

**MEMO# 10609**

December 28, 1998

# **SEC ADOPTS PROPOSALS REGARDING THE REGULATION OF EXCHANGES AND ALTERNATIVE TRADING SYSTEMS**

1 Securities Exchange Act Release No. 40760, December 8, 1998 (File No. S7-12-98) ("Adopting Release"). The rules become effective on April 21, 1999. The Adopting Release can be found on the SEC's web site at [www.sec.gov/rules/finrindx.htm](http://www.sec.gov/rules/finrindx.htm). If you wish to obtain a copy of the release referred to in this memorandum, please call the Institute's Library Services Division at (202) 326-8304. 2 The term "alternative trading system" is defined as any organization, association, person, group of persons, or system that (1) 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 Securities Exchange Act Rule 3b-16; and (2) 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. See Securities Exchange Act Rule 300(a). [10609] December 28, 1998 TO: SEC RULES MEMBERS No. 116-98 EQUITY MARKETS ADVISORY COMMITTEE No. 1-98 RE: SEC ADOPTS PROPOSALS REGARDING THE REGULATION OF EXCHANGES AND ALTERNATIVE TRADING SYSTEMS

On December 8, the Securities and Exchange Commission ("SEC") issued new rules and rule amendments<sup>1</sup> regarding the regulation of exchanges and alternative trading systems ("ATSS").<sup>2</sup> The new rules and rule amendments allow ATSSs to choose whether to register as national securities exchanges, or as broker-dealers and comply with additional requirements under new Regulation ATS. The amendments also make changes to the interpretation of the definition of "exchange" and the rules regarding the registration as an exchange, and exclude from the rule filing requirements for self-regulatory organizations ("SROs") certain pilot trading systems operated by national securities exchanges and national securities associations. The final rules and rule amendments reflect most of the Institute's comments on the original proposals. A. Interpretation of the Definition of "Exchange" The statutory definition of "exchange" under Section 3(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") 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 Adopting Release states that ATSSs are increasingly performing many of the functions typically carried out by registered exchanges and are being used by many market participants as the functional equivalents of exchanges. 3 The Adopting Release states that a system brings together orders if it displays, or otherwise represents, trading interests entered on the system to system users. A system also brings together orders if it receives subscribers' orders

centrally for future processing and execution, such as a limit order matching book. 4 The Adopting Release states that these include any methods that dictate the terms of trading among the multiple buyers and sellers entering orders into the system. 5 Rule 3b-16(a). The Adopting Release provides twenty examples of the types of systems addressed in Rule 3b-16. 6 Rule 3b-16(c). - 2 - The SEC therefore adopted new Rule 3b-16 under the Exchange Act. Rule 3b-16 defines terms used in the statutory definition of "exchange" in order to include systems, such as ATSS, within the definition of "exchange." Specifically, Rule 3b-16 interprets the terms used in the statutory definition of "exchange" to include any entity that (1) brings together<sup>3</sup> the orders for securities of multiple buyers and sellers and (2) uses established, non-discretionary methods<sup>4</sup> under which the orders interact with each other, and the buyers and sellers entering the orders agree to the terms of a trade.<sup>5</sup> Rule 3b-16 excludes systems that the SEC believes perform only traditional broker-dealer activities. For example, Rule 3b-16(b) expressly excludes from the revised interpretation of "exchange": (1) order routing systems, i.e., systems that merely route orders to an exchange or broker-dealer for execution; (2) systems operated by a single registered market maker to display its own quotes and customer limit orders, and which allows its customers and other broker-dealers to enter orders for execution against the displayed orders; and (3) systems that allow persons to enter orders for execution against the bids and offers of a single dealer. 1. Definition of "Order" The term "order" used in Rule 3b-16's interpretation of the definition of "exchange" includes "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."<sup>6</sup> The Adopting Release states that an examination of what actually takes place between the buyer and the seller is necessary to determine whether an indication of interest is "firm." For example, an ATS which states that it displays only "indications of interest" that are not orders may fall within the new interpretation of "exchange" if those indications of interest are actually firm in practice. The Adopting Release also states that an indication of interest will be considered firm if it can be executed without the further agreement of the person entering the indication. However, even if the person entering the indication must give their consent to an execution, the indication will still be considered firm if, for example, the agreement is largely a formality because consent is usually granted. Indications of interest to buy or sell a security without either prices or quantities attached to those indications, however, would not be "orders" for purposes of Rule 3b-16. 7 Currently, the only national securities association is the NASD. 8 Rule 3a1-1 also contains an exception to the exemption from the exchange definition. Under this exception, the SEC can determine that an entity should register as an exchange if they have a very large percentage (as specified in the rule) of the average daily dollar trading volume in any security and the SEC determines that an exemption is not necessary or appropriate in the public interest or consistent with the protection of investors. The SEC, however, would provide the entity with notice and an opportunity to respond before determining that the entity should register as an exchange. 9 ATSS that are registered as exchanges, exempt from registration as an exchange based on the limited volume of transactions effected, or are operated by a national securities association are excluded from the scope of Regulation ATS. In addition, the SEC proposed that any ATS that trades only government securities, Brady Bonds, and repurchase and reverse repurchase agreements involving government securities or Brady Bonds would be excluded from the scope of Regulation ATS, as long as the ATS is registered as a broker-dealer. The SEC adopted this exclusion with a number of modifications. Specifically, the SEC eliminated Brady Bonds from the exclusion and expanded the exclusion to include commercial paper and certain options on government securities. The SEC also expanded the exclusion to include ATSS that are banks and that trade only government securities, repurchase and reverse repurchase agreements on government securities, certain options of government

securities, and commercial paper. See Exchange Act Rule 301(a). 10 Electronic communications networks are types of alternative trading systems. - 3 - 2. Exemption for Regulated Alternative Trading Systems Section 36 of the Exchange Act gives the SEC authority to exempt any person, security, or transaction from provisions of the Exchange Act. Under this authority, the SEC adopted Exchange Act Rule 3a1-1, which exempts certain entities from the definition of "exchange," and therefore the requirement to register as an exchange, if they are operated by a national securities association,<sup>7</sup> comply with new Regulation ATS, or are not required to comply with Regulation ATS. However, any ATS exercising self-regulatory authority, such as regulating its members' conduct when they perform activities outside of the system, must register as an exchange or be operated by a national securities association.<sup>8</sup> B. Regulation ATS As discussed above, ATSs may choose to register either as national securities exchanges or as broker-dealers. ATSs that choose to register as broker-dealers, however, must comply with the requirements found in new Regulation ATS.<sup>9</sup> These requirements include:

1. Market Transparency In 1997, the SEC implemented the Order Handling Rules, which require that a market maker or specialist make publicly available any superior prices that it privately offers through electronic communications networks ("ECNs").<sup>10</sup> The Order Handling Rules, however, did not require that institutional orders being entered into ECNs be disclosed. Because of the significantly increasing use of ECNs by institutions to conduct trades, the SEC became concerned that the securities markets were becoming less transparent. <sup>11</sup> The term "covered security" includes all exchange-listed securities, Nasdaq National Market securities, and Nasdaq SmallCap securities. <sup>12</sup> This provision of the rule will allow institutions and non-market makers to shield the full size of their orders from public display by using a "reserve size" feature used by several ATSs. The reserve size feature allows subscribers to display orders incrementally. <sup>13</sup> A negotiation feature allows one participant in an ATS to send orders to another participant proposing specific terms of a trade without either participant revealing their identity. <sup>14</sup> Rule 301(b)(3)(iii). <sup>15</sup> Rule 301(b)(4). - 4 - To address these concerns and increase the transparency of orders displayed on ATSs, the SEC adopted new Exchange Act Rule 301(b)(3). Specifically, the rule will require ATSs with five percent or more of the aggregate average daily share volume in any "covered security"<sup>11</sup> during at least four of the preceding six calendar months to publicly disseminate their best priced orders (including institutional orders) in those securities. Only those subscribers' orders, or portions thereof, that are displayed to more than one other ATS subscriber would be subject to the public display requirement.<sup>12</sup> ATSs therefore will not be required to publicly disseminate orders displayed through the use of a negotiation feature.<sup>13</sup> Anonymity of the subscriber also will be retained under the rules, as the ATS will identify itself, rather than the ATS subscriber, as the entity placing an order. The display requirement will be applied on a security by security basis. An ATS therefore will be required to publicly display their best priced orders only in securities that meet the five percent volume requirement, not in all securities traded through the ATS. The final rules will allow ATSs to phase in the display of institutional orders. Before April 21, 1999, the SEC 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. The remaining fifty percent will be phased in on August 30, 1999.
2. Access to Publicly Displayed Orders ATSs also are required to provide all registered broker-dealers with access to displayed orders. Specifically, an ATS must provide any broker-dealer that has access to the national securities exchange or national securities association with which the ATS is linked the ability to effect transactions with those displayed orders.<sup>14</sup> ATSs will not, however, be required to provide access to a security until the public display requirement is effective for that security. In order to discourage ATSs from using access fees as a method to prevent non-subscriber broker-dealers from obtaining access to the ATS's publicly displayed orders, the rules prohibit an

ATS from charging fees that are "inconsistent with equivalent access" to the ATS orders by non-subscribers.<sup>15</sup> The rules also require an ATS to comply with the rules and standards governing fees established by the national securities exchange or national securities association through which the non-subscribers have access. <sup>16</sup> The categories of debt securities are municipal securities, investment grade corporate debt securities, and non-investment grade corporate debt securities. The fair access requirement will be effective for ATSs in municipal securities on April 21, 1999. Because information on the aggregate trading for investment grade and non-investment grade corporate debt is not as readily available as it is for municipal securities, the fair access requirements for these securities will not become effective until April 1, 2000. <sup>17</sup> Id. <sup>18</sup> The effective date for implementation of the system capacity, integrity, and security requirements will not be made effective until April 1, 2000 for investment grade corporate debt securities and non-investment grade corporate debt securities. <sup>19</sup> Rule 301(b)(7). <sup>20</sup> Rule 301(b)(8) and (b)(9), Rule 302. - 5 - 3. Fair Access Rule 301(b)(5) requires that an ATS establish standards for fair access to its system if the ATS, during four of the preceding six calendar months, had twenty percent or more of the average daily volume in an equity security or in certain categories of debt securities.<sup>16</sup> The fair access requirement will be applied on a security by security basis. In the Proposing Release, the SEC requested comment on whether persons denied access to an ATS should have the right to appeal directly to the SEC. The SEC decided not to provide this right of appeal. 4. Other Requirements ATSs are required to file with the SEC an initial operation report on Form ATS at least twenty days before commencing operation as an ATS. An ATS also must file an amendment on Form ATS at least twenty days before implementing a material change either to the operation of the ATS, to the types of securities traded on the ATS, or to the types of system subscribers. In addition, an ATS must file a notice upon ceasing operations. Rule 301(b)(6) requires ATSs trading twenty percent or more of the average daily volume during four of the preceding six calendar months in any equity security or in certain categories of debt securities<sup>17</sup> to comply with standards regarding the capacity, integrity, and security of their systems.<sup>18</sup> This requirement will be applied on a security by security basis. In addition, Regulation ATS requires that all ATSs permit the SEC or an SRO of which a subscriber is a member to examine and inspect the ATSs' premises, systems, and records and cooperate with the inspection, examination, or investigation of its subscribers.<sup>19</sup> Regulation ATS also requires all ATSs to adopt certain recordkeeping and reporting requirements.<sup>20</sup> In particular, the rules require that ATSs file with the SEC transaction reports within thirty calendar days after the end of each calendar quarter on Form ATS-R. This information will facilitate the monitoring of trading volume on ATSs. The rules also require that all ATSs have in place safeguards and procedures to protect subscribers' confidential <sup>21</sup> Rule 301(b)(10). <sup>22</sup> Rule 310(b)(11). <sup>23</sup> The Adopting Release clarifies that registered exchanges may structure themselves as for-profit organizations. This will allow ATSs, which are typically proprietary in nature, to choose to register as exchanges without having to change their current structure. <sup>24</sup> The term "pilot trading system" is defined in Rule 19b-5(c). <sup>25</sup> Before the two year period expires, however, the SRO must submit a rule filing to obtain permanent approval of the pilot trading system or it must stop operation of the system. - 6 - trading information.<sup>21</sup> Finally, all ATSs are prohibited from using in their name the word "exchange" or derivations of the word "exchange," such as the word "stock market."<sup>22</sup> C. Registration as a National Securities Exchange ATSs are only required to comply with Regulation ATS if they choose to register as a broker-dealer; ATSs, however, may choose instead to register as a national securities exchange.<sup>23</sup> An ATS registering as a national securities exchange must comply with all the current requirements of registered exchanges. For example, an ATS must perform all the self-regulatory responsibilities of an exchange, including enforcing compliance by its members, and persons associated with its

members, with the federal securities laws and the rules of the exchange. The Exchange Act also requires that registered exchanges have in place rules that assure fair representation of their members in the selection of directors and prohibits registered exchanges from granting new membership to any person not registered as a broker-dealer or associated with a broker-dealer. An ATS registering as an exchange also would be required to ensure the fair access of registered broker-dealers and would be prohibited from adopting any anti-competitive rules. In addition, registered exchanges must have adequate computer system capacity, integrity, and security to support the operation of the exchange and must comply with the procedures outlined by the SEC in its policy statements concerning its automation review program. An ATS registering as an exchange also would be required to trade only registered securities and would be expected to become a participant in the national market system.

**D. Temporary Exemption from Rule Filing Requirements for Pilot Trading Systems**

In order to provide SROs with an opportunity to better compete with ATSS registered as broker-dealers, the SEC adopted new Rule 19b-5. Rule 19b-5 allows SROs to operate new pilot trading systems<sup>24</sup> for up to two years without pre-approval by the SEC.<sup>25</sup> Currently, these entities are required to submit a rule filing to the SEC for approval before they are permitted to operate any new trading system. <sup>26</sup> An SRO must file Form PILOT at least twenty days before commencing operation of the pilot trading system. The SRO also must file an amendment on Form PILOT at least twenty days before implementing a material change to the operation of the pilot trading system. In addition, the SRO must file a quarterly report on Form PILOT within thirty calendar days after the end of each calendar quarter that would include information about the trading volume effected on the pilot trading system during the most recent calendar quarter.

- 7 - Under Rule 19b-5, in order to be exempt from submitting proposed rule changes to establish a pilot trading system, SROs must comply with certain requirements. In particular, SROs will be required to: (1) submit informational filings and reports on new Form PILOT,<sup>26</sup> (2) have in place written rules to provide fair access to the pilot trading system to all members of the SRO, (3) have in place written trading rules and procedures and listing standards, (4) establish internal procedures for the effective surveillance of trading activity, (5) establish reasonable clearance and settlement procedures, (5) limit the types of securities traded, (6) regulate the activities of specialists, (7) cooperate in examinations, inspections or investigations by the SEC of transactions effected on the pilot trading system, and (8) make publicly available all trading rules and procedures.

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