be eligible for the exemption in Rule 19b-5 if it traded derivative securities, such as options, warrants, or hybrid products, the value of which were based, in whole or in part, upon the performance of any security traded on another trading system operated by that SRO. Similarly, the proposed exemption excluded SRO pilot trading systems that traded any security or instrument, such as an equity security, the derivative of which traded on another trading system operated by that SRO. The Commission, in proposing these limitations, intended to preclude an SRO from relying on the temporary exemption if a pilot trading system simultaneously traded a security overlying or underlying a security traded on that SRO's primary market. The Commission has always considered this type of trading to raise special concerns that should be resolved through the normal rule filing process.[507]

In commenting on proposed Rule 19b–5, the CBOE and the Amex considered these limitations overly restrictive. The Amex suggested removing this limitation and instead requiring SROs to specify on Form PILOT their rules and procedures for trading such securities on the pilot trading system.[508] The CBOE suggested an alternative to the limitation that pilot trading systems may not trade securities that overlie or underlie securities traded on another trading system operated by the same SRO. In particular, the CBOE suggested requiring the SRO to create firewalls or other safeguards between persons trading the derivative and the underlying or overlying securities, rather than flatly prohibiting it.[509]

After considering the commenters' recommendations, the Commission has determined that SROs may operate pilot trading systems under Rule 19b–5 that simultaneously trade a security that is overlying or underlying a security traded on another trading system operated by that market, provided that such trading remains separate. This means that, as part of the SRO's general requirement to have written trading rules and procedures to operate the pilot trading system,[510] an SRO must have adequate rules and procedures to trade related securities simultaneously. In addition, the Commission is adopting a more narrow prohibition than it proposed, which prohibits a member firm that is a specialist in a security from acting as a specialist on a pilot trading system operating during the same hours in a related security.[511] For example, a member firm may not be a specialist in a security, such as an equity security, on the pilot trading system when it is also a specialist in a derivative of that security, such as an option or equity-linked note, whose value, in whole or significant part, is based on the performance of that security.[512] The Commission would not consider listed options in a single underlying instrument to be related securities, for purposes of the pilot trading system exemption. The

[502] Rule 19b–-5(e)(4), 17 CFR 240.19b–5(e)(4).

[503] Rule 19b–5(e)(5), 17 CFR 240.19b–5(e)(5).

[504] 15 U.S.C. 78l(f).

[505] *See* Securities Exchange Act Release No. 39505 (Dec. 31, 1997), 63 FR 1515 (Jan. 9, 1998).

[506] Rule 19b–5(e)(6), 17 CFR 240.19b–5(e)(6).

[507] *See, e.g.,* Securities Exchange Act Release Nos. 21759 (Feb. 14, 1985), 50 FR 7250 (Feb. 21, 1985) (order approving NYSE proposal to trade options on NYSE-listed stocks in a separate physical location from the equity trading floor); 26147 (Oct. 3, 1988), 53 FR 39556 (Oct. 7, 1988) (order approving the trading on the Amex of options on Amex-listed stocks, concluding that side-by-side trading or integrated market-making issues did not arise because the Amex proposed to trade stocks and related options in physically separate locations); and 28556 (Oct. 19, 1990), 55 FR 43233 (Oct. 26, 1990) (order approving rule changes to establish rules governing the trading of stocks, warrants, and other securities instruments and contracts on the CBOE conditioned on the fact that trading in securities other than options will take place on a trading floor separate from the location where options are traded).

[508] Amex Letter at 4.

[509] CBOE Letter at 10.

[510] Rule 19b–5(e)(3), 17 CFR 240.19b–5(e)(3).

[511] Rule 19b–5(e)(7)(iii), 17 CFR 240.19b–5(e)(7)(iii), defines related securities to mean any two securities in which the value of one security is determined, in whole or significant part, by the performance of the other security; or the value of both securities is determined, in whole or significant part, by the performance of a third security, combination of securities, index, indicator, interest rate or other common factor.

[512] A specialist, for purposes of the pilot trading system rule, means any member that is subject to an SRO requirement to regularly maintain a market in a particular security. Rule 19b–5(a), 17 CFR 240.19b–5(a). The definition of specialist is meant to preclude member firms with exclusive information about buy and sell orders from using unfairly such non-public material market information to their competitive advantage. For instance, a member acting as a specialist on the NYSE also could not simultaneously act as a specialist in related securities on a pilot trading system sponsored by the NYSE. Similarly, a member acting as a designated primary market maker on the CBOE also could not simultaneously act as a designated primary market maker in related securities on a pilot trading system sponsored by the CBOE.

limitation under Rule 19b-5(e)(7)(ii) does not preclude any member firm from being a specialist on a pilot trading system in a security related to a security in which the member firm is a specialist on the SRO's other trading systems, when such related securities trade at different times.[513] Also, a member may be a specialist in related securities that, the Commission, upon application by the SRO, later determines is necessary or appropriate in the public interest and consistent with the protection of investors.[514]

The Commission notes that Rule 19b–5 does not prohibit an SRO from developing a trading system that permits a member firm to be a specialist in related securities that trade simultaneously on trading systems operated by the same SRO. However, the SRO could not avail itself of the Rule 19b–5 temporary exemption, and instead would have to file proposed rule changes with the Commission under Section 19(b) of the Exchange Act for public notice and comment and obtain Commission approval prior to operating such trading system.

h. *Inspections and Examinations.* As a condition to the exemption, the Commission proposed that an SRO cooperate with any examination or inspection by the Commission of persons effecting transactions on the pilot trading system. The Commission received no comments on this requirement and is adopting it as proposed.[515] As adopted, the SRO shall cooperate with the examination, inspection, or investigation by the Commission of transactions effected on the pilot trading system. The Commission staff will review SRO compliance with the conditions in Rule 19b–5 through its routine inspections. In order for the Commission staff to determine whether an SRO has properly relied on the exemption under Rule 19b–5, the SRO must maintain at its principal place of business all relevant records and information pertaining to the pilot trading system and the basis for which the SRO relied on the exemption from the rule filing requirement.[516] The Commission notes that if an SRO outsources the operation or maintenance of any aspect of a pilot trading system, such vendor would be considered to be operating a facility of an SRO and therefore would also be subject to Commission examination or inspection.

i. *Public Availability of Pilot Trading System Rules.* Although pilot trading system rules do not need to be approved by the Commission, the Commission believes the current trading rules and procedures of the pilot trading system should be publicly available. Accordingly, the Commission is adopting a requirement that the SRO make its trading rules and procedures of the pilot trading system publicly available.[517]

C. Rule Filing Under Section 19(b)(2) of the Exchange Act Required Within Two Years

Within two years of a pilot trading system commencing operation, an SRO must submit a rule filing under section 19(b)(2) of the Exchange Act to obtain approval for the pilot trading system to operate on a permanent basis.[518] In accordance with section 19(b) of the Exchange Act, after a formal notice and comment period, the Commission will decide whether to approve the proposed rule changes relating to a pilot trading system on a permanent basis or whether to institute proceedings to disapprove the proposed rule changes. Simultaneous with its request for Commission approval under to section 19(b)(2) of the Exchange Act, an SRO may request Commission approval pursuant to Section 19(b)(3)(A) of the Exchange Act, effective immediate upon filing, to continue to operate the trading system for a period not to exceed six months.[519]

VII. The Commission's Interpretation of the "Exchange" Definition

A. The Commission's Interpretation in Delta

In the Exchange Act, Congress provided a broad definition of the term "exchange," permitting the Commission to apply the definition flexibly as the securities markets evolve over time.[520] Section 3(a)(1) of the Exchange Act provides that:

> The term "exchange" means 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 or market facilities maintained by such exchange.[521]

Although the statutory definition of "exchange" is quite broad, in the 1990 *Delta Release*,[522] the Commission interpreted the definition narrowly 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." [523] Based on this

[513] An SRO also may request an exemption from the limitation under Rule 19b–5(e)(7)(i) by filing an application for an order for exemptive relief under section 36. See 17 CFR 240.0–12.

[514] Rule 19b–5(e)(7), 17 CFR 240.19b–5(e)(7).

[515] Rule 19b–5(e)(8), 17 CFR 240.19b–5(e)(8).

[516] Rule 19b–5(e)(9), 17 CFR 240.19b–5(e)(9).

[517] Rule 19b–5(e)(10), 17 CFR 240.19b–5(e)(10). This specific requirement is necessary because Rule 6a–2, as amended, requires exchanges to file its trading rules and procedures only once every three years, while national securities associations have no such publication requirement except through the rule filing process under section 19(b) of the Exchange Act.

[518] Rule 19b–5(f)(1), 17 CFR 240.19b–5(f)(1).

[519] Rule 19b–5(f)(1) and (f)(2), 17 CFR 240.19b–5(f)(1) and (f)(2).

[520] It was recognized at the time the Exchange Act was enacted that a regulatory structure for securities exchanges would "be of little value tomorrow if it is not flexible enough to meet new conditions immediately as they arise and demand attention in the public interest." *See* 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 (1963) ("*Special Study*"), at 6. *See also* S. Rep. No. 792, 73rd Cong., 2d Sess. (1934) at 5 (noting that "exchanges cannot be regulated efficiently under a rigid statutory program," and that "considerable latitude is allowed for the exercise of administrative discretion in the regulation of both exchanges and the over-the-counter market.")

[521] 15 U.S.C. 78c(a)(1).

[522] *Delta Release, supra* note 32. In 1988, the Commission granted 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 of the City of Chicago v. Securities and Exchange Commission,* 883 F.2d 525 (7th Cir. 1989) ("*Delta I*"). 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.

[523] *See Delta Release, supra* note 32. The Commission also identified the following factors as supporting the conclusion that the system in *Delta* should not be classified as an exchange. Unlike a traditional exchange, the system (1) was not open to the participation of retail investors on an agency basis; (2) did not offer limit order protection; and (3) provided a forum for trading instruments that lacked certain indicia of standardization. These factors were admittedly outside the Commission's "central focus" in *Delta. Id.* Moreover, most alternative trading systems that will fall now under

interpretation, which was upheld by the Seventh Circuit on review,[524] the Commission staff has given operators of trading systems that do not enhance liquidity in traditional ways through market makers, specialists, or a single price auction structure, assurances that it would not recommend enforcement action if those systems operated without registering as exchanges.[525]

Several concerns compelled the Commission in 1990 to narrowly interpret the definition of the term ''exchange.'' First, the Commission was concerned that a broad interpretation would place ''evolving (alternative) trading systems within the 'strait jacket' of exchange regulation,'' thus stifling innovation.[526] Second, the Commission was concerned that a broad definition would subject brokers, dealers, and other statutorily defined entities to the regulatory scheme prescribed for exchanges.[527] Third, the Commission was concerned that ''an expansive definition of the term 'exchange' would force a non-member, for-profit, proprietary trading system into a regulatory scheme for which it is ill-suited, thus ignoring the Congressional and judicial mandate to apply flexibly the definition of the term 'exchange' to the economic realm.'' [528] These concerns, however, are largely eliminated by Congress' broad grant of exemptive authority in 1996,[529] which has permitted the Commission to craft a regulatory framework for markets which excludes other statutorily defined entities (e.g., broker-dealers operating internal matching systems) and flexibly regulate markets to accommodate their diverse business structures. In addition, while the Delta interpretation was appropriate at the time, its emphasis on the ''expectation'' of regular execution of orders at quoted prices no longer reflects today's markets where alternative trading systems compete directly with registered exchanges and Nasdaq. The Delta approach has resulted in the anomaly of regulating as exchanges small volume entities that raise an expectation of liquidity within their system (such as AZX), while regulating as broker-dealers higher volume entities (such as Instinet).

More fundamentally, although traditional exchanges still provide liquidity through two-sided quotations and, hence, raise an expectation of execution at the quoted price, this is no longer the essential characteristic of a securities market where stock and other securities exchange hands. Today's technology enables market participants and investors to tap simultaneous and multiple sources of liquidity from remote locations. Market makers and specialists may be important liquidity providers on a particular exchange, but liquidity now comes from many sources across multiple markets.[530] For example, the public exposure of investor limit orders means that it is now easier to access liquidity in trading venues that do not have market makers or specialists.[531] Today, through their computer terminals and other communication links, brokers acting on behalf of their customers or institutions trading for themselves can see what the quoted price is on an exchange or Nasdaq and check it against the price available for the same security on one or more alternative trading systems.[532]

Notably, in *Delta*, the Commission indicated that the Exchange Act does not preclude an alternative trading system from coming within the ''exchange definition.'' [533] The Commission recognized that its interpretation of the term ''exchange'' could be subject to change as the securities markets continued to change:

> In order to permit the Commission to apply flexibly the (Exchange) Act's definition of the term ''exchange'' to innovative trading systems in securities, Congress imbued the (Exchange) Act's definition of the term ''exchange'' with a certain ''plasticity'' * * *; ''it invites reinterpretation as the way the term * * * 'generally understood' evolves.'' [534]

Moreover, on review, although the United States Court of Appeals for the Seventh Circuit Court accepted the Commission's interpretation of the term ''exchange'' and affirmed the Commission's determination that Delta was not an ''exchange,'' the court nevertheless stated that the ''Commission could have interpreted the section to embrace the Delta System'' but that it was not compelled to do so.[535]

B. The Growing Significance of Alternative Trading Systems in the National Market System

Within the past six years, the significance of alternative trading systems in the securities markets has increased dramatically. In 1994, the Commission's Division of Market Regulation reported that alternative trading systems accounted for thirteen percent of the volume in Nasdaq securities and 1.4 percent of the trading volume in NYSE-listed securities.[536] In the Proposing Release, the Commission estimated that, as of the end of 1996, the trading volume on alternative trading systems amounted to almost twenty percent of the trades in Nasdaq stocks, and almost four percent of orders in securities listed on the NYSE.

In addition to the general increase in the volume of trading occurring on alternative trading systems, the actual number of alternative trading systems has skyrocketed. In 1991, the Commission was aware of only a few such systems. Today, over forty such systems are currently operating. The viability of this number of alternative trading systems indicates that these systems account for an increasing proportion of trading and that a growing number of investors use these systems. Moreover, the arrival of trading services on the Internet portends an increasing level of retail interest in alternative means for trading.

As more alternative trading systems have developed to offer varying services to diverse customer bases, the availability of trading information and the accessibility of trading opportunities have become increasingly fragmented. The national market system relies on centralized sources of trading

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the Commission's new interpretation in Rule 3b–16 allow broker-dealer subscribers to act on behalf of retail customers in placing and executing orders on the system; function as limit order books where orders are executed according to time, price, and size priority; and trade standard securities.

[524] *Board of Trade of the City of Chicago v. SEC,* 923 F.2d 1270 (7th Cir. 1991).

[525] 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). *See also* Letters from the Division of Market Regulation to: 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).

[526] *Delta Release, supra* note 32, at 1899.

[527] *Id.*

[528] *Id.*

[529] *See supra* note 7.

[530] The rules adopted today reflect and facilitate multiple sources of liquidity. Increasing the linkages among markets where significant trading activity occurs—both exchanges and alternative trading systems—will make the overall market for securities more transparent and liquid.

[531] *See* Order Handling Rules Adopting Release, *supra* note 177 at Section III.

[532] In fact, an alternative trading system that posts firm orders to buy or sell a security does raise a certain expectation of execution at those quoted prices. The expectation is based on the life of the outstanding orders in the system, rather than on continuous two-sided quotations published by specialists or market makers.

[533] *See Delta Release, supra* note 32, at 1900.

[534] *Delta Release, supra* note 32, at 1895 (quoting *Delta I, supra* note 522, at 535).

[535] *Delta II, supra* note 348, at 1273. The court held that, because the statutory provision is ambiguous, the Commission had the discretion to interpret the definition the way it did.

[536] *See* Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments app IV (1994) (''Market 2000 Study'').

opportunities and trading information. Exchange regulation is designed to facilitate centralization and enhance the general public's opportunities to obtain trading information and to access trading interest.

The narrow interpretation of the term ''exchange'' in Delta has eroded the effectiveness of the Commission's oversight of markets. For example, as discussed in the Concept Release, it is clear that regulatory concerns may be raised by entities that constitute a market where buyers and sellers interact, but do not necessarily ensure a two-sided market by design.[537] Moreover, the Commission's traditional approach to broker-dealer regulation is not designed to substitute for market regulation. Consequently, these alternative trading systems are not fully integrated into the mechanisms that promote market fairness, efficiency, and transparency. In addition to raising regulatory fairness concerns, this lack of integration into the national market system has had a negative impact on the quality and pricing efficiency of secondary markets.[538]

C. The Revised Interpretation of ''Exchange''

For purposes of effectively regulating the securities markets, including alternative trading systems, the Commission believes a revised interpretation of what constitutes an exchange is in order.[539] Although the Commission has considered many characteristics of the modern exchange in revising its interpretation,[540] it believes two elements most accurately reflect the functions and uses of today's exchange markets. Under the interpretation in Rule 3b–16, the first essential element of an exchange is the bringing together of orders of multiple buyers and sellers. This reflects the statutory concept of bringing together purchasers and sellers and also reflects the reality of today's marketplace—where supply and demand originate from a variety of sources, not simply from individual brokers and dealers.[541] The second essential element is that trading on an exchange takes place according to established, non-discretionary rules or procedures. As discussed above, an essential indication of the non-discretionary status of rules and procedures is that those rules and procedures are communicated to the system's users. Thus, participants have an expectation regarding the manner of execution—that is, if an order is entered, it will be executed in accordance with those procedures and not at the discretion of a counterparty or intermediary.[542]

Some commenters thought the Commission should retain its current interpretation of an exchange. For example, TBMA advocated a less expansive definition of exchange, and recommended that the Commission continue to regulate alternative trading systems within the broker-dealer framework, crafting appropriate regulations to address particular issues presented by unique operations as they develop.[543] TBMA also raised a question about whether, by eliminating the requirement that a system provide a reasonable expectation of liquidity to be considered an exchange, the Commission's proposal conflicted with the statutory definition of ''exchange'' because liquidity is ''generally understood'' to be a fundamental characteristic of an exchange. As noted above, however, today's technology gives market participants the ability to access multiple markets for liquidity at any given time. As a result, assuring liquidity within a single market by posting continuous two-sided quotations is no longer the essential characteristic of a market where securities exchange hands.[544]

Accordingly, the Commission believes that new Rule 3b–16 more accurately describes the range of markets that perform exchange functions as understood today. At the same time, the Commission's exemption from the exchange definition for many alternative trading systems provides a flexible framework, permitting each participant to choose the regulatory approach that best serves its own business needs.

D. Other Practical Reasons for Revising the Current Interpretation

1. Additional Flexibility Provided by the National Securities Markets Improvement Act of 1996

As stated above, one principal reason the Commission, to date, has interpreted the term ''exchange'' narrowly has been to avoid the imposition of unnecessary and burdensome regulatory obligations on small and emerging trading systems, which could stifle innovation.[545] The enactment of NSMIA,[546] however, alleviates the concern that an expanded interpretation of the term exchange will inhibit innovation.[547] Specifically,

[537] *See* Proposing Release, *supra* note 3, at n.290.

[538] For example, the evidence in the Commission's report on the NASD and the Nasdaq market pursuant to section 21(a) of the Exchange Act suggests that widespread use of Instinet by market makers as a private market has had a significant impact on public investors and the operation of the Nasdaq market. *See* NASD 21(a) Report, *supra* note 4.

[539] 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)). *See also Arkansas AFL–CIO v. FCC,* 11 F.3rd 1430, 1441 (8th Cir. 1993) (deferring to Federal Communications Commission decision to alter its interpretation of the statutory term ''operated in the public interest'' to meet the changing realities of the broadcast industry).

[540] *See Concept Release, supra* note 2, at nn.125–133 and accompanying text.

[541] This broad conception of ''bringing together'' buyers and sellers is consistent with the *Delta Release,* which emphasized that the means employed for bringing together buyers and sellers ''may be varied, ranging from a physical floor or trading system * * * 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).'' *Delta Release, supra* note 32, at 1899.

[542] The elements of the interpretation are discussed in greater detail in Section III, *supra.*

[543] *See* TBMA Letter at 3–4.

[544] The Commission also notes that the statutory definition of ''exchange'' is written in the disjunctive: facilities for bringing together purchasers and sellers *or* facilities performing functions commonly performed by stock exchanges. Section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c(a)(1). *See* TBMA Letter, at 8–9 (recommending that the Commission continue to rely on its interpretation in the *Delta Release*); SIA Letter at 2, 6–7 (a significant characteristic of exchanges is structural features that create a reasonable expectation of the regular execution of orders at posted prices). *See also* Letter from Christopher J. Carroll, Managing Director, Deutsche Bank Securities, Inc. to Jonathan G. Katz, Secretary, SEC, dated July 31, 1998 (''DBSI Letter'') at 2; NYSE Letter at 2–3, 4–5, 8 (commenting that only alternative trading systems meeting the *Delta* interpretation of exchange should have the ability to register with the Commission as an exchange); Instinet Letter at 8 (recommending that the Commission retain its current interpretation of ''exchange''); CBB Letter at 3 (recommending that if the Commission believed its current interpretation of ''exchange'' in the *Delta Release* was inadequate, that the Commission should simply withdraw that interpretation and rely solely on the statutory definition of ''exchange'').

[545] 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. One key factor in the Commission's decision not to regulate the Delta system as an exchange was the concern that doing so would subject traditional broker-dealer activities to exchange regulation. *Delta Release, supra* note 32.

[546] Pub. L. 104–290, 110 Stat. 3416 (1996). 15 U.S.C. 78mm.

[547] Throughout the past 60 years, the Commission has attempted to accommodate market innovations within the existing statutory framework to the

NSMIA added section 36(a)(1) to the Exchange Act, which provides that:

the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of (the Exchange Act) or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.[548]

Prior to adoption of NSMIA, the Commission's authority under the Exchange Act to reduce or eliminate certain consequences of exchange registration was limited.[549] Section 36, however, allows the Commission greater flexibility in regulating new trading systems by giving the Commission broad authority to exempt any person from any provision of the Exchange Act. As a result, the Commission now has greater authority to adopt a more consistent regulatory approach to securities markets in general, and particularly for alternative trading systems that do not neatly fit into the existing regulatory framework.[550]

2. No-action Approach to Alternative Trading Systems Is No Longer Workable

The Commission also believes that the proliferation of new trading systems necessitates the revision of the interpretation of the term ''exchange.'' The no-action review process that the Commission has used to date to address hybrid systems that incorporate features of both exchanges and broker-dealers worked well and was consistent with the protection of investors when relatively few systems applied for no-action treatment. The no-action process allowed the Division to review the system's services and mechanisms and to monitor the impact of such systems on a case-by-case basis. This is no longer practicable. Absent a revised interpretation of ''exchange,'' the Commission would have to continue to respond to an increasing volume of no-action requests from developing alternative trading systems that seek to avoid the burdens associated with registration as a national securities exchange. The Commission's revised interpretation eliminates the need for this no-action approach. By codifying a regulatory framework that does not rely on Commission staff review of each novel system development, the Commission believes that technological improvements and enhanced services will become available more rapidly.

3. More Rational Treatment of Regulated Entities

The Commission believes that the revised interpretation of the term exchange, in combination with the adoption of Regulation ATS, which allows alternative trading systems to register as broker-dealers,[551] is consistent with other goals and provisions of the Exchange Act. The new regulatory framework, including the revised interpretation of ''exchange'' avoids the need for the Commission to draw what are now arbitrary distinctions between organizations that perform similar functions, avoids classifying alternative trading systems in a manner that does not fit the structure of these systems, and squarely addresses the regulatory concerns raised by these systems.

Moreover, the Commission's new framework helps assure consistency with existing broker-dealer regulations. For those alternative trading systems that wish to participate in the markets as exchanges, regulation as a national securities exchange is available. However, the Commission expects that many alternative trading systems will not elect to register as national securities exchanges. Under the Commission's proposal, these systems would have to maintain a structure more akin to that of traditional broker-dealers and comply with regulatory obligations more appropriately tailored to their chosen business structure. These obligations include the new requirements for more significant alternative trading systems to address the transparency, fair access, and systems capacity, integrity, and security concerns raised by these particular systems.[552]

VIII. Effective Dates and Compliance Dates

The rules and rule amendments adopted in this release are effective on April 21, 1999, except for Exchange Act Rules 301(b)(5)(D) and (E) and Rules 301(b)(6)(D) and (E), which shall become effective on April 1, 2000. Alternative trading systems, however, will only have to comply with the public display requirement in Rule 301(b)(3) for fifty percent of the securities subject to this requirements on April 21, 1999. Alternative trading systems will have to comply with Rule 301(b)(3) for all such securities by August 30, 1999.[553] Prior to April 21, 1999, the Commission will publish a schedule of those securities for which alternative trading systems must comply with Rule 301(b)(3) on April 21, 1999.

IX. Costs and Benefits of the Rules and Amendments

To assist the Commission in its evaluation of the costs and benefits that may result from the rules and amendments, commenters were requested to provide analysis and data, if possible, relating to the costs and benefits associated with the proposals. The Commission initially identified certain costs and benefits associated with its changes in the Proposing Release. Although the Commission received seventy comment letters, as of December 1, 1998 concerning the proposed rules, none of the commenters responded specifically to the request for comment on the cost/benefit analysis. Some commenters did raise related issues and the Commission will address those comments in this analysis. After considering the comments, the Commission continues to believe that the benefits of the rules and amendments justify the associated costs.

A. Costs and Benefits of the Rules and Amendments Regarding Alternative Trading Systems

The Commission identified several benefits and costs to investors and market participants in the Proposing Release with regard to alternative trading systems. The Commission is not making any changes to the rules or amendments that increase the cost estimates for alternative trading system notice, reporting and recordkeeping obligations. The most significant change

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, the Commission considered the implications of evolving market conditions on exchange regulation. *See* Securities Exchange Act Release Nos. 8661 (Aug. 4, 1969), 34 FR 12952 (initially proposing Rule 15c2–10); 11673 (Sept. 23, 1975), 40 FR 45422 (withdrawing then-proposed Rule 15c2–10 and providing for registration of securities information processors); 26708 (Apr. 13, 1989), 54 FR 15429 (reproposing Rule 15c2–10); 33621 (Feb. 14, 1994), 59 FR 8379 (withdrawing proposed Rule 15c2–10).

[548] 15 U.S.C. 78mm(a)(1).

[549] Prior to the addition of section 36 to the Exchange Act, the Commission could only exempt an exchange from the registration provisions of sections 5 and 6 on the basis of an exchange's limited volume of transactions. *See* Section 5 of the Exchange Act, 15 U.S.C. 78e.

[550] *See* S. Rep. No. 104–293, 104th Cong. 2d Sess. 15 (1996).

[551] *See supra* Section IV.A.

[552] *See supra* IV.A.2.

[553] Because the rules and rule amendments regarding Regulation ATS, exchange registration, and Rule 19b–5 constitute ''major rules'' within the meaning of the Small Business Regulatory Enforcement Act of 1996, 5 U.S.C. 801 *et seq.*, the rules and rule amendments cannot take effect until 60 days after the date of publication in the **Federal Register.** Although the amendments to Rules 17a–3 and 17a–4 and repeal of Rule 17a–23 and Form 17A–23 do not constitute ''major rules,'' they will become effective at the same time as Regulation ATS because they operate in an integrated fashion with Regulation ATS.

the Commission is making in the rules as adopted is to revise the fair access provisions. The rules and amendments in the Proposing Release provided investors with a right of appeal to the Commission and required alternative trading systems to provide investors denied or limited access to the system with notice of that action and their right to appeal the decision to the Commission. The Commission has decided not to adopt the right of appeal provisions and the requirement of notice to investors denied or limited access. Instead, alternative trading systems with significant volume will be required to provide quarterly notices to the Commission on Form ATS–R of all grants, denials, and limitations of access as well as descriptive information regarding those access decisions. The net effect of these changes to the fair access requirements is a decrease, relative to the original proposal, in the burdens on alternative trading systems with significant volume. Several commenters objected to the proposed fair access rules on various grounds.[554]

Several commenters had general comments with regard to the burdens imposed on respondents under Regulation ATS. One commenter argued that the Commission should impose only minimal requirements on start-up or smaller trading systems.[555] The alternative trading system rules have been tailored to minimize their burden on alternative trading systems generally and small systems specifically. Because many of the provisions in the rules are triggered by a volume threshold, the Commission expects that small alternative trading systems will not have sufficient volume to trigger those thresholds and will, therefore, not have to comply with those provisions. The recordkeeping and reporting requirements with which smaller, lower volume alternative trading systems will have to comply under Regulation ATS are substantially similar to those with which alternative trading systems currently comply. Consequently the costs for smaller alternative trading systems should remain unchanged.

One commenter argued that material changes on Form ATS should be reported twenty days after such a change is made rather than twenty days before.[556] The Commission believes that is important to have some advance notice of significant changes in order to permit it to carry out its market oversight and investor protection functions. By requiring notice before such changes are made, the Commission has an opportunity to make inquiries to clarify any questions that might arise. Currently, alternative trading systems are required to give twenty days prior notice of material changes on Part 1–A of Form 17A–23. This burden remains unchanged under the new rules.

Several commenters pointed out areas for possible reductions of regulatory overlap. One commenter argued that the Commission should eliminate those broker-dealer requirements that would be irrelevant for alternative trading systems.[557] The Commission, however, does not believe that the broker-dealer requirements as they apply to alternative trading systems, are irrelevant or overly burdensome. Another commented that recordkeeping burdens should be coordinated with the NASD's OATS program.[558] These recordkeeping rules do not specify the manner in which such records must be maintained, but only that they must be made available upon request. Such records may be required for other purposes, but it is important to assure that all alternative trading systems maintain records sufficient to construct an audit trail.

One commenter argued that the Commission's rules and amendments impose costs and burdens on market innovators rather than encouraging such systems.[559] As discussed above, however, the Commission does not intend its new regulatory framework to impose a penalty on systems because of their use of technology. The Commission's new framework is based on the functions performed by a trading system, not on its use of technology.

Finally, a large number of institutional subscribers to alternative trading systems submitted comments within the last two weeks. These commenters expressed a number of concerns about the public display requirement. Among the concerns voiced by these commenters was a concern about decreasing liquidity, limiting a potentially advantageous trading strategy, being able to provide best execution for their clients, and increasing costs to execute trades. The Commission responds to these concerns below.[560]

The Commission solicited comment on the feasibility of permitting alternative trading systems to file forms electronically. Three commenters supported electronic filing as an option to reduce the burdens on respondents.[561] While not feasible at this time, the Commission intends to make electronic filing an option when it is possible.

Three commenters argued that the Commission's rules should not apply to debt securities, in part, due to the burdens that such requirements would place on a largely decentralized market.[562] Other commenters supported including debt securities within Regulation ATS.[563] The Commission continues to believe that many of the same concerns about the trading of equity securities on alternative trading systems apply equally to the trading of fixed income securities on alternative trading systems. Debt securities are increasingly being traded on alternative trading systems, similar to the way that equity securities are traded. Accordingly, the Commission's new regulatory framework would require alternative trading systems trading debt securities, other than alternative trading systems trading solely government and related securities, to register as an exchange or register as a broker-dealer and comply with Regulation ATS. If an alternative trading system chooses to register as a broker-dealer, Regulation ATS applies the same notice, recordkeeping, and reporting requirements on debt alternative trading systems as apply to equity alternative trading systems. Because of the way the debt market currently operates, however, the transparency provisions do not apply to alternative trading systems that trade debt securities. Only those alternative trading systems that trade at least twenty percent of certain categories of debt are be subject to the fair access requirements[564] and the provisions governing systems capacity, security, and integrity.[565]

Under the rules and amendments in this release, alternative trading systems have a choice between registering as a national securities exchange or registering as a broker-dealer and complying with Regulation ATS. The choice between these two options is

[554] *See* ICI Letter at 4 (stating that requirements would be overly burdensome for alternative trading systems); IBEX Letter at 13 (arguing that appeal process should begin at the SRO level); Instinet Letter at 19 (stating that a right of appeal to the Commission could lead to frequent frivolous appeals).

[555] TBMA Letter at 16.

[556] SIA Letter at 17–18. *But see* IBEX Letter at 5 (stating that the reporting requirements under proposed Regulation ATS were not inappropriately burdensome).

[557] CBB Letter at 4.

[558] Instinet Letter at 20.

[559] Instinet Letter at 10.

[560] *See supra* Section IV.A.2.c.

[561] *See* IBEX Letter at 5; SIA Letter at 18; American Century Letter at 6.

[562] *See* TBMA Letter at 6–7, 21; SIA Letter at 3, 11; DBSI Letter at 1; MSDW Letter at 13.

[563] *See* NYSE Letter at 6; IBEX Letter at 2–3.

[564] Rule 301(b)(5), 17 CFR 242.301(b)(5).

[565] Rule 301(b)(6), 17 CFR 242.301(b)(6).

complex and each alternative trading system will make a choice based on its business plan and the role it wishes to play in the market. There are several factors that will have an impact on each alternative trading system's decision.

First, the regulatory costs associated with registering and operating as a national securities exchange are higher than the regulatory costs associated with registering as a broker-dealer and complying with Regulation ATS. Second, registered exchanges have national market system obligations that require those exchanges to bear the expenses associated with joining the CTA, CQS, and ITS plans. To offset some of those costs, however, registered exchanges also participate in the revenue generated from the sale of quotation information. Third, registered exchanges are SROs and, therefore, have obligations to surveil trading activity and member conduct on the exchange. These obligations can be significant in terms of time, personnel, and financial resources. However, a significant advantage to a registered exchange of being an SRO is that it is not subject to oversight by a competitor. Fourth, registered exchanges are subject to the statutory requirement to provide fair access, which requires a commitment of resources to consider membership applications and to report denials to the Commission and defend any denial decisions before the Commission if an appeal is made.

Because of the range of obligations of registered exchanges, operation as an exchange requires a significant investment of financial resources. A relatively high volume of trading may be required to justify this financial investment. While the advent of for-profit and non-member owned exchanges may make it easier to raise the financial resources necessary to operate as a registered exchange, the Commission does not expect that many alternative trading systems will choose to register as exchanges.

On the other hand, alternative trading systems that register as broker-dealers must comply with the filing and conduct obligations associated with being a registered broker-dealer including membership in an SRO and compliance with that SRO's rules. They must also comply with Regulation ATS, which includes filing, recordkeeping and reporting obligations. Unlike registered exchanges, alternative trading systems are subject to oversight by an SRO, which may operate a competing market. Regulation ATS is designed to impose few requirements on lower volume alternative trading systems. Only alternative trading systems with significant volume are required to link to an SRO and publicly display orders, provide investors with fair access, and comply with systems capacity, integrity, and security requirements. These obligations for alternative trading systems with significant volume are similar, although not identical, to obligations of registered exchanges. Therefore, it is more likely that a high volume alternative trading system will consider the costs and benefits of registering as an exchange to be more comparable to the costs and benefits of regulation as a broker-dealer alternative trading system. The costs associated with regulation as a registered exchange, and with operating as a broker-dealer and complying with Regulation ATS are discussed more fully below.

1. Benefits

a. *Improved Market Transparency.* The Commission's amendments and rules enhance transparency of trading on alternative trading systems. Transparency of orders helps ensure that publicly available prices fully reflect overall supply and demand and helps reduce the negative consequences of market fragmentation (*e.g.*, the chance that an order for a security in one market will be executed at a price inferior to that available at the same time in another market). The Commission has been particularly concerned that the development of so-called ''hidden markets,'' in which a market participant privately publishes quotations at prices superior to the quotation information it disseminates publicly, impedes national market system objectives. Some systems that permit this activity have become significant markets in their own right, but are not currently required to integrate their orders into the public quote because they are not registered as national securities exchanges or national securities associations.

For alternative trading systems choosing to register as broker-dealers, the Commission's amendments and rules improve the transparency of orders in systems that account for a significant portion of the trading volume in any security. The amendments and rules help to incorporate alternative trading system quotes into the national market system, thus reducing fragmentation, improving liquidity, facilitating price discovery, and narrowing the quoted spread.[566]

Because non-market maker broker-dealers and institutions at times enter the best priced orders in an alternative trading system, the Commission expects that display of these orders in the public quote will also improve the NBBO. For example, of all orders on ECNs by non-market maker broker-dealers and institutions that could improve the NBBO if included in the public quote stream, only about six percent of those orders were actually entered into the public quote stream. Consequently, about ninety-four percent of those orders that could have improved the NBBO were not included in the public quote stream and thus did not impact the NBBO. These orders were therefore unavailable to some investors, in particular, retail investors, who do not have direct access to ECNs. The unavailability of these quotes continues to effectively result in a two-tiered market. While the Commission is unable to precisely quantify the market impact of these changes, it does believe that the benefit for investors will be significant based on preliminary estimates.

Based on an analysis of ECN trading activity during a four day period in June 1997 (June 23, 1997 to June 27, 1997), the staff estimates that spreads could decrease by as much as four percent for Nasdaq issues when non-market maker broker-dealer and institutional orders are displayed in the public quote. In making this estimate, the staff has assumed an average spread of 35 cents per share, a maximum increase of eleven percent for the times that ECNs could narrow the inside, and a maximum of 12.5 cents per share improvement. In addition to the effects on the bid-ask spread, retail investors and other non-subscribers will gain access to the liquidity and better prices now available only to alternative trading system subscribers. Moreover, because many broker-dealers offer retail customers automatic execution of their small orders at the publicly quoted price, a better price in the public quote potentially improves the price received by thousands of broker-dealer customers. Larger orders negotiated between institutions and broker-dealers also potentially benefit because the price negotiated will reflect a smaller spread. For these reasons, the Commission believes that new display and access requirements will result in significant benefits to investors.

[566] The Office of Management and Budget has recognized that although it may be difficult to quantify the benefits of price transparency, ''[t]here is a strong consensus among economists that regulations requiring the disclosure of information about the price and quality of products and services can produce significant benefits for consumers and improve the functioning of markets when this information would not otherwise be available.'' Office of Management and Budget, *Draft Report to Congress on the Costs and Benefits of Federal Regulations,* 63 FR 44034 (Aug. 17, 1998).

The above data is consistent with the results of the transparency improvements achieved through the implementation of the Order Handling Rules.[567] The NASD studied the effect of the Order Handling Rules on the Nasdaq market by comparing various measures between a pre-period of twenty days in the beginning of 1997 (December 18, 1997 to January 17, 1998) and a post-period of twenty days in the beginning of 1998 (January 5, 1998 to February 2, 1998). The success of the Order Handling Rules further supports the view that the amendments and rules the Commission is adopting today will further investors' opportunities to trade at the best prices.

In its study, the NASD also found that quoted spreads in the Nasdaq market decreased by an average of forty-one percent. The NASD estimates that this reduction in spreads resulted in annual savings to investors of between $284 million and $673 million. Because of the increased market transparency provided by the display of institutional and non-market maker broker-dealer orders, the Commission believes that the rules and amendments in this release will also further shrink spreads.

Finally, the Commission believes that improved transparency of orders in alternative trading systems will reduce the potential for alternative trading system subscribers to manipulate the public market. It has been alleged that institutions and non-market makers intentionally influence the market by displaying an order in an alternative trading system that locks the price displayed in the public market. For example, if the public market is displaying a bid of 20 and an offer of 21, an institution or non-market maker might display an offer of 20 in an alternative trading system. Market participants often then assume that the order in the alternative trading system indicates the direction in which the market is moving and begin selling to market makers bidding 20, pushing the public market lower. The price in the alternative trading system is then canceled and the institution or non-market maker buys securities at a lower price. This type of activity is possible only because institution and non-market maker orders in alternative trading systems are not displayed to the public market. The Commission believes that the integrity of the public markets is threatened when institutions and non-market makers can affect the public markets without participating in them.

The transparency of trading on alternative trading systems that choose to register as exchanges will also improve. All registered exchanges are expected to participate in the national market system plans, such as the CTA, CQS, and ITS. These plans form an integral part of the national market system, and contribute greatly to the operation of linked, transparent, efficient, and fair markets. In addition to improving transparency, alternative trading system participation in these market-wide mechanisms will benefit investors by reducing trading fragmentation.

b. *Improved Investor Protections.* The Commission's amendments and rules provide benefits to investors by improving the surveillance of trading on alternative trading systems. Adequate surveillance of the trading on alternative trading systems is critical to the continued integrity of our markets. This is particularly the case with regard to alternative trading systems that have a significant percentage of the trading volume in one or many issues of securities. The oversight of trading activities on alternative trading systems that choose to register as broker-dealers will improve because the proposals clarify the relationship between SROs and alternative trading systems.

The notice, reporting, and recordkeeping requirements under Regulation ATS also contribute to the Commission's and the SROs' ability to effectively oversee alternative trading systems regulated as broker-dealers. The Commission believes that these enhancements to the surveillance and oversight of alternative trading systems regulated as broker-dealers benefit the public by helping to prevent fraud and manipulation.

The surveillance of trading on alternative trading systems that choose to register as exchanges under the Commission's proposal will also be improved. All registered exchanges are SROs, which have direct obligations to surveil the trading on their own markets. The Commission believes that, through improved surveillance mechanisms, it will be better able to detect fraud and manipulation that could occur on alternative trading systems. For example, alternative trading systems can be used to artificially narrow the NBBO spreads for the sole purpose of trading through a broker-dealer's automatic execution system at the artificial prices.[568] The Commission and the SROs will be able to more readily detect such activity through enhanced surveillance. The Commission believes that this more direct oversight of trading activities will therefore benefit investors and the market generally by helping to prevent fraud and manipulation.

c. *Fair Access.* The Commission's rules require alternative trading systems with significant volume to provide a fair opportunity to participate in alternative trading systems. Fair and non-discriminatory treatment of potential and current subscribers by alternative trading systems is important, especially when an alternative trading system captures a large percentage of trading volume in a security. Although an alternative trading system with significant volume is required to provide access to orders that it is required to display in the public quote stream, there are other benefits to direct participation on an alternative trading system. In particular, participation on an alternative trading system allows an investor to enter its own orders, view contingent orders not publicly displayed (such as all or none orders) and use special features of an alternative trading system, such as a negotiation feature or reserve size feature. Accordingly, the rules prevent discriminatory denials of access and ensure that market participants are not prevented from gaining access to significant sources of liquidity.

d. *Systems Capacity, Integrity, and Security.* The Commission believes that its rules regarding systems capacity, integrity, and security of alternative trading systems provide several benefits to the marketplace and to investors. Marketplaces are increasingly reliant on technology and most of their functions are becoming highly automated. Alternative trading systems are subject only to business incentives to avoid system breakdowns that may disrupt the market. In the past, alternative trading system failures have affected the public market, particularly during periods of high trading volume. Some alternative trading systems have had prolonged shut-downs during the busiest trading sessions due to systems problems. For example, during the past year, Instinet, Island, Bloomberg, and Archipelago (operated by Terra Nova) have all experienced systems outages due to problems with their automated systems. On a number of occasions, ECNs have had to stop disseminating market maker quotations in order to keep from closing altogether, including during the market decline of October 1997 when one significant ECN withdrew its quotes from Nasdaq because of lack of capacity. Similarly, a major IDB in non-exempt

[567] *See supra* note 177. Under the Order Handling Rules, market makers who enter orders on ECNs are required to reflect those prices in their public quotations. In the alternative, the ECN can make the best market maker prices publicly available through an SRO.

[568] *See supra* note 5.

securities experienced serious capacity problems in processing the large number of transactions in October 1997 and had to close down temporarily.

The Commission's rules require alternative trading systems that handle a significant volume of trades to establish reasonable capacity estimates, conduct stress tests, implement procedures to monitor system development, review systems vulnerability, and establish adequate contingency plans. Investors will benefit from the rules because significant systems will be less likely to shut down as a result of systems failures and will be better equipped to handle market demand and provide liquidity during periods of market stress. The ability of alternative trading systems to provide more reliable and consistent service in the market benefits investors and the public markets generally. The Commission also believes that investors will benefit from robust system security provided by ensuring that significant alternative trading systems maintain sufficient security measures to prevent unauthorized access.

All currently registered exchanges participate in the Commission's automation review program. Alternative trading systems that choose to register as exchanges will similarly be expected to participate in this program. Under the automation review program, exchanges are expected to maintain sufficient systems capacity to meet current and anticipated volume levels. The benefits to investors and the public generally, as with significant alternative trading systems, will be the assurance that systems are reasonably equipped to handle market demand and provide liquidity during periods of market stress.

2. Costs

The alternative trading system rules and amendments have been tailored to minimize their burden on alternative trading systems and especially small systems. Many of the provisions in the rules and amendments are triggered by a volume threshold. The Commission expects that small alternative trading systems will not have sufficient volume to trigger those thresholds and will therefore not have to comply with those provisions. The recordkeeping and reporting requirements with which smaller, lower volume alternative trading systems have to comply under Regulation ATS are substantially similar to those with which alternative trading systems currently comply. Consequently the costs for smaller alternative trading systems should remain materially unchanged. The paperwork, filing, and recordkeeping costs are discussed in the Paperwork Reduction Act section below.

a. *Notice, Reporting, and Recordkeeping.* All alternative trading systems that will be subject to notice, reporting, and recordkeeping requirements under the Commission's new rules are currently subject to similar requirements under Rule 17a–23. The requirements under Regulation ATS, however, require some additional information that is not currently required under Rule 17a–23.

Under Regulation ATS, alternative trading systems file an initial operation report, notices of material systems changes, and quarterly reports. The rules also include new Forms ATS and ATS–R to standardize reporting of such information and make it more useful for the Commission. The rules require information that is not currently required under Rule 17a–23, such as greater detail about the system operations, the volume and types of securities traded, criteria for granting access to subscribers, procedures governing order execution, reporting, clearance and settlement, procedures for reviewing systems capacity and contingency procedures, and the identity of any other entities involved in operating the system.

Regulation ATS requires staff time to comply with the initial notice and amendment requirements. While the Commission has designed the requirements in an effort to balance the costs of filing with the benefits to be gained from the information, some effort will be necessary to gather and file this information. Most of the information, however, already exists. Alternative trading systems will only be required to gather this information and supply it in the required format to the Commission. The periodic updating requirements will also require staff time over the life of the alternative trading system to comply with the rules.

The Commission estimates that there are currently about forty-five alternative trading systems that will be required to register as exchanges or register as broker-dealers and comply with Regulation ATS.[569] The Commission also estimates that, over time, there will be approximately three new alternative trading systems each year that choose to register as broker-dealers and comply with Regulation ATS.[570] The Commission also estimates that, over time, there will be approximately three alternative trading systems that file cessation of operations reports each year. Thus, the Commission anticipates that, over time, if all forty-five current alternative trading systems choose to register as broker-dealers and comply with Regulation ATS, there will be approximately forty-five alternative trading systems operating each year.

b. *Public Display of Orders and Equal Execution Access.* Regulation ATS requires that alternative trading systems with significant volume display their best-priced orders for securities in which they have 5 percent or more of total trading volume in the public quote. The Commission identified the anticipated benefits of this requirement above. Below is a discussion of possible costs associated with this requirement.

One possible cost is the impact on institutional order flow to alternative trading systems generally. Institutions have several options available to them to execute trades. They can send orders to block trading desks, a number of different types of alternative trading systems, or directly to registered exchanges through broker-dealer give-ups. Although not currently displayed to the public, orders sent to an alternative trading system by institutions are displayed to other alternative trading system subscribers.[571] Thus, placing large orders, or a series of successive small orders, in an alternative trading system signals to a large number of sophisticated market participants the interest in a particular security.

The Commission is not persuaded by commenters that suggest that institutions currently willing to use alternative trading systems to display their orders to other alternative trading system subscribers, including other institutions, market-markers, and broker-dealers, will be less willing to use alternative trading systems that must display those orders to the public market. Our reasons are as follows. The primary group of market participants

[569] This estimate is based on filings made with the Commission under Rule 17a–23. At the time of the Proposing Release, the Commission estimated that forty-three alternative trading systems would be required to register as exchanges or broker-dealers and comply with Regulation ATS. The Commission now estimates that there are forty-five alternative trading systems operating.

[570] Based on the Commission's experience over the last three years with Rule 17a–23, it appears that there are more than three new alternative trading systems per year. However, we expect that in the future, there will be approximately three new alternative trading systems per year. The rapid growth experienced over the last several years is unlikely to continue in perpetuity.

[571] A number of ECNs, however, currently display the best order in their system in the public quote, regardless of whether that order is entered by an institution, market maker or another broker-dealer although the Commission's Order Handling Rules only require the display of market maker orders. Thus, institutional orders sent to these systems are already displayed to the public.

that will benefit from the public display of institutional orders is retail investors. Retail investors are not currently alternative trading system subscribers. To avoid market impact, institutions try to avoid signaling other institutions and market professionals, not retail investors. Almost all market professionals and a significant number of institutions already subscribe to alternative trading systems. Thus, the Commission believes that the additional exposure to the market should not affect institutions' use of alternative trading systems. Moreover, to the extent that institutions want to display small sized orders in the public market, rather than their entire order, they will still be able to make use of an alternative trading system's ''reserve size'' feature. This will enable institutions to avoid exposing the total size of their order to the public market.

Nonetheless, assuming institutions do have a preference for showing their sized orders to other alternative trading system subscribers but not the public market, there may be two reactions by institutions. First, institutions could choose to move their orders to more opaque venues, such as block trading desks. The cost of this movement of orders would be a loss of transparency to the limited group of alternative trading system subscribers who now benefit from the display of institutional orders on alternative trading systems, and the loss of business to alternative trading systems. While block trading desks would benefit from the increased business, it likely would increase institutions' transaction costs. For this reason, as well as those discussed above, the Commission believes it unlikely for institutions to react this way. Second, because the public display requirement only applies to alternative trading systems with five percent or more of the volume in a particular security, there is a possibility that institutions may move their order flow to smaller alternative trading systems in order to avoid the public display requirement. Such movements of order flow could benefit some alternative trading systems in the form of increased revenue and be a cost to other alternative trading systems who lose revenue.

Currently, alternative trading systems are able to attract subscribers because prices in their systems are often better than the prices available in the public markets. Because alternative trading systems are now required to publicly display their best priced orders for securities in which they represent five percent or more of the trading volume, the best priced orders for certain securities will also be available through the public markets. Alternative trading systems will no longer be able to provide subscribers with the unlimited ability to avoid public display in the NBBO and possible interaction with non-subscribers. Consequently, some subscribers could leave an alternative trading system if they think there are fewer advantages than before in having direct access to the alternative trading system.

However, the growth of ECNs since the Order Handling Rules were implemented indicates that alternative trading systems can, and are, attracting subscribers.[572] As mentioned above, there are still significant benefits to being a subscriber to an alternative trading system, including, but not limited to: the ability to enter orders and the use of such features as a negotiation feature or a ''reserve size'' feature; the ability to access the best priced orders for securities in which an alternative trading system represents less than 5 percent of the trading volume and therefore is not subject to the transparency requirements; and access to the entire ''book,'' not merely the ''top of the book,'' that contains important real-time market information regarding depth of trading interest. All of these benefits will be retained under the new display requirement.

Despite the impact on high volume alternative trading systems, integrating their best-priced orders into the public market is critical to the national market system. Section 11A of the Exchange Act directs the Commission to facilitate a national market system and to carry out Congress' objectives of, among other things, assuring ''the practicability of brokers executing investors' orders in the best market.''[573] The public display requirement adopted today furthers the objectives in Section 11A of the Exchange Act by ensuring that the public markets reflect the best priced orders displayed in alternative trading systems that have a significant trading market in particular securities.

Several commenters also expressed concern about whether or not alternative trading systems will be permitted to continue charging fees to non-subscribers that access alternative trading systems publicly displayed orders. Currently, alternative trading systems charge a range of fees to subscribers. In particular, alternative trading systems may allow institutional subscribers to select higher fees and then have soft-dollars rebated in an amount equal to the excess above the actual cost for execution of a trade. Because of the presence of soft dollars, it is difficult to estimate the amount of revenue that alternative trading systems receive from institutional subscribers. The Commission notes, however, that it is not requiring alternative trading systems to change their fee structures. The Commission is merely limiting alternative trading systems to charging non-subscribers fees that are consistent with equivalent access.[574] The Commission does not believe that such limitations will substantially affect an alternative trading system's revenues. In fact, some alternative trading systems may have increased revenues from the fees charged to non-subscribers.

The rules the Commission is adopting today prohibit an alternative trading system from charging fees that would effectively deny non-subscribers equivalent access to an alternative trading system's publicly displayed orders. As long as a fee does not deny equivalent access, it would be permissible under these rules. The SROs will be able to establish rules to ensure that alternative trading system fees are not inconsistent with the standard of equivalent access. Any SRO rule impacting an alternative trading system's access fees would have to be filed with the Commission for public comment, review, and approval. The Commission cannot approve any SRO rule unless it finds that such rule is consistent with the Exchange Act, including whether the rule will promote ''efficiency, competition, and capital formation.''[575]

As discussed above, one of the expected benefits of displaying the best-priced orders in alternative trading systems to all investors is that spreads will shrink. The success of the Order Handling Rules indicates that the Commission's current proposal should further enhance liquidity and price improvement opportunities in the public markets. Because non-market maker broker-dealers and institutions at times enter the best priced orders in an alternative trading system, the Commission expects that display of these orders in the public quote will improve the NBBO. As a result, some market markers may experience a loss of revenue. For example, a market maker

[572] When the Order Handling Rules were implemented on January 17, 1997, four ECNs linked to Nasdaq. Today there are a total of nine ECNs linked to the public quote stream. *See supra* note 178.

[573] Section 11A(a)(1)(C) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(C).

[574] Under the Order Handling Rules, ECNs are limited to charging non-subscribers fees consistent with equivalent access.

[575] Section 3(f) of the Exchange Act, 15 U.S.C. 78c(f).

may currently be at the NBBO even when an alternative trading system is better than that market maker's bid or offer. Accordingly, if the better priced institutional or non-market maker broker-dealer order were displayed in the public quote, that market maker would not execute an order unless it improved its quote. While reduced spreads may represent a cost to market makers, as discussed above, it represents a corresponding benefit to investors. Moreover, reduced spreads make the overall market more efficient by reducing transaction costs. If trading is less expensive, all other things being equal, investors can be expected to trade more.

The staff also notes that a market maker is not required to execute a customer order at the NBBO if the best available price is represented by an alternative trading system quote. Instead, a market maker may attempt to execute that customer order against the alternative trading system quote. If the market maker acts as agent in effecting the customer's trade, it may be entitled to a brokerage fee. Therefore, market makers may be able to offset, at least partially, the loss of trading profits with additional brokerage revenues.

c. *Fair Access.* Under Regulation ATS, alternative trading systems with significant volume are required to establish and maintain standards for granting access to their system and keep records of such standards. In addition, such alternative trading systems must apply those standards in a fair and non-discriminatory manner and submit certain information regarding grants, denials, and limitations of access with their quarterly reports on Form ATS–R. Based on current volume estimates, at most two alternative trading systems will be initially subject to this requirement. The Paperwork Reduction Act section of this release summarizes the filing and recordkeeping costs associated with the fair access requirement.

The fair access requirement, as adopted, differs from that proposed. The proposal would have provided market participants who believe they had been unfairly denied or limited access to an alternative trading system subject to the fair access requirement with a right to appeal that alternative trading system's action to the Commission. Alternative trading systems subject to the fair access requirement would also have been required to provide investors with notice of a denial or limitation of access and their right to appeal that action to the Commission. The fair access requirement being adopted today does not include any right to appeal an alternative trading system's access decisions to the Commission. Instead, the Commission intends to enforce the prohibition on alternative trading systems with significant volume unfairly denying access through its inspection and enforcement authority. The Commission believes the fair access requirement it is adopting will be less costly to alternative trading systems than the one proposed because alternative trading systems will not be required to defend their access decisions in appeals before the Commission. Moreover, the requirement adopted does not require alternative trading systems to send notice of their decisions to market participants.

d. *Systems Capacity, Integrity, and Security.* The Commission does not believe that its amendments and rules requiring alternative trading systems to meet certain systems related standards imposes significant costs. The standards the Commission is adopting are general standards that are consistent with good business practices. In addition, smaller alternative trading systems will not be subject to the proposed requirements. For those alternative trading systems that do not, for business reasons alone, ensure adequate capacity, integrity, and security of their systems, there will be costs associated with complying with the requirements. The costs associated with upgrading systems to an adequate level may include, for example, investing in computer hardware and software. In addition, alternative trading systems will incur costs associated with the independent review of their systems on an annual basis. An independent review should be performed by competent, independent audit personnel following established audit procedures and standards. If internal auditors are used by an alternative trading system to complete the review, these auditors should comply with the standards of the EDPAA. If external auditors are used, they should comply with the standards of the AICPA and the EDPAA. The review must be conducted according to established procedures and standards. The costs involved may vary widely depending on the business of the alternative trading system. Alternative trading systems will also be subject to paperwork burdens and recordkeeping and reporting requirements. These requirements are necessary for the Commission and the appropriate SROs to ensure compliance with systems related requirements. In addition, keeping such records permits alternative trading systems to effectively analyze systems problems that occur. While alternative trading systems are not required to file such documentation with the Commission on a regular basis, the Commission recognizes that generating and maintaining such documentation will impose some additional costs.

The notification requirement for material systems outages should impose relatively little additional costs on alternative trading systems. Moreover, the Commission believes that this small burden is justified by the need to keep Commission staff abreast of systems' developments and problems. The Paperwork Reduction Act section of this release summarizes the costs associated with the recordkeeping and reporting burdens of compliance with the systems capacity, integrity, and security requirements.

e. *Costs of Exchange Registration.* The framework the Commission is adopting today for alternative trading systems is designed to allow such systems the option of registering as national securities exchanges. If an alternative trading system chooses to register as an exchange, corresponding regulatory obligations could impose costs on such systems, however, the elective nature of exchange regulation under the framework the Commission is adopting today ensures that only those entities for whom it is cost-effective will choose exchange registration and therefore bear the costs.

For example, exchange-registered alternative trading systems will have to be organized to, and have the capacity to, carry out the purposes of the Exchange Act, including their own compliance and the ability to enforce member compliance with the securities laws. Consequently, any newly registered exchange will have to establish appropriate surveillance and disciplinary mechanisms. In addition, newly registered exchanges will incur certain start-up costs associated with this obligation, such as writing rule manuals.

National securities exchanges currently operating have significant assets and expenses in order to carry out their functions. The cost of acquiring the necessary assets and the operating funds required to carry out the day-to-day functions of a national securities exchange are significant. For example, for the fiscal year 1997, the NYSE had total assets of $1,174,887,000 and total expenses of $488,811,000. The Cincinnati Stock Exchange (''CSE''), currently the only completely automated national securities exchange, had total assets of $13,124,585 and total expenses of $5,343,403. Due to these costs, it appears that an alternative trading system will need to have

significant volume in order to make the benefits of exchange registration outweigh the costs.

As registered exchanges, alternative trading systems will also be subject to more frequent inspection by the Commission. As broker-dealers, alternative trading systems will be inspected on a regular basis by any SRO of which they are a member, and by the Commission only on an intermittent basis. As registered exchanges, these systems will be inspected more regularly by Commission staff, but will, of course, no longer be subject to examinations by SROs.

The Commission inspects different SRO programs on independent review cycles. For example, separate inspections are conducted for an SRO's surveillance, arbitration, listings, and financial soundness programs. Where appropriate, SROs will be examined for other programs they may operate, such as index programs. Each type of examination will be performed at regular intervals, which are typically two to three years. An SRO, however, may expect several examinations throughout a particular year, each in a different program. Each examination typically involves three to four attorneys and/or accountants from the Commission, who spend one week at the SRO, or up to two weeks for particularly large programs, to examine records and interview SRO personnel. In order to comply with section 17(b) under the Exchange Act, an SRO must expend resources to provide copies of relevant documents to, and answer questions from, the Commission staff. The cost to an SRO of each examination varies greatly depending on the scope of the examination and the size or complexity of the SRO's particular program.

In addition, there will also be costs associated with meeting the obligations set forth in section 11A of the Exchange Act and the rules thereunder. These costs include the costs of joining, or creating new, market-wide plans, such as the CQS, CTA, ITS, and OTC–UTP, although some of these costs will be offset by the right to share in the revenues generated by these plans. For example, to join the CTA plan, applicants will be asked to pay, as a condition to entry into the plan, an amount that reflects the value of the tangible and intangible assets created by the CTA plan that will be available to the applicant.[576] Similarly, new participants in ITS will have to pay a share of the development costs, which will reflect a share of the initial development costs, which were $721,631, and a share of costs incurred after June 30, 1978.[577] These costs will also include the costs of complying with Rule 11Ac1–1(b) under the Exchange Act,[578] which requires national securities exchanges and national securities associations to make the best bid, best offer, and aggregate quotation size for each security traded on its facilities available to quotation vendors for public dissemination.[579]

The Commission notes that the remaining costs will be partially offset because the alternative trading systems assuming the costs of exchange registration will no longer be regulated as broker-dealers. Consequently, they will no longer be obligated to comply with the broker-dealer requirements, such as filing and updating Form BD, maintaining books and records in accordance with Rules 17a–3 and 17a–4 under the Exchange Act, and paying fees for membership in an SRO. In addition, because exchange-registered alternative trading systems share the responsibilities of self-regulation, the regulatory burden carried by currently registered exchanges should be reduced. Other benefits include the freedom from oversight by a competing SRO, no obligation to comply with net capital requirements, the right to establish trading and conduct rules, the right to establish fee schedules, the ability to directly participate in the national market system mechanisms, and the right to share in the profits and benefits produced by the national market system mechanisms such as the CQS, CTA, ITS and OTC–UTP plans.[580]

The costs of exchange registration also include certain paperwork, filing, and recordkeeping requirements. These costs are discussed in the Paperwork Reduction Act section below.

The Commission anticipates that only a few of the existing alternative trading systems would consider registering as a national securities exchange. For most of the alternative trading systems currently in existence, the Commission believes that the costs and obligations discussed above potentially make registering as a national securities exchange less commercially viable than registering as a broker-dealer and complying with Regulation ATS.

B. Amendments to Application and Related Rules for Registration as an Exchange

The Commission identified several costs and benefits to investors and market participants in the Proposing Release with respect to amendments to the application and rules for exchange registration. Only two commenters identified areas of concern regarding exchange registration. These commenters suggested that the Commission was seeking to reimpose annual filing requirements previously eliminated in 1994.[581] In response, the Commission has made technical modifications to Rule 6a–2 to clarify the operation of the rule. The Commission does not believe that these filing burdens are reimposed under the rules as adopted. These commenters also questioned the value of requiring exchanges to compile and submit amendments to Form 1 that contain information that has been provided to the Commission throughout the year in other contexts. The Commission continues to believe that it is important to have all the required information gathered in one place in order to make it useful for Commission staff. In addition, the additional costs should be minimal because the respondents are required only to compile existing documents rather than generate new material.

1. Benefits

The Commission believes that the amendments provide benefits to organizations that are currently

[576] The amount to be paid to the CTA plan will vary on a case-by-case basis and may reflect a current independent valuation of the CTA facilities, prior valuations, an assessment of costs contributed to the plan by existing members, the estimated usage of the plan facilities by the applicant, costs for anticipated system modifications to accommodate the applicant, and other relevant factors as determined by the current participants. *CTA Plan: Second Restatement of Plan Submitted to the Securities and Exchange Commission Pursuant to Rule 11Aa3–1 under the Securities Exchange Act of 1934,* May 1974 as restated March 1980 and December 1995, at 8–9. *See supra* note 391. The terms of the CQ plan are substantially similar with respect to the assessment of a payment upon entry into the system. *CQ Plan: Restatement of Plan Submitted to the Securities and Exchange Commission Pursuant to Rule 11Ac1–1 under the Securities Exchange Act of 1934,* July 1978, as restated December 1995, at 8–9. *See supra* note 392.

[577] *Plan for the Purpose of Creating and Operating an Intermarket Communication Linkage Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934, Composite: Amendments through May 30, 1997,* at 78–79.

[578] 17 CFR 240.11Ac1–1.

[579] The Commission estimates that each national securities exchange or national securities association will submit information to vendors approximately 24,266,000 times per year, which reporting is generally done through automated facilities that conduct the reporting on a continuous basis. Due to the continuous nature of the information feeds, the Commission does not believe that it is feasible to estimate the average cost per response or annual burdens hours involved in complying with Rule 11Ac1–1(b) for a new registered exchange. 17 CFR 240.11Ac1–1(b).

[580] *See supra* Section III.B.1.

[581] *See* NYSE Letter at 10; Amex Letter at 5–6.

registered, or in the future will apply for registration, as national securities exchanges. Generally, the Commission expects that the regulatory framework discussed in this release accommodates automated and for-profit exchanges and makes registering as a national securities exchange more commercially viable for possible future exchanges.[582] First, the amendments to Rules 6a–1, 6a–2, and 6a–3 ease compliance burdens by simplifying the rule. By simplifying the rule language itself, the Commission anticipates that parties attempting to comply with Rules 6a–1, 6a–2, and 6a–3 will be better able to understand the rules' requirements and comply with them. Much of the information required on Form 1 will not change, but the revised form recasts the questions and exhibits in a different format that will ease compliance and make the responses more relevant to investors and the Commission. While national securities exchanges have traditionally been membership-owned, Form 1 also is revised to accommodate proprietary national securities exchanges.

Second, the amendments give national securities exchanges the option of complying with certain ongoing filing requirements by posting information on an Internet web site and supplying the location to the Commission, instead of filing a complete paper copy with the Commission. The Commission anticipates that exchanges will choose to use the Internet to comply with Rules 6a–2 and 6a–3 rather than filing many exhibits on paper. The availability of such information on the Internet will also provide the public with easier and less expensive access to the information than requesting paper copies from the Commission or the national securities exchanges as currently required. In addition, permitting exchanges to use the Internet as a means of compliance will reduce expenses associated with clerical time, postage, and copying.

The amended rules also reduce the frequency of certain ongoing filings to update the information in Form 1, directly reducing the compliance burden on national securities exchanges while still meeting investors' and the Commission's need for reasonably current information. Specifically, the amendments eliminate exchanges' requirement to submit changes to their constitution, their rules, or the securities listed on the exchange within ten days. The amendments also permit exchanges to file certain information regarding subsidiaries and affiliates every three years rather than annually. These amendments will conserve registered exchanges' staff time to comply with the rules.

2. Costs

The amendments are intended to simplify the filing requirements and reduce the compliance burdens for national securities exchanges and will likely impose few additional costs on national securities exchanges. Initially, there may be some additional personnel costs required to review the proposed rules and revised Form 1, but the Commission believes that the simplified requirements will reduce overall compliance burdens and costs over time. Reducing the frequency of filings for some requirements may result in some information being less current. The Commission, however, believes that much of this type of information does not change frequently. Moreover, the option of posting such information on an Internet web site should encourage more frequent updating of current information. Compliance with Rules 6a–1, 6a–2, and 6a–3 also include certain paperwork costs, which are discussed as ''burdens'' in the Paperwork Reduction Act section below.

C. Costs and Benefits of the Repeal of Rule 17a–23 and the Amendments to Rules 17a–3 and 17a–4

The Commission identified several costs and benefits to investors and market participants in the Proposing Release with respect to Rules 17a–23, 17a–3, and 17a–4. One commenter stated that the transfer of recordkeeping burdens would impose no additional burdens.[583]

Approximately forty-five of the broker-dealer trading systems currently filing reports under Rule 17a–23 will be alternative trading systems under the amendments and rules in this release. These trading systems will not fall within the definition of ''internal broker-dealer system,'' and will, therefore, not be required to maintain records under the new provisions of Rules 17a–3(a)(16) and 17a–4(b)(10). In its Paperwork Reduction Act analysis, the Commission notes that annual aggregate burdens for the recordkeeping obligations under Rule 17a–23 will be eliminated. Although the reporting requirements under Rule 17a–23 will be eliminated, alternative trading systems will be subject to similar recordkeeping requirements under Regulation ATS.[584] These paperwork ''burdens'' are discussed below in the Paperwork Reduction Act section.

D. SRO Pilot Trading System

The Commission identified several costs and benefits to investors and market participants in the Proposing Release with respect to Rule 19b–5. While the Commission solicited comment on the costs and benefits of Rule 19b–5, no comments were received specifically on that point. Several commenters did, however, address the Commission's proposal. One commenter agreed that Rule 19b–5 would reduce regulatory costs and encourage innovation, but believed that the rule's limitations should be reduced.[585] Two other commenters expressed support for the goals of Rule 19b–5, but argued that burdens wouldn't be reduced as a practical matter due to the limitations of the rule.[586] In response, the Commission notes that it has adopted the rule with some changes that should permit SROs more flexibility in taking advantage of the temporary exemption from rule filing requirements.

By permitting SROs to begin operating eligible pilot trading systems immediately and to continue operating for two years under a flexible regulatory scheme, the Commission believes that Rule 19b–5 will benefit SROs and investors. Rule 19b–5 will enhance competition in the trading markets without imposing significant SRO compliance burdens.[587] Rule 19b–5 will permit the timely implementation of pilot trading systems without the widespread dissemination of critical business information. Therefore, Rule 19b–5 will reduce SRO costs associated with the Commission approval process and improve the competitive balance between SROs and alternative trading

[582] For example, the International Securities Exchange, which announced its intentions to register as a national securities exchange on November 10, 1998, would not be able to register as a national securities exchange without the changes to the rules as adopted today. *See International Securities Exchange Will be First Fully Electronic Options Exchange in U.S.*, International Securities Exchange Press Release, Nov. 10, 1998.

[583] TBMA Letter at 25–26.

[584] The costs and benefits associated with these recordkeeping requirements are discussed in Section IX.A.2.a. *supra.*

[585] CBOE Letter at 8–9.

[586] *See* CME Letter at 3–4; PCX Letter at 8.

[587] The Commission estimates that the current preparation and filing of proposed rule changes pursuant to section 19(b)(2) of the Exchange Act to operate a pilot trading system constitute major market impact filings requiring approximately 100 hours and $10,000 to $15,000 of SRO time and money, respectively, for each proposal. This does not include the cost to the SRO of any delay in obtaining Commission approval or in disclosing business information; nor does this include the benefit to an SRO of bringing its new pilot trading system to market in a shorter amount of time. The cost per hour and per filing is derived from information supplied by the SROs. For the purposes of our estimates, we have valued related overhead at thirty-five percent of the value of legal work. *See GSA Guide to Estimating Reporting Costs* (1973).

systems that are regulated as broker-dealers.[588] Moreover, the Commission believes that Rule 19b–5 will foster innovation and create a streamlined procedure for SROs to operate pilot trading systems and will reduce filing costs for SROs pilot trading systems.

The costs of complying with Rule 19b–5 includes certain paperwork, filing, and recordkeeping requirements that are discussed below in the Paperwork Reduction Act section.

X. Effects on Competition, Efficiency and Capital Formation

Section 23(a)(2)[589] of the Act requires that the Commission, when promulgating rules under the Exchange Act, to consider the impact any rule would have on competition and to not adopt any rule that would impose a burden on competition that is not necessary or appropriate in the public interest. In the Proposing Release, the Commission solicited comment on the effects on competition, efficiency and capital formation of the rules and amendments. Specifically, the Commission requested commenters to address how the proposed rules and amendments would affect competition between and among alternative trading systems, broker-dealers, exchanges, investors, and other market participants. The Commission received no comments specifically regarding these issues.

The Commission has considered the rules and rule amendment in light of the standards cited in section 23(a)(2) of the Act and believes they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. As discussed above in the Cost-Benefit Section, the Commission recognizes that some alternative trading systems and their institutional users will be affected competitively by the rules adopted today. Nonetheless, the Commission believes that the rules and amendments will encourage innovation, accommodate the growing role of technology in the securities markets, improve transparency for market participants and ensure the stability of trading systems with a significant role in the markets, thereby furthering the development of a national market system in accordance with the goals under section 11A of the Exchange Act. In particular, as discussed above in the Cost-Benefit Section, the Commission believes that the rules and amendments will significantly reduce spreads, thereby benefiting all investors.

In adopting these rules and amendments, the Commission has considered whether the action will protect investors, and promote efficiency, competition, and capital formation.[590] The Commission believes that the rules and amendments will allow the Commission to better oversee the activities of alternative trading systems and integrate alternative trading systems into the national market system. The rules and amendments will also better accommodate automated and for-profit exchanges and permit SROs to operate pilot trading systems temporarily without Commission approval. These steps will help to protect investors by preventing discriminatory denials or limitations of access, preventing systems related failures, and permitting access to best-priced orders. In addition, alternative trading systems should continue to compete based on innovation, price, and service rather than access to ''hidden markets.''

Rules 3a1–1, 3b–16, and Regulation ATS adopted today are intended to provide a choice between registering as a broker-dealer and registering as an exchange for markets operated as alternative trading systems.[591] In addition, the amendments to Rules 6a–1, 6a–2, and 6a–3 adopted today are intended to update the requirements for registered or exempt exchanges in order to accommodate different forms of organization and methods of operation. The Commission believes that these changes will create a more efficient market, encourage competition among alternative trading systems, and stimulate capital formation by making the regulatory framework sufficiently flexible to accommodate new or different approaches to exchange formation and operation, including automated and for-profit exchanges. The Commission further believes that the costs identified in the above analysis are not substantial enough to deter any market participants from attempting to become an alternative trading system.[592]

In addition, Rule 19b–5 and Form Pilot are intended to provide SROs the opportunity to develop and operate pilot trading systems with less cost and time delay. As previously stated, currently, SROs are required to submit a rule filing to the Commission and undergo a public notice, comment, and approval process, before they operate a new pilot trading system. Rule 19b–5 would permit SROs that develop pilot trading systems to begin operation shortly after submitting Form PILOT to the Commission. One of the consequences of SROs filing rule changes before implementation is that the rule filing process informs SROs' competitors about the proposed pilot trading system and provides an avenue for those competitors to copy, delay, or obstruct implementation of a pilot trading system before it can be tested in the marketplace. As a result, the Commission believes that proposed Rule 19b–5 and Form Pilot should help create a more efficient market, encourage competition between SROs and alternative trading systems, and stimulate capital formation by creating a streamlined procedure for SROs to operate pilot trading systems and reducing filing costs for SROs generally.

XI. Summary of Final Regulatory Flexibility Analysis

A Final Regulatory Flexibility Analysis (''FRFA'') has been prepared in accordance with section 4 of the Regulatory Flexibility Act (''RFA'').[593] The FRFA relates to the adoption of new rules 3a1–1,[594] 3b–16,[595] 19b–5,[596] Regulation ATS,[597] new Forms ATS,[598]

[588] The Commission estimates that under current procedures, a rule filing for a new pilot trading system takes 90 days, on average, from the date of the original submission to be approved. In contrast, the expedited treatment of SRO rule changes for pilot trading systems in this release permits SROs to operate a pilot trading system twenty days after submitting an initial operation report on Form PILOT, so long as such system complies with Rule 19b–5 under the Exchange Act.

[589] 15 U.S.C. 78w(a)(2).

[590] 15 U.S.C. 78c(f).

[591] The Commission further believes that repealing Rule 17a–23 and amending Rules 17a–3 and 17a–4 under the Act will help to create a more efficient market, encourage competition, and stimulate capital formation innovation.

[592] As previously stated, alternative trading systems are able to attract subscribers because prices in their systems are often better than the prices available in the public markets. Because alternative trading systems are now required to publicly display their best priced orders for securities in which they represent more than 5 percent of the trading volume, the best priced orders for certain securities will also be available through the public markets. Consequently, some subscribers could leave an alternative trading system if they think there are fewer advantages than before in having direct access to the alternative trading system. However, the growth of ECNs since the Order Handling Rules were implemented indicates that alternative trading systems can, and are, attracting subscribers. As mentioned above, there are still significant benefits to being a subscriber to an alternative trading system, including, but not limited to: the ability to enter orders and the use of such features as a negotiation feature or a ''reserve size'' feature; the ability to access the best priced orders for securities in which an alternative trading system represents less than 5 percent of the trading volume and therefore is not subject to the transparency requirements; and access to the entire ''book,'' not merely the ''top of the book,'' that contains important real-time market information regarding depth of trading interest.

[593] 5 U.S.C. 604.

[594] 17 CFR 240.3a1–1.

[595] 17 CFR 240.3b–16.

[596] 17 CFR 240.19b–5.

[597] 17 CFR 242.300 *et seq.*

[598] 17 CFR 242.637.

ATS–R,[599] PILOT,[600] amendments to rules 6a–1,[601] 6a–2,[602] 6a–3,[603] 11Ac1–1,[604] 17a–3,[605] 17a–4,[606] the Commission's rules of practice,[607] to Form 1, and the repeal of Rule 17a–23[608] under the Exchange Act.[609] The FRFA notes the potential costs of operation and procedural changes that may be necessary to comply with the new rules and rule amendments (''new regulatory framework''). A summary of the Initial Regulatory Flexibility Analysis (''IRFA'') appeared in the Proposing Release.[610]

As more fully discussed in the FRFA, market participants have developed a variety of alternative trading systems that furnish services traditionally provided solely by registered exchanges. Our current regulatory framework, designed more than six decades ago, however, did not foresee many of these trading and business functions. Alternative trading systems now handle twenty percent or more of the orders in securities listed on Nasdaq, and almost four percent of orders in listed securities. Even though these systems provide services that are similar to those provided by the registered exchanges and Nasdaq, the current regulatory framework largely ignores the market functions of alternative trading systems. This creates disparities that affect investor protection, market intermediaries, and other markets. For example, activity on alternative trading systems is not fully disclosed to, or accessible by, public investors and 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. In addition, they do not have an obligation to ensure that their capacity is sufficient to handle trading demand. Because of the increasingly important role of alternative trading systems, these differences call into question not only the fairness of current regulatory requirements, but also the efficacy of the existing national market system structure.

As described in the FRFA, under the new regulatory framework, the Commission will offer trading systems a choice between broker-dealer regulation and exchange regulation. Specifically, the Commission proposed to allow alternative trading systems to choose whether to register as national securities exchanges, or to register as broker-dealers and comply with additional requirements under proposed Regulation ATS depending on their activities and trading volume. In conjunction with this proposal, the Commission proposed to repeal Rule 17a–23, which currently requires alternative trading systems—as well as broker-dealer trading systems that are not alternative trading systems—to maintain certain records and file reports with the Commission. The Commission also proposed amendments to Form 1, which securities markets file to register as national securities exchanges, and related rules. Finally, to enable registered exchanges and national securities associations to better compete in the fast changing marketplace, the Commission proposed to temporarily exempt certain pilot trading systems operated by such exchanges and associations from the rule filing requirements of the Exchange Act.

In the Proposing Release, the Commission solicited public comment on the proposed new rules and rule amendments which were designed to resolve many of the concerns raised by alternative trading systems. As discussed in the FRFA, commenters generally supported the Commission's proposals and welcomed the regulatory flexibility these proposals offered. While no public comments were received in response to the IRFA, several of the comments were related to the IRFA. Several commenters encouraged the Commission to accept electronic filings as a means of reducing the burden on market participants. The Commission is, in fact, working toward the goal of accepting filings in electronic form. One commenter suggested that the Commission impose only minimal regulatory requirements, if any, on alternative trading systems that trade only minimal volume in order to avoid erecting significant barriers to entry and innovation. The Commission believes that the requirements of Regulation ATS are minimal for new alternative trading systems, especially as compared to the current no-action letter process. Regulation ATS sets forth concrete requirements for a system to operate, imposes only notice filings, and reserves more burdensome requirements for high volume systems. Another commenter stated that the reporting requirements under proposed Regulation ATS are similar to current Rule 17a–23 and, thus, are not inappropriately burdensome. The Commission agrees and notes that most current potential respondents under Regulation ATS already have experience with the requirements and burdens associated with Rule 17a–23, so Regulation ATS will not impose significant new burdens on currently operating alternative trading systems.

The Commission is adopting new Regulation ATS substantially in the form it was proposed.

The FRFA addresses how the proposal would affect broker-dealers that operate alternative trading systems and internal broker-dealer trading systems that are small entities. As more fully explained in the FRFA, the Commission believes that the improved regulatory framework provided by Regulation ATS justifies the costs incurred by industry participants to comply with Regulation ATS. The FRFA also describes the Commission's consideration of significant alternatives to Regulation ATS. The FRFA concludes that the alternatives, in the context of a new regulatory framework, would not accomplish the stated objectives of Regulation ATS. A copy of the FRFA may be obtained by contacting Denise Landers, Attorney, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 10–1, Washington D.C. 20549.

XII. Paperwork Reduction Act

As explained in the Proposing Release, certain provisions of the rules and rule amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*) (''PRA''). Accordingly, the Commission submitted the collection of information requirements contained in the rules and rule amendments to the Office of Management and Budget (''OMB'') for review and were approved by OMB which assigned the following control numbers: Form 1, Rules 6a-1 and 6a-2, control number 3235–0017; Rule 6a-3, control number 3235–0021; Rule 17a–3(a)(16), control number 3235-0508; Rule 17a–4(b)(10), control number 3235–0506; Rule 19b–5 and Form PILOT, control number 3235–0507; Rule 301, Form ATS and Form ATS-R, control number 3235–0509; Rule 302, control number 3235–0510; and Rule 303, control number 3235–0505. The collections of information are in accordance with Section 3507 of the

[599] 17 CFR 242.638.
[600] 17 CFR 249.821.
[601] 17 CFR 240.6a–1.
[602] 17 CFR 240.6a–2.
[603] 17 CFR 240.6a–3.
[604] 17 CFR 240.11Ac1–1.
[605] 17 CFR 240.17a–3.
[606] 17 CFR 240.17a–4.
[607] 17 CFR 202.3.
[608] 17 CFR 240.17a–23.
[609] 15 U.S.C. 78a *et seq.*
[610] *See supra* note .

PRA.[611] With regard to Rule 301, Form ATS, and Form ATS-R, Rule 302, and Rule 303, the Commission staff has changed its estimate of the paperwork burdens slightly due to an increase in the estimated number of respondents that will be affected and a change to the fair access rules. Accordingly, the Commission has submitted a PRA change worksheet to OMB.[612]

The collection of information obligations imposed by the rules and rule amendments are mandatory. However, it is important to note that an alternative trading system operating as a broker-dealer is optional, operation of a national securities exchange is optional, and operating a pilot trading system is optional. The information collected, retained, and/or filed pursuant to the rules and rule amendments under Regulation ATS will be kept confidential to the extent permitted by the Freedom of Information Act (5 U.S.C. § 552 *et seq.*). The information collected, retained, and/or filed pursuant to the rules for registration as a national securities exchange will not be confidential and will be available to the public. The information collected, retained, and/or filed pursuant to the rules for operation of pilot trading systems will not be confidential and will be made available to the public when the pilot trading system starts to operate. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid OMB control number.

The collections of information are necessary for persons to obtain certain benefits or to comply with certain requirements. As described in the Proposing Release, the rules and rule amendments to which the collections of information are related allow the Commission to respond to the impact of technological developments in the securities markets and permit the Commission to more effectively oversee the growing number of alternative trading systems. The collections of information are also necessary to permit the Commission to effectively oversee SRO pilot trading systems. With the exception of two changes to the final rules, there are no material changes to the rules and amendments as adopted that affect the burden estimates in the Proposing Release. The Commission is adopting different fair access requirements from those it published in the Proposing Release. The Commission has determined to not adopt the fair access requirements that would have required investors denied or limited access to have a right to appeal to the Commission and alternative trading systems making access denial or limitation decisions to notify such investors of the decision and their right of appeal to the Commission. Instead, the Commission has decided to adopt rules that require alternative trading systems to report quarterly to the Commission a record of all grants, denials, and limitations of access as well as other descriptive information surrounding the decision. These changes eliminate the proposed paperwork burden of providing notice to investors and adds a compliance burden on Form ATS–R to report such information to the Commission. Aggregate paperwork burdens have also been revised to reflect updated information regarding the estimated number of alternative trading systems that will be subject to the rules. In the Proposing Release, the Commission staff estimated that there were approximately forty-three alternative trading systems operating. The Commission staff now estimates that there are forty-five alternative trading systems operating, so the aggregate paperwork burdens have been revised to reflect this change.

The Commission solicited public comment on the collection of information requirements contained in the Proposing Release. While the Commission received no comments that specifically addressed the PRA portion of the release, it did receive several comments that touched on PRA related issues.

Several commenters encouraged the Commission to accept electronic filings as a means of reducing the burden on market participants. The Commission is, in fact, working toward the goal of accepting filings in electronic form. The Commission anticipates that the option of electronic filing will be made available to respondents at some point in the relatively near future. Several commenters also suggested that the Commission reduce the burden on national securities exchanges by relieving them of the obligation to file annual amendments to Form 1 due to the same information being submitted to the Commission in other forms periodically throughout the year. The Commission believes that it is important to have one complete annual filing that compiles all the changes to the information contained on Form 1 throughout the year and all other required SRO information. Additionally, the Commission believes that such a filing represents only a compilation of existing information, so the additional burden of requiring an annual filing is largely clerical and generally minimal.

One commenter suggested that the Commission impose only minimal regulatory requirements, if any, on alternative trading systems that trade only minimal volume in order to avoid erecting significant barriers to entry and innovation. The Commission believes that the requirements of Regulation ATS are minimal for new alternative trading systems, especially as compared to the current no-action letter process. Regulation ATS sets forth concrete requirements for a system to operate, imposes only notice filings, and reserves more burdensome requirements for high volume systems. Another commenter stated that the reporting requirements under proposed Regulation ATS are similar to current Rule 17a–23 and, thus, are not inappropriately burdensome. The Commission agrees and notes that most current potential respondents under Regulation ATS already have experience with the requirements and burdens associated with Rule 17a–23, so Regulation ATS will not impose significant new burdens on currently operating alternative trading systems.

As noted above in the Cost-Benefit section, below is a summary of the paperwork burdens that were identified in the Proposing Release. Although not mandated by the PRA, to give regulated entities and others an understanding of the paperwork costs, the discussion below provides dollar estimates assuming certain labor costs.

A. Form 1, Rules 6a–1 and 6a–2

These amendments are intended to simplify the filing requirements and reduce the compliance burdens for national securities exchanges and will likely impose few additional costs on national securities exchanges. Initially, there may be some additional personnel costs required to review the proposed rules and revised Form 1, but the Commission believes that the simplified requirements will reduce overall compliance burdens and costs over time. Reducing the frequency of filings for some requirements may result in some information being less current. The Commission, however, believes that much of this type of information does not change frequently. Moreover, the option of posting such information on an Internet web site should encourage more frequent updating of current information.

The Commission staff has estimated that each respondent will incur an average burden of forty-seven hours to comply with Rule 6a–1 and file an

[611] 44 U.S.C. 3507.

[612] For a further discussion of the changes, see the discussions of Rule 301, Form ATS, Form ATS–R, Rule 302, and Rule 303, infra.

initial application for registration on Form 1. This represents a two hour increase from the current average burden due to the estimated additional burden of the added exhibits. The Commission staff has estimated that the average additional cost per response will be approximately $30.[613] Because the Commission receives applications for registration as an exchange on Form 1 from time to time, and not on a predictable basis, it cannot estimate the annual aggregate costs and burden hours associated with such filings.[614]

The Commission notes that it is making no material changes to Rule 6a–1, Rule 6a–2, or Form 1 from the Proposing Release. Thus, the collection of information burdens are not changing from those proposed.

B. Rule 6a–3

The Commission anticipates that the amendments will not change the paperwork burden associated with complying with Rule 6a–3. The Commission staff has estimated that the average burden for each respondent to comply with Rule 6a–3 is one-half hour per response because compliance only requires photocopying existing documents. The Commission also estimates that each respondent will file supplemental information under Rule 6a–3 approximately twenty-five times per year. The estimated average cost per response for each individual respondent is $9.50, resulting in an estimated annual average cost burden for each respondent of $237.50.[615]

C. Rule 17a–3(a)(16)

No additional recordkeeping burdens will be imposed on internal broker-dealer systems under the amendments to Rule 17a–3. The amendments apply only to systems that are presently subject to the recordkeeping requirements of Rule 17a–23. Because the Commission is repealing Rule 17a–23 and amending Rules 17a–3 and 17a–4 by transferring the recordkeeping requirements from Rule 17a–23, the Commission does not anticipate any new recordkeeping costs or burdens for respondents.

Based on Commission experience with the burdens associated with Rule 17a–23, the Commission has estimated the burdens that will be associated with Rule 17a–3(a)(16). The Commission staff has estimated that there will be approximately ninety-four broker-dealers operating one hundred twenty-three internal broker-dealer systems that will have to make the records described in Rule 17a–3(a)(16). The Commission staff has estimated that each respondent will spend approximately twenty-seven hours per year keeping the required records under Rule 17a–3(a)(16) at an annual cost of $1,298.16.[616] The aggregate burden for approximately ninety-four broker-dealers operating internal broker-dealer trading systems is estimated to be 2,619 hours for a total average cost of $122,027.04.[617]

D. Rule 17a–4(b)(10)

No additional recordkeeping burdens will be imposed on internal broker-dealer systems under the amendments to Rule 17a–4. The amendments apply only to systems that are presently subject to the recordkeeping requirements of Rule 17a–23. Because the Commission is repealing Rule 17a–23 and amending Rules 17a–3 and 17a–4 by transferring the recordkeeping requirements from Rule 17a–23, the Commission does not anticipate any new recordkeeping costs or burdens for respondents.

Based on Commission experience with the burdens associated with Rule 17a–23, the Commission has estimated the burdens that will be associated with Rule 17a–4(b)(10). The Commission staff has estimated that there will be approximately ninety-four broker-dealers operating one hundred twenty-three internal broker-dealer systems that will have to keep the records described in Rule 17a–4(b)(10). The Commission staff has estimated that each respondent will spend approximately three hours to preserve the required records under Rule 17a–4(b)(10) at an annual cost of $144.24.[618] The aggregate burden for approximately ninety-four broker-dealers operating internal broker-dealer trading systems is estimated to be two hundred eighty two hours for a total average cost of $13,558.56.[619]

E. Rule 19b–5 and Form PILOT

For SROs that choose to operate pilot trading systems and avail themselves of the provisions of Rule 19b–5, compliance with Rule 19b–5 and the filings required on Form PILOT are mandatory. Initial filings on Form PILOT are confidential until the pilot system is operational and subsequent filings are not confidential. Thus, after a pilot trading system starts to operate, all filings on Form PILOT are available to the public. Rule 19b–5 reiterates SROs' existing recordkeeping obligations under Rule 17a–1, which requires that such records be kept for not less than five years, the first two years in an easily accessible place.

The Commission anticipates receiving approximately 6 notices per year regarding pilot trading systems on Form PILOT.[620] An SRO will be required to submit a Form PILOT providing detailed operational data and update this information quarterly. The Commission staff has estimated that an SRO will expend twenty-four hours to file an initial operation report and three hours to file a quarterly report and a systems change notice.[621] The Commission also estimates that an SRO will file two amendments per year to report changes to the system.[622] The Commission staff has estimated that an SRO will expend $1,242 per initial Form PILOT filing and $155 for each quarterly Form PILOT and system

[613] The estimated average additional cost per response of $30 is derived from two additional hours of clerical work at $15 per hour.

[614] Since 1991, the Commission has received three total applications for registration as a national securities exchange.

[615] The estimated average cost per response of $9.50 is composed of $7.50 for clerical work (0.5 hours at $15 per hour) and $2 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs). The Commission staff has estimated overhead for this collection of information burden, and all other collection of information burdens discussed below, based on thirty-five percent of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973). The estimated average annual cost of $237.50 is derived from twenty-five annual filings at a cost of $9.50 per filing.

[616] The Commission staff has estimated that an employee of a broker-dealer charged to ensure compliance with Commission regulations receives annual compensation of $100,000. This compensation is the equivalent of $48.08 per hour ($100,000 divided by 2,080 payroll hours per year). The estimated annual cost of $1,298.16 is derived from twenty-seven burden hours per respondent at $48.08 per hour.

[617] The estimated aggregate burden of 2,619 hours is derived from ninety-four broker-dealer respondents incurring an average burden of twenty-seven hours each. The estimated aggregate cost of $122,027.04 is derived from ninety-four broker-dealer respondents incurring an average burden of $1,298.16 each.

[618] The Commission staff has estimated that an employee of a broker-dealer charged to ensure compliance with Commission regulations receives annual compensation of $100,000. This compensation is the equivalent of $48.08 per hour ($100,000 divided by 2,080 payroll hours per year). The estimated annual cost of $144.24 is derived from three burden hours per respondent at $48.08 per hour.

[619] The estimated aggregate burden of two hundred eighty-two hours is derived from ninety-four broker-dealer respondents incurring an average burden of three hours each. The estimated aggregate cost of $13,558.56 is derived from ninety-four broker-dealer respondents incurring an average burden of $144.24 each.

[620] This estimate is based on a review of past SRO filings under section 19(b) of the Exchange Act. The Commission staff has estimated that approximately 6 rule filings per year in the past could have been filed under Rule 19b–5.

[621] The estimates for burden hours involved with filing Form PILOT are based on the Commission's experience with similar reporting requirements under Rule 17a–23.

[622] This estimate is based on the Commission's experience with collection of similar information under Rule 17a–23.

change notice filed.[623] Thus, the total estimated annual burden for SROs to comply with Rule 19b–5 by filing an initial notice on Form PILOT is estimated to be one hundred forty-four hours for a total average cost of $7,452.[624] The total estimated annual burden for SROs to file systems change notices and quarterly reports on Form PILOT is estimated to be one hundred eight hours for a total average cost of $5,580.[625]

F. Rule 301, Form ATS and Form ATS–R

For alternative trading systems that choose to register as a broker-dealer, the requirements of Rule 301, Form ATS and Form ATS–R are mandatory. All filings required under Rule 301, Form ATS and Form ATS–R are considered confidential and are not available to the public. All records required to be made under the Rule are required to be preserved for three years, the first two years in an easily accessible place.

The alternative trading system amendments and rules have been tailored to minimize their burden on alternative trading systems and especially small systems. Many of the provisions in the proposed rules are triggered by a volume threshold. The Commission expects that small alternative trading systems will not have sufficient volume to trigger those thresholds and will therefore not have to comply with those provisions. The recordkeeping and reporting requirements with which smaller, lower volume alternative trading systems have to comply under proposed Regulation ATS are substantially similar to those with which alternative trading systems currently comply. Consequently the costs for smaller alternative trading systems should remain unchanged.

1. Notice, Reporting, and Recordkeeping

All alternative trading systems that will be subject to notice, reporting, and recordkeeping requirements under the Commission's rules as adopted today are currently subject to similar requirements under Rule 17a–23. The requirements under Regulation ATS, however, require some additional information that is not currently required under Rule 17a–23.

Under Regulation ATS, alternative trading systems file an initial operation report, notices of material systems changes, and quarterly reports. The rules also include new Forms ATS and ATS–R to standardize reporting of such information and make it more useful for the Commission. The rules require information that is not currently required under Rule 17a–23, such as greater detail about the system operations, the volume and types of securities traded, criteria for granting access to subscribers, procedures governing order execution, reporting, clearance and settlement, procedures for reviewing systems capacity and contingency procedures, and the identity of any other entities involved in operating the system.

Regulation ATS requires staff time to comply with the initial notice and amendment requirements. While the Commission has designed the requirements in an effort to balance the costs of filing with the benefits to be gained from the information, some effort will be necessary to gather and file this information. Most of the information, however, already exists. Alternative trading systems will only be required to gather this information and supply it in the required format to the Commission. The periodic updating requirements will also require staff time over the life of the alternative trading system to comply with the rules.

The Commission staff has estimated that there are currently about forty-five alternative trading systems that will be required to register as exchanges or register as broker-dealers and comply with Regulation ATS.[626] The Commission also estimates that, over time, there will be approximately three new alternative trading systems each year that choose to register as broker-dealers and comply with Regulation ATS.[627]

The Commission also estimates that, over time, there will be approximately three alternative trading systems that file cessation of operations reports each year. Thus, the Commission anticipates that, over time, if all forty-five current alternative trading systems choose to register as broker-dealers and comply with Regulation ATS, there will be approximately forty-five alternative trading systems operating each year.

The Commission staff has estimated that the average burden per respondent to file the initial operations report on Form ATS will be twenty hours. This burden is computed by estimating that completing the report will require an average of thirteen hours of professional work and seven hours of clerical work.[628] The Commission staff has estimated that the average cost per response will be $1,019 representing the twenty hours and cost of supplies.[629] If all forty-five alternative trading systems opt to register as broker-dealers and comply with Regulation ATS, the total, one time cost to comply with the proposed requirements to file initial operation reports is estimated to be $45,855.[630] The Commission also estimates that, over time, approximately three new alternative trading systems will register as broker-dealers per year, incurring an annual aggregate burden of sixty hours for an average total cost of $3,057 after the first year following adoption of Regulation ATS.[631]

In addition, the rules require alternative trading systems to amend their initial operations report to notify the Commission of material systems changes and other changes to the

[623] The estimated average cost of $1,242 to file an initial Form PILOT is composed of $800 for in-house professional work (sixteen hours at $50 per hour), $120 for clerical work (eight hours at $15 per hour) and $322 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

The total estimated average cost of $155 to file quarterly reports and system change notices on Form PILOT is composed of $100 for in-house professional work (two hours at $50 per hour), $15 for clerical work (one hour at $15 per hour) and $40 for printing, supplies, copying and postage (approximately thirty-five percent of the total labor costs).

[624] The estimated average burden of one hundred forty-four hours is derived from six SRO respondents incurring an average burden of twenty-four hours per filing. The estimated average cost of $7,452 is derived from six SRO respondents making six initial Form PILOT filings at $1,242 per filing.

[625] The estimated average burden of one hundred eight hours is derived from six SRO respondents filing four quarterly reports and two systems change notices at three burden hours per filing. The estimated average cost of $5,580 is derived from six SRO respondents filing four quarterly reports and two systems change notices at $155 per filing.

[626] This estimate is based on filings made with the Commission under Rule 17a–23. At the time of the Proposing Release, the Commission estimated that forty-three alternative trading systems would be required to register as exchanges or broker-dealers and comply with Regulation ATS. Since that time, two such alternative trading systems have started to operate.

[627] Based on the Commission's experience over the last three years with Rule 17a–23, it appears that there are more than three new alternative trading systems per year. However, we expect that in the steady state over time, there will be approximately three new alternative trading systems per year. The rapid growth experienced over the last several years is unlikely to continue at such a high rate in perpetuity.

[628] This estimate for burden hours of filing Form ATS is based on the burdens associated with filing Form 1, adjusted for differences between Form 1 and Form ATS. The division between professional and clerical time is based on estimates of the proportions used in the estimates of burdens for filing Form 1.

[629] The estimated average cost per response of $1,019 is composed of $650 for in-house professional work (thirteen hours at $50 per hour), $105 for clerical work (seven hours at $15 per hour) and $264 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

[630] This estimated cost of $45,855 is derived from forty-five alternative trading systems filing at an average cost of $1,019 each.

[631] This estimated cost of $3,057 is derived from three new alternative trading systems filing at an average cost of $1,019 each.

information contained in the initial operations report. The Commission staff has estimated that each respondent will file six such amendments per year.[632] The Commission staff has estimated that each respondent will incur an average burden of two hours per response and incur an average cost of $111.50 for each amendment to the initial operation report that it submits.[633] If all forty-five alternative trading systems opt to comply with Regulation ATS rather than to register as exchanges, the total aggregate cost per year to comply with the proposed requirement to file amendments to the initial operation reports is estimated to be $30,105.[634]

Alternative trading systems registering as broker-dealers will also be required to file quarterly reports on Form ATS–R, reporting participating system subscribers, the securities traded on the system, and aggregate volume information. The Commission staff has estimated that the quarterly reports will cause each respondent to incur an average burden of 4 hours per response and incur an average cost of $223 for each Form ATS–R that it submits.[635] The annual burden per respondent is estimated to be $892.[636] If all forty-five alternative trading systems opt to register as broker-dealers and comply with Regulation ATS, the total cost per year to comply with the requirement to file quarterly reports is estimated to be $40,140.[637]

Finally, alternative trading systems registered as broker-dealers will be required to submit a notice and a report on Form ATS when they cease operations. The Commission anticipates a total of three such filings per year. The Commission staff has estimated that individual respondents will incur a burden of two hours to file the cessation notice. The Commission staff has estimated that individual respondents will incur a cost of $111.50 to file the cessation of operations report on Form ATS.[638] The annual aggregate burden for three alternative trading systems to file cessation of operations reports is estimated to be $334.50.[639]

2. Fair Access

Under Regulation ATS, alternative trading systems with significant volume are required to establish and maintain standards for granting access to their system and keep records of such standards. In addition, alternative trading systems with significant volume are required to submit certain information regarding grants, denials, and limitations of access with their quarterly reports on Form ATS–R. The Commission staff has estimated that each respondent obligated to establish and maintain such records will incur a burden of seventeen hours per year to make and keep standards for granting access for a total estimated cost of $958.50.[640]

Although these estimates reflect a program change from the Proposing Release, the total burdens on respondents are decreasing slightly as a result of the program changes. The Commission is eliminating the proposal to require alternative trading systems that deny investors access to the system to provide them with notice of the denial and their right of appeal to the Commission. Under the rules as adopted, there is no right of appeal to the Commission. In the Proposing Release, the Commission estimated that the burden to comply with the notice requirement would be approximately twenty-seven hours per year for each respondent. Under the rules as adopted, such alternative trading systems are required to submit fair access information on Form ATS–R on a quarterly basis. The burden for this requirement is only twelve hours per year for each respondent. Thus, the changes from the Proposing Release are anticipated to reduce the burden on each respondent by approximately fifteen hours per year. The Commission staff has estimated that only two respondents will be affected by this program change, resulting in an aggregate reduction of thirty burden hours for all respondents. This reduction, however, is offset by an increase in the estimated number of respondents. Specifically, the aggregate paperwork burden for Rule 301, Form ATS, and Form ATS–R is increasing by one hundred sixty hours due to updating the estimate of the number of potential respondents from forty-three in the Proposing Release to forty-five currently.

3. Systems Capacity, Integrity, and Security

The notification requirement for material systems outages should impose relatively little additional costs on alternative trading systems. Moreover, the Commission believes that this small burden is justified by the need to keep Commission staff abreast of systems' developments and problems.

The Commission staff has estimated that each respondent will incur an average annual burden of fifteen hours to comply with the recordkeeping requirements associated with the systems capacity, integrity, and security provisions of Regulation ATS. The Commission staff has estimated that each respondent will make an average of five system outage notices per year, for an estimated average burden of 1.25 hours per year.[641] The Commission staff has estimated that the total estimated average cost of compliance for each respondent will be $85 per year.[642] Such alternative trading systems will

[632] This estimate is based on the Commission's experience with collection of similar information under Rule 17a–23.

[633] The estimated average cost per response of $111.50 is composed of $75 for in-house professional work (1.5 hours at $50 per hour), $7.50 for clerical work (0.5 hours at $15 per hour), and $29 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

[634] This estimated cost of $30,105 is composed of $111.50 cost per amendment for forty-five alternative trading systems filing six times per year.

[635] The estimated cost of $223 per response is composed of $150 for in-house professional work (three hours at $50 per hour), $15 for clerical work (one hour at $15 per hour) and $58 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

[636] The estimated annual cost of $892 to file Form ATS–R is derived from four quarterly reports at an estimated annual cost of $223 per filing.

[637] This estimated cost of $40,140 is derived from forty-five alternative trading systems with an estimated annual filing cost for each of $892.

[638] The estimated cost of $111.50 per response is composed of $75 for in-house professional work (1.5 hours at $50 per hour), $7.50 for clerical work (0.5 hours at $15 per hour), and $29 for printing, supplies, copying and postage (approximately thirty-five percent of the total labor costs).

[639] The estimated cost of $334.50 is derived from an average of three alternative trading systems filing one cessation of operations report per year on Form ATS at an estimated cost of $111.50 each.

[640] The estimated burden of seventeen hours is derived from five hours for establishing and maintaining standards for fair access and twelve hours to report fair access information on Form ATS–R on a quarterly basis (four responses at three hours per response). The estimated cost of $958.50 is derived from $650 for professional work (thirteen hours at $50 per hour), $60 for clerical work (four hours at $15 per hour), and $248.50 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs). The Commission staff has estimated overhead based on thirty-five percent of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973). The estimated burden of thirteen hours of professional work is derived from five hours for establishing and maintaining standards for fair access and eight hours (two hours for four quarterly reports on Form ATS–R) to compile and report fair access information. The estimated burden of four hours of clerical work is derived from one hour per quarter to compile and send information on Form ATS–R.

[641] The Commission notes that compliance with the notice provision can be achieved by a telephone call, so the burden for each notice is minimal. The Commission staff has estimated only 0.25 hours per notice will be required. The estimate of five system outage notices per year is based on the Commission's experience with the Automated Review Program.

[642] The estimated average cost per response of $17 is composed of $12.50 for in-house professional work (0.25 hours at $50 per hour) and $4.50 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs). The estimated annual cost of $85 is derived from five notices at $17 per notice.

also be required to keep records relating to the steps taken to comply with systems capacity, integrity, and security requirements under Regulation ATS. The Commission staff has estimated that each respondent will incur a burden of ten hours per year to comply with such recordkeeping requirements for a total estimated cost of $675 per year.[643] The Commission staff has estimated that two alternative trading systems will be required to comply with the systems capacity, integrity, and security provisions of Regulation ATS due to their significant volume. The estimated aggregate cost for these alternative trading systems chose to comply with the systems capacity, integrity, and security requirements is $1,520.[644]

G. Rule 302

Rule 302 requires alternative trading systems to make certain records with respect to trading activity through the alternative trading systems. This collection of information will permit the Commission to detect and investigate potential market irregularities and to ensure investor protection. Such information is not available in any other form from any other sources.

For alternative trading systems that choose to register as a broker-dealer, the requirements of Rule 302 are mandatory. All records required to be made under Rule 302 are considered confidential and are not available to the public. All records required to be made under the Rule are required to be preserved for three years, the first two years in an easily accessible place.

The Commission staff has estimated that each alternative trading system that chooses to register as a broker-dealer will be required to expend an average of thirty-six hours to comply with Rule 302 at an average cost of $1,730.88.[645] If all forty-five alternative trading systems opt to register as broker-dealers, rather than as exchanges, the total cost for recordkeeping under Rule 302 is estimated to be $77,889.60 per year.[646]

The Commission notes that it is making no material changes to Rule 302 from the Proposing Release. The collection of information burdens are increasing slightly due to an updated estimate of the number of respondents and not due to any changes to the rule as proposed.

H. Rule 303

Rule 303 requires alternative trading systems registered as broker-dealers to preserve certain records produced under Rule 302, as well as standards for granting access to the system and records generated in complying with the systems capacity, integrity and security requirements for alternative trading systems with significant trading volume. Alternative trading systems registered as broker-dealers are not required to file such information, but merely to retain it in an organized manner and make it available to the Commission upon request.

For alternative trading systems that choose to register as a broker-dealer, the requirements of Rule 303 are mandatory. All records required to be made under Rule 303 are considered confidential and are not available to the public. All records required to be made under the Rule are required to be preserved for three years, the first two years in an easily accessible place.

The Commission staff has estimated that each alternative trading system that chooses to register as a broker-dealer will be required to expend an average of four hours per year to comply with Rule 303 at an average cost of $192.32.[647] If all forty-five alternative trading systems opt to register as broker-dealers, rather than as exchanges, the total cost for record preservation is estimated to be $8,654.40 per year.[648]

The Commission notes that it is making no material changes to Rule 302 from the Proposing Release. The collection of information burdens are increasing slightly due to an updated estimate of the number of respondents and not due to any changes to the rule as proposed.

XIII. Statutory Authority

The rules and rule amendments in this release are being adopted pursuant to 15 U.S.C. 78 *et seq.*, particularly sections 3(b), 5, 6, 11A, 15, 17(a), 17(b), 19, 23(a), and 36 of the Exchange Act, 15 U.S.C. 78c, 78e, 78f, 78k–1, 78o, 78q(a), 78q(b), 78s(b), 78w(a), and 78mm.

List of Subjects

17 CFR Part 202

Administrative practice and procedure, Securities.

17 CFR Part 240

Brokers-dealers, Fraud, Issuers, Reporting and recordkeeping requirements, Securities.

17 CFR Part 242

Securities.

17 CFR Part 249

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows.

PART 202—INFORMAL AND OTHER PROCEDURES

1. The authority citation for part 202 continues to read in part as follows:

Authority: 15 U.S.C. 77s, 77t, 78d–1, 78u, 78w, 78*11*(d), 79r, 79t, 77sss, 77uuu, 80a–37, 80a–41, 80b–9, and 80b–11, unless otherwise noted.

* * * * *

2. Paragraph (b) of § 202.3 is revised to read as follows:

§ 202.3 Processing of filings.

(a) * * *

(b)(1) Applications for registration as brokers, dealers, investment advisers, municipal securities dealers and transfer agents are submitted to the Office of Filings and Information Services where they are examined to determine whether all necessary information has been supplied and whether all required financial statements and other documents have been furnished in proper form. Defective applications may be returned with a request for correction or held until corrected before being accepted as a filing. The files of the Commission and other sources of information are considered to determine whether any person connected with the applicant appears to have engaged in activities which would warrant commencement of proceedings on the question of denial of registration. The staff confers with applicants and makes suggestions in

[643] The total estimated cost of $675 is composed of $500 for in-house professional work (ten hours at $50 per hour) and $175 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

[644] The estimated aggregate cost of $1,520 is derived from two alternative trading systems incurring an estimated annual cost of $760 each ($85 for providing systems outage notices and $675 for recordkeeping requirements).

[645] The estimated cost of $1,730.88 is derived from an average of thirty-six hours of compliance time at $48.08 per hour. The value of compliance time is estimated as follows: an employee of a broker-dealer charged to ensure compliance with Commission regulations receives estimated annual compensation of $100,000. This compensation is the equivalent of $48.08 per hour ($100,000 divided by 2,080 payroll hours per year).

[646] This estimated cost of $77,889.60 is derived from forty-five alternative trading systems incurring an annual cost of $1,730.88 each.

[647] The estimated cost of $192.32 is derived from an average of four hours of compliance time at $48.08 per hour. The value of compliance time is estimated as follows: An employee of a broker-dealer charged to ensure compliance with Commission regulations receives estimated annual compensation of $100,000. This compensation is the equivalent of $48.08 per hour ($100,000 divided by 2,080 payroll hours per year).

[648] This estimated cost of $8,654.40 is derived from forty-five alternative trading systems incurring an annual cost of $192.32 each.

appropriate cases for amendments and supplemental information. Where it appears appropriate in the public interest and where a basis therefore exists, denial proceedings may be instituted. Within forty-five days of the date of the filing of a brokerûdealer, investment adviser or municipal securities dealer application (or within such longer period as to which the applicant consents), the Commission shall by order grant registration or institute proceedings to determine whether registration should be denied. An application for registration as a transfer agent shall become effective within 30 days after receipt of the application (or within such shorter period as the Commission may determine). The Office of Filings and Information Services is also responsible for the processing and substantive examination of statements of beneficial ownership of securities and changes in such ownership filed under the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940, and for the examination of reports filed pursuant to § 230.144 of this chapter.

(2) Applications for registration as national securities exchanges, or exemption from registration as exchanges by reason of such exchanges' limited volume of transactions filed with the Commission are routed to the Division of Market Regulation, which examines these applications to determine whether all necessary information has been supplied and whether all required financial statements and other documents have been furnished in proper form. Defective applications may be returned with a request for correction or held until corrected before being accepted as a filing. The files of the Commission and other sources of information are considered to determine whether any person connected with the applicant appears to have engaged in activities which would warrant commencement of proceedings on the question of denial of registration. The staff confers with applicants and makes suggestions in appropriate cases for amendments and supplemental information. Where it appears appropriate in the public interest and where a basis therefore exists, denial proceedings may be instituted. Within 90 days of the date of the filing of an application for registration as a national securities exchange, or exemption from registration by reason of such exchanges' limited volume of transactions (or within such longer period as to which the applicant consents), the Commission shall by order grant registration, or institute proceedings to determine whether registration should be denied as provided in § 240.19(a)(1) of this chapter.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*(d), 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

4. Section 240.3a1–1 is added before the undesignated center heading ''Definition of 'Equity Security' as Used in Sections 12(g) and 16'' to read as follows:

§ 240.3a1–1 Exemption from the definition of ''Exchange'' under Section 3(a)(1) of the Act.

(a) An organization, association, or group of persons shall be exempt from the definition of the term ''exchange'' under section 3(a)(1) of the Act, (15 U.S.C. 78c(a)(1)), if such organization, association, or group of persons:

(1) Is operated by a national securities association;

(2) Is in compliance with Regulation ATS, 17 CFR 242.300 through 242.303; or

(3) Pursuant to paragraph (a) of § 242.301 of Regulation ATS, 17 CFR 242.301(a), is not required to comply with Regulation ATS, 17 CFR 242.300 through 242.303.

(b) Notwithstanding paragraph (a) of this section, an organization, association, or group of persons shall not be exempt under this section from the definition of ''exchange,'' if:

(1) During three of the preceding four calendar quarters such organization, association, or group of persons had:

(i) Fifty percent or more of the average daily dollar trading volume in any security and five percent or more of the average daily dollar trading volume in any class of securities; or

(ii) Forty percent or more of the average daily dollar trading volume in any class of securities; and

(2) The Commission determines, after notice to the organization, association, or group of persons, and an opportunity for such organization, association, or group of persons to respond, that such an exemption would not be necessary or appropriate in the public interest or consistent with the protection of investors taking into account the requirements for exchange registration under section 6 of the Act, (15 U.S.C. 78f), and the objectives of the national market system under section 11A of the Act, (15 U.S.C 78k–1).

(3) For purposes of paragraph (b) of this section, each of the following shall be considered a ''class of securities'':

(i) Equity securities, which shall have the same meaning as in § 240.3a11–1;

(ii) Listed options, which shall mean any options traded on a national securities exchange or automated facility of a national securities exchange;

(iii) Unlisted options, which shall mean any options other than those traded on a national securities exchange or automated facility of a national securities association;

(iv) Municipal securities, which shall have the same meaning as in section 3(a)(29) of the Act, (15 U.S.C. 78c(a)(29));

(v) Investment grade corporate debt securities, which shall mean any security that:

(A) Evidences a liability of the issuer of such security;

(B) Has a fixed maturity date that is at least one year following the date of issuance;

(C) Is rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and

(D) Is not an exempted security, as defined in section 3(a)(12) of the Act, (15 U.S.C. 78c(a)(12));

(vi) Non-investment grade corporate debt securities, which shall mean any security that:

(A) Evidences a liability of the issuer of such security;

(B) Has a fixed maturity date that is at least one year following the date of issuance;

(C) Is not rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and

(D) Is not an exempted security, as defined in section 3(a)(12) of the Act, (15 U.S.C. 78o);

(vii) Foreign corporate debt securities, which shall mean any security that:

(A) Evidences a liability of the issuer of such debt security;

(B) Is issued by a corporation or other organization incorporated or organized under the laws of any foreign country; and

(C) Has a fixed maturity date that is at least one year following the date of issuance; and

(viii) Foreign sovereign debt securities, which shall mean any security that:

(A) Evidences a liability of the issuer of such debt security;

(B) Is issued or guaranteed by the government of a foreign country, any political subdivision of a foreign country, or any supranational entity; and

(C) Does not have a maturity date of a year or less following the date of issuance.

5. Section 240.3b–16 is added before the undesignated center heading ''Registration and Exemption of Exchanges'' to read as follows:

§ 240.3b–16 Definitions of terms used in Section 3(a)(1) of the Act.

(a) An organization, association, or group of persons shall be considered to constitute, maintain, or provide ''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 those terms are used in section 3(a)(1) of the Act, (15 U.S.C. 78c(a)(1)), if such organization, association, or group of persons:

(1) Brings together the orders for securities of multiple buyers and sellers; and

(2) Uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.

(b) An organization, association, or group of persons shall not be considered to constitute, maintain, or provide ''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,'' solely because such organization, association, or group of persons engages in one or more of the following activities:

(1) Routes orders to a national securities exchange, a market operated by a national securities association, or a broker-dealer for execution; or

(2) Allows persons to enter orders for execution against the bids and offers of a single dealer; and

(i) As an incidental part of these activities, matches orders that are not displayed to any person other than the dealer and its employees; or

(ii) In the course of acting as a market maker registered with a self-regulatory organization, displays the limit orders of such market maker's, or other broker-dealer's, customers; and

(A) Matches customer orders with such displayed limit orders; and

(B) As an incidental part of its market making activities, crosses or matches orders that are not displayed to any person other than the market maker and its employees.

(c) For purposes of this section the term *order* means any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order.

(d) For the purposes of this section, the terms *bid* and *offer* shall have the same meaning as under § 240.11Ac1–1.

(e) The Commission may conditionally or unconditionally exempt any organization, association, or group of persons from the definition in paragraph (a) of this section.

6. Section 240.6a–1 is amended by revising the section heading and paragraphs (a) and (b) to read as follows:

§ 240.6a–1 Application for registration as a national securities exchange or exemption from registration based on limited volume.

(a) An application for registration as a national securities exchange, or for exemption from such registration based on limited volume, shall be filed on Form 1 (§ 249.1 of this chapter), in accordance with the instructions contained therein.

(b) Promptly after the discovery that any information filed on Form 1 was inaccurate when filed, the exchange shall file with the Commission an amendment correcting such inaccuracy.

* * * * *

7. Section 240.6a–2 is revised to read as follows:

§ 240.6a–2 Amendments to application.

(a) A national securities exchange, or an exchange exempted from such registration based on limited volume, shall file an amendment to Form 1, (§ 249.1 of this chapter), which shall set forth the nature and effective date of the action taken and shall provide any new information and correct any information rendered inaccurate, on Form 1, (§ 249.1 of this chapter), within 10 days after any action is taken that renders inaccurate, or that causes to be incomplete, any of the following:

(1) Information filed on the Execution Page of Form 1, or amendment thereto; or

(2) Information filed as part of Exhibits C, F, G, H, J, K or M, or any amendments thereto.

(b) On or before June 30 of each year, a national securities exchange, or an exchange exempted from such registration based on limited volume, shall file, as an amendment to Form 1, the following:

(1) Exhibits D and I as of the end of the latest fiscal year of the exchange; and

(2) Exhibits K, M, and N, which shall be up to date as of the latest date practicable within 3 months of the date the amendment is filed.

(c) On or before June 30, 2001 and every 3 years thereafter, a national securities exchange, or an exchange exempted from such registration based on limited volume, shall file, as an amendment to Form 1, complete Exhibits A, B, C and J. The information filed under this paragraph (c) shall be current as of the latest practicable date, but shall, at a minimum, be up to date within 3 months as of the date the amendment is filed.

(d)(1) If an exchange, on an annual or more frequent basis, publishes, or cooperates in the publication of, any of the information required to be filed by paragraphs (b)(2) and (c) of this section, in lieu of filing such information, an exchange may:

(i) Identify the publication in which such information is available, the name, address, and telephone number of the person from whom such publication may be obtained, and the price of such publication; and

(ii) Certify to the accuracy of such information as of its publication date.

(2) If an exchange keeps the information required under paragraphs (b)(2) and (c) of this section up to date and makes it available to the Commission and the public upon request, in lieu of filing such information, an exchange may certify that the information is kept up to date and is available to the Commission and the public upon request.

(3) If the information required to be filed under paragraphs (b)(2) and (c) of this section is available continuously on an Internet web site controlled by an exchange, in lieu of filing such information with the Commission, such exchange may:

(i) Indicate the location of the Internet web site where such information may be found; and

(ii) Certify that the information available at such location is accurate as of its date.

(e) The Commission may exempt a national securities exchange, or an exchange exempted from such registration based on limited volume, from filing the amendment required by this section for any affiliate or subsidiary listed in Exhibit C of the exchange's application for registration, as amended, that either:

(1) Is listed in Exhibit C of the application for registration, as amended,

of one or more other national securities exchanges; or

(2) Was an inactive subsidiary throughout the subsidiary's latest fiscal year.

Any such exemption may be granted upon terms and conditions the Commission deems necessary or appropriate in the public interest or for the protection of investors, provided however, that at least one national securities exchange shall be required to file the amendments required by this section for an affiliate or subsidiary described in paragraph (e)(1) of this section.

8. Section 240.6a–3 is revised to read as follows:

§ 240.6a–3 Supplemental material to be filed by exchanges.

(a)(1) A national securities exchange, or an exchange exempted from such registration based on limited volume, shall file with the Commission any material (including notices, circulars, bulletins, lists, and periodicals) issued or made generally available to members of, or participants or subscribers to, the exchange. Such material shall be filed with the Commission within 10 days after issuing or making such material available to members, participants or subscribers.

(2) If the information required to be filed under paragraph (a)(1) of this section is available continuously on an Internet web site controlled by an exchange, in lieu of filing such information with the Commission, such exchange may:

(i) Indicate the location of the Internet web site where such information may be found; and

(ii) Certify that the information available at such location is accurate as of its date.

(b) Within 15 days after the end of each calendar month, a national securities exchange or an exchange exempted from such registration based on limited volume, shall file a report concerning the securities sold on such exchange during the calendar month. Such report shall set forth:

(1) The number of shares of stock sold and the aggregate dollar amount of such stock sold;

(2) The principal amount of bonds sold and the aggregate dollar amount of such bonds sold; and

(3) The number of rights and warrants sold and the aggregate dollar amount of such rights and warrants sold.

9. Section 240.11Ac1–1 is amended by redesignating paragraph (c)(5)(ii)(A) as paragraph (c)(5)(ii)(A)(*l*), paragraph (c)(5)(ii)(B), introductory text, as paragraph (c)(5)(ii)(A)(*2*), paragraph (c)(5)(ii)(B)(*1*) as paragraph (c)(5)(ii)(A)(*2*)(*i*), paragraph (c)(5)(ii)(B)(*2*) as paragraph (c)(5)(ii)(A)(*2*)(*ii*), in newly designated paragraph (c)(5)(ii)(A)(*2*)(*ii*) by removing the period and adding in its place ''; or'', and adding new paragraph (c)(5)(ii)(B) to read as follows:

§ 240.11Ac1–1 Dissemination of quotations.

* * * * *

(c) * * *

(5) * * *

(ii) * * *

(A)(*1*) * * *

(B) Is an alternative trading system that:

(*1*) Displays orders and provides the ability to effect transactions with such orders under § 242.301(b)(3) of this chapter; and

(*2*) Otherwise is in compliance with Regulation ATS, § 242.300 through § 242.303 of this chapter.

* * * * *

10. Section 240.17a–3 is amended by adding paragraph (a)(16) to read as follows:

§ 240.17a–3 Records to be made by certain exchange members, brokers and dealers.

(a) * * *

(16)(i) The following records regarding any internal broker-dealer system of which such a broker or dealer is the sponsor:

(A) A record of the broker's or dealer's customers that have access to an internal broker-dealer system sponsored by such broker or dealer (identifying any affiliations between such customers and the broker or dealer);

(B) Daily summaries of trading in the internal broker-dealer system, including:

(*1*) Securities for which transactions have been executed through use of such system; and

(*2*) Transaction volume (separately stated for trading occurring during hours when consolidated trade reporting facilities are and are not in operation):

(*i*) With respect to equity securities, stated in number of trades, number of shares, and total U.S. dollar value;

(*ii*) With respect to debt securities, stated in total settlement value in U.S. dollars; and

(*iii*) With respect to other securities, stated in number of trades, number of units of securities, and in dollar value, or other appropriate commonly used measure of value of such securities; and

(C) Time-sequenced records of each transaction effected through the internal broker-dealer system, including date and time executed, price, size, security traded, counterparty identification information, and method of execution (if internal broker-dealer system allows alternative means or locations for execution, such as routing to another market, matching with limit orders, or executing against the quotations of the broker or dealer sponsoring the system).

(ii) For purposes of paragraph (a) of this section, the term:

(A) *Internal broker-dealer system* shall mean any facility, other than a national securities exchange, an exchange exempt from registration based on limited volume, or an alternative trading system as defined in Regulation ATS, §§ 242.300 through 242.303 of this chapter, that provides a mechanism, automated in full or in part, for collecting, receiving, disseminating, or displaying system orders and facilitating agreement to the basic terms of a purchase or sale of a security between a customer and the sponsor, or between two customers of the sponsor, through use of the internal broker-dealer system or through the broker or dealer sponsor of such system;

(B) *Sponsor* shall mean any broker or dealer that organizes, operates, administers, or otherwise directly controls an internal broker-dealer trading system or, if the operator of the internal broker-dealer system is not a registered broker or dealer, any broker or dealer that, pursuant to contract, affiliation, or other agreement with the system operator, is involved on a regular basis with executing transactions in connection with use of the internal broker-dealer system, other than solely for its own account or as a customer with access to the internal broker-dealer system; and

(C) *System order* means any order or other communication or indication submitted by any customer with access to the internal broker-dealer system for entry into a trading system announcing an interest in purchasing or selling a security. The term ''system order'' does not include inquiries or indications of interest that are not entered into the internal broker-dealer system.

* * * * *

11. Section 240.17a–4 is amended by revising paragraph (b)(1) and adding paragraph (b)(10) to read as follows:

§ 240.17a–4. Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(b) * * *

(1) All records required to be made pursuant to paragraphs (a)(4), (a)(6), (a)(7), (a)(8), (a)(9), and (a)(10) of § 240.17a–3.

* * * * *

(10) All notices relating to an internal broker-dealer system provided to the customers of the broker or dealer that sponsors such internal broker-dealer system, as defined in paragraph (a)(16)(ii)(A) of § 240.17a–3. Notices, whether written or communicated through the internal broker-dealer trading system or other automated means, shall be preserved under this paragraph (b)(10) if they are provided to all customers with access to an internal broker-dealer system, or to one or more classes of customers. Examples of notices to be preserved under this paragraph (b)(10) include, but are not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, and instructions pertaining to access to the internal broker-dealer system.

* * * * *

§ 240.17a–23 [Removed]

12. Section 240.17a–23 is removed and reserved.

13. Section 240.19b–5 is added to read as follows:

§ 240.19b–5 Temporary exemption from the filing requirements of Section 19(b) of the Act.

Preliminary Notes

1. The following section provides for a temporary exemption from the rule filing requirement for self-regulatory organizations that file proposed rule changes concerning the operation of a pilot trading system pursuant to section 19(b) of the Act (15 U.S.C. 78s(b), as amended). All other requirements under the Act that are applicable to self-regulatory organizations continue to apply.

2. The disclosures made pursuant to the provisions of this section are in addition to any other applicable disclosure requirements under the federal securities laws.

(a) For purposes of this section, the term *specialist* means any member subject to a requirement of a self-regulatory organization that such member regularly maintain a market in a particular security.

(b) For purposes of this section, the term *trading system* means the rules of a self-regulatory organization that:

(1) Determine how the orders of multiple buyers and sellers are brought together; and

(2) Establish non-discretionary methods under which such orders interact with each other and under which the buyers and sellers entering such orders agree to the terms of trade.

(c) For purposes of this section, the term *pilot trading system* shall mean a trading system operated by a self-regulatory organization that is not substantially similar to any trading system or pilot trading system operated by such self-regulatory organization at any time during the preceding year, and that:

(1)(i) Has been in operation for less than two years;

(ii) Is independent of any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b));

(iii) With respect to each security traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 5 percent of the average daily trading volume of such security in the United States; and

(iv) With respect to all securities traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 20 percent of the average daily trading volume of all trading systems operated by such self-regulatory organization; or

(2)(i) Has been in operation for less than two years;

(ii) With respect to each security traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 1 percent of the average daily trading volume of such security in the United States; and

(iii) With respect to all securities traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 20 percent of the average daily trading volume of all trading systems operated by such self-regulatory organization; or

(3)(i) Has been in operation for less than two years; and

(ii)(A) Satisfied the definition of *pilot trading system* under paragraph (c)(1) of this section no more than 60 days ago, and continues to be independent of any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)); or

(B) Satisfied the definition of *pilot trading system* under paragraph (c)(2) of this section no more than 60 days ago.

(d) A pilot trading system shall be deemed *independent* of any other trading system operated by a self-regulatory organization if:

(1) Such pilot trading system trades securities other than the issues of securities that trade on any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b));

(2) Such pilot trading system does not operate during the same trading hours as any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)); or

(3) No specialist or market maker on any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)), is permitted to effect transactions on the pilot trading system in securities in which they are a specialist or market maker.

(e) A self-regulatory organization shall be exempt temporarily from the requirement under section 19(b) of the Act, (15 U.S.C. 78s(b)), to submit on Form 19b–4, 17 CFR 249.819, proposed rule changes for establishing a pilot trading system, if the self-regulatory organization complies with the following requirements:

(1) *Form PILOT.* The self-regulatory organization:

(i) Files Part I of Form PILOT, 17 CFR 249.821, in accordance with the instructions therein, at least 20 days prior to commencing operation of the pilot trading system;

(ii) Files an amendment on Part I of Form PILOT at least 20 days prior to implementing a material change to the operation of the pilot trading system; and

(iii) Files a quarterly report on Part II of Form PILOT within 30 calendar days after the end of each calendar quarter in which the market has operated after the effective date of this section.

(2) *Fair access.*

(i) The self-regulatory organization has in place written rules to ensure that all members of the self-regulatory organization have fair access to the pilot trading system, and that information regarding orders on the pilot trading system is equally available to all members of the self-regulatory organization with access to such pilot trading system.

(ii) Notwithstanding the requirement in paragraph (e)(2)(i) of this section, a specialist on the pilot trading system may have preferred access to information regarding orders that it represents in its capacity as specialist.

(iii) The rules established by a self-regulatory organization pursuant to paragraph (e)(2)(i) of this section will be considered rules governing the pilot trading system for purposes of the temporary exemption under this section.

(3) *Trading rules and procedures and listing standards.*

(i) The self-regulatory organization has in place written trading rules and procedures and listing standards necessary to operate the pilot trading system.

(ii) The rules established by a self-regulatory organization pursuant to paragraph (e)(3)(i) of this section will be considered rules governing the pilot trading system for purposes of the temporary exemption under this section.

(4) *Surveillance.* The self-regulatory organization establishes internal procedures for the effective surveillance of trading activity on the self-regulatory organization's pilot trading system.

(5) *Clearance and settlement.* The self-regulatory organization establishes reasonable clearance and settlement procedures for transactions effected on the self-regulatory organizations pilot trading system.

(6) *Types of securities.* The self-regulatory organization permits to trade on the pilot trading system only securities registered under section 12 of the Act, (15 U.S.C. 78*l*).

(7) *Activities of specialists.*

(i) The self-regulatory organization does not permit any member to be a specialist in a security on the pilot trading system and a specialist in a security on a trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)), or on another pilot trading system operated by such self-regulatory organization, if such securities are related securities, except that a member may be a specialist in related securities that the Commission, upon application by the self-regulatory organization, later determines is necessary or appropriate in the public interest and consistent with the protection of investors;

(ii) Notwithstanding paragraph (e)(7)(i) of this section, a self-regulatory organization may permit a member to be a specialist in any security on a pilot trading system, if the pilot trading system is operated during trading hours different from the trading hours of the trading system in which such member is a specialist.

(iii) For purposes of paragraph (e)(7) of this section, the term *related securities* means any two securities in which:

(A) The value of one security is determined, in whole or significant part, by the performance of the other security; or

(B) The value of both securities is determined, in whole or significant part, by the performance of a third security, combination of securities, index, indicator, interest rate or other common factor.

(8) *Examinations, inspections, and investigations.* The self-regulatory organization cooperates with the examination, inspection, or investigation by the Commission of transactions effected on the pilot trading system.

(9) *Recordkeeping.* The self-regulatory organization shall retain at its principal place of business and make available to Commission staff for inspection, all the rules and procedures relating to each pilot trading system operating pursuant to this section for a period of not less than five years, the first two years in an easily accessible place, as prescribed in § 240.17a–1.

(10) *Public availability of pilot trading system rules.* The self-regulatory organization makes publicly available all trading rules and procedures, including those established under paragraphs (e)(2) and (e)(3) of this section.

(11) Every notice or amendment filed pursuant to this paragraph (e) shall constitute a ''report'' within the meaning of sections 11A, 17(a), 18(a), and 32(a), (15 U.S.C. 78k–1, 78q(a), 78r(a), and 78ff(a)), and any other applicable provisions of the Act. All notices or reports filed pursuant to this paragraph (e) shall be deemed to be confidential until the pilot trading system commences operation.

(f)(1)A self-regulatory organization shall request Commission approval, pursuant to section 19(b)(2) of the Act, (15 U.S.C. 78s(b)(2)), for any rule change relating to the operation of a pilot trading system by submitting Form 19b–4, 17 CFR 249.819, no later than two years after the commencement of operation of such pilot trading system, or shall cease operation of the pilot trading system.

(2) Simultaneous with a request for Commission approval pursuant to section 19(b)(2) of the Act, (15 U.S.C. 78s(b)(2)), a self-regulatory organization may request Commission approval pursuant to section 19(b)(3)(A) of the Act, (15 U.S.C. 78s(b)(3)(A)), for any rule change relating to the operation of a pilot trading system by submitting Form 19b–4, 17 CFR 249.819, effective immediate upon filing, to continue operations of such trading system for a period not to exceed six months.

(g) Notwithstanding paragraph (e) of this section, rule changes with respect to pilot trading systems operated by a self-regulatory organization shall not be exempt from the rule filing requirements of section 19(b)(2) of the Act, (15 U.S.C. 78s(b)(2)), if the Commission determines, after notice to the SRO and opportunity for the SRO to respond, that exemption of such rule changes is not necessary or appropriate in the public interest or consistent with the protection of investors.

PART 242—REGULATIONS M AND ATS

14. The authority citation for part 242 is revised to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 80a–23, 80a–29, and 80a–37.

15. The part heading for part 242 is revised as set forth above.

16. Part 242 is amended by adding Regulation ATS, §§ 242.300 through 242.303 to read as follows:

Regulation ATS—Alternative Trading Systems

Sec.
242.300 Definitions.
242.301 Requirements for alternative trading systems.
242.302 Recordkeeping requirements for alternative trading systems.
242.303 Record preservation requirements for alternative trading systems.

Regulation ATS—Alternative Trading Systems

Preliminary Notes

1. An alternative trading system is required to comply with the requirements in this Regulation ATS, unless such alternative trading system:

(a) Is registered as a national securities exchange;

(b) Is exempt from registration as a national securities exchange based on the limited volume of transactions effected on the alternative trading system; or

(c) Trades only government securities and certain other related instruments.

All alternative trading systems must comply with the antifraud, antimanipulation, and other applicable provisions of the federal securities laws.

2. The requirements imposed upon an alternative trading system by Regulation ATS are in addition to any requirements applicable to broker-dealers registered under section 15 of the Act, (15 U.S.C. 78o).

3. An alternative trading system must comply with any applicable state law relating to the offer or sale of securities or the registration or regulation of persons or entities effecting transactions in securities.

4. The disclosures made pursuant to the provisions of this section are in addition to any other disclosure requirements under the federal securities laws.

§ 242.300 Definitions.

For purposes of this section, the following definitions shall apply:

(a) *Alternative trading system* means any organization, association, person, group of persons, or system:

(1) That 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 within the meaning of § 240.3b–16 of this chapter; and

(2) That does not:

(i) Set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or

(ii) Discipline subscribers other than by exclusion from trading.

(b) *Subscriber* means any person that has entered into a contractual agreement with an alternative trading system to access such alternative trading system for the purpose of effecting transactions in securities or submitting, disseminating, or displaying orders on such alternative trading system, including a customer, member, user, or participant in an alternative trading system. A subscriber, however, shall not include a national securities exchange or national securities association.

(c) *Affiliate of a subscriber* means any person that, directly or indirectly, controls, is under common control with, or is controlled by, the subscriber, including any employee.

(d) *Debt security* shall mean any security other than an equity security, as defined in § 240.3a11–1 of this chapter, as well as non-participatory preferred stock.

(e) *Order* means any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order.

(f) *Control* means the power, directly or indirectly, to direct the management or policies of an alternative trading system, whether through ownership of securities, by contract, or otherwise. A person is presumed to *control* an alternative trading system, if that person:

(1) Is a director, general partner, or officer exercising executive responsibility (or having similar status or performing similar functions);

(2) Directly or indirectly has the right to vote 25 percent or more of a class of voting security or has the power to sell or direct the sale of 25 percent or more of a class of voting securities of the alternative trading system; or

(3) In the case of a partnership, has contributed, or has the right to receive upon dissolution, 25 percent or more of the capital of the alternative trading system.

(g) *Covered security* shall have the meaning provided in § 240.11Ac1–1(a)(6) of this chapter, *provided, however*, that a debt or convertible debt security shall not be deemed a covered security for purposes of Regulation ATS.

(h) *Effective transaction reporting plan* shall have the meaning provided in § 240.11Aa3–1(a)(3) of this chapter.

(i) *Exchange market maker* shall have the meaning provided in § 240.11Ac1–1(a)(9) of this chapter.

(j) *OTC market maker* shall have the meaning provided in § 240.11Ac1–1(a)(13) of this chapter.

(k) *Investment grade corporate debt security* shall mean any security that:

(1) Evidences a liability of the issuer of such security;

(2) Has a fixed maturity date that is at least one year following the date of issuance;

(3) Is rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and

(4) Is not an exempted security, as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)).

(l) *Non-investment grade corporate debt security* shall mean any security that:

(1) Evidences a liability of the issuer of such security;

(2) Has a fixed maturity date that is at least one year following the date of issuance;

(3) Is not rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and

(4) Is not an exempted security, as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)).

(m) *Commercial paper* shall mean any note, draft, or bill of exchange which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

§ 242.301 Requirements for alternative trading systems.

(a) *Scope of section.* An alternative trading system shall comply with the requirements in paragraph (b) of this section, unless such alternative trading system:

(1) Is registered as an exchange under section 6 of the Act, (15 U.S.C. 78f);

(2) Is exempted by the Commission from registration as an exchange based on the limited volume of transactions effected;

(3) Is operated by a national securities association;

(4)(i) Is registered as a broker-dealer under sections 15(b) or 15C of the Act (15 U.S.C. 78o(b), and 78o–5), or is a bank, and

(ii) Limits its securities activities to the following instruments:

(A) Government securities, as defined in section 3(a)(42) of the Act, (15 U.S.C. 78c(a)(42));

(B) Repurchase and reverse repurchase agreements solely involving securities included within paragraph (a)(4)(ii)(A) of this section;

(C) Any put, call, straddle, option, or privilege on a government security, other than a put, call, straddle, option, or privilege that:

(*1*) Is traded on one or more national securities exchanges; or

(*2*) For which quotations are disseminated through an automated quotation system operated by a registered securities association; and

(D) Commercial paper.

(5) Is exempted, conditionally or unconditionally, by Commission order, after application by such alternative trading system, from one or more of the requirements of paragraph (b) of this section. The Commission will grant such exemption only after determining that such an order is consistent with the public interest, the protection of investors, and the removal of impediments to, and perfection of the mechanisms of, a national market system.

(b) *Requirements.* Every alternative trading system subject to this Regulation ATS, pursuant to paragraph (a) of this section, shall comply with the requirements in this paragraph (b).

(1) *Broker-dealer registration.* The alternative trading system shall register as a broker-dealer under section 15 of the Act, (15 U.S.C. 78o).

(2) *Notice.* (i) The alternative trading system shall file an initial operation report on Form ATS, § 249.637 of this chapter, in accordance with the instructions therein, at least 20 days prior to commencing operation as an alternative trading system, or if the alternative trading system is operating as of April 21, 1999, no later than May 11, 1999.

(ii) The alternative trading system shall file an amendment on Form ATS at least 20 calendar days prior to implementing a material change to the operation of the alternative trading system.

(iii) If any information contained in the initial operation report filed under paragraph (b)(2)(i) of this section becomes inaccurate for any reason and has not been previously reported to the

Commission as an amendment on Form ATS, the alternative trading system shall file an amendment on Form ATS correcting such information within 30 calendar days after the end of each calendar quarter in which the alternative trading system has operated.

(iv) The alternative trading system shall promptly file an amendment on Form ATS correcting information previously reported on Form ATS after discovery that any information filed under paragraphs (b)(2)(i), (ii) or (iii) of this section was inaccurate when filed.

(v) The alternative trading system shall promptly file a cessation of operations report on Form ATS in accordance with the instructions therein upon ceasing to operate as an alternative trading system.

(vi) Every notice or amendment filed pursuant to this paragraph (b)(2) shall constitute a ''report'' within the meaning of sections 11A, 17(a), 18(a), and 32(a), (15 U.S.C. 78k–1, 78q(a), 78r(a), and 78ff(a)), and any other applicable provisions of the Act.

(vii) The reports provided for in paragraph (b)(2) of this section shall be considered filed upon receipt by the Division of Market Regulation, Stop 10–2, at the Commission's principal office in Washington, DC. Duplicate originals of the reports provided for in paragraphs (b)(2)(i) through (v) of this section must be filed with surveillance personnel designated as such by any self-regulatory organization that is the designated examining authority for the alternative trading system pursuant to § 240.17d–1 of this chapter simultaneously with filing with the Commission. Duplicates of the reports required by paragraph (b)(9) of this section shall be provided to surveillance personnel of such self-regulatory authority upon request. All reports filed pursuant to this paragraph (b)(2) and paragraph (b)(9) of this section shall be deemed confidential when filed.

(3) *Order display and execution access.* (i) An alternative trading system shall comply with the requirements set forth in paragraph (b)(3)(ii) of this section, with respect to any covered security in which the alternative trading system:

(A) Displays subscriber orders to any person (other than alternative trading system employees); and

(B) During at least 4 of the preceding 6 calendar months, had an average daily trading volume of 5 percent or more of the aggregate average daily share volume for such covered security as reported by an effective transaction reporting plan or disseminated through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Act, (15 U.S.C. 78c(a)(51)(A)(ii)).

(ii) Such alternative trading system shall provide to a national securities exchange or national securities association the prices and sizes of the orders at the highest buy price and the lowest sell price for such covered security, displayed to more than one person in the alternative trading system, for inclusion in the quotation data made available by the exchange or association to quotation vendors pursuant to § 240.11Ac1–1 of this chapter.

(iii) With respect to any order displayed pursuant to paragraph (b)(3)(ii) of this section, an alternative trading system shall provide to any broker-dealer that has access to the national securities exchange or national securities association to which the alternative trading system provides the prices and sizes of displayed orders pursuant to paragraph (b)(3)(ii)(A) of this section, the ability to effect a transaction with such orders that is:

(A) Equivalent to the ability of such broker-dealer to effect a transaction with other orders displayed on the exchange or by the association; and

(B) At the price of the highest priced buy order or lowest priced sell order displayed for the lesser of the cumulative size of such priced orders entered therein at such price, or the size of the execution sought by such broker-dealer.

(4) *Fees.* The alternative trading system shall not charge any fee to broker-dealers that access the alternative trading system through a national securities exchange or national securities association, that is inconsistent with equivalent access to the alternative trading system required by paragraph (b)(3)(iv) of this section. In addition, if the national securities exchange or national securities association to which an alternative trading system provides the prices and sizes of orders under paragraphs (b)(3)(ii) and (b)(3)(iii) of this section establishes rules designed to assure consistency with standards for access to quotations displayed on such national securities exchange, or the market operated by such national securities association, the alternative trading system shall not charge any fee to members that is contrary to, that is not disclosed in the manner required by, or that is inconsistent with any standard of equivalent access established by such rules.

(5) *Fair access.* (i) An alternative trading system shall comply with the requirements in paragraph (b)(5)(ii) of this section, if during at least 4 of the preceding 6 calendar months, such alternative trading system had:

(A) With respect to any covered security, 20 percent or more of the average daily volume in that security reported by an effective transaction reporting plan or disseminated through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii));

(B) With respect to an equity security that is not a covered security and for which transactions are reported to a self-regulatory organization, 20 percent or more of the average daily volume in that security as calculated by the self-regulatory organization to which such transactions are reported;

(C) With respect to municipal securities, 20 percent or more of the average daily volume traded in the United States;

(D) With respect to investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States;

(E) With respect to non-investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States.

(ii) An alternative trading system shall:

(A) Establish written standards for granting access to trading on its system;

(B) Not unreasonably prohibit or limit any person in respect to access to services offered by such alternative trading system by applying the standards established under paragraph (b)(5)(ii)(A) of this section in an unfair or discriminatory manner; and

(C) Make and keep records of:

(*1*) All grants of access including, for all subscribers, the reasons for granting such access;

(*2*) All denials or limitations of access and reasons, for each applicant, for denying or limiting access.

(D) Report the information required on Form ATS–R, § 249.638 of this chapter, regarding grants, denials, and limitations of access.

(iii) Notwithstanding paragraph (b)(5)(i) of this section, an alternative trading system shall not be required to comply with the requirements in paragraph (b)(5)(ii) of this section, if such alternative trading system:

(A) Matches customer orders for a security with other customer orders;

(B) Such customers' orders are not displayed to any person, other than employees of the alternative trading system; and

(C) Such orders are executed at a price for such security disseminated by an effective transaction reporting plan or through an automated quotation system as described in section 3(a)(51)(A)(ii) of

the Act, (15 U.S.C. 78c(a)(51)(A)(ii)), or derived from such prices.

(6) *Capacity, integrity, and security of automated systems.* (i) The alternative trading system shall comply with the requirements in paragraph (b)(6)(ii) of this section, if during at least 4 of the preceding 6 calendar months, such alternative trading system had:

(A) With respect to any covered security, 20 percent or more of the average daily volume reported by the effective transaction reporting plan or disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Act, (15 U.S.C. 78c(a)(51)(A)(ii));

(B) With respect to equity securities that are not covered securities and for which transactions are reported to a self-regulatory organization, 20 percent or more of the average daily volume as calculated by the self-regulatory organization to which such transactions are reported;

(C) With respect to municipal securities, 20 percent or more of the average daily volume traded in the United States;

(D) With respect to investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States;

(E) With respect to non-investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States.

(ii) With respect to those systems that support order entry, order routing, order execution, transaction reporting, and trade comparison, the alternative trading system shall:

(A) Establish reasonable current and future capacity estimates;

(B) Conduct periodic capacity stress tests of critical systems to determine such system's ability to process transactions in an accurate, timely, and efficient manner;

(C) Develop and implement reasonable procedures to review and keep current its system development and testing methodology;

(D) Review the vulnerability of its systems and data center computer operations to internal and external threats, physical hazards, and natural disasters;

(E) Establish adequate contingency and disaster recovery plans;

(F) On an annual basis, perform an independent review, in accordance with established audit procedures and standards, of such alternative trading system's controls for ensuring that paragraphs (b)(6)(ii)(A) through (E) of this section are met, and conduct a review by senior management of a report containing the recommendations and conclusions of the independent review; and

(G) Promptly notify the Commission staff of material systems outages and significant systems changes.

(iii) Notwithstanding paragraph (b)(6)(i) of this section, an alternative trading system shall not be required to comply with the requirements in paragraph (b)(6)(ii) of this section, if such alternative trading system:

(A) Matches customer orders for a security with other customer orders;

(B) Such customers' orders are not displayed to any person, other than employees of the alternative trading system; and

(C) Such orders are executed at a price for such security disseminated by an effective transaction reporting plan or through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Act, (15 U.S.C. 78c(a)(51)(A)(ii)), or derived from such prices.

(7) *Examinations, inspections, and investigations.* The alternative trading system shall permit the examination and inspection of its premises, systems, and records, and cooperate with the examination, inspection, or investigation of subscribers, whether such examination is being conducted by the Commission or by a self-regulatory organization of which such subscriber is a member.

(8) *Recordkeeping.* The alternative trading system shall:

(i) Make and keep current the records specified in § 242.302; and

(ii) Preserve the records specified in § 242.303.

(9) *Reporting.* The alternative trading system shall:

(i) File the information required by Form ATS–R (§ 249.638 of this chapter) within 30 calendar days after the end of each calendar quarter in which the market has operated after the effective date of this section; and

(ii) File the information required by Form ATS–R within 10 calendar days after an alternative trading system ceases to operate.

(10) *Procedures to ensure the confidential treatment of trading information.*

(i) The alternative trading system shall establish adequate safeguards and procedures to protect subscribers' confidential trading information. Such safeguards and procedures shall include:

(A) Limiting access to the confidential trading information of subscribers to those employees of the alternative trading system who are operating the system or responsible for its compliance with these or any other applicable rules;

(B) Implementing standards controlling employees of the alternative trading system trading for their own accounts; and

(ii) The alternative trading system shall adopt and implement adequate oversight procedures to ensure that the safeguards and procedures established pursuant to paragraph (b)(10)(i) of this section are followed.

(11) *Name.* The alternative trading system shall not use in its name the word ''exchange,'' or derivations of the word ''exchange,'' such as the term ''stock market.''

§ 242.302 Recordkeeping requirements for alternative trading systems.

To comply with the condition set forth in paragraph (b)(8) of § 242.301, an alternative trading system shall make and keep current the following records:

(a) A record of subscribers to such alternative trading system (identifying any affiliations between the alternative trading system and subscribers to the alternative trading system, including common directors, officers, or owners);

(b) Daily summaries of trading in the alternative trading system including:

(1) Securities for which transactions have been executed;

(2) Transaction volume, expressed with respect to equity securities in:

(i) Number of trades;

(ii) Number of shares traded; and

(iii) Total settlement value in terms of U.S. dollars; and

(3) Transaction volume, expressed with respect to debt securities in:

(i) Number of trades; and

(ii) Total U.S. dollar value; and

(c) Time-sequenced records of order information in the alternative trading system, including:

(1) Date and time (expressed in terms of hours, minutes, and seconds) that the order was received;

(2) Identity of the security;

(3) The number of shares, or principal amount of bonds, to which the order applies;

(4) An identification of the order as related to a program trade or an index arbitrage trade as defined in New York Stock Exchange Rule 80A;

(5) The designation of the order as a buy or sell order;

(6) The designation of the order as a short sale order;

(7) The designation of the order as a market order, limit order, stop order, stop limit order, or other type or order;

(8) Any limit or stop price prescribed by the order;

(9) The date on which the order expires and, if the time in force is less than one day, the time when the order expires;

(10) The time limit during which the order is in force;

(11) Any instructions to modify or cancel the order;

(12) The type of account, *i.e.*, retail, wholesale, employee, proprietary, or any other type of account designated by the alternative trading system, for which the order is submitted;

(13) Date and time (expressed in terms of hours, minutes, and seconds) that the order was executed;

(14) Price at which the order was executed;

(15) Size of the order executed (expressed in number of shares or units or principal amount); and

(16) Identity of the parties to the transaction.

§ 242.303 Record preservation requirements for alternative trading systems.

(a) To comply with the condition set forth in paragraph (b)(9) of § 242.301, an alternative trading system shall preserve the following records:

(1) For a period of not less than three years, the first two years in an easily accessible place, an alternative trading system shall preserve:

(i) All records required to be made pursuant to § 242.302;

(ii) All notices provided by such alternative trading system to subscribers generally, whether written or communicated through automated means, including, but not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, instructions pertaining to access to the market and denials of, or limitations on, access to the alternative trading system;

(iii) If subject to paragraph (b)(5)(ii) of § 242.301, at least one copy of such alternative trading system's standards for access to trading, all documents relevant to the alternative trading systems decision to grant, deny, or limit access to any person, and all other documents made or received by the alternative trading system in the course of complying with paragraph (b)(5) of § 242.301; and

(iv) At least one copy of all documents made or received by the alternative trading system in the course of complying with paragraph (b)(6) of § 242.301, including all correspondence, memoranda, papers, books, notices, accounts, reports, test scripts, test results, and other similar records.

(2) During the life of the enterprise and of any successor enterprise, an alternative trading system shall preserve:

(i) All partnership articles or, in the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books; and

(ii) Copies of reports filed pursuant to paragraph (b)(2) of § 242.301 of this chapter and records made pursuant to paragraph (b)(5) of § 242.301 of this chapter.

(b) The records required to be maintained and preserved pursuant to paragraph (a) of this section must be produced, reproduced, and maintained in paper form or in any of the forms permitted under § 240.17a–4(f) of this chapter.

(c) Alternative trading systems must comply with any other applicable recordkeeping or reporting requirement in the Act, and the rules and regulations thereunder. If the information in a record required to be made pursuant to this section is preserved in a record made pursuant to § 240.17a–3 or § 240.17a–4 of this chapter, or otherwise preserved by the alternative trading system (whether in summary or some other form), this section shall not require the sponsor to maintain such information in a separate file, provided that the sponsor can promptly sort and retrieve the information as if it had been kept in a separate file as a record made pursuant to this section, and preserves the information in accordance with the time periods specified in paragraph (a) of this section.

(d) The records required to be maintained and preserved pursuant to this section may be prepared or maintained by a service bureau, depository, or other recordkeeping service on behalf of the alternative trading system. An agreement with a service bureau, depository, or other recordkeeping service shall not relieve the alternative trading system from the responsibility to prepare and maintain records as specified in this section. The service bureau, depository, or other recordkeeping service shall file with the Commission a written undertaking in a form acceptable to the Commission, signed by a duly authorized person, to the effect that such records are the property of the alternative trading system required to be maintained and preserved and will be surrendered promptly on request of the alternative trading system, and shall include the following provision: With respect to any books and records maintained or preserved on behalf of (name of alternative trading system), the undersigned hereby undertakes to permit examination of such books and records at any time, or from time to time, during business hours by representatives or designees of the Securities and Exchange Commission, and to promptly furnish to the Commission or its designee a true, correct, complete and current hard copy of any, all, or any part of, such books and records.

(e) Every alternative trading system shall furnish to any representative of the Commission promptly upon request, legible, true, and complete copies of those records that are required to be preserved under this section.

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

17. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a, *et seq.*, unless otherwise noted;

* * * * * *

18. Section 249.1 and Form 1 are revised to read as follows:

§ 249.1 Form 1, for application for, and amendments to applications for, registration as a national securities exchange or exemption from registration pursuant to Section 5 of the Exchange Act.

The form shall be used for application for, and amendments to applications for, registration as a national securities exchange or exemption from registration pursuant to Section 5 of the Act, (15 U.S.C. 78e).

Note: Form 1 does not and the amendments will not appear in the Code of Federal Regulations.

OMB APPROVAL

OMB Number: 3235–0017

Expires: 8/31/2001

Estimated Average burden hours per form: 30

Form 1—Application for, and Amendments to Application for, Registration as a National Securities Exchange or Exemption From Registration Pursuant to Section 5 of the Exchange Act

BILLING CODE 8010–01–M

FORM 1 INSTRUCTIONS

A. GENERAL INSTRUCTIONS

1. Form 1 is the application for registration as a national securities exchange or an exchange exempt from registration pursuant to Section 5 of the Securities Exchange Act of 1934 ("Exchange Act").

2. **UPDATING** - A registered exchange or exchange exempt from registration pursuant to Section 5 of the Exchange Act must file amendments to Form 1 in accordance with Exchange Act Rule 6a-2.

3. **CONTACT EMPLOYEE** - The individual listed on the Execution Page (Page 1) of Form 1 as the contact employee must be authorized to receive all contact information, communications and mailings and is responsible for disseminating such information within the applicant's organization.

4. **FORMAT**
   - Attach an Execution Page (Page 1) with original manual signatures.
   - Please type all information.
   - Use only the current version of Form 1 or a reproduction.

5. If the information called for by any Exhibit is available in printed form, the printed material may be filed provided it does not exceed 8 1/2 X 11 inches in size.

6. If any Exhibit required is inapplicable, a statement to that effect shall be furnished in lieu of such Exhibit.

7. An exchange that is filing Form 1 as an application may not satisfy the requirements to provide certain information by means of an Internet web page. All materials must be filed with the Commission in paper.

8. **WHERE TO FILE AND NUMBER OF COPIES** - Submit one original and two copies of Form 1 to: SEC, Division of Market Regulation, Office of Market Supervision, 450 Fifth Street, N.W., Washington, DC 20549.

9. **PAPERWORK REDUCTION ACT DISCLOSURE**
   - Form 1 requires an exchange seeking to register as a national securities exchange or seeking an exemption from registration as a national securities exchange pursuant to Section 5 of the Exchange Act to provide the Securities and Exchange Commission ("SEC" or "Commission") with certain information regarding the operation of the exchange. Form 1 also requires national securities exchanges or exchanges exempt from registration based on limited volume to update certain information on a periodic basis.

   - An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(a)(1), 5, 6(a) and 23(a) authorize the Commission to collect information on this Form 1 from exchanges. *See* 15 U.S.C. §§78c(a)(1), 78e, 78f(a) and 78w(a).

   - Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form 1 and any suggestions for reducing this burden.

   - Form 1 is designed to enable the Commission to determine whether an exchange applying for registration is in compliance with the provisions of Sections 6 and 19 of the Exchange Act. Form 1 is also designed to enable the Commission to determine whether a national securities exchange or exchange exempt from registration based on limited volume is operating in compliance with the Exchange Act.

   - It is estimated that an exchange will spend approximately 47 hours completing the initial application on Form 1 pursuant to Rule 6a-1. It is also estimated that each exchange will spend approximately 25 hours to prepare each amendment to Form 1 pursuant to Rule 6a-2.

   - Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.

   - It is mandatory that an exchange seeking to operate as a national securities exchange or as an exchange exempt from registration based on limited volume file a Form 1 with the Commission. It is also mandatory that national securities exchanges or exchanges exempt from registration based on limited volume file amendments to Form 1 under Rule 6a-2.

   - No assurance of confidentiality is given by the Commission with respect to the responses made in Form 1. The public has access to the information contained in Form 1.

   - This collection of information has been reviewed by the Office of Management and Budget ("OMB") in accordance with the clearance requirements of 44 U.S.C. §3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records at set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).

FORM 1 INSTRUCTIONS

B. EXPLANATION OF TERMS

APPLICANT - The entity or organization filing an application for registration, or an exemption for registration, or amending any such application on this Form 1.

AFFILIATE - Any person that, directly or indirectly, controls, is under common control with, or is controlled by, the national securities exchange or exchange exempt from registration based on the limited volume of transactions effected on such exchange, including any employees.

CONTROL - The power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. Any person that (i) is a director, general partner or officer exercising executive responsibility (or having similar status or functions); (ii) directly or indirectly has the right to vote 25% or more of a class of voting securities or has the power to sell or direct the sale of 25% or more of a class of voting securities; or (iii) in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that entity.

DIRECT OWNERS - Any person that owns, beneficially owns, has the right to vote, or has the power to sell or direct the sale of, 5% or more of a class of a voting security of the applicant. For purposes of this Form 1, a person beneficially owns any securities (i) owned by his/her child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, sister-in-law, sharing the same residence; or (ii) that he/she has the right to acquire, within 60 days, through the exercise of any option, warrant or right to purchase the security.

MEMBER - Shall have the same meaning as assigned in Exchange Act Section 3(a)(3).

NATIONAL SECURITIES EXCHANGE - Shall mean any exchange registered pursuant to Section 6 of the Exchange Act.

PERSON ASSOCIATED WITH A MEMBER - Shall have the same meaning as assigned in Section 3(a)(21) of the Exchange Act.

Form 1 Page 1 Execution Page	**U.S. SECURITIES AND EXCHANGE COMMISSION** **WASHINGTON, D.C. 20549** **APPLICATION FOR, AND AMENDMENTS TO APPLICATION FOR REGISTRATION AS A NATIONAL SECURITIES EXCHANGE OR EXEMPTION FROM REGISTRATION PURSUANT TO SECTION 5 OF THE EXCHANGE ACT**	Date filed (MM/DD/YY):	OFFICIAL USE ONLY

WARNING: Failure to keep this form current and to file accurate supplementary information on a timely basis, or the failure to keep accurate books and records or otherwise to comply with the provisions of law applying to the conduct of the applicant would violate the federal securities laws and may result in disciplinary, administrative or criminal action.

INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACTS MAY CONSTITUTE CRIMINAL VIOLATIONS

❑ APPLICATION ❑ AMENDMENT

1. State the name of the applicant: _____

2. Provide the applicant's primary street address (Do not use a P.O. Box):

_____

_____

3. Provide the applicant's mailing address (if different):

_____

_____

4. Provide the business telephone and facsimile number:

_____

(Telephone) (Facsimile)

5. Provide the name, title and telephone number of a contact employee:

_____

(Name) (Title) (Telephone Number)

6. Provide the name and address of counsel for the applicant:

_____

_____

_____

7. Provide the date that applicant's fiscal year ends: _____

8. Indicate legal status of applicant: ☐ Corporation ☐ Sole Proprietorship ☐ Partnership

☐ Limited Liability Company ☐ Other (specify): _____

If other than a sole proprietor, indicate the date and place where applicant obtained its legal status (e.g. state where incorporated, place where partnership agreement was filed or where applicant entity was formed):

(a) Date (MM/DD/YY): _____ (b) State/Country of formation: _____

(c) Statute under which applicant was organized: _____

EXECUTION:

The applicant consents that service of any civil action brought by or notice of any proceeding before the Securities and Exchange Commission in connection with the applicant's activities may be given by registered or certified mail or confirmed telegram to the applicant's contact employee at the main address, or mailing address if different, given in Items 2 and 3. The undersigned, being first duly sworn, deposes and says that he/she has executed this form on behalf of, and with the authority of, said applicant. The undersigned and applicant represent that the information and statements contained herein, including exhibits, schedules, or other documents attached hereto, and other information filed herewith, all of which are made a part hereof, are current, true and complete.

Date: _____ _____

(MM/DD/YY) (Name of applicant)

By: _____ _____

(Signature) (Printed Name and Title)

Subscribed and sworn before me this _____ day of _____, _____ by _____

(Month) (Year) (Notary Public)

My Commission expires _____ County of _____ State of _____

This page must always be completed in full with original, manual signature and notarization.
Affix notary stamp or seal where applicable.

DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY

Form 1 Page 2	U.S. SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 APPLICATION FOR, AND AMENDMENTS TO APPLICATION FOR, REGISTRATION AS A NATIONAL SECURITIES EXCHANGE OR EXEMPTION FROM REGISTRATION PURSUANT TO SECTION 5 OF THE EXCHANGE ACT	OFFICIAL USE	OFFICIAL USE ONLY

EXHIBITS

File all Exhibits with: an application for registration as a national securities exchange, or exemption from registration pursuant to Section 5 of the Exchange Act and Rule 6a-1, or amendments to such applications pursuant to Rule 6a-2. For each exhibit, include the name of the applicant, the date upon which the exhibit was filed and the date as of which the information is accurate (if different from the date of the filing). If any Exhibit required is inapplicable, a statement to that effect shall be furnished in lieu of such Exhibit.

Exhibit A A copy of the constitution, articles of incorporation or association with all subsequent amendments, and of existing by-laws or corresponding rules or instruments, whatever the name, of the applicant.

Exhibit B A copy of all written rulings, settled practices having the effect of rules, and interpretations of the Governing Board or other committee of the applicant in respect of any provisions of the constitution, by-laws, rules, or trading practices of the applicant which are not included in Exhibit A.

Exhibit C For each subsidiary or affiliate of the applicant, and for any entity with whom the applicant has a contractual or other agreement relating to the operation of an electronic trading system to be used to effect transactions on the exchange ("System"), provide the following information:

1. Name and address of organization.
2. Form of organization (e.g., association, corporation, partnership, etc.).
3. Name of state and statute citation under which organized. Date of incorporation in present form.
4. Brief description of nature and extent of affiliation.
5. Brief description of business or functions. Description should include responsibilities with respect to operation of the System and/or execution, reporting, clearance, or settlement of transactions in connection with operation of the System.
6. A copy of the constitution.
7. A copy of the articles of incorporation or association including all amendments.
8. A copy of existing by-laws or corresponding rules or instruments.
9. The name and title of the present officers, governors, members of all standing committees or persons performing similar functions.
10. An indication of whether such business or organization ceased to be associated with the applicant during the previous year, and a brief statement of the reasons for termination of the association.

Exhibit D For each subsidiary or affiliate of the exchange, provide unconsolidated financial statements for the latest fiscal year. Such financial statements shall consist, at a minimum, of a balance sheet and an income statement with such footnotes and other disclosures as are necessary to avoid rendering the financial statements misleading. If any affiliate or subsidiary is required by another Commission rule to submit annual financial statements, a statement to that effect, with a citation to the other Commission rule, may be provided in lieu of the financial statements required here.

Form 1 Page 3	**U.S. SECURITIES AND EXCHANGE COMMISSION** **WASHINGTON, D.C. 20549** **APPLICATION FOR, AND AMENDMENTS TO APPLICATION FOR, REGISTRATION AS A NATIONAL SECURITIES EXCHANGE OR EXEMPTION FROM REGISTRATION PURSUANT TO SECTION 5 OF THE EXCHANGE ACT**	OFFICIAL USE	OFFICIAL USE ONLY

EXHIBITS

Exhibit E Describe the manner of operation of the System. This description should include the following:

1. The means of access to the System.
2. Procedures governing entry and display of quotations and orders in the System.
3. Procedures governing the execution, reporting, clearance and settlement of transactions in connection with the System.
4. Proposed fees.
5. Procedures for ensuring compliance with System usage guidelines.
6. The hours of operation of the System, and the date on which applicant intends to commence operation of the System.
7. Attach a copy of the users' manual.
8. If applicant proposes to hold funds or securities on a regular basis, describe the controls that will be implemented to ensure safety of those funds or securities.

Exhibit F A complete set of all forms pertaining to:

1. Application for membership, participation or subscription to the entity.
2. Application for approval as a person associated with a member, participant or subscriber of the entity.
3. Any other similar materials.

Exhibit G A complete set of all forms of financial statements, reports or questionnaires required of members, participants, subscribers or any other users relating to financial responsibility or minimum capital requirements for such members, participants or any other users. Provide a table of contents listing the forms included in this Exhibit G.

Exhibit H A complete set of documents comprising the applicant's listing applications, including any agreements required to be executed in connection with listing and a schedule of listing fees. If the applicant does not list securities, provide a brief description of the criteria used to determine what securities may be traded on the exchange. Provide a table of contents listing the forms included in this Exhibit H.

Exhibit I For the latest fiscal year of the applicant, audited financial statements which are prepared in accordance with, or in the case of a foreign applicant, reconciled with, United States generally accepted accounting principles, and are covered by a report prepared by an independent public accountant. If an applicant has no consolidated subsidiaries, it shall file audited financial statements under Exhibit I alone and need not file a separate unaudited financial statement for the applicant under Exhibit D.

Exhibit J A list of the officers, governors, members of all standing committees, or persons performing similar functions, who presently hold or have held their offices or positions during the previous year, indicating the following for each:

1. Name.
2. Title.
3. Dates of commencement and termination of term of office or position.
4. Type of business in which each is primarily engaged (e.g. floor broker, specialist, odd lot dealer, etc.).

Form 1 Page 4	U.S. SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 APPLICATION FOR, AND AMENDMENTS TO APPLICATION FOR, REGISTRATION AS A NATIONAL SECURITIES EXCHANGE OR EXEMPTION FROM REGISTRATION PURSUANT TO SECTION 5 OF THE EXCHANGE ACT	OFFICIAL USE	OFFICIAL USE ONLY

EXHIBITS

Exhibit K This Exhibit is applicable only to exchanges that have one or more owners, shareholders, or partners that are not also members of the exchange. If the exchange is a corporation, please provide a list of each shareholder that directly owns 5% or more of a class of a voting security of the applicant. If the exchange is a partnership, please provide a list of all general partners and those limited and special partners that have the right to receive upon dissolution, or have contributed, 5% or more of the partnership's capital. For each of the persons listed in the Exhibit K, please provide the following:

1. Full legal name;
2. Title or Status;
3. Date title or status was acquired;
4. Approximate ownership interest; and
5. Whether the person has control, a term that is defined in the instructions to this Form.

Exhibit L Describe the exchange's criteria for membership in the exchange. Describe conditions under which members may be subject to suspension or termination with regard to access to the exchange. Describe any procedures that will be involved in the suspension or termination of a member.

Exhibit M Provide an alphabetical list of all members, participants, subscribers or other users, including the following information:

1. Name;
2. Date of election to membership or acceptance as a participant, subscriber or other user;
3. Principal business address and telephone number;
4. If member, participant, subscriber or other user is an individual, the name of the entity with which such individual is associated and the relationship of such individual to the entity (e.g. partner, officer, director, director, employee, etc.);
5. Describe the type of activities primarily engaged in by the member, participant, subscriber, or other user (e.g. floor broker, specialist, odd lot dealer, other market maker, proprietary trader, non-broker dealer, inactive or other functions). A person shall be "primarily engaged" in an activity or function for purposes of this item when that activity or function is the one in which that person is engaged for the majority of their time. When more than one type of person at an entity engages in any of the six types of activities or functions enumerated in this item, identify each type (e.g. proprietary trader, Registered Competitive Trader and Registered Competitive Market Maker) and state the number of members, participants, subscribers, or other users in each; and
6. The class of membership, participation or subscription or other access.

Exhibit N Provide a schedule for each of the following:

1. The securities listed in the exchange, indicating for each the name of the issuer and a description of the security;
2. The securities admitted to unlisted trading privileges, indicating for each the name of the issuer and a description of the security;
3. The unregistered securities admitted to trading on the exchange which are exempt from registration under Section 12(a) of the Act. For each security listed, provide the name of the issuer and a description of the security, and the statutory exemption claimed (e.g. Rule 12a-6); and
4. Other securities traded on the exchange, including for each the name of the issuer and a description of the security.

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§ 249.1a and Form 1–A [Removed]

19. Section 249.1a and Form 1–A are removed.

§ 249.636 and Form 17A–23 [Removed and reserved]

20. Section 249.636 and Form 17A–23 are removed and reserved.

21. Section 249.637 and Form ATS are added to read as follows:

§ 249.637 Form ATS, information required of alternative trading systems pursuant to § 242.301(b)(2) of this chapter.

This form shall be used by every alternative trading system to file required notices, reports and amendments under § 242.301(b)(2) of this chapter.

Note: Form ATS does not and the amendments will not appear in the Code of Federal Regulations.

OMB APPROVAL
OMB Number: 3235–0509
Expires: 8/31/2001
Estimated Average burden hours per form: 8

Form ATS—Intial Operation Report, Amendment to Initial Operation Report and Cessation of Operations Report of Alternative Trading System Activities

BILLING CODE 8010–01–M

FORM ATS INSTRUCTIONS

A. GENERAL INSTRUCTIONS

1. Form ATS is the form an alternative trading system must file to notify the Securities and Exchange Commission ("SEC" or "Commission") of its activities pursuant to Regulation ATS, § 242.300 et seq.

2. **WHEN TO FILE FORM ATS**
   - An alternative trading system must file an initial operation report on Form ATS at least 20 days prior to commencing operation.
   - The alternative trading system must update Form ATS information by submitting amendments to the initial operation report at least 20 calendar days prior to implementing a material change to the operation of the alternative trading system as described on Form ATS or any amendment thereto. Additionally, the alternative trading system must update Form ATS information by submitting amendments to the initial operation report on Form ATS within 30 calendar days after the end of each calendar quarter in which the alternative trading system has operated, correcting any information contained in any initial operation report or any amendment thereto that has been rendered inaccurate and that has not previously been reported to the SEC.
   - An alternative trading must also file a cessation of operations report on Form ATS promptly upon ceasing to operate.
   - Form ATS shall not be considered filed, unless it complies with applicable requirements.

3. **CONTACT EMPLOYEE** - The individual listed on page 1 as the contact employee must be authorized to receive all contact information, communications and mailings and be responsible for disseminating that information within the alternative trading system's organization.

4. **FORMAT**
   - Attach an Execution Page (Page 1) with original manual signatures.
   - Please type all information.
   - Provide the name of the alternative trading system, the CRD number, the SEC File number, and the filing date on each page.
   - Use only the current version of Form ATS or a reproduction.

5. **WHERE TO FILE AND NUMBER OF COPIES** - Submit one original and two copies of Form ATS to: SEC, Division of Market Regulation, 450 Fifth Street, N.W., Stop 10-2, Washington D.C. 20549. Simultaneously with the filing of the original with the SEC, file one duplicate copy of Form ATS with surveillance personnel designated by the self-regulatory organization that is the designated examining authority for the alternative trading system pursuant to Rule 17d-1 under the Securities Exchange Act of 1934.

6. **RECORDKEEPING** - A copy of this Form ATS, as well as the forms filed with the SEC, must be retained by the alternative trading system and made available for inspection upon request of the SEC.

7. **PAPERWORK REDUCTION ACT DISCLOSURE**
   - Form ATS requires an alternative trading system subject to Regulation ATS to provide the Commission with certain information regarding the operation of the alternative trading system, material and other changes to the operation of the alternative trading system, and notice upon ceasing operation of the alternative trading system.
   - An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(b), 11A(a), 11A(c), 15(c), 17(a), 23(a) and 36(a) authorize the Commission to collect information on this Form ATS from alternative trading systems that are subject to Regulation ATS. *See* 15 U.S.C. §§78c(b), 78k-1(a), 78k-1(c), 78o(c), 78q(a), 78w(a) and 78mm(a).
   - Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form ATS and any suggestions for reducing this burden.
   - Form ATS is designed to enable the Commission to determine whether an alternative trading system subject to Regulation ATS is in compliance with Regulation ATS and other federal securities laws.
   - It is estimated that an alternative trading system will spend approximately 20 hours completing the initial operation report on Form ATS, approximately 2 hours preparing each amendment to Form ATS, and approximately 2 hours preparing a cessation of operations report on Form ATS.
   - Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.
   - It is mandatory that an alternative trading system subject to Regulation ATS file an initial operation report on Form ATS, file an amendment to Form ATS prior to making a material change, file quarterly amendments to Form ATS to reflect changes not previously reported, and file notice on Form ATS upon ceasing operation of the ATS.

FORM ATS INSTRUCTIONS

- All reports provided to the Commission on Form ATS are deemed confidential and will be available only to the examination of Commission staff, state securities authorities and the self-regulatory organizations. Subject to the provisions of the Freedom of Information Act, 5 U.S.C. 522 ("FOIA"), and the Commission's rules thereunder (17 CFR 200.80(b)(4)(iii)), the Commission does not generally publish or make available information contained in any reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of, or in connection with an examination or inspection of the books and records of any person or any other investigation.

- This collection of information has been reviewed by the Office of Management and Budget ("OMB") in accordance with the clearance requirements of 44 U.S.C. §3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records are set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).

B. EXPLANATION OF TERMS

ALTERNATIVE TRADING SYSTEM - Shall mean any organization, association, person, group of persons, or system: (1) that 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 within the meaning of Rule 3b-16 under the Exchange Act; and (2) that does not (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system, or (ii) discipline subscribers other than by exclusion from trading.

SUBSCRIBER - Shall mean any person that has entered into a contractual agreement with an alternative trading system to access such alternative trading system for the purpose of effecting transactions in securities or for submitting, disseminating, or displaying orders on such alternative trading system, including a customer, member, user, or participant in an alternative trading system. A subscriber, however, shall not include a national securities exchange or national securities association.

ORDER - Shall mean any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order or other priced order.

Form ATS Page 1 Execution Page	**U.S. SECURITIES AND EXCHANGE COMMISSION** **WASHINGTON, D.C. 20549** **INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT AND CESSATION OF OPERATIONS REPORT FOR ALTERNATIVE TRADING SYSTEMS**	Date filed (MM/DD/YY):	OFFICIAL USE ONLY

WARNING: Failure to keep this form current and to file accurate supplementary information on a timely basis, or the failure to keep accurate books and records or otherwise to comply with the provisions of law applying to the conduct of alternative trading systems, would violate the federal securities laws and may result in disciplinary, administrative or criminal action.

INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACTS MAY CONSTITUTE CRIMINAL VIOLATIONS

❑ INITIAL OPERATION REPORT ❑ AMENDMENT TO INITIAL OPERATION REPORT ❑ CESSATION OF OPERATIONS REPORT

1. Exact name, principal business address, mailing address, if different, and telephone number of alternative trading system:

A. Full name of alternative trading system (if sole proprietor, last, first and middle name): _____

B. CRD Number: _____

C. Name(s) under which business is conducted, if different from Item 1A. _____

D. SEC File No.: 8- _____

E. If this filing makes a name change on behalf of the alternative trading system, enter the previous name and specify whether the name change is of the _____ alternative trading system name (1A), or _____ business name (1C):

Previous name: _____

F. Alternative trading system's main street address (Do not use a P.O. Box):

_____

_____

G. Mailing address (if different):

_____

_____

H. Business telephone and facsimile number:

_____

(Telephone) (Facsimile)

I. Contact employee:

_____

(Name and Title) (Telephone Number) (Facsimile)

EXECUTION:

The alternative trading system consents that service of any civil action brought by, or notice of any proceeding before, the SEC or a self-regulatory organization in connection with the alternative trading system's activities may be given by registered or certified mail or confirmed telegram, to the alternative trading system's contact employee at the main address, or mailing address if different, given in Items 1F and 1G. The undersigned, being first duly sworn, deposes and says that he/she has executed this form on behalf of, and with the authority of, said alternative trading system. The undersigned and alternative trading system represent that the information and statements contained herein, including exhibits, schedules, or other documents attached hereto, and other information filed herewith, all of which are made a part hereof, are current, true and complete.

Date: _____ _____

(MM/DD/YY) (Name of alternative trading system)

By: _____ _____

(Signature) (Printed Name and Title)

Subscribed and sworn before me this _____ day of _____, _____ by _____

(Month) (Year) (Notary Public)

My Commission expires _____ County of _____ State of _____

This page must always be completed in full with original, manual signature and notarization.

Affix notary stamp or seal where applicable.

DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY

Form ATS Page 2	U.S. SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT AND CESSATION OF OPERATIONS REPORT FOR ALTERNATIVE TRADING SYSTEMS	OFFICIAL USE	OFFICIAL USE ONLY

Alternative trading system name: _____ CRD No: _____

Filing date: _____ SEC File No.: 8- _____

2. If this is an initial operation report, the date the alternative trading system expects to commence operation: _____

3. Attach as Exhibit A, a description of classes of subscribers (for example, broker-dealer, institution, or retail). Also describe any differences in access to the services offered by the alternative trading system to different groups or classes of subscribers.

4. Attach as Exhibit B:

   a. A list of the types of securities the alternative trading system trades (for example, debt, equity, listed, Nasdaq NM) or, if this is an initial operation report, the types of securities it expects to trade. Note whether any types of securities are not registered under Section 12(a) of the Exchange Act of 1934 ("Exchange Act").

   b. A list of the securities the alternative trading system trades, or if this is an initial operation report, the securities it expects to trade. Note whether any securities are not registered under Section 12(a) of the Exchange Act.

5. Attach as Exhibit C, the name, address, and telephone number of counsel for the alternative trading system.

6. Attach as Exhibit D, a copy of the constitution, articles of incorporation or association, with all amendments, and of the existing by-laws or corresponding rules or instruments, whatever the name, of the alternative trading system. If this information is publicly available on a continuous basis on an Internet site controlled by the alternative trading system, the alternative trading system may indicate the location of the Internet web site where such information may be found in lieu of filing such information with the Commission.

7. Attach as Exhibit E, the name of any entity, other than the alternative trading system, that will be involved in operation of the alternative trading system, including the execution, trading, clearing and settling of transactions on behalf of the alternative trading system. Provide a description of the role and responsibilities of each entity.

8. Attach as Exhibit F, the following information:

   a. The manner of operation of the alternative trading system;

   b. Procedures governing entry of orders into the alternative trading system;

   c. The means of access to the alternative trading system;

   d. The procedures governing execution, reporting, clearance and settlement of transactions effected through the alternative trading system;

   e. Procedures for ensuring subscriber compliance with system guidelines; and

   f. A copy of the alternative trading system's subscriber manual and any other materials provided to subscribers.

9. Attach as Exhibit G, a brief description of the alternative trading system's procedures for reviewing system capacity, security and contingency planning procedures.

10. If any other entity, other than the alternative trading system, will hold or safeguard subscriber funds or securities on a regular basis, attach as Exhibit H the name of such entity and a brief description of the controls that will be implemented to ensure the safety of such funds and securities.

11. Attach as Exhibit I, a list providing the full legal name of those direct owners reported on Schedule A of Form BD.

BILLING CODE 8010–01–C

FORM ATS-R INSTRUCTIONS

A. GENERAL INSTRUCTIONS

1. Form ATS-R must be filed by alternative trading systems subject to Regulation ATS within 30 days after the end of each calendar quarter, or more frequently upon request of the Securities and Exchange Commission ("SEC" or "Commission"). This Form should be prepared as of the last day of each calendar quarter.

2. **WHEN TO FILE A FORM ATS-R** - File Form ATS-R within 30 calendar days after the end of each calendar quarter in which the alternative trading system has operated after the effective date of Regulation ATS. Also file Form ATS-R within 10 calendar days after an alternative trading system ceases to operate.

3. **CONTACT EMPLOYEE** - The individual listed on page 1 as the contact employee must be authorized to receive all contact information, communications and mailings and be responsible for disseminating that information within the alternative trading system's organization.

4. **FORMAT**
   - Attach the Execution Page (Page 1) with every filing of Form ATS-R.
   - Please type all information.
   - Be sure to note the alternative trading system name, CRD number, SEC file number, and report period dates on each page.
   - Use only the current version of Form ATS-R or a reproduction.

5. **WHERE TO FILE AND NUMBER OF COPIES** - Submit one original and two copies of Form ATS-R to: SEC, Division of Market Regulation, 450 Fifth Street, N.W., Stop 10-2, Washington D.C. 20549.

6. **RECORDKEEPING** - A copy of this Form ATS-R, as well as the forms filed with the SEC, must be retained by the alternative trading system and made available for inspection upon request of the SEC.

7. **PAPERWORK REDUCTION ACT DISCLOSURE**
   - Form ATS-R requires an alternative trading system subject to Regulation ATS to provide the Commission with quarterly reports regarding trading activities.
   - An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(b), 11A(a), 11A(c), 15(c), 17(a), 23(a) and 36(a) authorize the Commission to collect information on this Form ATS from alternative trading systems that are subject to Regulation ATS. *See* 15 U.S.C. §§78c(b), 78k-1(a), 78k-1(c), 78o(c), 78q(a), 78w(a) and 78mm(a).
   - Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form ATS-R and any suggestions for reducing this burden.
   - Form ATS-R is designed to enable the Commission to more effectively track the growth and development of alternative trading systems, as well as to more effectively comply with its statutory obligations with respect to alternative trading systems and improve investor protection.
   - It is estimated that an alternative trading system will spend approximately 4 hours completing Form ATS-R.
   - Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.
   - It is mandatory that an alternative trading system subject to Regulation ATS file quarterly reports on Form ATS-R with the Commission.
   - All reports provided to the Commission on Form ATS-R are deemed confidential and will be available only to the examination of Commission staff, state securities authorities and the self-regulatory organizations. Subject to the provisions of the Freedom of Information Act, 5 U.S.C. 522 ("FOIA"), and the Commission's rules thereunder (17 CFR 200.80(b)(4)(iii)), the Commission does not generally publish or make available information contained in any reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of, or in connection with an examination or inspection of the books and records of any person or any other investigation.
   - This collection of information has been reviewed by the Office of Management and Budget ("OMB") in accordance with the clearance requirements of 44 U.S.C. §3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records at set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).

8. Only those alternative trading systems subject to the fair access obligations under Rule 301(b)(5) are required to respond to question 7 on Form ATS-R.

FORM ATS-R INSTRUCTIONS

B. EXPLANATION OF TERMS

ALTERNATIVE TRADING SYSTEM - Shall mean any organization, association, person, group of persons, or system (1) that 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 within the meaning of Rule 3b-16 under the Exchange Act; and (2) that does not (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system, or (ii) discipline subscribers other than by exclusion from trading.

INVESTMENT GRADE CORPORATE DEBT SECURITIES - Shall mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; (3) is rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and (4) is not an exempted security, as defined in §3(a)(12) of the Act (15 U.S.C. 78o).

NON-INVESTMENT GRADE CORPORATE DEBT SECURITIES - Shall mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; (3) is not rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and (4) is not an exempted security, as defined in §3(a)(12) of the Act (15 U.S.C. 78o).

DEBT SECURITIES - Shall mean any security other than an equity security, as defined in §240.3a11-1.

EQUITY SECURITIES - Shall have the same meaning as in §240.3a11-1.

GOVERNMENT SECURITIES - Shall have the same meaning as in Exchange Act Section 3(a)(42), including those instruments in paragraph (D) of § 3(a)(42) of the Exchange Act.

LISTED EQUITY SECURITIES - Shall mean any equity securities that are listed and registered, or admitted to unlisted trading privileges, on a national securities exchange.

LISTED OPTIONS - Shall mean any options traded on a registered national securities exchange or automated facility of a registered national securities association.

MORTGAGE RELATED SECURITIES - Shall have the same meaning as in Exchange Act Section 3(a)(41).

MUNICIPAL SECURITIES - Shall have the same meaning as in Exchange Act Section 3(a)(29).

NASDAQ NATIONAL MARKET SECURITIES - Shall mean any securities designated as Nasdaq National Market Securities by The Nasdaq Stock Market.

NASDAQ SMALLCAP MARKET SECURITIES - Shall mean any securities designated as Nasdaq SmallCap Market Securities by The Nasdaq Stock Market.

PENNY STOCK - Shall have the same meaning as in Exchange Act Section 3(a)(51).

SUBSCRIBER - Shall mean any person that has entered into a contractual agreement with an alternative trading system to access such alternative trading system for the purpose of effecting transactions in securities or to submit, disseminate, or display orders on such alternative trading system, including a customer, member, user, or participant in an alternative trading system. A subscriber, however, shall not include a national securities exchange or national securities association.

UNLISTED OPTIONS - Shall mean any options other than those traded on a registered national securities exchange or automated facility of a registered national securities association.

Form ATS-R Page 1 Execution Page	**U.S. SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 QUARTERLY REPORT OF ALTERNATIVE TRADING SYSTEM ACTIVITIES**	OFFICIAL USE	OFFICIAL USE ONLY

INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACTS MAY CONSTITUTE CRIMINAL VIOLATIONS

Alternative Trading System Name: _____

Period covered by this report: _____ to _____

1. Exact name, principal business address, mailing address, if different, and telephone number of alternative trading system:
   A. Full name of alternative trading system (if sole proprietor, last, first and middle name): _____
   B. CRD Number: _____
   C. Name(s) under which business is conducted, if different from Item 1A. _____
   D. SEC File No.: 8- _____
   E. If this filing makes a name change on behalf of the alternative trading system, enter the previous name and specify whether the name change is of the _____ alternative trading system name (1A), or _____ business name (1C):

      Previous name: _____
   F. Alternative trading system's main street address (Do not use a P.O. Box): _____
   G. Mailing address (if different): _____
   H. Business telephone and facsimile number: _____
      (Telephone) (Facsimile)
   I. Contact employee: _____
      (Name and Title) (Telephone) (Facsimile)
2. Attach as Exhibit A, a list of all subscribers that were participants of the alternative trading system at any time during the period covered by this report.
3. Attach as Exhibit B, a list of all securities that were traded on the alternative trading system at any time during the period covered by this report.

EXECUTION:
The alternative trading system consents that service of any civil action brought by, or notice of any proceeding before, the SEC or self-regulatory organization in connection with the alternative trading system's activities may be given by registered or certified mail, or confirmed telegram, to the alternative trading system's contact employee at the main address, or mailing address if different, given in Items 1F and 1G. The undersigned, being first duly sworn, deposes and says that he/she has executed this form on behalf of, and with the authority of, said alternative trading system. The undersigned and alternative trading system represent that the information and statements contained herein, including exhibits, schedules, or other documents attached hereto, and other information filed herewith, all of which are made a part hereof, are current, true and complete.

Date: _____ (MM/DD/YY) _____ (Name of alternative trading system)

By: _____ (Signature) _____ (Printed Name and Title)

Subscribed and sworn before me this _____ day of _____ (Month), _____ (Year) by _____ (Notary Public)

My Commission expires _____ County of _____ State of _____

This page must always be completed in full with original, manual signature and notarization.
Affix notary stamp or seal where applicable.

DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY

Form ATS-R Page 2	U.S. SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 QUARTERLY REPORT OF ALTERNATIVE TRADING SYSTEM ACTIVITIES	OFFICIAL USE	OFFICIAL USE ONLY

Alternative trading system name: _____ CRD Number: _____

Period covered in this report: _____ to _____ SEC File Number: 8-_____

4. Provide the total unit and dollar volume of transactions in the following securities. For securities reported in 4J-4N, report total settlement value in U.S. Dollars. Enter "None," "N/A" or "0" where appropriate.

Category of Securities	*Total Unit Volume of Transactions*	*Total Dollar Volume of Transactions*
A. Listed Equity Securities		
B. Nasdaq National Market Securities		
C. Nasdaq SmallCap Market Securities		
D. Equity securities issued pursuant to Rule 144A of the Securities Act of 1933		
E. Penny Stock, other than any securities included in Items 4A-4D above		
F. Other equity securities not included in Items 4A-4E above		
G. Rights and warrants		
H. Listed options		
I. Unlisted options		
J. Government securities		
K. Municipal securities		
L. Investment grade corporate debt securities		
M. Non-investment grade corporate debt securities		
N. Mortgage related securities		
O. Debt securities other than any securities included in Items 4J-4N above		

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Form ATS-R Page 3	**U.S. SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 QUARTERLY REPORT OF ALTERNATIVE TRADING SYSTEM ACTIVITIES**	OFFICIAL USE	OFFICIAL USE ONLY

Alternative trading system name: _____ CRD Number: _____

Period covered in this report: _____ to _____ SEC File Number: 8-_____

5. A. List the types of equity securities reported in Item 4F above: _____

B. List the types of debt reported in Item 4O above: _____

6. Provide the total unit and dollar volume of transactions for after-hours trading in the following securities. Enter "None," "N/A" or "0" where appropriate.

Category of Securities	*Total Unit Volume of Transactions*	*Total Dollar Volume of Transactions*
A. Listed Equity Securities		
B. Nasdaq National Market Securities		
C. Nasdaq SmallCap Market Securities		
D. Listed options		

7. Attach as Exhibit C, a list of all persons granted, denied, or limited access to the alternative trading system during the period covered by this report, designating for each person (a) whether they were granted, denied, or limited access; (b) the date the alternative trading system took such action; (c) the effective date of such action; and (d) the nature of any denial on limitation of access.

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22. Section 249.638 and Form ATS–R are added to read as follows:

§ 249.638 Form ATS–R, information required of alternative trading systems pursuant to § 242.301(b)(8) of this chapter.

This form shall be used by every alternative trading system to file required reports under § 242.301(b)(8) of this chapter.

Note: Form ATS–R does not and the amendments will not appear in the Code of Federal Regulations.

OMB APPROVAL

OMB Number: 3235–0509

Expires: 8/31/2001

Estimated Average burden hours per form: 3.5

Form ATS–R—Quarterly Report of Alternative Trading System Activities

BILLING CODE 8010–01–M

FORM ATS-R INSTRUCTIONS

A. GENERAL INSTRUCTIONS

1. Form ATS-R must be filed by alternative trading systems subject to Regulation ATS within 30 days after the end of each calendar quarter, or more frequently upon request of the Securities and Exchange Commission ("SEC" or "Commission"). This Form should be prepared as of the last day of each calendar quarter.

2. **WHEN TO FILE A FORM ATS-R** - File Form ATS-R within 30 calendar days after the end of each calendar quarter in which the alternative trading system has operated after the effective date of Regulation ATS. Also file Form ATS-R within 10 calendar days after an alternative trading system ceases to operate.

3. **CONTACT EMPLOYEE** - The individual listed on page 1 as the contact employee must be authorized to receive all contact information, communications and mailings and be responsible for disseminating that information within the alternative trading system's organization.

4. **FORMAT**
   - Attach the Execution Page (Page 1) with every filing of Form ATS-R.
   - Please type all information.
   - Be sure to note the alternative trading system name, CRD number, SEC file number, and report period dates on each page.
   - Use only the current version of Form ATS-R or a reproduction.

5. **WHERE TO FILE AND NUMBER OF COPIES** - Submit one original and two copies of Form ATS-R to: SEC, Division of Market Regulation, 450 Fifth Street, N.W., Stop 10-2, Washington D.C. 20549.

6. **RECORDKEEPING** - A copy of this Form ATS-R, as well as the forms filed with the SEC, must be retained by the alternative trading system and made available for inspection upon request of the SEC.

7. **PAPERWORK REDUCTION ACT DISCLOSURE**
   - Form ATS-R requires an alternative trading system subject to Regulation ATS to provide the Commission with quarterly reports regarding trading activities.
   - An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(b), 11A(a), 11A(c), 15(c), 17(a), 23(a) and 36(a) authorize the Commission to collect information on this Form ATS from alternative trading systems that are subject to Regulation ATS. *See* 15 U.S.C. §§78c(b), 78k-1(a), 78k-1(c), 78o(c), 78q(a), 78w(a) and 78mm(a).
   - Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form ATS-R and any suggestions for reducing this burden.
   - Form ATS-R is designed to enable the Commission to more effectively track the growth and development of alternative trading systems, as well as to more effectively comply with its statutory obligations with respect to alternative trading systems and improve investor protection.
   - It is estimated that an alternative trading system will spend approximately 4 hours completing Form ATS-R.
   - Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.
   - It is mandatory that an alternative trading system subject to Regulation ATS file quarterly reports on Form ATS-R with the Commission.
   - All reports provided to the Commission on Form ATS-R are deemed confidential and will be available only to the examination of Commission staff, state securities authorities and the self-regulatory organizations. Subject to the provisions of the Freedom of Information Act, 5 U.S.C. 522 ("FOIA"), and the Commission's rules thereunder (17 CFR 200.80(b)(4)(iii)), the Commission does not generally publish or make available information contained in any reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of, or in connection with an examination or inspection of the books and records of any person or any other investigation.
   - This collection of information has been reviewed by the Office of Management and Budget ("OMB") in accordance with the clearance requirements of 44 U.S.C. §3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records at set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).

8. Only those alternative trading systems subject to the fair access obligations under Rule 301(b)(5) are required to respond to question 7 on Form ATS-R.

BILLING CODE 8010–01–C

23. Section 249.821 and Form PILOT are added to read as follows:

§ 249.821 Form PILOT, information required of self-regulatory organizations operating pilot trading systems pursuant to § 240.19b–5 of this chapter.

This form shall be used by all self-regulatory organizations, as defined in section 3(a)(26) of the Act, (15 U.S.C 78c(a)(26)), to file required information and reports with regard to pilot trading systems pursuant to § 240.I20240.19b–5 of this chapter.

Note: Form PILOT does not and the amendments will not appear in the Code of Federal Regulations.

OMB APPROVAL
OMB Number: 3235–0507
Expires: 8/31/2001
Estimated Average burden hours per form: 6

Form PILOT—Initial Operation Report, Amendment to Initial Operation Report and Quarterly Report for Pilot Trading Systems Operated by Self-Regulatory Organizations

BILLING CODE 8010–01–M

FORM PILOT INSTRUCTIONS

A. GENERAL INSTRUCTIONS

1. Form PILOT is the form a self-regulatory organization ("SRO") files to notify the Securities and Exchange Commission ("SEC" or "Commission") of its intention to operate a pilot trading system pursuant to Rule 19b-5, § 240.19b-5, under the Securities Exchange Act of 1934 ("Exchange Act").

2. **WHEN TO FILE A FORM PILOT** - The SRO must file the initial operation report, Part I of Form PILOT, at least 20 days prior to commencing operation of the pilot trading system. The SRO operating a pilot trading system under Rule 19b-5 must update information reported in Part I of Form PILOT by submitting amendments to the initial operation report at least 20 calendar days prior to implementing a material change to the operation of the pilot trading system as described on Form PILOT or any amendment thereto, other than information reported in Items 3b and 4b on Form PILOT relating to subscribers to, and securities traded on, the pilot trading system. Additionally, the SRO must file Part II of Form PILOT by submitting quarterly reports within 30 calendar days after the end of each calendar quarter in which the pilot trading system has operated after the effective date of Regulation ATS.

3. **CONTACT EMPLOYEE** - The individual listed on page 1 as the contact employee must be authorized to receive all contact information, communications and mailings and be responsible for disseminating that information within the SRO.

4. **FORMAT**
   - Attach an Execution Page (Page 1) with original manual signatures.
   - Please type all information.
   - Provide the name of the SRO, pilot trading system and the filing date on each page.
   - Use only the current version of Form PILOT or a reproduction.

5. **WHERE TO FILE AND NUMBER OF COPIES** - Submit one original and eight copies of Form Pilot to: SEC, Division of Market Regulation, 450 Fifth Street, N.W., Washington D.C. 20549.

6. **RECORDKEEPING** - A copy of this Form PILOT, as well as any amendments thereto filed with the SEC, must be retained by the SRO operating the pilot trading system at its principal place of business and made available for inspection upon request of the SEC.

7. **PAPERWORK REDUCTION ACT DISCLOSURE**
   - Form PILOT requires an SRO intending to operate a pilot trading system pursuant to the temporary exemption under Rule 19b-5 to file certain information about the operation of the pilot trading system and notices of material changes to the pilot trading system. In addition, Form PILOT requires SROs to report transaction volume on the pilot trading system on a quarterly basis.
   - An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(a)(26), 3(a)(27), 3(a)(28) 19(b), 23(a) and 36(a) authorize the Commission to collect information on this Form PILOT from SROs. *See* 15 U.S.C. §§78c(a)(26), 78c(a)(27), 78c(a)(28), 78s(b), 78w(a) and 78mm(a).
   - Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form PILOT and any suggestions for reducing this burden.
   - Form PILOT is designed to enable the Commission to determine whether an SRO has properly availed itself of Rule 19b-5, is operating a pilot trading system in compliance with the Exchange Act, and is carrying out its statutory oversight obligations under the Exchange Act.
   - It is estimated that an SRO will spend approximately 24 hours completing the initial operation report on Form PILOT pursuant to Rule 19b-5. It is also estimated that each SRO will spend approximately 3 hours to prepare each notice of a material change and approximately 3 hours to prepare quarterly transaction information.
   - It is mandatory that an SRO seeking to operate a pilot trading system under Rule 19b-5 file a Form PILOT with the Commission. It is also mandatory that an SRO operating a pilot trading system file notices of material systems changes and quarterly transaction reports on Form PILOT.
   - Prior to commencing operations, all reports provided to the Commission on Form PILOT are deemed confidential and will be available only to the examination of Commission staff and state securities authorities. Subject to the provisions of the Freedom of Information Act, 5 U.S.C. 522 ("FOIA") and the Commission's rules thereunder (17 CFR 200.80(b)(4)(iii)), the Commission does not generally publish or make available information contained in any reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of, or in connection with an examination or inspection of the books and records of any person or any other investigation. Once the pilot trading system commences operation, all reports provided to the Commission on Form PILOT will be publicly available as of the operation date provided on Form PILOT or any amendment to Form PILOT.
   - This collection of information has been reviewed by the Office of Management and Budget ("OMB") in accordance with the clearance requirements of 44 U.S.C. §3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records at set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).

FORM PILOT INSTRUCTIONS

B. EXPLANATION OF TERMS

PILOT TRADING SYSTEM - Shall mean any trading system, operated by an SRO, that:

(1)(i) has been in operation for less than two years; (ii) is independent of any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to Section 19(b) of the Exchange Act; (iii) with respect to each security traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 5% of the average daily trading volume of such security in the United States; and (iv) with respect to all securities traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 20% of the average daily trading volume of all trading systems operated by such self-regulatory organization; or

(2)(i) has been in operation for less than two years; (ii) with respect to each security traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 1% of the average daily trading volume of such security in the United States; and (iii) with respect to all securities traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 20% of the average daily trading volume of all trading systems operated by such self-regulatory organization; or

(3)(i) has been in operation for less than two years; and (ii)(A) satisfied the definition of "pilot trading system" under paragraph (1) above no more than 60 days ago, and continues to be independent of any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to Section 19(b) of the Exchange Act; or (B) satisfied the definition of "pilot trading system" under paragraph (2) above no more than 60 days ago.

INVESTMENT GRADE CORPORATE DEBT SECURITIES - Shall mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; (3) is rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and (4) is not an exempted security, as defined in §3(a)(12) of the Act (15 U.S.C. 78o).

NON-INVESTMENT GRADE CORPORATE DEBT SECURITIES - Shall mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; (3) is not rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and (4) is not an exempted security, as defined in §3(a)(12) of the Act (15 U.S.C. 78o).

DEBT SECURITIES - Shall mean any security other than an equity security, as defined in §240.3a11-1.

EQUITY SECURITIES - Shall have the same meaning as in §240.3a11-1.

GOVERNMENT SECURITIES - Shall have the same meaning as in Exchange Act Section 3(a)(42).

LISTED EQUITY SECURITIES - Shall mean any equity securities that are listed and registered, or admitted to unlisted trading privileges, on a national securities exchange.

LISTED OPTIONS - Shall mean any options traded on a registered national securities exchange or automated facility of a registered national securities association.

MORTGAGE RELATED SECURITIES - Shall have the same meaning as in Exchange Act Section 3(a)(41).

MUNICIPAL SECURITIES - Shall have the same meaning as in Exchange Act Section 3(a)(29).

NASDAQ NATIONAL MARKET SECURITIES - Shall mean any securities designated as Nasdaq National Market Securities by The Nasdaq Stock Market.

NASDAQ SMALLCAP MARKET SECURITIES - Shall mean any securities designated as Nasdaq SmallCap Market Securities by The Nasdaq Stock Market.

PENNY STOCK - Shall have the same meaning as in Exchange Act Section 3(a)(51).

Form PILOT Page 1 Execution Page	U.S. SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 PART I INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT, AND QUARTERLY REPORT FOR PILOT TRADING SYSTEMS OPERATED BY A SELF-REGULATORY ORGANIZATION	Date filed (MM/DD/YY):	OFFICIAL USE ONLY

WARNING: Failure to keep this form current and to file accurate supplementary information on a timely basis, or the failure to keep accurate books and records or otherwise to comply with the provisions of law applying to the conduct of pilot trading systems would violate the federal securities laws and may result in disciplinary, administrative or criminal action.

INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACTS MAY CONSTITUTE CRIMINAL VIOLATIONS

❑ INITIAL OPERATION REPORT ❑ AMENDMENT TO INITIAL OPERATION REPORT ❑ QUARTERLY REPORT

1. Exact name, principal business address, mailing address, if different, and telephone number of pilot trading system:

A. Name of the SRO filing Form PILOT: _____

C. File No. PILOT- _____

B. Full Name of pilot trading system: _____

D. If this filing makes a name change on behalf of the pilot trading system, enter the previous name.

Previous name: _____

E. Pilot trading system's business address (Do not use a P.O. Box): _____

F. Business telephone and facsimile number: _____

(Telephone) (Facsimile)

G. Contact employee: _____

(Name and Title) (Telephone Number) (Facsimile)

2. If this is an initial operation report, the date the SRO expects to commence operation of the pilot trading system:

Operation Date: _____

EXECUTION:

The SRO consents that service of any civil action brought by, or notice of any proceeding before, the SEC in connection with the pilot trading system's activities may be given by registered or certified mail, or confirmed telegram, to the pilot trading system's contact employee at the business address given in Item 1E. The undersigned, being first duly sworn, deposes and says that he/she has executed this form on behalf of, and with the authority of, said SRO. The undersigned and the SRO represent that the information and statements contained herein, including exhibits, schedules, or other documents attached hereto, and other information filed herewith, all of which are made a part hereof, are current, true and complete.

Date: _____ (MM/DD/YY) _____ (Name of SRO)

By: _____ (Signature) _____ (Printed Name and Title)

Subscribed and sworn before me this _____ day of _____ (Month), _____ (Year) by _____ (Notary Public)

My Commission expires _____ County of _____ State of _____

This page must always be completed in full with original, manual signature and notarization.

Affix notary stamp or seal where applicable.

DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY

Form PILOT Page 2	**U.S. SECURITIES AND EXCHANGE COMMISSION** **WASHINGTON, D.C. 20549** **PART I** **INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT, AND QUARTERLY REPORT FOR PILOT TRADING SYSTEMS OPERATED BY A SELF-REGULATORY ORGANIZATION** **(to be filed at least 20 calendar days prior to commencing operation)**	OFFICIAL USE	OFFICIAL USE ONLY

SRO name: _____
Pilot trading system name: _____
Filing date: _____

3. Attach as Exhibit A:

   a. A description of classes of members trading on the pilot trading system, and any persons to whom those members provide access to trading on the pilot trading system. Also describe any differences in access to the services offered by the pilot trading system to different classes of members.

   b. A list of the members, by name, or if this is an initial operation report, a list of the anticipated members who may trade on the pilot trading system.

4. Attach as Exhibit B:

   a. A list of the types of securities the pilot trading system trades (for example, debt, equity, listed, Nasdaq NM), or if this is an initial operation report, the types of securities it expects to trade. Note whether any types of securities are not registered under Section 12(a) of the Exchange Act.

   b. A list of the securities the pilot trading system trades, or if this is an initial operation report, the securities the SRO expects to trade on the pilot trading system. Note whether any securities are not registered under Section 12(a) of the Exchange Act.

5. Attach as Exhibit C, the name, address, and telephone number of counsel for the pilot trading system.

6. Attach as Exhibit D, the name of any entity, other than the SRO, that will be involved in the operation of the pilot trading system, including the execution, trading, clearing and settling of transactions on behalf of the SRO. Provide a detailed description of the role and responsibilities of each entity.

7. Attach as Exhibit E, the following information:

   a. The manner of operation of the pilot trading system;

   b. Procedures governing entry of orders into the pilot trading system;

   c. The SRO's means of granting access to the pilot trading system;

   d. The procedures governing execution, reporting, clearance and settlement of transactions effected through the pilot trading system;

   e. The procedures for ensuring compliance with system guidelines;

   f. A copy of the pilot trading system's manual and any other materials provided to members trading on the pilot trading system; and

   g. A copy of the agreement between the SRO and members trading on the pilot trading system, and, if applicable, any agreement between members and those persons members provide access to trading on the pilot trading system.

8. Attach as Exhibit F, a brief description of the SRO's procedures for reviewing capacity, security and contingency planning with respect to the pilot trading system.

Form PILOT Page 3	U.S. SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 Part II INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT, AND QUARTERLY REPORT FOR PILOT TRADING SYSTEMS OPERATED BY A SELF-REGULATORY ORGANIZATION	OFFICIAL USE	OFFICIAL USE ONLY

SRO name: _____

Pilot trading system name: _____

Period covered in this report: _____ to _____

9. Provide the total unit and dollar volume of transactions in the following securities. For securities reported in Item 9. J. through 9. O, report total settlement value in U.S. dollars. Enter "None," "N/A" or "0" where appropriate.

Category of Securities	*Total Unit Volume of Transactions*	*Total Dollar Volume of Transactions*
A. Listed Equity Securities		
B. Nasdaq National Market Securities		
C. Nasdaq SmallCap Market Securities		
D. Equity securities issued pursuant to Rule 144A of the Securities Act of 1933		
E. Penny Stock, other than any securities included in Items 9A-9D above		
F. Other equity securities not included in Items 9A-9E above		
G. Rights and warrants		
H. Listed options		
I. Unlisted options		
J. Investment-grade corporate debt securities		
K. Non-investment-grade corporate debt securities		
L. Government securities		
M. Municipal securities		
N. Mortgage related securities		
O. Debt securities other than any securities included in Items 9J - 9N above		

10. A. List the types of equity securities reported in Item 9O above: _____

B. List the types of debt reported in Item 9O above: _____

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By the Commission.

Dated: December 8, 1998.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 98–33299 Filed 21–21–98; 8:45 am]

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