SECURITIES AND EXCHANGE COMMISSION

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[Release No. 34–39884; File No. S7–12–98]

RIN 3235–AH41

Regulation of Exchanges and Alternative Trading Systems

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: The Securities and Exchange Commission today is proposing 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 proposed Regulation ATS depending on their activities and trading volume. The Commission is also proposing amendments to Form 1 and related rules regarding registration as a national securities exchange. Finally, the Commission is proposing to exclude from the rule filing requirements certain pilot trading systems operated by national securities exchanges and national securities associations. These proposals would 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.

DATES: Comments should be submitted on or before July 28, 1998.

ADDRESSES: Interested persons should submit three copies of their written data, views and opinions to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–12–98. All submissions will be made available for public inspection and copying at the Commission's Public Reference Room, Room 1024, 450 Fifth Street, NW., Washington DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: Elizabeth King, Senior Special Counsel, at (202) 942–0140, Marianne Duffy, Special Counsel, at (202) 942–4163, Constance Kiggins, Special Counsel, at (202) 942–0059, Lauren Mullen, Special Counsel, at (202) 942–0196, Kevin Ehrlich, Attorney, at (202) 942–0778, and Denise Landers, Attorney, at (202) 942–0137, Division of Market Regulation, Securities and Exchange Commission, Stop 10–1, 450 Fifth Street, NW., Washington, DC 20549. For questions or comments regarding securities registration issues raised in this release, contact David Sirignano, Associate Director, at (202) 942–2870, Division of Corporation Finance, Securities and Exchange Commission, Stop 3–1, 450 Fifth Street, NW., Washington, DC 20549.

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I. Executive Summary

A. Introduction

Technological developments have changed our markets in many ways. They have greatly expanded the number of investment and execution choices, increased market efficiency, and reduced trading costs. Market participants have incorporated technology into their businesses to provide investors with an increasing array of services, and to furnish these services during more hours, often at lower prices. Many of these trading and business functions, however, were not foreseen by a regulatory framework designed more than six decades ago. In particular, market participants have developed a variety of alternative trading systems [1] that furnish services traditionally provided solely by registered exchanges. Consequently, the distinctions between markets, intermediaries, and service providers have blurred.

In light of these changes, in May 1997, the Securities and Exchange Commission (''Commission'' or ''SEC'') published a Concept Release,[2] which requested comment on ways to update the regulatory framework for alternative trading systems. In the Concept Release, the Commission considered two principal alternatives for the regulation of alternative trading systems. First, the Concept Release solicited comment on incorporating these systems into a tiered-exchange regulation framework, under which alternative trading systems would be subject to requirements tailored to their size and role in the market. Second, comment was solicited on increasing the Commission's oversight of alternative trading systems through enhanced broker-dealer regulation.

After reviewing the comment letters and current market conditions, the Commission is proposing to address the activities of alternative trading systems by combining the two approaches discussed in the Concept Release. Under today's proposal, alternative trading systems would be able to choose whether to: (1) Register as national securities exchanges under sections 5 and 6 of the Exchange Act; or (2) register as broker-dealers and comply with the additional requirements being proposed as new Regulation ATS.

B. Need for a New Regulatory Framework for Alternative Trading Systems

The federal securities laws have served the markets well. This basic regulatory structure has enabled the United States to have the safest, most liquid securities markets in the world. One of the principal reasons for these markets' success is the widely acknowledged benefit of securities markets that are free from fraud and manipulation. Moreover, the securities laws—to a great extent—have provided a level playing field so that competition among market participants can thrive. In addition, the Commission has worked to apply and implement the federal securities laws in a way that encourages our securities markets to take advantage of the many benefits of technology.

As a result, investors have available a wide range of options for executing their securities trades. In particular, alternative trading systems now handle more than twenty percent of the orders in securities listed on The Nasdaq Stock Market (''Nasdaq''), which represents an almost one percent increase from the previous year. Alternative trading systems also continue to trade 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, most alternative trading systems are regulated as broker-dealers. This creates disparities that affect investors, 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 (''NMS'') structure.

In 1996 Congress provided the Commission with greater flexibility in regulating new trading systems by adding Section 36 to the Securities Exchange Act of 1934 (''Exchange Act''). This Section gives the Commission broad authority to exempt any person from any of the provisions of the Exchange Act.[3] As a result, the Commission now has a greater ability to adopt a regulatory approach more tailored to today's securities markets, which will allow the Commission to integrate trading on alternative markets more fully into the NMS, without jeopardizing the commercial viability of these markets. The Commission is also now able to exempt registered exchanges from requirements that are unnecessary or inappropriate.

C. The Concept Release

On May 23, 1997, the Commission issued the Concept Release soliciting comment on ways to update the regulatory framework in light of the dramatic changes in the U.S. securities

[1] The Commission used the term ''alternative trading system'' in the Concept Release, *see infra* note 2, to describe trading systems not registered as exchanges. This term encompasses some systems that previous Commission releases called ''proprietary trading systems,'' ''broker-dealer trading systems,'' and ''electronic communications networks.'' The latter two terms are defined in Rules 17a–23 and 11Ac1–1 under the Exchange Act, 17 CFR 240.17a–23 and 240.11Ac1–1, respectively, and trigger specific regulatory obligations under those rules. In this release, the Commission is proposing to define the term ''alternative trading system.'' *See* Proposed Rule 300(a).

[2] Securities Exchange Act Release No. 38672, 62 FR 30485 (May 23, 1997) (''Concept Release'').

[3] 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 VI.D.1.

markets brought about by new and evolving technology.[4] The Concept Release began a dialogue about how the Commission should best respond to the legal and regulatory challenges created by both existing—and future—technological developments. In particular, the Commission asked for comment on how to effectively oversee alternative trading systems in general, and especially those that are becoming increasingly significant market centers. Although these alternative trading systems perform the functions of a market, they are not required to surveil their markets for manipulative activity, to make all of their quotes public, to treat participants fairly, or to maintain adequate capacity to prevent outages. Thus, as these alternative trading systems are increasingly used for trade execution, the existing regulations fail to provide investors with access to the best prices, or to integrate these systems fully into the NMS, including the surveillance and enforcement mechanisms operated by the registered exchanges and the National Association of Securities Dealers, Inc. (''NASD'').

The Concept Release solicited commenters' views on two principal approaches to address these concerns. Under the first approach, alternative trading systems would be incorporated into the Commission's regulation of exchanges under a three-tiered framework. Under the second approach, alternative trading systems would continue to be regulated as broker-dealers, but would be required to comply with rules designed to improve their transparency and surveillance, as well as their systems capacity, integrity, and security. A wide variety of market participants, including self-regulatory organizations (''SROs''), traditional broker-dealers, and alternative trading systems, provided the Commission with thoughtful comments on both of these approaches.[5]

In general, commenters supported the Commission's efforts to make the regulatory structure more responsive to technological innovation and agreed that the current structure should be revised to apply enhanced linkage, surveillance, and other requirements to alternative trading systems. A number of commenters agreed that technology has made the line between broker-dealers and exchanges more difficult to draw and that the roles of broker-dealers and exchanges are becoming increasingly interchangeable. Many commenters emphasized the need to make any new regulatory scheme flexible enough to accommodate the varying needs and structures of these market participants. Commenters differed considerably, however, on what the Commission's goals should be in enhancing the oversight of alternative trading systems, the extent of change necessary, and how to best achieve enhanced oversight. Consequently, there were few instances in which commenters were in consensus. Nevertheless, commenters did, generally, express a preference for continuing to regulate alternative trading systems as broker-dealers, rather than incorporating them into exchange regulation.

While some commenters argued that the importance of some electronic markets as trading venues justifies the imposition of exchange regulation, several regional exchanges and other market participants were not convinced that the exchange approach would fulfill the regulatory goals outlined in the Concept Release. Many commenters believed integrating alternative trading systems into existing surveillance mechanisms could impose burdens on both the market as a whole and the Commission. Many commenters noted that this approach could potentially lead to uneven and fragmented market oversight. At the heart of many of these objections was the fear that alternative trading systems would be forced to submit to some degree of exchange regulation, albeit modified for most systems, which could lead to structural changes. Commenters also feared that an exchange-based regulatory approach could frustrate innovation and reduce the benefits offered by alternative trading systems.

D. Current Proposal

Technological developments continue to change market structure. The Commission firmly believes that there should be a regulatory framework in place that makes sense both for current and future securities markets. This regulatory framework should encourage market innovation without compromising basic investor protections.

After considering the comment letters, the Commission is proposing to address the activities of alternative trading systems by combining the two approaches discussed in the Concept Release. This combined approach should allay commenters' concerns that a new regulatory scheme would not be flexible enough to accommodate the business objectives of, and the benefits provided by, alternative trading systems. Specifically, the Commission is proposing to allow an alternative trading system to choose whether to: (1) Register as a national securities exchange under sections 5 and 6 of the Exchange Act; or (2) register as a broker-dealer and comply with the additional requirements being proposed as new Regulation ATS.[6] The proposal set forth in this release is intended—to the extent consistent with the federal securities laws—to allow alternative trading systems to choose the market role that works best for them.[7] At the same time, this proposal is designed to preserve the benefits of a competitive market structure that has greatly enhanced market liquidity, transparency, and efficiency.

To implement this approach, the Commission is proposing Rule 3b–12 under the Exchange Act, which would define terms used in the statutory definition of ''exchange''[8] to encompass most alternative trading systems. This new rule would include any organization, association, person, group of persons, or system 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 subscribers entering such orders agree to the terms of a trade. Proposed Rule 3b–12 would specifically exclude those systems that only: (1) Route orders to a registered exchange, a market operated by a national securities association, or any broker-dealer; (2) display the quotes of a single dealer and allows persons to enter orders for execution against such dealer's quotes;[9] or (3) provide the means for a single broker-dealer to internally manage its customers' orders, including crossing or

[4] *See* Concept Release, *supra* note 2. The Concept Release also solicited comment on the Commission's regulation of foreign market activities in the United States. The proposals discussed in this release, however, do not address issues relating to foreign market activities in the U.S.

[5] The comment letters and a summary of comments have been placed in Public File S7–16–97, which is available for inspection in the Commission's Public Reference Room.

[6] *See infra* Section III.A. As discussed in the Concept Release, the government securities market is subject to its own specialized oversight structure. For this reason, the Commission does not believe it is necessary to change the regulation of alternative trading systems to the extent that they exclusively trade government securities. *See infra* notes 70 and 71 accompaning text.

[7] The Commission notes that organizations that conduct a regulatory function with respect to their members are excluded from the definition of alternative trading system. Consequently, such system would have to register as national securities exchanges. *See infra* notes 65 and 66 and accompanying text.

[8] The statutory definition of ''exchange'' appears in section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c(a)(1).

[9] The Commission would consider a customer order displayed by a dealer in its quote to be the ''dealer's quote'' for purposes of this exclusion, if a customer order were displayed solely to comply with a Commission or SRO rule.

matching such orders with each other provided that (i) those orders are not displayed to any person other than the broker-dealer and its employees and (ii) those orders are not executed according to a predetermined procedure that is communicated to the customers. Because most alternative trading systems are not encompassed by the Commission's current interpretation of ''exchange,'' [10] the Commission is also proposing to revise its interpretation to better reflect the ever-evolving securities markets and to give alternative trading systems the option of registering as national securities exchanges.

For alternative trading systems that choose to register as national securities exchanges, the Commission is proposing to accommodate their proprietary structure by amending the application for registration and providing guidance on ways for proprietary markets to meet their fair representation requirements as non-membership national securities exchanges.[11]

For alternative trading systems that choose to register as broker-dealers, the Commission is proposing new Regulation ATS, which would require alternative trading systems to comply with additional requirements designed to address the concerns raised by their market activities. To provide for continuing innovation and competition through the introduction of new alternative trading systems, the Commission proposes that systems with limited volume be required only to: (1) File with the Commission a notice of operation and quarterly reports; and (2) maintain records, including an audit trail of transactions. If, however, an alternative trading system with significant trading volume 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 NMS. Therefore, in addition to the requirements for smaller alternative trading systems, significant volume alternative trading systems that trade NMS securities would be required to link with a registered market in order to disseminate the best priced orders displayed in their systems (including institutional orders) into the public quote stream. They would also be required to comply with the same market rules governing execution priorities and obligations that apply to members of the registered market.[12] In addition, alternative trading systems with significant volume in any security, whether equity or debt, would be required to: (1) Grant or deny access based on 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. These requirements would more actively integrate those significant alternative trading systems into NMS mechanisms. Moreover, because alternative trading systems that choose to register as broker-dealers would not be required to surveil activities on their markets, the Commission intends to work with the SROs to improve the SROs' ongoing, real-time surveillance for market manipulation and fraud and to develop surveillance and examination procedures specifically targeted to alternative trading systems they supervise.

The Commission is also proposing to repeal Rule 17a–23.[13] This rule was adopted to provide the Commission with certain information about the activities of automated markets operated by broker-dealers. Alternative trading systems would continue to provide the Commission with information about their activities either as registered exchanges or as registered broker-dealers subject to Regulation ATS. Some broker-dealer trading systems that are currently subject to Rule 17a–23, however, would not be alternative trading systems. The Commission believes that these internal broker-dealer systems should, nevertheless, continue to keep records of trading conducted through these systems. Therefore, the Commission is proposing to amend Rules 17a–3 [14] and 17a–4 [15] under the Exchange Act to require that records of these transactions be maintained. Internal broker-dealer trading systems would, however, no longer have to report any information to the Commission.[16]

Finally, the Commission is proposing to allow SROs, without filing for approval with the Commission, to operate pilot trading systems for no more than two years. These pilot trading systems would be subject to specific conditions, including limitations on their trading volumes.[17]

E. Conclusion

The explosive growth of alternative trading systems over the past several years has significant implications for market regulation. The Commission believes it is critical to develop a regulatory framework that both accommodates traditional market structures and provides sufficient flexibility to ensure that new markets promote fairness, efficiency, and transparency. While the questions raised by technological developments in the U.S. markets could be addressed in a variety of ways, the Commission preliminarily believes that the regulatory approach proposed today would be the most effective way to facilitate these goals.

II. Proposed Rule 3b–12 Under the Exchange Act

As part of this new approach, the Commission is proposing new Rule 3b–12 under the Exchange Act. This rule would define terms used in the statutory definition of ''exchange,'' found in section 3(a)(1) of the Exchange Act.[18] 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 would define these terms 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.*[19] The Commission recognizes that the proposed rule would revise the current interpretation of the term ''exchange,'' as set forth in the *Delta Release*.[20]

The Commission believes that the proposed rule is an important element of its proposed 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. Many alternative trading systems provide services more akin to exchange functions than broker-dealer functions,

[10] The Commission's current interpretation of ''exchange'' is set forth in Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 FR 1980, 1900 (Jan. 19, 1990) (''*Delta Release*''). *See infra* Section II for a discussion of proposed Rule 3b–12.

[11] *See infra* Section III.B.

[12] 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 the extent that they trade securities other than NMS securities. *See infra* Section III.A.2.c.(i).

[13] 17 CFR 240.17a–23.

[14] 17 CFR 240.17a–3.

[15] 17 CFR 240.17a–4.

[16] *See infra* Section IV.

[17] *See infra* Section V.

[18] 15 U.S.C. 78c(a)(1).

[19] Proposed Rule 3b–12(a).

[20] *See Delta Release supra* note 10. The basis and purpose of the revised interpretation is set forth *infra* Section VI.

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 would more appropriately fit their economic functions. Thus, a broader interpretation of exchange is needed to cover 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.[21] The proposed rule would help modernize the Commission's approach to these systems because it would adapt the concept of what is ''generally understood'' to be an exchange to reflect changes in the markets brought about by automated trading. In addition, proposed Rule 3b–12 would closely reflect the statutory concept of ''bringing together'' buying and selling interests.

The Concept Release set forth a similar interpretation.[22] In response to commenters' concerns that any revised interpretation of exchange should not be so broad as to include traditional brokerage activities, proposed Rule 3b–12 would specifically exclude certain systems whose activities the Commission does not believe rise to the level of being an ''exchange.''[23] These specific exclusions are designed to clarify the types of activities the Commission would not consider to be exchange activities under proposed Rule 3b–12.

A. Consolidates the Orders of Multiple Parties

In order to be an exchange, a system must satisfy the first part of proposed Rule 3b–12(a)—*consolidate orders of multiple parties*. This incorporates 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. A system would be consolidating orders if it displayed trading interest entered on the system to system users. This would include consolidated quote screens, such as the system operated by Nasdaq.[24] A system would also be consolidating orders if it receives subscribers' orders centrally for future processing and execution. For example, limit order matching book systems that allow subscribers to display buy and sell offers in particular securities and to obtain execution against matching offers contemporaneously entered or stored in the system would be considered to consolidate orders. This type of consolidation is currently performed by systems that consolidate orders internally for crossing[25] or matching,[26] as well as floor based markets that impose trading rules. In addition, interdealer brokers[27] would be considered to consolidate orders, regardless of their level of automation.[28] On the other hand, systems that merely provide information, such as information vendors, would not be viewed as consolidating orders. Consolidation thus means that each order entered in the system for a given security has the opportunity to interact with other orders entered into the system for the same security.

In addition, the system's consolidation of orders must be of *multiple parties—i.e.*, multiple buyers and multiple sellers. Systems designed for the purpose of executing orders against a single counterparty, such as the dealer operating the system, would not be considered to have multiple parties. 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 proposed Rule 3b–12.[29] 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 parties. In addition, a system that has multiple sellers, but only one seller for each instrument, and multiple buyers for that instrument would not be considered to meet the ''multiple parties'' requirement.[30]

Finally, the proposed rule would make clear that the consolidation must be of participants' ''orders.'' The term ''order'' would be defined in paragraph (c) of proposed Rule 3b–12 to include any firm indication of a willingness to buy or sell a security, whether made on a principal or agency basis.[31] Firm indications of buying or selling interest would specifically include bid or offer quotations, market orders, limit orders, and any other priced order.

B. Non-Discretionary Material Conditions

In addition to consolidating the orders of multiple parties, in order to be an ''exchange'' under proposed Rule 3b–12, a system would have to *set non-discretionary material conditions under which parties entering orders agree to*

[21] *See infra* Section III.B. (discussing registration as a national securities exchanges).

[22] In the Concept Release, the Commission suggested expanding its interpretation of the term exchange ''to include any organization that both: (1) Consolidates orders of multiple parties; and (2) provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of a trade.'' *See* Concept Release, *supra* note 2, at 50.

[23] *See infra* Section II.C. (discussing paragraph (b) of proposed Rule 3b–12).

[24] An electronic bulletin board on which subscribing broker-dealers may post indications of interest in securities they wish to trade, and advertise trades they have recently conducted, would be considered to consolidate orders. For example, AutEx operates such a bulletin board. AutEx, however, would not be an exchange under the proposed interpretation because it does not set non-discretionary material conditions under which parties entering orders agree to the terms of a trade. AutEx does not require that the price and quantity quoted on the screen be firm, nor does AutEx set priorities that govern trades. Further, transactions resulting from posted indications of interest, if any, are executed outside AutEx. *See infra* Section II.B. discussing paragraph (a)(2) of proposed Rule 3b–12.

[25] 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.

[26] Matching systems allow participants to enter 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 with respect to matched orders, or contracts with another broker-dealer to perform this function.

[27] 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.

[28] *But see infra* notes 70 and 71 and accompanying text (discussing the exemption for systems that trade exclusively government securities).

[29] This type of system also would be expressly excluded from proposed Rule 3b–12 under paragraph (b)(2). *See infra* Section II.C.2.

[30] An example of this type of system is CP Direct in which issuers offer to sell their commercial paper to the customers of CS First Boston. *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 parties'' requirement. The Commission, however, is not aware of any system that currently operates this way.

[31] Proposed Rule 3b–12(c).

the terms of the trade. A system may establish non-discretionary material conditions either by providing a trading facility or by setting rules governing trading among subscribers. The Commission intends for ''non-discretionary material conditions'' to include any conditions that dictate the terms of trading among the multiple counterparties entering orders into the system. In other words, such conditions would include those that set procedures or priorities under which open terms of the trade will later be determined. For example, a system that trades limited partnership units might set non-discretionary material conditions even though approval from the general partner is required prior to settlement. Similarly, systems that allow the trading price to be determined at some designated future date on the basis of pre-established criteria (such as the weighted average trading price for the security on the specified date in a specified market) would be setting non-discretionary material conditions.

Trading rules or trading facilities that do not determine the manner of execution or the means for agreeing to the terms of a trade would not be considered to set non-discretionary material conditions. Similarly, rules that merely address the means of communication with a system (for example, software or hardware tools that subscribers may use in accessing the system), would not satisfy this element of proposed Rule 3b–12. Further, conditions would not be deemed material and non-discretionary unless they were communicated to subscribers. Thus, broker-dealers' internal order management and execution systems would not be exchanges.[32]

1. Non-Discretionary Material Conditions Established by a Trading Facility

A trading facility that sets non-discretionary material conditions would include a traditional exchange floor where specialists are available to receive orders, or a computer system (whether comprised of software, hardware, protocols, or any combination thereof) through which orders may interact, or any other trading mechanism that provides a means or location for the execution of orders. For example, the Commission would consider the use of an algorithm by an electronic trading system that sets trading procedures and priorities to be a trading facility that sets non-discretionary material conditions.

The Commission would 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 arranges for a third party vendor to distribute software to enable persons to access the system, that system would be deemed to have established a trading facility, even though system participants gained access via a third party provider. Similarly, if a bulletin board operator contracted with another party to provide execution facilities for the bulletin board users, the bulletin board would be deemed to have established a trading facility because it took affirmative steps to arrange for the necessary exchange functions for its users.[33] In addition, if an organization arranged for separate entities to provide different pieces of a trading system which together met the definition contained in paragraph (a) of proposed Rule 3b–12, the organization responsible for arranging the collective efforts would 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,[34] would together be an exchange. In this case, the arranging organization, Delta, would be considered the exchange under proposed Rule 3b–12.

2. Non-Discretionary Material Conditions Established by Setting Rules

Alternatively, a system can establish non-discretionary material conditions through the imposition of rules under which parties entering orders on the system may agree to the terms of a trade. For example, the NASD imposes basic rules by which securities will be 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.

In addition, the Commission would consider rules imposing execution priorities, such as time and price priority rules, to be non-discretionary material conditions. Similarly, the Commission would consider 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,*[35] to set non-discretionary material conditions.

The Commission believes it is appropriate to include markets, such as that operated by the NASD, in proposed Rule 3b–12, although it comprises a dealer market. Through Nasdaq, market participants act in concert to centralize and disseminate trading interest and establish the basic rules by which securities will be 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[36] and is operated by the NASD, a registered securities association under Section 15A of the Exchange Act.[37] 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.[38] Under the proposal, however, Nasdaq could choose to register under Section 6 of the Exchange Act as an exchange.[39]

C. Systems Not Included in Proposed Rule 3b–12

The Commission also asked in the Concept Release whether certain specific brokerage functions should be excluded from any revised exchange regulatory scheme. The Concept Release

[32] *See infra* Section II.C.3. (discussing the exclusion of internal broker-dealer systems from the coverage of proposed Rule 3b–12).

[33] Whether or not a bulletin board would be considered an exchange under the proposed rule would also depend on whether it met the other elements of the definition.

[34] *See Delta Release, supra* note 10.

[35] *See Delta Release, supra* note 10, at 1897.

[36] 15 U.S.C. 78k–1.

[37] 15 U.S.C. 78*o*–3. As a registered securities information processor, Nasdaq does not have SRO responsibilities itself. 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. 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. Nasdaq also surveils trading conducted on its market and refers potential violations to NASDR. The Commission is prepared to use its authority under sections 17 and 19 of the Exchange Act, 15 U.S.C. 78q and 78s, to allocate any obligations Nasdaq would have to enforce compliance by its members (and persons associated with its members) with the federal securities laws to NASDR. *See also infra* note 166.

[38] *See infra* notes 51–53 and accompanying text (discussing Proposed Rule 3a1–1(a)(1), which explicitly exempts any systems operated by a national securities association from the definition of the term ''exchange'').

[39] 15 U.S.C. 78f.

noted that unlike organized markets, traditional broker-dealer activities do not involve the systematic interaction of customer orders where the customers themselves are informed of and have an opportunity to agree to the terms of their trades (or agree to the priorities under which the terms will be set). The Concept Release specifically mentioned several types of activities that could be considered traditional brokerage activities, including routine intermediary functions performed by brokers, such as block positioning, the automation of internal order management where the matching of customer orders is incidental to the order management activities, the automation of order routing and execution for a single market maker, and other types of trading where the broker has discretion as to the means of execution.

Commenters widely agreed that automated brokerage functions should not be encompassed by the meaning of the term ''exchange.'' [40] The Commission agrees. The Commission has included paragraph (b) of proposed Rule 3b–12 to clarify those types of systems that the Commission does not believe should be encompassed within paragraph (a) of proposed Rule 3b–12. Paragraph (b) of Rule 3b–12 would expressly exclude: (1) Systems that merely route orders to other execution facilities; (2) systems that allow customers of a dealer to execute solely against the dealer's inventory; [41] and (3) systems that allow a broker-dealer to cross or match customer orders internally at the broker-dealer's discretion. These exclusions are intended to make clear that paragraph (a) of proposed Rule 3b–12 does not cover customary brokerage activity.

1. Order Routing Systems

Systems that merely route orders to an exchange or broker-dealer for execution, like the New York Stock Exchange's (''NYSE's'') SuperDOT [42] system and BRASS,[43] would be explicitly excluded from proposed Rule 3b–12,[44] because they do not consolidate orders. Instead, all orders entered into a routing system are sent to another facility that consolidates orders. In addition, routing systems do not set non-discretionary material conditions under which parties entering orders agree to the terms of the trade.

2. Dealer Quotation Systems

A sophisticated market maker that develops a system to disseminate its own quotations to the public, or to allow its customers to direct orders for execution solely against that market maker's inventory, is conducting broker-dealer activity. Such systems automate the order routing and execution mechanisms of a single market maker and guarantee that the market maker will execute orders submitted to it at its own posted quotation for the security or, for example, at the inside price quoted on Nasdaq. Because single market maker systems merely provide a more efficient means of communicating the trading interest of separate customers to one dealer, they should not be considered exchanges. Therefore, the Commission proposes that systems that display the quotes of a single dealer and allow customers to execute solely against those quotes be excluded under paragraph (b) of proposed Rule 3b–12. [45]

3. Internal Broker-Dealer Order Management and Execution Systems

Finally, a system that provides the means for a single broker-dealer to internally manage its customers' orders, including crossing or matching such orders with each other, would be specifically excluded from paragraph (a) of proposed Rule 3b–12, if : (1) No orders were displayed to persons other than the broker-dealer's employees; and (2) customer orders were not executed according to a predetermined procedure that is communicated to the customer.[46] For example, broker-dealers may automate part of their intermediary function by developing internal programs that allow traders within a firm to search and match orders with customer orders of other traders within the same firm, or with orders and quotes of other traders. Such systems, however, generally serve as a means of providing information regarding a firm's customer orders solely to the employees of the broker-dealer operating the system to facilitate the employees' crossing of customer orders on a discretionary basis, as described below.

While these internal systems automate traditional brokerage functions, they still require a broker-dealer to use its discretion to handle customer orders. In this situation, a customer that gives its order to a broker-dealer typically gives discretion to that broker-dealer to select the market where the order will ultimately be executed, how the order may be split up or ''worked,'' and whether the broker-dealer will execute the order as principal or as agent. Although a broker-dealer may disclose its standard practices to customers, ultimately these execution decisions are left to the discretion of the broker-dealer, consistent with its statutory responsibilities.[47] Unless otherwise agreed, customers have no other expectations that the broker-dealer will handle the order in accordance with its general broker-dealer obligations. The Commission views this type of system as merely automating traditional broker-dealer functions and not as a means for consolidating the orders of multiple parties.

Similarly, while block trading desks provide a central location where employees of a single broker-dealer trade side-by-side, they do not systematically consolidate the customer orders handled by those employees. Although an employee may ultimately match a customer order with another customer order from a trader sitting across the room, this does not operate as an organized mechanism for ensuring that customer orders are matched, crossed, or otherwise centralized.

The Commission is seeking comment on whether paragraph (a) of proposed Rule 3b–12 accurately captures the fundamental features of an exchange as that term is commonly understood, and whether the proposed exclusions from the definition are appropriate. In addition, the Commission seeks comment on whether there are other types of activities or organizations that should be specifically excluded from proposed Rule 3b–12.

[40] A number of commenters named specific brokerage activities that they believed should not be considered exchange activities. Commenters specifically feared that the revised interpretation of exchange set forth in the Concept Release would capture internal crossing networks, block trading desks, third market makers, OTC market makers, and dealer markets.

[41] *See supra* note 9.

[42] The NYSE's SuperDOT (Designated Order Turnaround) system enables firms to transmit market and limit orders in all NYSE-listed securities directly to the specialist post for execution. Some NYSE members also allow selected institutional customers to route their orders through the members' connection to SuperDOT. A similar system is operated by the American Stock Exchange (''Amex'') (Automated Post Execution Reporting system, or AutoPERS).

[43] 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 for execution.

[44] Proposed Rule 3b–12(b)(1).

[45] Proposed Rule 3b–12(b)(2).

[46] Proposed Rule 3b–12(b)(3).

[47] For example, a block positioner may ''shop'' the order around in an attempt to find a contra-side order that has been placed with another trader. In some cases, the block positioner may take the other side of the order, keeping the block as a proprietary position. This decision is dictated by market conditions and typically lies within the block positioner's discretion.

D. Exemption From the Definition of ''Exchange'' for Certain Alternative Trading Systems

Section 36 of the Exchange Act [48] 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 proposing Rule 3a1–1, which would exempt any alternative trading system that complies with Regulation ATS from the definition of ''exchange.'' [49] The Commission believes that this proposed 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 would encourage the development of new and innovative trading facilities. The Commission also believes that the proposed exemption is consistent with the protection of investors.

The Commission intends for the exemption provided by proposed Rule 3a1–1 to make clear that alternative trading systems that register as broker-dealers and comply with proposed Regulation ATS should not be treated as national securities exchanges. The Commission believes that the proposed requirements in Regulation ATS would address the market-like functions of alternative trading systems without treating them as exchanges under the Exchange Act, with the attendant requirements applicable to exchanges. An alternative way that the Commission could accomplish this would be to create an exclusion from the definition in paragraph (a) of proposed Rule 3b–12 for alternative trading systems that register as broker-dealers and comply with the provisions of proposed Regulation ATS. The Commission requests comment on whether this alternative is preferable to today's proposed exemption from the definition of ''exchange'' under Rule 3a1–1.

As described more fully below, an alternative trading system exempt from the definition of ''exchange'' under proposed Rule 3a1–1 would still have to meet certain requirements in proposed Regulation ATS, including broker-dealer registration, notice of operations, and recordkeeping and reporting. Trading systems with significant volume would also have requirements regarding market transparency, fair access, and systems capacity, integrity, and security. Paragraph (b)(1) of proposed Rule 3a1–1 would also condition the exemption on the absence of a Commission determination that the exemption in a particular case would not be necessary or appropriate in the public interest or consistent with the protection of investors.[50] If the Commission determined to exercise this authority, it would be required to provide notice to the affected alternative trading system and an opportunity for that alternative trading system to respond. The Commission would not expect to exercise this authority on a regular basis, but intends for it to be used only in extraordinary circumstances. The Commission requests comment on the scope, form, and conditions of the proposed exemption in Rule 3a1–1.

In addition, because national securities associations are subject to requirements virtually identical to those applicable to national securities exchanges,[51] proposed Rule 3a1–1 would also exempt from the definition of ''exchange'' any system operated by a national securities association.[52] 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, under the proposals in this release, alternative trading systems operated by national securities associations could continue to operate as they do now.[53]

III. 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.[54] The Commission believes that it is consistent with Congress' goals to integrate significant alternative trading systems into the NMS.

In the 1975 Amendments, Congress specifically endorsed the development of an NMS, and sought to clarify and strengthen the Commission's authority to promote the achievement of such a system.[55] Because of uncertainty as to how technological and economic changes would affect the securities markets, Congress explicitly rejected mandating specific components of an NMS.[56] 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 NMS in accordance with Congressional goals and objectives.[57]

Congress identified two paramount objectives in the development of an NMS: 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.[58] 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.[59] In particular, Congress found that it was in the public interest

[48] 15 U.S.C. 78mm.

[49] Proposed Rule 3a1–1(b). *See infra* note 65 for the definition of an alternative trading system.

[50] Proposed Rule 3a1–1(b).

[51] 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.

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

[53] Any alternative trading system, however, currently operated by a national securities association could choose to register as an exchange.

[54] *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).

[55] Pub. L. 94–29, 89 Stat. 97 (1975).

[56] *See* S. Rep. No. 75, *supra* note 54. ''[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.

[57] S. Rep. No. 75 *supra* note 54, at 8–9.

[58] S. Rep. No. 75 *supra* note 54, at 7; *see* Section 11A(a)(1)(C) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(C).

[59] *See* S. Rep. No. 75 *supra* note 54, at 104–05.

to assure ''fair competition * * * between exchange markets and markets other than exchange markets.'' [60]

To further NMS goals, Congress granted the Commission broad authority to make rules, including those to: (i) Prevent the use and publication of deceptive trade and order information; (ii) assure the prompt, accurate, and reliable distribution of quotation and transaction information; (iii) enable non-discriminatory access to such information; and (iv) assure that all broker-dealers transmit and direct orders for securities in a manner consistent with the operation of an NMS.[61] Moreover, Congress recognized that in order to implement NMS goals, the Commission would need to classify markets, firms, and securities and facilitate the development of ''subsystems within the national market system.'' [62]

The Commission believes its proposal today advances NMS 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 NMS mechanisms, and the quality of public secondary markets. Under the Commission's proposal, those alternative trading systems that have the most significant effect on our markets would be required to integrate their trading into NMS mechanisms. Alternative trading systems could choose to register either as national securities exchanges or as broker-dealers. Systems that elect broker-dealer regulation would be integrated into the NMS under proposed Regulation ATS if they have significant trading volume.[63] Discussed in Section III.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 would be obligated—like currently registered exchanges—to participate in the NMS mechanisms. Section III.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

The Commission is proposing Rule 300(a) under Regulation ATS, which would define the term ''alternative trading system'' as any system that: (1) Would constitute, maintain, or provide 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 proposed Rule 3b–12 of the Exchange Act; [64] and (2) would not regulate its members or surviel its own market.[65] This proposed definition excludes trading systems that conduct a regulatory function because the Commission believes that self-regulatory systems should be registered as exchanges.[66]

Under proposed Regulation ATS, alternative trading systems would have to register as broker-dealers and comply with certain additional requirements depending on their volume. Any alternative trading system that is registered as an exchange or that is exempt from such registration either because of its limited volume or because it is operated by a national securities association would be excluded from the scope of the proposed regulation. In addition, any alternative trading system that trades only government securities,[67] Brady Bonds,[68] and repurchase and reverse repurchase agreements involving government securities or Brady Bonds would be excluded as long as the alternative trading system is registered as a broker-dealer.[69]

In the Concept Release, the Commission solicited comment on whether it would be appropriate to exempt government securities broker-dealers from any new regulatory scheme for alternative trading systems. 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.[70] Unlike

[60] Section 11A(a)(1)(C)(ii) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(C)(ii). A fundamental goal of an NMS 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 54, at 101.

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

[62] S. Rep. No. 75 *supra* note 54, at 7.

[63] In addition to its authority under Section 11A of the Exchange Act, 15 U.S.C. 78k–1, the Commission is proposing 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 supra* Section VI.D.1.

[64] *See supra* Section II. (discussing proposed Rule 3b–12).

[65] Specifically, the proposed definition of ''alternative trading system'' is any ''organization, association, person, group of persons, or system (1) (t)hat 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–12 of [the Exchange Act]; and (2) [t]hat does not: (A) (s)et 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 (B) [d]iscipline subscribers other than by exclusion from trading.'' Proposed Rule 300(a).

[66] Nothing, however, prevents a registered exchange from giving up its self-regulatory functions to register as a broker-dealer.

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

[68] In 1989 Treasury Secretary Nicholas F. Brady announced an initiative for the reduction of third world indebtedness. Under the Brady Plan, U.S. creditor banks and a debtor country agree to convert some of the country's existing debt, which generally carries a floating market interest rate, into a bond that carries a fixed, often below market, interest rates. These bonds are referred to as Brady Bonds.

[69] In other words, these systems would not be required to register as either an exchange or to comply with the requirements of Regulation ATS. Proposed Rule 301(a)(4).

[70] *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 (22 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 as 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

surveillance of trading in equities and other instruments traded primarily on registered exchanges,[71] 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 believes that any further regulation of alternative trading systems that trade these types of government and other related securities is not necessary in light of the specialized oversight structures for these markets. Because of this specialized oversight structure, excluding alternative trading systems that solely trade government securities and other related securities from this proposal should not weaken coordination of overall market oversight or create competitive inequities among differently regulated entities that perform similar functions.

The Commission requests comment on its proposal to exempt alternative trading systems that trade solely government and other related securities from the proposed regulatory framework described in this release. The Commission also requests comments on whether other alternative trading systems that exclusively trade securities with special characteristics should be exempt from Regulation ATS.

2. Requirements for Alternative Trading Systems Subject to Regulation ATS

Discussed below are the proposed requirements for alternative trading systems that would be subject to Regulation ATS.

a. Membership in an SRO. Because alternative trading systems that choose to register as broker-dealers would not themselves have self-regulatory responsibilities, the Commission believes it is important for such systems to be members of an SRO. Most alternative trading systems are currently registered as broker-dealers and, therefore, are also members of an SRO.[72] The Commission believes it is appropriate to continue to require alternative trading systems that register as broker-dealers to be SRO members. 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 managed using the Commission's oversight.[73] The Commission understands some alternative trading systems may have concerns about SROs abusing their regulatory authority for competitive reasons. The Commission considers it part of its own oversight responsibility over SROs to prevent such actions by SROs.[74] Further, an alternative trading system that wished to avoid potential conflicts of interest altogether could choose to register as an exchange. The Commission 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.[75] Such a national securities association could be established solely for purposes of overseeing the activities of alternative trading systems.

The Commission expects SROs to enhance their current surveillance of alternative trading systems to provide a consolidated view of the market through an integrated audit trail. SROs should also incorporate relevant information regarding the entities trading on such systems into their existing surveillance programs. The proposed enhanced recordkeeping requirements for alternative trading systems should aid SRO oversight considerably in this regard.[76]

b. Notice of operation as an alternative trading system and amendments. Under proposed Regulation ATS, alternative trading systems would be required to file an initial operation report with the Commission on Form ATS at least 20 days prior to commencing operation.[77] Form ATS requests information about the alternative trading system, including how it will operate, its prospective subscribers, and the securities it intends to trade. In addition, the alternative trading system would have to describe procedures for reviewing systems capacity, security, and contingency planning. Form ATS is not an application and the Commission would not ''approve'' an alternative trading system before it began to operate. Form ATS would, instead, be a notice to the Commission. Because alternative trading systems would be required to register as broker-dealers under Regulation ATS, proposed Form ATS would request only information about an alternative trading system's market activities that would not be included in the information filed on Form BD. Alternative trading systems are currently required to report most of this information on Part I of Form 17a–23, which the Commission is proposing to repeal.[78]

An alternative trading system would also be required to notify the Commission of material changes to its operation by filing an amendment to Form ATS at least 20 calendar days prior to implementing such changes.[79] A material change would include, among other things, any change to the operating platform of an alternative trading system. Further, changes to the types of securities traded on, or to the types of subscribers to an alternative trading system would be material changes. Alternative trading systems would be required to notify the Commission in quarterly amendments of any changes to the information on Form ATS that had not been reported in a previous amendment.[80] Finally, if an

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.

[71] 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).

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

[73] 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.

[74] *See infra* note 84.

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

[76] Proposed Rule 301(b)(8).

[77] Proposed Rule 301(b)(2)(i) and Proposed Form ATS.

[78] 17 CFR 240.17a–23. *See infra* Section IV.A.

[79] Proposed Rule 301(b)(2)(ii).

[80] Proposed Rule 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. Proposed Rule 301(b)(2)(iv).

alternative trading system ceases operations, it would be required to promptly file a notice with the Commission.[81]

An alternative trading system would be required to provide a duplicate of each of these filings to surveillance personnel designated by the SRO of which it is a member.[82] The Commission is also proposing that the initial operation report, any amendments, and the report filed when an alternative trading system ceases operation be kept confidential. The Commission, however, requests comment on whether the information filed on Form ATS should be public.

The Commission solicits comment on the notice requirements in proposed Form ATS. Specifically, the Commission seeks comment on whether such requirements would be burdensome for alternative trading systems, and if so, whether the burden is inappropriate. The Commission also seeks comment on the proposed frequency of filings and whether more or less frequent filings would be preferable. Finally, the Commission seeks comment on whether it would be appropriate to permit or to require electronic filing of Form ATS and all subsequent amendments.

c. Market transparency. The Commission for many years has been concerned that the development of so-called ''hidden markets,'' in which a market maker or specialist privately publishes quotations at prices superior to the quotation information it disseminates publicly, impedes NMS objectives. Over the course of the last decade, certain alternative trading systems that allow subscribers to disseminate significant trading interest to other system subscribers without making this trading interest known to the public market have become significant markets in their own right. Because these systems are not registered as national securities associations or national securities exchanges, they are not currently required to integrate into the public quote the prices at which their subscribers are willing to trade. The use of these systems to facilitate transactions in securities at prices not incorporated into the NMS has resulted in fragmented and incomplete dissemination of quotation information.

Recent evidence suggests that the failure of the current regulatory approach to fully integrate trading on alternative trading systems into NMS mechanisms has impaired the quality and pricing efficiency of secondary equity markets, particularly in light of the explosive growth in trading volume on such alternative trading systems. Although these systems are available to some market participants, they frequently are not available to the general investing public. The ability of market makers and specialists to display different and potentially superior prices on alternative trading systems than those displayed on markets available to the general public created, in the past, the potential for a two-tiered market.[83]

For example, during the Commission's recent investigation of Nasdaq trading,[84] analyses of trading in the two most significant trading systems for Nasdaq securities (Instinet and SelectNet) revealed that the majority of bids and offers displayed by market makers in these systems were better than those posted publicly on Nasdaq.[85] Moreover, the Commission found that, because market makers could trade with other market professionals through non-public alternative trading systems, they did not have a sufficient economic incentive to adjust their public quotations to reflect more competitive prices.[86] Ultimately, the wider spreads quoted publicly by market makers increased the transaction costs paid by public customers, impaired the ability of some institutional investors to obtain favorable prices in some securities, and placed institutions at a potential disadvantage in price negotiations.[87]

In response to these findings, the Commission took steps to bring greater transparency into the trading environment of certain alternative trading systems. 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 electronic communications networks (''ECNs'').[88] The new 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 public quotation displays (''ECN Display Alternative'').[89]

These rules, however, were not intended to fully coordinate trading on alternative trading systems with public market trading.[90] While these rules have helped integrate orders on certain alternative trading systems into the public quotation system, they only affect trading that is conducted by market makers and specialists, unless the system voluntarily undertakes to disclose institutional orders that reflect the best prices.[91] In many cases, institutional orders, as well as non-market maker orders, remain undisclosed to the public.[92] Moreover,

[81] Proposed Rule 301(b)(2)(v).

[82] Proposed Rule 301(b)(2)(vii).

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

[84] Following the filing of several class action lawsuits alleging collusion among Nasdaq market makers, and public allegations that Nasdaq market makers routinely refused to trade at their published quotes, intentionally reported transactions late in order to hide trades from other market participants, and engaged in other market practices detrimental to individual investors, the Commission opened a formal inquiry to investigate the functioning of the Nasdaq market and to determine whether the NASD was complying fully with its obligations as an SRO. In 1996, as a result of the investigation, the Commission instituted enforcement proceedings against the NASD pursuant to section 19(h) of the Exchange Act and issued a report under section 21(a) of the Exchange Act detailing the Commission's findings. 15 U.S.C. 78s and 78u(a). *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'').

[85] These conclusions are based on Instinet and SelectNet data for the months April through June 1994. *See* NASD 21(a) Report, *supra* note 84, at notes 48 to 52 and accompanying text.

[86] The Commission found that ''the ability of market makers to attract trading interest through Instinet allowed them to trade without using odd-eighth quotes and narrowing the Nasdaq spread.'' NASD 21(a) Report, *supra* note 84, at 20.

[87] NASD 21(a) Report, *supra* note 84, at 18.

[88] ECNs include any automated trading mechanism that widely disseminates market maker orders to third parties and permits such orders to be executed through the system, other than crossing systems. *See* Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (''Order Handling Rules Adopting Release'').

[89] To date, six 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); and 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).

[90] *See* Order Handling Rules Adopting Release, *supra* note 88, at 87–96.

[91] 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. Of the six ECNs that are currently linked to Nasdaq, three ECNs display to the public the best prices of any orders entered into their systems (including both market makers and institutions). The other three ECNs display to the public only orders of market makers, unless institutional customers of these ECNs choose to have their orders so displayed.

[92] Because such trading interest frequently remains undisclosed, within certain alternative

whether an ECN reflects the best priced quotations in the public quotation system on behalf of market makers and specialists that participate in its system is voluntary.

Because certain trading interest on alternative trading systems is not integrated into the NMS, 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.[93]

In addition, the Commission believes that it may be inconsistent with congressional goals for an NMS that the best trading opportunities are made accessible only to those customers who, due to their size or sophistication, can avail themselves of prices in alternative trading systems not currently available in the public quotation system. 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.

Accordingly, as described in more detail below, the Commission is proposing to further enhance transparency of orders displayed on alternative trading systems to ensure that publicly displayed prices more fully reflect market-wide supply and demand. Specifically, the Commission proposes that alternative trading systems with significant volume be required to disseminate their best priced orders (including institutional and non-market maker orders) into the public quotation system. Further, the Commission is proposing that alternative trading systems subject to these display requirements provide brokers and dealers with access to displayed orders.

(i) Integration of Orders Into the Public Quotation System

Under Proposed Rule 301(b)(3), the Commission proposes to further integrate alternative trading system quotes (priced orders) into the NMS. To accomplish this, an alternative trading system that displays subscriber orders to more than one person (other than alternative trading system employees) would be required to disseminate in the public quotation system the best priced orders in a covered security[94] in which, during at least four of the last six months, it traded more than ten percent of the aggregated average daily share volume for such security.[95] The Commission requests comment on whether the proposed volume threshold would effectively ensure that alternative trading systems comprising a significant percentage of the market are subject to basic market transparency requirements. In particular, the Commission requests comment on whether different volume thresholds are more appropriate for certain securities or types of alternative trading systems. Should the volume threshold be more or less than ten percent, or calculated on a basis other than four of the preceding six months?

The Commission is proposing that the display requirement be applied on a security-by-security basis. Thus, an alternative trading system would not have to display the best orders for any securities in which its trade volume accounted for less than ten percent of the total volume for such security. The Commission, however, requests 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. If commenters believe this type of requirement would be appropriate, the Commission requests comment on what number or percentage of securities would be an appropriate threshold to mandate display of the best priced orders of all securities. It should also be noted that the Commission is not proposing to require alternative trading systems to publicly display orders for securities in which no quotation data is disseminated. This means that trading systems—regardless of their size—would not have to publicly disseminate orders for fixed-income securities or equity securities that are not traded on an exchange or through Nasdaq.

The Commission is proposing today only to require 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, this proposal would not require those orders to be integrated into the public quote stream. In addition alternative trading systems would not be 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.

In this regard, the Commission's proposal would 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 these subscribers to display orders incrementally. For example, such a subscriber that wished 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 were to be displayed to other alternative trading system subscribers at a time. In this situation, only 10,000 shares would be required to be reflected in the public quote. Because the Commission would only require that an alternative trading system publicly display those orders that are displayed to alternative trading system participants, these subscribers could shield their orders from public view if they chose not to display their orders to other participants.

However, if the institution or non-market maker subscriber specified that the entire 100,000 share order were to be displayed to all subscribers at once, the order would have to be publicly displayed if it were the best priced order in the alternative trading system. The Commission, however, requests comment on whether alternative trading systems should be required to display

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.

[93] *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).

[94] A covered security would be defined in the same way as it is under Rule 11Ac1–1(a)(6) under the Exchange Act. 17 CFR 240.11Ac1–1. Specifically, a ''covered security'' would be 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* Proposed Rule 300(g). Accordingly, a covered security would include all exchange-listed securities, Nasdaq NM securities, and Nasdaq SmallCap securities.

[95] Proposed Rule 301(b)(3)(ii)(A). These orders would then be included in the quotation data made available to quotation vendors by national securities exchanges and national securities associations pursuant to Rule 11Ac1–1 under the Exchange Act, 17 CFR 240.11Ac1–1.

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.

This proposal is consistent with many commenters' recommendation that alternative trading systems be required to display all orders in the public quotation system and that alternative trading systems be more fully incorporated into the NMS.[96] For example, the NYSE suggested that the Commission extend the Order Handling Rules to further integrate alternative trading system trading interest into the NMS, perhaps by matching an alternative trading system with an SRO to reflect that alternative trading system's trading interest in the SRO's quotation.[97] The NASD similarly suggested that transparency could be improved and market fragmentation minimized by requiring the inclusion of non-market maker order information in the NBBO. The NASD pointed out the continued existence of a ''two-tier market,'' despite the new Order Handling Rules, because of the absence of any requirement for ECNs to display orders from institutions and other non-market makers in the public quote system.[98]

The Commission preliminarily believes that in light of the significant trading volume on some alternative trading systems, integration of these orders into the NMS may be essential to prevent the development of a two-tiered market. In response to commenters' concerns that a loss of trading anonymity would adversely affect the value that alternative trading systems provide to institutions, the Commission's proposal would allow an alternative trading system to 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, would preserve the benefits associated with anonymity. Moreover, the Commission preliminarily 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 would give institutions the ability to keep their full trading interest private. Requiring high volume alternative trading systems to furnish to the public quotation system the full size of the best displayed buy and sell orders would 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 may substantially strengthen the NMS.

A number of commenters recommended that the Commission not require alternative trading systems to publicly display all orders in the public quotation system.[99] The Commission understands that some commenters were concerned that a requirement to display institutional trading interest in the public quotation system might increase its market impact.[100] The types of impact which concerned these commenters included adverse effects on volatility, resulting in worse trade executions for institutional trading interests.[101]

Moreover, some commenters have expressed concerns that requiring the public display of institutional orders may create a disincentive for institutions to continue to route their orders to any alternative trading system subject to such a requirement. These commenters believe that a public display requirement would encourage institutions to route their orders to execution venues that do not offer any pre-trade transparency.

In light of these concerns, the Commission requests 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

[96] *See* Letter from Robert H. Forney, President and Chief Executive Officer, Chicago Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''CHX Letter'') at 1, 13–14 (the integration of alternative trading systems into the NMS and the transition to decimal trading highlights the need for Commission action in establishing minimum trading increments for NMS securities); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''ICI Letter'') at 2, 6 (Commission should enhance the NMS by requiring specialists and market makers to provide access to their limit orders in the same manner as alternative trading systems and by establishing linkages between alternative trading systems, market makers, and exchanges); Letter from Adam W. Gurwitz, Vice President Legal and Secretary, Cincinnati Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Oct. 2, 1997 (''CSE Letter'') at 2 (broker-dealers that operate alternative trading systems should make all orders in those systems available to the public quotation system); Letter from Charles J. Henry, President and Chief Operating Officer, Chicago Board Options Exchange, to Jonathan G. Katz, Secretary, SEC, dated Oct. 2, 1997 (''CBOE Letter'') at 4 (development of alternative trading systems should occur within the framework of the NMS); Letter from Daniel Parker Odell, Assistant Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC, dated Oct. 17, 1997 (''NYSE Letter'') at 4 (the best way to advance transparency is by enhancing the dissemination of, and access to alternative trading systems market interest through existing NMS facilities); Letter from Robert W. Seijas and Joel M. Surnamer, Co-Presidents, The Specialist Association, to Jonathan G. Katz, Secretary, SEC, dated Oct. 24, 1997 (''Specialist Assoc. Letter'') at 2 (alternative trading systems that trade NMS securities operate largely outside the NMS; this situation should be corrected).

[97] NYSE Letter at 4. *See also* Letter from R. Warren Langley, President and Chief Operating Officer, Pacific Exchange, to Jonathan G. Katz, Secretary, SEC, dated Oct. 20, 1997 (''PCX Letter'') at 18 (to achieve complete transparency, it is necessary to publicly disseminate information regarding the size and price of all prospective interest for each security, as well as the trade price and volume of completed transactions from all markets trading that security).

[98] Letter from John C. Conley, Secretary, NASD, Nasdaq, and NASD Regulation, to Jonathan G. Katz, Secretary, SEC, dated Oct. 10, 1997 (''NASD Letter'') at 7. *See also* Letter from Kenneth Pasternak, President and CEO, and Walter Raquet, Managing Director, Knight Securities, LP, to Jonathan G. Katz, Secretary, SEC, dated Sept. 11, 1997 (''Knight Letter'') at 3 (the continued exemption of non-market maker information from the public quotation system is damaging to competing over-the-counter market makers, and inconsistent with fair and reasonable regulation).

[99] *See* Letter from Daniel Jamieson, to Jonathan G. Katz, Secretary, SEC, dated July 23, 1997 (''Jamieson Letter'') at 4–5; Letter from Jonathan R. Macey, J. DuPratt White Professor of Law and Director, John M. Olin Program in Law and Economics, Cornell Law School and Maureen O'Hara, Robert W. Purcell Professor of Finance, Cornell University, to Jonathan G. Katz, Secretary, SEC, dated Oct 1. 1997 (''Macey and O'Hara Letter'') at 44–45; Letter from William A. Lupien, Chairman and Chief Executive Officer, OptiMark Technologies, Inc., to Jonathan G. Katz, Secretary, SEC, dated Oct. 6, 1997 (''OptiMark Letter'') at 6–7; Letter from Sam Scott Miller, Orrick, Herrington & Sutcliffe, LLP, to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''OHS Letter (10/3/97)'') at 14–15 (institutions and other non-market maker subscribers should not be required to sacrifice the benefits of limiting the size of their displayed orders because of their use of technology); Letter from Douglas M. Atkin, Instinet, to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''Instinet Letter'') at 12–15 (mandating pre-trade transparency could result in illiquid markets); Letter from John M. Liftin, Chair, Committee on Federal Regulation of Securities and Roger D. Blanc, Chair, Subcommittee on Market Regulation, American Bar Association, to Jonathan G. Katz, Secretary, SEC, dated Oct. 1, 1997 (''ABA Letter'') at 22–24; Letter from Lou Eccleston and Kevin M. Foley, Bloomberg L.P., to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''Bloomberg Letter'') at 8–9; ICI Letter at 3. *Cf.* Letter from A.B. Krongard, Chairman, SIA Task Force on Alternative Trading System Concept Release, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''SIA Letter (10/3/97)'') at 13 (tentatively supporting the display of the prices of the institutional orders in alternative trading systems, but not the size of such orders).

[100] ABA Letter at 24. *See also* Macey and O'Hara Letter at 45 (commenting that requiring institutional orders to be displayed would reduce market liquidity by reducing both trading volume and investors' incentives to engage in searches for better priced orders).

[101] ABA Letter at 24.

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.

In addition, the alternative approach would contain a separate provision requiring an alternative trading system to provide its institutional subscribers with an ongoing opportunity to decide whether or not to make their orders available for display to the public quotation system. Such a provision would require an institutional subscriber to affirmatively make the decision to opt out of displaying its orders to the public quote. In this regard, an alternative trading system would have to provide that any default setting offered by the system would be set for public display, unless the institutional subscriber affirmatively indicated otherwise. Further, the Commission would interpret this provision to prohibit an alternative trading system from taking any action to discourage its institutional subscribers from choosing to display their orders to the public quote. Except for these differences, this alternative would operate in the same fashion as proposed Rule 301(b)(3). The Commission requests comment on whether such an alternative would sufficiently address the Commission's concerns with transparency and fragmentation in the markets.

The Commission encourages commenters to address whether the proposed transparency requirements achieve the Commission's goals of minimizing the negative effects of fragmented markets, and to offer suggestions for other ways to achieve this goal. The Commission also requests comments and data regarding institutional use of alternative trading systems and the resulting impact of this proposal on market liquidity and pricing. In addition, the Commission requests comment on the most efficient method of integrating an alternative trading system's orders into the quotation system of a national securities exchange or national securities association. Finally, the Commission requests comment on whether institutional orders above a certain size should not be required to be displayed. If so, commenters are requested to specify what size order above which it would be appropriate to allow institutions to elect not to publicly display.

(ii) Access to Publicly Displayed Orders

The Commission is also proposing that alternative trading systems be required to provide non-subscriber broker-dealers equivalent access to the orders alternative trading systems would be required to disseminate in the public quotation system. The Commission agrees with those commenters who stressed the importance of equivalent access for non-participants and stated that requiring alternative trading systems to display prices in the public quotation system would not go far enough to facilitate the best execution of customer orders without a mechanism to access orders at those prices.[102] For example, the SIA commented that it would be reasonable to require alternative trading systems to provide non-participants access to orders in alternative trading systems, provided that access is offered through an entity that meets the general standards for system participants (*e.g.*, credit quality or net worth) and that access is provided through an entity that can provide appropriate clearance and settlement (unless the alternative trading system provides a clearance and settlement mechanism).[103] The NYSE noted that fostering transparency and market coordination also requires enhanced access to alternative trading systems through the Intermarket Trading System (''ITS'').[104] 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 NMS. Therefore, the Commission is proposing that alternative trading systems afford all non-subscriber broker-dealers equivalent access to orders displayed in the public quote, similar to the manner in which ECNs currently comply with the ECN Display Alternative under the Quote Rule.[105]

In particular, the Commission believes that an alternative trading system should allow non-subscribing broker-dealers to execute against the best priced order to the same extent as would be possible had that price 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. In addition, the Commission 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. For example, under the Integrated Order Delivery and Execution System proposed by the NASD,[106] alternative trading systems linked to Nasdaq would be required to take automatic executions up to the displayed size of orders in their systems. The Integrated Order Delivery and Execution System would replace Nasdaq's Small Order Execution System (''SOES'') and SelectNet (and related NASD rules), while maintaining features of each.

In its letter commenting on the Concept Release, Bloomberg suggested that alternative trading systems should be permitted to establish a direct connection with non-participants so that alternative trading systems would not be affected by any delay caused by an SRO's system to which it is linked.[107] The Commission questions whether this proposal is feasible, however, because such a connection would not permit the non-participant's

[102] Specialist Assoc. Letter at 10 (recommending that alternative trading systems be required to afford all non-participant broker-dealers equivalent access to orders in their systems); Letter from Jeffery T. Brown, Smith Lodge & Schneider (for Block Trading Inc.), to Jonathan G. Katz, Secretary, SEC, dated Oct. 7, 1997 (''SLS Letter'') at 4.

[103] SIA Letter (10/3/97) at 13. *See also* ABA Letter at 24 (commenting that the Commission consider whether the present SelectNet linkage to ECN prices provides an adequate model on which to base any future non-subscriber access to alternative trading system orders). *But see* Letter from Dan Sheridan, Head of Market Regulation, London Stock Exchange, to Richard R. Lindsey, Director, Division of Market Regulation, SEC, dated Sept. 2, 1997 (''LSE Letter'') at 8 (recommending that alternative trading systems be able to restrict access to executions if a particular non-participant is a credit risk, has a history of unresolved positions, or outstanding fees).

[104] NYSE Letter at 4. *See also* PCX Letter at 30 (noting that non-participant broker-dealers should have ''reasonable'' access to execute orders in an alternative trading system, but this access does not necessarily have to be as quick or convenient as direct participants' access to orders in the alternative trading system).

[105] Rule 11Ac1–1 under the Exchange Act, 17 CFR 240.11Ac1–1 (''Quote Rule''). *See also* Order Handling Rules Adopting Release, *supra* note 88.

[106] Securities Exchange Act Release No. 39718 (Mar. 4, 1998), 63 FR 12124 (Mar. 12, 1998). The Integrated Order Delivery and Execution System would feature a voluntary central limit order file that all market participants would be able to access either directly or through an Integrated Order Delivery and Execution System participant. Registered NASD members and certain customers they sponsor would be able to deliver various sized orders through the Integrated Order Delivery and Execution System to electronically access displayed quotations. Orders would remain anonymous until they are executed.

[107] Bloomberg Letter at 6–7 (recommending that the Commission establish an alternative to the SelectNet linkage for non-participant execution against displayed ECN orders which would allow an ECN to directly connect non-participants to its system without the three-second delay that currently accompanies access through SelectNet).

order to interact with any orders, other than those in the alternative trading system. In addition, a non-participant order sent through an SRO's system would not reach an alternative trading system that had provided a direct link for non-participants in lieu of a link to the SRO. The Commission asks for comment on whether the proposal to require alternative trading systems to provide equivalent access to displayed orders is appropriate and whether there are any reasons that non-participants of alternative trading systems should not be able to access such orders. Is there a feasible way to allow market-wide order interaction without linkage to SRO order execution systems? Is there a feasible way to grant equivalent non-subscriber access to institutions that are not broker-dealers?

(iii) Execution Access Fees

The Commission agrees with those commenters that suggested that fee schedules should not be used to circumvent the ability of non-participants to access a system's publicly displayed orders.[108] The Commission also understands that competitive forces will help determine appropriate fees.[109] Therefore, although reasonable fees are a component of equal access, the Commission is not proposing to set specific fees that alternative trading systems may charge. Rather, the fees would be determined by the system's internal cost structure.

The Commission, however, intends that fees charged not have the effect of denying non-subscribers access to the alternative trading system's publicly displayed orders. Under Regulation ATS, the Commission proposes to prohibit alternative trading systems subject to the display and execution access requirements under proposed Rule 301(b)(3) from charging broker-dealers for access to publicly displayed orders in excess of the fee charged by the alternative trading system to a substantial proportion of its existing broker-dealer subscribers. Specifically, under proposed Rule 301(b)(4), the highest fee an alternative trading system would be permitted to charge non-subscribers would be the lesser of the fee charged by the alternative trading system to a substantial portion of its existing broker-dealer subscribers or the fee permitted under the rules of the applicable national securities exchange or national securities association. The Commission preliminarily 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 be authorized to assure that fees charged by alternative trading systems to non-subscribers are consistent with fees typically charged by the exchange or association for access to displayed orders. Therefore, if the exchange or association did not permit any fees for access to the quotes on the system operated by the exchange or association, the exchange or association could prohibit the alternative trading system from charging fees to non-subscribers, regardless of the fees it charged to subscribers. Alternatively, the exchange or association could use this authority to 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.

The Commission requests comment on whether there are any reasons that alternative trading systems should be allowed to charge higher fees to non-participants than would be allowed under the proposed rule. The Commission also requests comment on whether there are alternatives for assuring fair execution access for non-subscribers or another test for determining whether the non-subscriber fees assure equal access. Finally, the Commission requests comment on whether fees should be included in the price of an order quoted to the public. The Commission is aware that while orders are displayed in fractions this might prove untenable, but would like commenters' views on this approach assuming orders are quoted in decimals. If this approach is taken, how would variations in a pricing schedule be taken into account?

The proposed rule is intended to ensure that no alternative trading system sets fees that render its system inaccessible to the investing public through non-participant broker-dealers. Further, 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.[110] In addition, to foster equivalent access to alternative trading systems for exchange-listed securities, the Commission would expect 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.

(iv) Amendment to Rule 11Ac1–1 under the Exchange Act

The Commission is also proposing an amendment to Rule 11Ac1–1 under the Exchange Act (''Quote Rule'').[111] 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.[112] Today's proposed 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. 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.[113] These requirements are intended to ensure that markets treat investors fairly.[114] Under the current regulatory approach, however, there is no regulatory redress for unfair denials or limitations of access by alternative trading systems. The availability of redress for such actions 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,

[108] *See* LSE Letter at 7; Bloomberg Letter at 11. *See also* Knight Letter at 8 (all fees charged by SelectNet, SOES, or an ECN should be borne by the taker of liquidity and should be based upon actual costs to ensure that fees are not subsidizing other activities).

[109] *See* Letter from Junius W. Peake, Mofort Distinguished Professor of Finance, University of Northern Colorado, to Jonathan G. Katz, Secretary, SEC, dated July 14, 1997 (''Peake Letter (7/14/97)'') at 15; ABA Letter at 24; PCX Letter at 31.

[110] *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).

[111] Proposed Amended Rule 11Ac1–1(c)(5)(ii) (A) and (B).

[112] *See supra* notes 88–92 and accompanying text.

[113] 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).

[114] ''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 nation market system.'' H.R. Rep. No. 123, 94th Cong. 1st Sess. 53 (1975).

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 proposing to require alternative trading systems with significant trading volume to publicly display their best bid and offer and provide equal execution access to those orders,[115] 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 participation in an alternative trading system, access to the best bid and offer through an SRO is an incomplete substitute. Therefore, the Commission proposes to require 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.[116]

While some commenters did not believe fair access requirements were warranted, they based this conclusion on their belief that denials of access have not been a problem.[117] The Commission, however, is aware of instances in which alternative trading systems applied access standards inconsistently.[118] Consequently, the Commission agrees with commenters who recommended that alternative trading systems provide fair access to subscribers if such systems attain a significant proportion of trading in a security.[119]

Specifically, the Commission is proposing 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 more than twenty percent of the average daily share volume in any equity security or category of debt.[120] For equity securities,[121] the proposed volume threshold is on a security-by-security basis. Accordingly, if an alternative trading system accounts for greater than twenty percent of the share volume in any equity security, it would be subject to the proposed fair access requirements with respect to that security. The Commission requests comment on whether the twenty percent threshold is appropriate, or whether the volume threshold should be higher or lower than twenty percent. The Commission also requests comment on the best method for an alternative trading system to notify interested parties that its system had reached the volume threshold in a given security. Should the designated examining authority, for example, publish such information for its members?

For debt securities, the Commission proposes that if an alternative trading system accounts for more than twenty percent of the volume in any category of debt security, the alternative trading system would be subject to the fair access requirements with respect to that category. The Commission requests comment on the appropriate categories of debt securities and whether the twenty percent volume threshold is appropriate. For example, the Commission would like comments on categories such as mortgage and asset-backed securities (private label issues only), municipal securities, corporate debt securities, foreign corporate debt securities, and sovereign debt securities. The Commission also requests comment on whether categories of debt securities should be further divided based on an instrument's maturity, credit rating, or other criteria. The Commission also requests comment on the best sources of data for the volume of a particular debt category.

For alternative trading systems that meet the proposed volume thresholds, the Commission is proposing to require those alternative trading systems to establish standards for granting access to trading on its system. An alternative trading system would be required to maintain these standards in its records,[122] but would not be required to provide the Commission with such standards, unless a person denied or limited access to the alternative trading system appealed that action to the Commission. In addition, the alternative trading system would be prohibited from unreasonably prohibiting or limiting any person with respect to access to its services and would be required to provide notice to any person denied or limited access to the alternative trading system that they have a right to appeal the alternative trading system's action to the Commission under the Commission's Rules of Practice.[123]

This right to appeal would be created through several amendments to the Commission's Rules of Practice. In particular, the Commission proposes to amend Rule 420 under the Commission's Rules of Practice [124] to allow a person who is aggrieved by an alternative trading system determination that prohibits or limits that person's access to services to file an application for review by the Commission. The Commission also proposes to amend Rule 410 under the Commission's Rules of Practice [125] so that a person who is aggrieved by a limitation or prohibition of access can move for a stay of action by the alternative trading system pending an appeal. Finally, the Commission proposes to amend Rules 101(a)(9),[126] 202(a),[127] 210(a)(1),[128] and 421 under the Commission's Rules of Practice [129] to include references to alternative trading systems so that the Commission's Rules of Practice with

[115] *See supra* Section III.A.2.c.(ii).

[116] Proposed Rule 301(b)(5).

[117] *See* NASD Letter at 7–8; ICI Letter at 3.

[118] The Commission understands that the NASD is currently reviewing a complaint against an alternative trading system for an unreasonable denial of access.

[119] *See* Jamieson Letter at 7; SLS Letter at 4; Letter from Christopher J. Carroll, Concept Release Task Force, The Bond Market Association, to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''Bond Market Assoc. Letter'') at 10–11. *See also* OptMark Letter at 5–6 (commenting that unreasonable denials of access raise concerns about anticompetitive behavior); LSE Letter at 9 (commenting that alternative trading systems not be required to make the system available to the public generally, but that such systems should not discriminate unfairly and that objective access standards for admission and acceptance should be established by alternative trading systems, subject to oversight by the Commission or the SROs).

[120] Proposed Rule 301(b)(5)(i).

[121] Section 3(a)(11) of the Exchange Act, 15 U.S.C. 78c(a)(11); 17 CFR 240.3a11–1. Options and limited partnerships are included within the definition of an equity security.

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

[123] Proposed Rule 301(b)(5)(ii).

[124] 17 CFR 201.420.

[125] 17 CFR 201.410.

[126] 17 CFR 201.101(a)(9).

[127] 17 CFR 201.202(a).

[128] 17 CFR 201.210(a)(1).

[129] 17 CFR 201.421.

respect to the appeals process apply to allegations of unfair denials of access by alternative trading systems.

These provisions are based on the principle that qualified market participants should have fair access to the nation's securities markets. Alternative trading systems would remain free to have reasonable standards for access. Such standards should act to prohibit *unreasonably* discriminatory denials of access. A denial of access would be reasonable, for example, if it were based on objective standards. For example, an alternative trading system could establish minimum capital or credit requirements for subscribers. Similarly, an alternative trading system could reasonably deny access to investors based on an unfavorable disciplinary history. 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 based solely on the trading strategy of a potential participant.

The Commission requests comment on its proposal to prohibit alternative trading systems with significant volume from unfairly discriminating against market participants in providing access. The Commission seeks commenters views regarding appropriate reasons for denying market participants access to an alternative trading system.[130] The Commission would also like commenters' views on whether the proposed fair access requirement would achieve the Commission's goal of promoting fair access to systems having a significant portion of the market in a particular security. The Commission requests comment on whether an alternative trading system should be required to provide fair access to *all* securities it trades when it reaches the twenty percent threshold in a security. Should fair access be granted only with respect to those securities that have reached the threshold, or with respect to all securities? Should access be granted to all after a certain number or percentage of securities traded have reached the twenty percent threshold? If so, what number or percentage? In addition, the Commission would like commenters' views on whether persons denied access to an alternative trading system should have the right to appeal this action to the Commission, the form the appeal should take, and the appropriate standard for Commission review.

e. Capacity, integrity, and security standards. In November 1989 and May 1991, the Commission published two policy statements regarding the use of technology in the securities markets.[131] 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.[132] 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.

The automation review program was established because of ''the impact that systems failures have on public investors, broker-dealer risk exposure, and market efficiency.''[133] 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.[134] 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 is proposing to require alternative trading systems with significant volume to meet certain systems capacity, integrity, and security standards.[135] These proposed requirements would be similar to those standards SROs currently follow under the automation review program.

Under proposed Rule 301(b)(6), certain alternative trading systems registered as broker-dealers would be required to comply with requirements designed to ensure adequate systems capacity, integrity, and security. These requirements would apply to an alternative trading system if during four of the preceding six months it had more than twenty percent of the aggregate daily share volume in any equity security or in a specified category of debt security.[136] For equity securities, the proposed volume thresholds are on a security-by-security basis. Accordingly, if any one equity security traded on an alternative trading system accounts for more than twenty percent of the share volume in that security, the alternative trading system would be required to meet the proposed capacity, integrity, and security requirements.

With respect to debt securities, the proposed volume threshold would be applied to categories of debt securities. As discussed in regard to the fair access requirements, the Commission is preliminarily considering categorizing debt securities as: mortgage and asset-backed securities (private issue only), municipal securities, corporate debt securities, foreign corporate debt securities, and sovereign debt securities. These categories could be further broken down into subcategories based on factors such as date of maturity and rating. As stated above, alternative trading systems subject to proposed Regulation ATS would be required to meet the proposed capacity, integrity, and security requirements if the alternative trading system accounted for more than twenty percent of the volume in a category of debt securities.

An alternative trading system that meets these volume thresholds would 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

[130] For example, the Commission has reorganized 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.

[131] 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 intergral part of securities trading.

[132] ARP II, *supra* note 131, set forth guidance concerning the nature of these independent reviews.

[133] ARP I, *supra* note 131, 54 FR at 48705; ARP II, *supra* note 131, 56 FR at 22490.

[134] *See* ARP I, *supra* note 131, 54 FR at 48706 n. 17; ARP II, *supra* note 131, 56 FR at 22493 n.15.

[135] Proposed Rule 301(b)(6).

[136] Proposed Rule 301(b)(6)(i).

recovery plans. An alternative trading system would be 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.[137] In addition, alternative trading systems subject to this provision would be required to notify the Commission staff of material systems outages and material systems changes.[138] This information would enable Commission staff to maintain an understanding of the operation of alternative trading systems generally and to identify potential problems and trends that may require attention.

Finally, under proposed Regulation ATS, alternative trading systems that meet the volume levels set forth above would be required to perform an annual independent review of the systems that support order entry, order handling, execution, order routing, transaction reporting and trade comparison.[139] As discussed in greater detail in the Commission's May 1991 Policy Statement,[140] 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 and the EDPAA.

Some commenters suggested that the Commission need not regulate capacity of alternative trading systems because market forces would ensure that such systems maintain sufficient capacity.[141] A number of commenters, however, said that systems integrity was a concern. In fact, several commenters recommended that the Commission develop general minimum criteria to assure that alternative trading systems maintain sufficient systems capacity.[142]

The Commission's experience has shown that market forces have not been a sufficient incentive for ensuring adequate capacity.[143] For example, 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.

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. For this reason, 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 proposed systems capacity, integrity, and security rules,[144] 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 avoid or minimize the effects of potential systems problems in the secondary markets. 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.

The Commission requests comment on whether the volume thresholds stated above are appropriate for the imposition of these capacity, integrity, and security standards. What volume thresholds would be most appropriate, and what is the best method of calculating them? Are there other capacity, integrity, and security standards that would be more appropriate, or other ways to monitor alternative trading systems capacity? In addition, the Commission would like commenters' views on whether the categories and subcategories of debt discussed above are appropriate and feasible. If commenters believe other categories or subcategories of debt should be used, the Commission requests suggestions. The Commission also asks for comment on whether the volume thresholds for limited partnerships and options should be based on categories of securities rather than on a security by security basis. Would this method better reflect an alternative trading system's market impact?[145]

f. Examination, inspection, and investigations of subscribers. Under the proposed rules, an alternative trading

[137] Proposed Rule 301(b)(6)(ii)(A)–(F)

[138] Proposed Rule 301(b)(6)(ii)(G).

[139] Proposed Rule 301(b)(6). Regulation ATS would also require alternative trading systems to preserve documentation relating to their efforts to meet the requirements of this rule. *See* Proposed Rule 303(a)(1)(iv).

[140] *See* ARP II, *supra* note 131.

[141] *See* Letter from Joanne T. Medero, Barclays Global Investors, to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''BGI Letter'') at 3 (any alternative trading system that is perceived by customers or potential customers as posing execution risks will not be used); Bloomberg Letter at 4 (competition will provide sufficient impetus for alternative trading systems to maintain adequate capacity); Peake Letter (7/14/97) at 16 (customers of alternative trading systems presumably need to be satisfied as to the quality of the vendor); Jamieson Letter at 4–6 (if alternative trading systems do not work customers will not use them); LSE Letter 8–9 (users will take their business elsewhere if an alternative trading system fails); OptiMark Letter at 7 (capacity should not be regulated because alternative trading systems make up a small portion of the market resulting in a relatively little market impact); Macey and O'Hara Letter at 47; OHS Letter (10/3/97) at 17. *See also* Letter from Joseph T. McLaughlin, Managing Director and General Counsel, Credit Suisse First Boston, to Jonathan G. Katz, Secretary, SEC, dated Oct. 7, 1997 (''CSFB Letter'') at 18 (commenting that capacity concerns are misplaced for most systems, but for larger alternative trading systems, the Commission could impose heightened regulation regarding capacity to the extend that the Commission determines that the failure of a particular system could result in risks comparable to the failure of a national securities exchange).

[142] *See* Letter from Scott L. Fagin, LIMITrader, to Jonathan G. Katz, Secretary, SEC, dated June 26 1997 (''Fagin Letter'') at 3; Letter from Thomas J. Jordan, Executive Director, Financial Information Forum, to Jonathan G. Katz, Secretary, SEC, dated Oct. 3, 1997 (''FIF Letter'') at 1; Letter from Robert C. Weaver, Attorney, to Jonathan G. Katz, Secretary, SEC, dated Oct. 2, 1997 (''Weaver Letter'') at 7; Specialist Assoc. Letter at 12 (the Commission should develop criteria for alternative trading systems to safeguard the integrity and security of their trading systems); PCX Letter at 28; NYSE Letter at 5 (although alternative trading systems have strong incentives to ensure their systems have adequate capacity, to the extent that market forces do not provide adequate protection, the Commission should require alternative trading systems to certify at specified intervals that they have adequate capacity, subject to SRO oversight). *See also* ICI Letter at 4 (commenting that it could support a periodic reporting requirement, but substantive regulation might impede innovation).

[143] In addition, 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 Outages (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 Need Strengthening (Aug. 1991) (regarding systems related risks at stock markets); GAO, Active Oversight of Market Automation by SEC and CRTC 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).

[144] Proposed Rule 301(b)(6)(ii).

[145] *See supra* note 121.

system would be required to cooperate with the Commission's or an SRO's inspection or examination of the alternative trading system or any of the alternative trading system's subscribers.[146] 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 have certain other subscribers, such as banks, 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,[147] it is imperative that alternative trading systems cooperate in all inspections and examinations. Although neither the Commission nor the SROs have 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 be required to be made available upon request to its SRO or the Commission.

g. Recordkeeping. Proposed Regulation ATS would require alternative trading systems to make and keep the records necessary to create a meaningful audit trail.[148] Specifically, the Commission proposes that alternative trading systems 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 would be required to maintain a record of subscribers and any affiliations between subscribers and the alternative trading system.[149] While some of the information that would be required by the proposed rule will also be required under the NASD's Order Audit Trail System (''OATS''),[150] OATS is an NASD rule and does not cover all securities traded through alternative trading systems.

This proposal also requires 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. In addition, alternative trading systems would be required to keep documents made (if any) in the course of complying with the systems capacity, integrity, and security standards in Proposed Rule 301(b)(6). These documents would 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 would 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 would be required to keep a record of its access standards.[151]

The Commission proposes that these records be kept for at least three years, the first two years in an easily accessible place. Proposed Regulation ATS also would require some records, such as partnership articles and articles of incorporation, to be kept for the life of the alternative trading system.[152] The Commission is proposing to allow alternative trading systems to keep records in any form broker-dealers are permitted to keep records under Rule 17a–4(f) under the Exchange Act.[153]

The Commission recognizes that alternative trading systems subject to proposed Regulation ATS would be subject to the recordkeeping requirements for broker-dealers under Rules 17a–3 and 17a–4 of the Exchange Act,[154] which may require that some of the same records be made and kept. Proposed Regulation ATS would 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 could sort and retrieve system records separately upon request. In addition, as broker-dealers are currently permitted to do,[155] proposed Regulation ATS would permit 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.[156]

The Commission believes that the records it is proposing to require alternative trading systems to make and keep are records that alternative trading systems would otherwise keep as part of their business, and that therefore these proposed requirements would not place undue burdens upon alternative trading systems.

h. Reporting and Form ATS–R. Proposed Regulation ATS would require 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.[157] Specifically, proposed Form ATS–R would require 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,[158] (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 would have to report the total dollar value for: (1) Corporate debt securities, (2) government securities, (3) municipal securities, (4) mortgage related securities, and (5) debt securities not included in (1)–(4). The Commission is also proposing that alternative trading systems file after-hours trading information in listed equity, Nasdaq NM, and Nasdaq SmallCap securities, as well as listed options. This information would permit the Commission to monitor the trading on alternative trading systems.

Because this release proposes to eliminate Rule 17a–23,[159] data filed by

[146] Proposed Rule 301(b)(7).

[147] The Commission is aware of several incidents involving the manipulation of quotations through alternative trading systems. The participants who engaged in this manipulation were able to gain a profit as a result.

[148] Proposed Rule 301(b)(8).

[149] Proposed Rule 302.

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

[151] *See supra* notes 122–123 and accompanying text.

[152] Proposed Rule 303.

[153] Proposed Rule 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 will likely generate much of the information in electronic form and generally may wish to keep records in electronic format. 17 CFR 240.17a–4(f).

[154] 17 CFR 240.17a–3 and 17 CFR 240.17a–4.

[155] 17 CFR 240.17a–4(i).

[156] Proposed Rule 303(d).

[157] Proposed Rule 301(b)(9).

[158] 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 make sure those systems are structured to permit the traders' compliance with their obligations under Rule 144A and under the Securities Act of 1933.

[159] *See infra* Section IV.A. Rule 17a–23 under the Exchange Act generally requires U.S. broker-dealers

alternative trading systems on Form ATS–R would replace the information currently filed on Form 17A–23 by broker-dealers operating trading systems, although proposed Form ATS–R modifies what broker-dealer trading systems are currently required to file on Part II of Form 17a–23. By creating a template for alternative trading systems to file periodic reporting data, the information would be filed in a more uniform manner and would be more useful to the Commission. For example, this information would be used by Commission staff to develop examination modules for the inspection of alternative trading systems. It would also be used by the Commission staff to further understand the effect of alternative trading systems on the securities markets. In addition, the Commission is now proposing to ask for 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 should improve the quality of the data that the Commission gathers. 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 would be overly burdensome.

Alternative trading systems would also be required to make reports on Form ATS–R available to surveillance personnel of any SRO of which they are a member.[160] Alternative trading systems would not be required to routinely provide these reports to their SRO, but would be required to make such reports available upon request of the SRO. The Commission, however, requests comment on whether alternative trading systems should be required routinely to provide reports made on Form ATS–R to their SROs.

The Commission solicits comment on the transaction reporting requirements and Form ATS–R. In particular, the Commission solicits comment on the frequency and scope of transaction reporting requirements proposed in Regulation ATS, as well as the appropriateness of permitting Form ATS–R to be filed electronically.

i. Procedures to ensure confidential treatment of trading information. The proposed rules would 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.

In inspections of some ECNs, 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. This situation creates 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 the Commission is proposing 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 combine traditional brokerage services with their 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 proposing that: (i) 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 have 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.[161]

The Commission expects that existing alternative trading systems will 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 proposing 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, the potential for abuse and the Commission regards these procedures as essential. Commenters are encouraged to comment on these requirements, including how to prevent misuse of customer confidential information while offering brokerage services. If commenters believe specific procedures would be more beneficial, the Commission requests that suggestions be included with the comments.

j. Name of alternative trading systems. Under proposed Rule 301(b)(11), the Commission proposes to prohibit an alternative trading system registered as a broker-dealer from using the term ''exchange'' in its name. The Commission believes that use of the term ''exchange'' by a system not regulated as an exchange would be deceptive and could mislead investors that such alternative trading system is registered as a national securities exchange. The Commission believes that the proposed regulatory framework provides alternative trading systems with the flexibility to position themselves as either exchanges or broker-dealers. The Commission does not propose to dictate which form of regulation an alternative trading systems chooses, but it is important that the investing public not be confused about the market role such systems have chosen to assume. Accordingly, the Commission believes that if an alternative trading system chooses to register as a broker-dealer under Regulation ATS, it should not use the term ''exchange'' in its name.

The Commission requests comment on issues raised by the proposed prohibition on alternative trading systems registered as broker-dealers under Regulation ATS from using the

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).

[160] Proposed Rule 301(b)(2)(vii).

[161] Proposed Rule 301(b)(10).

term ''exchange'' in their names, and whether other terms, such as ''stock market'' are similarly misleading. The Commission also requests comment on whether it is misleading for other types of systems, such as bulletin board systems, to use the term ''stock market'' in their name.

B. Registration as a National Securities Exchange

1. Benefits of Registration as a National Securities Exchange

Registration as a national securities exchange provides several attractive benefits that may make this option more suitable to the business objectives of certain alternative trading systems. The primary advantage of exchange registration is the relative autonomy that exchanges enjoy in their daily operation. Exchanges are SROs, and are thus subject to surveillance and oversight only by the Commission. Consequently, any alternative trading system that elects exchange registration would not be subject to oversight by a competing national securities exchange or national securities association.[162] Similarly, as a national securities exchange, an alternative trading system would be able to establish its own rules of conduct, trading rules, and fee structures for external 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 the automatic execution of small orders.

In addition, systems that elect to register as exchanges may gain added prestige and investor confidence. As a registered exchange, an alternative trading system would be able to establish listing standards, which could promote investor confidence in the quality of the securities listed on the alternative trading system. In addition, registered exchanges can become direct participants in the NMS 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 alternative trading system subscribers. As direct participants in the NMS mechanisms, registered exchanges are also entitled to share in the profits generated by the NMS systems, such as revenue from CTA fees. Further, only exchanges are eligible to be participants of the Options Clearing Corporation and thereby determine such matters as listing, registration, clearance, issuance and exercise of options contracts.[163]

2. Responsibilities of Registered National Securities Exchanges

A fundamental objective of the Commission's proposal is to create regulations that are sufficiently flexible to accommodate the chosen business objectives of the various alternative trading systems, including those that elect to register as exchanges. Nevertheless, the Commission views certain exchange obligations as fundamental to the fair and efficient operation of exchanges in the marketplace and critical for the protection of investors. Thus, the Commission proposes to require those alternative trading systems that choose to register as exchanges to satisfy these fundamental exchange obligations in order to ensure that the goals of market regulation, as set forth in the Exchange Act, are met. The Commission requests comment on whether any exemptions from exchange regulatory provisions would be necessary or appropriate to enable alternative trading systems to register as exchanges.

a. Self-regulatory responsibilities. One of the central functions performed by exchanges under the current regulatory structure is the self-regulatory function, which includes the implementation and enforcement of rules for trading on the exchange, and surveillance of members' trading and sales activities. The self-regulatory role of exchanges is vital to the effective management of the securities industry. Therefore, as a prerequisite for the Commission's approval of an exchange's application for registration, an exchange would have to organize and have the capacity to carry out the purposes of the Exchange Act. Specifically, an exchange would have to 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. The exchange's rules would have to be 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.[164] In addition, once registered, an exchange would have to submit copies of any proposed rule changes to the Commission for approval.[165] As part of its compliance activities, an exchange must maintain procedures to surveil for violations such as insider trading and manipulation on its facilities. While an exchange is required to have adequate measures in place, not all exchanges must use the same procedures. Their surveillance procedures, while fundamentally similar in effect, can be tailored to the particular requirements of each exchange and will depend on the nature of trading that occurs and the type of securities that are traded on the exchange.

The Commission would consider, however, measures to reduce the surveillance burdens for exchanges. The Commission believes that some of the self-regulatory obligations for exchanges may be contracted to another party. 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.[166] The Commission has previously permitted existing SROs to contract with each

[162] 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 III.A.2.a.

[163] Options Clearing Corporation By-laws, Art. VII, Sections 1 and 4. Registered exchanges that are members of the Options Clearing Corporation are also able to use registration and disclosure materials tailored for standardized options.

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

[165] Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b). If Nasdaq chose to register as an exchange, the Commission notes that any rules governing trading on Nasdaq that have been filed by the NASD and approved by the Commission would not constitute proposed rules changes for purposes of Section 19(b) of the Exchange Act. *See also infra.* Section V (discussing a proposed temporary rule filing exemption).

[166] 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 section 17(d) of the Exchange Act. 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 (Sep. 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).

other to allocate non-financial regulatory responsibilities.[167] An SRO participating in a regulatory plan is relieved of regulatory responsibilities with respect to a broker-dealer member of such an SRO, if those regulatory responsibilities have been designated to another SRO under the regulatory plan. These programs would also be applicable to alternative trading systems that choose to register as exchanges.

These plans permit an SRO to allocate its oversight obligations with respect to certain members' compliance with various requirements, but do not permit an SRO to allocate its oversight obligations with respect to the activities taking place on its market. The Commission believes that the 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. Existing exchanges generally employ personnel and establish extensive programs to fulfill this responsibility. Fully automated exchanges, however, might be able to contract with other exchanges to perform certain oversight activities while retaining ultimate responsibility for ensuring that these activities are performed. For example, fully automated exchanges can produce comprehensive, instantaneous automated records that can be monitored remotely. As a result, it may be possible for such an exchange to contract with another exchange to perform its day-to-day enforcement and disciplinary activities. The Commission could consider whether allowing an automated market to do so would be consistent with the public interest.

In addition, existing Commission initiatives and SRO plans that coordinate supervision of broker-dealers that are members of more than one SRO (''common members'') would also apply to alternative trading systems that choose to register as exchanges.[168] 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.[169] When an SRO has been named as a common member's DEA, all other SROs to which the common member belongs are relieved of the responsibility to examine the firm for compliance with applicable financial responsibility rules.[170] Consistent with past Commission action, the Commission could continue to designate one SRO, such as the NASD or the NYSE, as the primary DEA for common members of exchanges.

b. Fair Representation. The Commission understands that certain obligations may be inconsistent with the proprietary nature of alternative trading systems. For example, a major obstacle to the regulation of proprietary alternative trading systems as exchanges has been the concern that they would be subject to certain exchange obligations incompatible with their structures.[171] Specifically, section 6(b)(3) of the Exchange Act requires that exchanges have member controlled boards of directors and assure the ''fair representation'' of their members in the selection of their boards of directors.[172] Without some modification, the current application of these requirements could inappropriately dictate the corporate governance choices of alternative trading systems that register as exchanges and could prevent them from adopting innovative means of carrying out self-regulatory obligations. In particular, for a proprietary system, the ''fair representation'' obligations strictly applied could require the customers of a system to govern the system. Customer control of a commercial enterprise could change the relationship of the system to its subscribers, could foreseeably conflict with the profit-driven nature of the organization, and could impose a public structure on a private enterprise. The Commission therefore proposes to allow non-membership, for-profit alternative trading systems that choose to register as exchanges some flexibility in satisfying the ''fair representation'' requirement in the Exchange Act.

The Commission believes that ''fair representation'' does not necessarily require exchanges to be owned by their members. For example, in the past, the Commission has stated that registered clearing agencies may employ several methods to comply with the fair representation standard.[173] These methods include: (1) Solicitation of board of director 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. Other structures may also provide independent, fair representation in the material decision making processes of an exchange that is not owned by its subscribers. For example, an alternative trading system that registers as an exchange might be able to fulfill this requirement by establishing an independent subsidiary that has final, binding responsibility for bringing and adjudicating disciplinary proceedings and rule making processes for the exchange, and ensuring that the governance of such subsidiary equitably

[167] For example, the Commission has approved a regulatory plan filed by the Amex, CBOE, NASD, NYSE, PCX, and the 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.*

[168] For example, while exchanges are required to enforce compliance by their members (and persons associated with their members) with applicable laws and rules, the Commission has used its authority under sections 17 and 19 of the Exchange Act to allocate oversight of common members to particular exchanges, and to exempt exchanges from enforcement obligations with respect to persons that are associated with a member, but that are not engaged in the securities business. *See* 17 CFR 240.17d–2; 17 CFR 240.19g2–1.

[169] 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).

[170] *See* Securities Exchange Act Release No. 23192 (May 1, 1986) 51 FR 17426 (May 12, 1986). Moreover, section 108 of NSMIA. *supra* note 3, 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.

[171] *See Delta Release, supra* note 10, 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 system to the institutions. The system would be kaput.

Id. at 1272–73.

[172] 15 U.S.C. 78f(b)(3).

[173] *See* Securities Exchange Act Release No. 14531 (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).

represents the exchange's participants.[174] 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.[175] What constitutes fair representation for a particular exchange would be determined in the context of that system's application for registration under Sections 6(a) and 19(a) under the Exchange Act, subject to public notice and comment.[176] The Commission solicits commenters' views regarding application of the fair representation requirement to alternative trading systems that choose to register as exchanges.

c. Membership on a national securities exchange. Section 6(c)(1) of the Exchange Act[177] 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, however, the Commission sought commenters' views on whether to allow institutional membership on national securities exchanges. Most commenters opposed institutional membership on exchanges, voicing myriad concerns. Some commenters thought that institutional membership would be contrary to the purposes of the Exchange Act and would create a competitive disadvantage for registered broker-dealers. A number of commenters opposed any arrangement that would allow a class of members or participants to be subject to less restrictive regulations than another class. Other commenters feared that the practical implications would overwhelm Commission resources as the Commission tried to decide which rules should apply to institutions and which should not. In addition, a number of commenters feared that institutional exchange membership would subject institutions to unwarranted oversight by exchanges and the Commission or to duplicative or inconsistent regulations for those institutions that are already subject to oversight by other federal agencies.[178] Some commenters were concerned about the ability of exchanges or the Commission to exercise appropriate oversight over institutions and questioned the ability of an exchange to reject the membership or direct access of an institution with a questionable operating history.

After reviewing commenters' concerns, as well as considering the practical effects that institutional membership or access may have on other exchange members and on the effective oversight of exchange trading, the Commission is not proposing to exempt national securities exchanges from the prohibition on membership by non-broker-dealers.[179] Thus, just as currently registered exchanges are required to limit membership to broker-dealers, the Commission proposes that alternative trading systems that choose to register as exchanges be prohibited from including non-broker-dealer participants.

The legislative history of the Exchange Act contemplates possible direct institutional access to exchange execution facilities.[180] In addition, sections 15(e) and 6(f) of the Exchange Act[181] would permit the Commission to subject institutional members to all exchange rules and relevant Exchange Act provisions. The Commission, however, believes that, in order to ensure the central goals of exchange regulation, it would have to subject institutional members or participants to the majority of rules and regulations to which broker-dealers are currently subject. This would undermine most benefits an institution would receive by not having to register as a broker-dealer. 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. Thus, the Commission does not believe that allowing institutional membership on exchanges is currently practical or serves the best interests of investors or the markets generally.

The Commission is also concerned about the systemic risks that direct institutional access may pose to the national clearance and settlement systems. If institutional investors were granted exchange membership or direct access to exchanges, they would need to arrange for the clearance and settlement of their trades. This would likely be accomplished by the direct membership of such investors in one or more of the national clearance and settlement corporations. They would also need to demonstrate and maintain financial creditworthiness. The Commission could, pursuant to section 15(e) of the Exchange Act,[182] require non-broker-dealer institutions to comply with risk management obligations, including the requirements to maintain certain minimum levels of net capitalization and appropriate books and records. 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. If these important risk management measures could not be assured for institutions, the health of the markets and the national clearance and settlement systems could be jeopardized. As discussed above, the Commission believes that this course would effectively require non-broker-dealer institutions to comply with the same requirements imposed on registered broker-dealers. 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.

Accordingly, the Commission continues to believe 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.[183] Institutions, however, would continue to be able to access alternative trading systems registered as exchanges through

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

[175] 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).

[176] 15 U.S.C. 78f(a) and 78s(a).

[177] 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. Section 15(e) of the Exchange Act, 15 U.S.C. 78*o*(e), gives the Commission authority to require any member of a registered exchange that is not required to register with the Commission as a broker-dealer to comply with any provision of the Exchange Act (other than section 15(a) which requires registration of broker-dealers with the Commission or an exemption therefrom) and rules thereunder that regulate or prohibit any practice by a broker-dealer.

[178] For example, institutional investors may include commercial banks, mutual funds, insurance companies and pension funds. These institutions may be subject to regulatory oversight by other federal agencies, and may be regulated for purposes that differ from the regulatory goals of the Exchange Act.

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

[180] *See* Concept Release, *supra* note 2.

[181] 15 U.S.C. 78f(f) and 78*o*(e).

[182] 15 U.S.C. 78*o*(e).

[183] 15 U.S.C. 78f(c)(1).

a registered broker-dealer member of such a trading system, similar to the way in which institutions currently have direct access to the NYSE through SuperDOT terminals given to them by NYSE members.[184] For example, the OptiMark System [185] enables institutions to directly enter orders in the OptiMark system through an exchange member. Similarly, Nasdaq's proposed Integrated Order Delivery and Execution System would provide institutional access to Nasdaq through Nasdaq primary market makers.[186] This form of access should not impose significant costs or burdens on institutions or on broker-dealers providing such access. The Commission believes that this approach would readily serve institutional investors' needs without compromising important regulatory objectives.

The Commission, however, is soliciting comment on whether institutions should be permitted to be members of a registered exchange.

d. Fair access. The Commission would continue to require all national securities exchanges to ensure the fair access of registered broker-dealers in accordance with sections 6(b)(2) [187] and 6(c) [188] of the Exchange Act, which prohibit discriminatory denials of access and discriminatory treatment of members.[189] The obligation to ensure fair access for members does not, however, restrict the authority of a national securities exchange or national securities association from maintaining reasonable standards for access.[190] The securities industry and the general public need access to exchanges to ensure the best execution of orders and view exchanges as venues for trading that are open to all qualified persons. Thus, the Commission believes that it is consistent with the objectives of the Exchange Act to prevent any discriminatory denial of access on an alternative trading system that elects to register as a national securities exchange.

In a similar vein, exchanges are prohibited from adopting any anti-competitive rules.[191] To further emphasize the goal of vigorous competition, Congress required the Commission to consider the competitive effects of exchange rules,[192] as well as the Commission's own rules.[193] The fair access and fair competition requirements in the Exchange Act are intended to ensure that national securities exchanges and national securities associations operating markets treat investors and their participants fairly, consistent with the expectations of the investing public. Accordingly, the Commission proposes to require all alternative trading systems registered as exchanges to comply with these requirements of the Exchange Act.

e. Compliance with ARP Guidelines. All national securities exchanges are expected to maintain sufficient systems capacity to handle foreseeable trading volume. 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 ensure adequate systems capacity, the Commission established the automation review program.[194] All exchanges and the NASD currently participate in this program. Given the highly automated nature of most alternative trading systems, the Commission would expect any alternative trading system that registers as an 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.

f. Registration of securities. Securities traded on a national securities exchange must be registered with the Commission and approved for listing on the exchange.[195] In addition, national securities exchanges are permitted to trade securities listed on other exchanges and Nasdaq pursuant to unlisted trading privileges, or UTP.[196] Alternative trading systems that choose to register as exchanges would be required to have rules for trading the class or type of securities it seeks to trade pursuant to UTP.[197] Moreover, to trade Nasdaq NM securities, these systems would have to become signatories to an existing plan governing such trading.[198] 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. Alternative trading systems that choose to register as national securities exchanges would be subject to these requirements. Therefore such alternative trading systems could only trade listed securities and would have to comply with Commission regulations governing UTP. These requirements would not apply to alternative trading systems that choose to register as broker-dealers.

The Commission is not proposing that alternative trading systems that choose to register as broker-dealers and be regulated under Regulation ATS be limited in the types of securities they trade. The Commission, however, solicits comment on whether securities traded on all alternative trading systems should be registered under section 12 of the Exchange Act. Alternatively, the Commission requests comment on whether a securities registration requirement should apply when the trading volume on the alternative trading system, or in any particular security traded through an alternative trading system, reaches a specified level. If so, the Commission requests comment on what the appropriate volume threshold should be. Because

[184] 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.

[185] *See infra* note 255.

[186] *See supra* note 106 and accompanying text.

[187] 15 U.S.C. 78f(b)(2).

[188] 15 U.S.C. 78f(c).

[189] Section 15A(b)(8) of the Exchange Act applies similar obligations to registered national securities associations. 15 U.S.C. 78*o*–3(b)(8).

[190] 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.

[191] 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).

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

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

[194] *See supra* notes 131–134 and accompanying text.

[195] 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 exchanges that the Commission has exempted from registration as national securities exchanges. *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).

[196] 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 registered 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 registered 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 210. Thus, registered exchanges cannot currently trade Nasdaq SmallCap securities or exempted securities that are not separately listed on the exchange.

[197] Rule 12f–5 under the Exchange Act, 17 CFR 240.12f–5.

[198] *See* OTC–UTP plan, *infra* note 210 and accompanying text.

some unregistered securities traded through alternative trading systems may be foreign securities traded on foreign markets, the Commission requests comment on whether any volume threshold should be measured against worldwide trading volume, similar to the test for ''average daily trading volume'' under Rule 100 of Regulation M.[199]

The Commission also requests comment on whether there are other ways to ensure that information about unregistered securities traded on alternative trading systems is available to investors.[200] The Commission requests comment on whether the proposed amendments to Rule 15c2–11 would address this concern.[201]

g. NMS participation. 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 comprise the CQS, the CTA, the ITS,[202] the Options Price Reporting Authority (''OPRA''),[203] and the Nasdaq/National Market System/Unlisted Trading Privileges (''OTC–UTP'').[204] These plans 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 NMS and participation in these plans by all registered exchanges is vital to the success of the NMS.

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.[205] The CTA and the CQS, which make quote and transaction information in exchange-listed securities available to the public, satisfy the requirements for effective quote and transaction reporting plans and procedures.[206] Both of these plans have provisions governing the entry of participants to the plans,[207] and allow any national securities exchange or registered national securities association to become a participant.[208] New participants are required to pay certain entry fees to the existing participants.[209] Participants in these plans share in the income and expenses associated with the plans' operations.[210] While national securities exchanges are required to participate in an effective quote and transaction reporting plan, the specific plans are not mandated. Accordingly, if the CTA and the CQS plans' terms are not compatible with the structure of alternative trading systems that register as exchanges, new plans could be formed to satisfy this requirement. Such initiatives may prove cumbersome, and would have to satisfy the goals of consolidation of quotes and trading information. It may ultimately be advisable for the participants of existing plans to work with newly registered exchanges to meet any special needs posed by the new exchanges.

In addition to requiring participation by newly registered exchanges in some or all of the effective quote and transaction reporting plans described above, the Commission would expect newly registered exchanges to participate in ITS,[211] 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.[212] ITS rules require that the members of participant markets avoid initiating a purchase or sale at a worse price than that available on another ITS participant market (''trade-throughs'').[213] Participation in the ITS

[199] 17 CFR 242.100.

[200] The Commission notes that any market maker in a security that posts quotations in an alternative trading system that is a ''quotation medium'' under Rule 15c2–11 of the Exchange Act, 17 CFR 240.15c2–11, currently would have to comply with Rule 15c2–11, which requires market makers to obtain fundamental information about an issuer prior to initiating or resuming quotes.

[201] The Commission has requested comment in a release proposing changes to Rule 15c2–11 under the Exchange Act on whether the information that would be required by such amendment should continue to apply to quotations in alternative trading systems. *See* Securities Exchange Act Release No. 39670 (Feb. 17, 1998), 63 FR 9661 (Feb. 25, 1998).

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

[203] *See infra* note 210 and accompanying text for a description of the OPRA plan.

[204] *See infra* note 210 and accompanying text for a description of the OTC–UTP plan.

[205] *See* Rules 11 Ac1–1(b)(1) and 11Aa3–2(c) under the Exchange Act, 17 CFR 240.11Ac1–1(b)(1) and 240.11Aa3–2(c).

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

[207] 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.

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

[209] These fees represent the ''tangible and intangible assets'' provided by the plans to the new participant. *See infra* notes 342–343 (discussing entry fees for the CTA, CQS, and ITS plans).

[210] Similar to the CTA and CQS 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 plans' 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'').

[211] 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 202, at section 3(c).

[212] 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.

[213] 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 20½. In

would give users of these new exchanges access to other ITS participant markets. Moreover, participation in ITS would require new exchanges to comply with other applicable ITS rules and policies on matters such as, for example, trade-throughs, locked markets,[214] and block trades.[215] 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 NMS. In either case, the linkage system would need to accommodate certain practices important to alternative trading system users that may be incompatible with current ITS requirements.

The Commission solicits comment on issues raised by integration of new exchanges in ITS. It also requests comment on what changes would be necessary to NMS mechanisms to accommodate the registration of alternative trading systems as exchanges and what steps would need to be taken to integrate alternative trading systems registered as exchanges into the NMS mechanisms.

h. Uniform trading standards. In addition to participation in NMS mechanisms, alternative trading systems that register as exchanges would be required to comply with any Commission-instituted trading halt relating to securities traded on or through its facilities.[216] Newly registered exchanges would be required in some instances to adopt trading halt rules to comply with certain Commission rules.[217] Newly registered exchanges would also have the authority and be expected to impose trading halts for individual securities, for classes of securities, and for their system as a whole under the appropriate circumstances.[218] 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,[219] the Commission would expect all newly registered national securities exchanges to implement circuit breaker rules to temporarily halt trading during periods of extraordinary market volatility or unusual market declines. Circuit breakers have been adopted to help stabilize the markets and allow the realignment of order imbalances due to such extreme volatility and believes that for circuit breakers to be effective, all markets must impose corresponding circuit breakers.[220]

3. Application for Registration as an Exchange

Rules 6a–1, 6a–2, and 6a–3 under the Exchange Act[221] set forth the application process for registration as a national securities exchange, for seeking an exemption from the Commission based on limited volume, and the ongoing filing requirements for registered or exempted exchanges. The Commission is proposing to revise these rules to clarify the requirements for registration as an exchange and to accommodate the registration as exchanges of automated and proprietary trading systems. The Commission is also proposing 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.[222]

a. Revisions to Form 1. Form 1 would be revised by reorganizing and redesignating the Statement and the Exhibits. In addition, because the Commission expects applicants using Form 1 to be fully or partially automated, the Commission is proposing to revise some of the information requested in Form 1 so that it is more applicable to automated exchanges. In particular, the Commission is proposing to add two new exhibits asking an exchange to describe the way any of its electronic trading system operates, and the criteria used by the exchange in admitting members.[223] The information requested on Form 1 would also be updated to reflect new forms of exchange organization, including the possibility that an exchange is owned by shareholders, rather than members. Further, if an exchange is not owned by its members, those trading on the exchange would be considered participants or subscribers, rather than members. The Commission is proposing to amend Form 1 to reflect this possibility. Finally, the Commission is proposing that exchanges use Form 1, rather than Form 1–A, to file amendments. Therefore, the Commission is proposing to repeal Form 1–A.

b. Amendments to Rules 6a–1, 6a–2, and 6a–3 under the Exchange Act. The proposed amendments to Rules 6a–1, 6a–2, and 6a–3 under the Exchange Act are designed 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.

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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.

[214] 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.

[215] 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).

[216] 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).

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

[218] 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.

[219] 15 U.S.C. 78f.

[220] 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) (approving proposed changes to SRO rules regarding circuit breakers).

[221] 17 CFR 240.6a–1, 240.6a–2, and 240.6a–3.

[222] 17 CFR 249.1; 17 CFR 249.1a.

[223] New Exhibit E would require 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. New Exhibit L would require 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. Proposed Amended Form 1.

(i) Application for Registration as an Exchange or Exemption Based on Limited Volume of Transactions

Rule 6a–1 generally requires an applicant for registration as an exchange, or for exemption from registration, to file an application with the Commission on Form 1 together with accompanying exhibits.[224] Currently, the only exemption from registration available to an exchange is under section 5 of the Exchange Act, which permits the Commission to grant an exemption ''by reason of the limited volume of transactions effected on such exchange.'' [225] Because proposed Regulation ATS would provide another exemption from exchange registration, under which exchanges would not use Form 1, the Commission is proposing to amend Rule 6a–1 to clarify that Form 1 should only be used by an exchange to apply for registration or for an exemption from registration under section 5 of the Exchange Act based on such exchange's limited volume of transactions.[226]

(ii) Periodic Amendments.

Once registered, or exempted from registration based on its limited volume of transactions, current Rule 6a–3 requires an exchange to file with the Commission written notice of actions that render inaccurate certain information filed in its application.[227] This notice must be filed within 10 days after such action is taken. The Commission is proposing to relieve exchanges from some of these requirements. Under the proposed amendments, an exchange would no longer have to file notices within 10 days of changes to: (1) Its constitution, articles of incorporation or association, or by-laws; (2) written rulings or settled practices of any governing board or committee of the exchange that have the effect of rules or interpretations; and (3) the schedule of securities listed on the exchange. These types of changes are required to be filed with the Commission under section 19(b) of the Exchange Act and must be approved by the Commission.[228] In addition, rather than exchanges filing these changes in the form of a notice, as is currently required under paragraph (a) of Rule 6a–3, the Commission is proposing a technical change that would require changes to be filed in the form of an amendment on Form 1.[229]

In addition, Rule 6a–2 currently requires each registered or exempted exchange to file an annual amendment on Form 1–A.[230] This annual amendment must include: (1) Any changes since the last annual amendment to the basic information about an exchange filed in the Statement to Form 1;[231] (2) consolidated financial statements of the exchange and unconsolidated financial statements for the exchange and each affiliate and subsidiary of the exchange; [232] (3) information about the exchange's affiliates and subsidiaries, including the officers, governors, or members of standing committees of the affiliates, and its subsidiaries; [233] (4) a list of the officers, governors, or members of standing committees of the exchange; (5) a list of all member organizations of the exchange; [234] and (6) schedules of all securities admitted to unlisted trading privileges, and of all unregistered securities trading, on the exchange.[235] The Commission is proposing to eliminate the requirement to file an annual amendment to reflect changes in the information currently filed on the Statement to Form 1. As discussed above, the Commission is proposing that most of this information be filed on the Execution Page of Revised Form 1. Changes to this information would continue to be required to be filed with the Commission within 10 days. The Commission, however, no longer believes it is necessary to also receive an annual amendment summarizing all changes in the past year. The Commission is proposing to eliminate the requirement that information about the exchange's affiliates and subsidiaries filed on Exhibit C to Revised Form 1, and the information about an exchange's officers, governors, or members of standing committees filed on Exhibit J to Revised Form 1, be included as part of an annual amendment. Because exchanges are required to notify the Commission of changes to this information within 10 days, the Commission believes it would be adequate if exchanges file complete Exhibits C and J only every three years.[236]

Finally, the Commission is proposing to reduce the filing burdens on national securities exchanges and exchanges exempt from registration by reason of the limited volume of transactions by allowing such exchanges to comply with certain filing requirements by maintaining the information on an Internet web page and providing the location of such web site to the Commission.[237] The proposed amendments would permit national securities exchanges to also post certain information on an Internet web site and submit that location to the Commission in lieu of filing the information in hard copy.[238]

(iii) 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.[239] The proposed changes would continue to require exchanges to provide the Commission with such materials, but as an alternative to filing such information on paper, the Commission is proposing that exchanges be permitted to make the information available on an Internet web site and provide the Commission with the location of the web site.[240]

The Commission is not proposing to change the requirement in paragraph (c) of Rule 6a–3 that registered exchanges file transaction reports within fifteen days after the end of each calendar

[224] Rule 6a–1(a) under the Exchange Act, 17 CFR 240.6a–1(a). Rule 6a–1 also requires an exchange, promptly after discovering that any information in its statement or any exhibit or amendment thereto was inaccurate when filed, to file with the Commission an amendment correcting such inaccuracy. 17 CFR 240.6a–1.

[225] Section 5 of the Exchange Act, 15 U.S.C. 78e.

[226] Proposed Rule 6a–1(a).

[227] Rule 6a–3(a) under the Exchange Act, 17 CFR 240.6a–3(a). An exchange need not file notices within 10 days of any changes to Exhibits E, F, L, and M of Form 1 concerning the exchange's, and its affiliates' and subsidiaries', financial statements, the securities admitted to unlisted trading privileges on the exchange, and the unregistered securities trading on the exchange. *Id*.

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

[229] Proposed Amended Rule 6a–2(a).

[230] Rules 6a–2(a) under the Exchange Act, 17 CFR 240.6A–2(a)

[231] Rule 6a–2(a)(1) under the Exchange Act, 17 CFR 240.6a–2(a)(1).

[232] Rule 6a–2(a)(2) under the Exchange Act, 17 CFR 240.6a–2(a)(2); Form 1, Exhibits E and F, 17 CFR 249.1.

[233] Rule 6a–2(a)(3) under the Exchange Act 17 CFR 240.6a–2(a)(3); Form 1, Exhibits G and H, 17 CFR 249.1.

[234] Rule 6a–2(a)(3) under the Exchange Act, 17 CFR 240.6a–2(a)(3); Form 1, Exhibit J, 17 CFR 249.1.

[235] Rule 6a–2(a)(3) under the Exchange Act, 17 CFR 240.6a–2(a)(3); Form 1, Exhibits L and M, 17 CFR 249.1.

[236] Amended Rule 6a–2(c) under the Exchange Act.

[237] Amended Rule 6a–2(d)(3) under the Exchange Act. Currently, in lieu of filing certain information in paper with the Commission, an exchange is permitted to refer to materials published by, or in cooperation with, the exchange that contain the required information or to make the information available upon request at its office, instead of filing that information in paper. Rules 6a–2(a)(3) and 6a–2(b) under the Exchange Act, 17 CFR 240.6a–2(a)(3) and 6a–2(b). These alternatives would continue to be available to exchanges. Proposed Amended Rule 6a–2(d)(1)–(2).

[238] Proposed Amended Rule 6a–2(d)(3) under the Exchange Act.

[239] 17 CFR 240.6a–3.

[240] Proposed Amended Rule 6a–3(a) under the Exchange Act.

month containing information regarding the volume of stocks, bonds, rights, and warrants sold on the exchange.[241] The Commission, however, solicits comment on whether to permit such information to be filed electronically with the Commission and whether changing the monthly filing requirement to a quarterly filing requirement would appropriately reduce burdens on registered exchanges.

IV. Broker-Dealer Recordkeeping and Reporting Obligations

A. Elimination of Rule 17a–23

Under the proposals in the release, the most significant alternative trading systems would be required to register as exchanges or register as broker-dealers and comply with the requirements under proposed Regulation ATS. These systems are currently subject to recordkeeping and reporting requirements under Rule 17a–23 under the Exchange Act.[242] These alternative trading systems would be 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 therefore proposing to eliminate duplicative recordkeeping and reporting obligations for these systems by repealing Rule 17a–23 and moving its recordkeeping requirements (as they apply to broker-dealers that are not also alternative trading systems) to the broker-dealer recordkeeping rules.

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

Certain trading systems that are operated by broker-dealers would not be affected by today's proposals, and therefore would not be required to register as exchanges or comply with Regulation ATS. This residual group of internal broker-dealer systems[243] would continue to be regulated under the traditional broker-dealer regulatory scheme. The Commission is proposing to amend Rules 17a–3 and 17a–4 under the Exchange Act[244] to require broker-dealers to make and keep records regarding the activities of internal broker-dealer systems for non-alternative trading systems. These proposed recordkeeping requirements are similar to the recordkeeping requirements under current Rule 17a–23. The Commission believes that these recordkeeping requirements continue to be valuable for the oversight and inspections of internal broker-dealer systems by the Commission and by the SROs.

These amendments would require broker-dealers to keep records of any of its customers that have access to its internal broker-dealer system, as well as any affiliations between those customers and the broker-dealer. Broker-dealers would also be 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.[245]

To clarify the application of Rule 17a–3, the Commission also is proposing to add definitions, for the purposes of the rule, for the terms ''internal broker-dealer system,''[246] ''sponsor,''[247] and ''system order.''[248]

The Commission is also proposing to amend Rule 17a–4 under the Exchange Act to require that the records that would be required under the amendments to Rule 17a–3 be preserved for three years, the first two years in an accessible place.[249] The proposed amendment would also require 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.

V. Temporary Exemption of Pilot Trading System Rule Filings

A. Introduction

In contrast to registered exchanges, alternative trading systems are not required to submit rule filings for Commission approval. This difference creates a disadvantage for registered exchanges competing with alternative trading systems. 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.[250] Several 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,''[251] and attributed it, in part, to exchanges' inability to implement new trading systems before submitting a rule filing and receiving Commission approval.[252] In response to these concerns and to make existing markets more competitive, the Commission is proposing a temporary exemption for SROs that would defer the rule filing requirements of section 19(b) under the Exchange Act[253] for pilot trading systems (''pilot trading system rule'').[254] In formulating the pilot trading system rule, the Commission draws on its experience in the past several years with SROs'

[241] 17 CFR 240.6a–3(c).

[242] 17 CFR 240.17a–23.

[243] The term ''international broker-dealer system'' would be 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.'' Proposed Rule 17a–3(16)(ii)(A) under the Exchange Act.

[244] 17 CFR 240.17a–3 and 240.1–7a–4.

[245] Proposed Rules 17a–3(16)(i)(B) and (C) under the Exchange Act.

[246] *See supra* note 243.

[247] The term ''sponsor'' would be 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.'' Proposed Rule 17a–3(16)(ii)(B).

[248] The term ''system order'' would be 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 will specifically exclude ''inquiries or indications of interest that are not entered into the internal broker-dealer system.'' Proposed Rule 17a–3(16)(ii)(C).

[249] Proposed Rules 17a–4(b)(1) and (10) under the Exchange Act.

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

[251] The Pacific Exchange stated that the ''restrictions, procedural requirements or pricing restraints to which the exchange is subject[,] * * * [t]he relative burdens and benefits, obligations and opportunities, administrative requirements and entrepreneurial incentives imposed on or available to the traditional exchange versus the [alternative trading systems] are seriously skewed.'' PCK Letter at 11. *See also* CSE Letter at 3; SIA Letter (10/3/97) at 9; OptiMark Letter at 8.

[252] *See* CSE Letter at 3; SIA Letter (10/3/97) at 9; OptiMark Letter at 8.

[253] 15 U.S.C. 78s(b).

[254] Today, the Commission is also proposing 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. Under this proposal, the SRO would have to have trading rules, procedures, and listing standards for the product class in which the new derivative securities product is included, and have surveillance procedures for this product class. Securities Exchange Act Release No. 39885, Apr. 20, 1998.

attempts to operate new pilot trading systems for their members.[255]

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.[256] The proposed pilot trading system rule would permit SROs that develop ''pilot trading systems,'' [257] to begin operation shortly after submitting new Form PILOT to the Commission. During the operation of the pilot trading system, the sponsoring SRO would have to submit to the Commission quarterly reports, as well as amendments to Form PILOT concerning material changes to the pilot trading system. Before two years have expired, the SRO must submit a rule filing to obtain from the Commission permanent approval of the pilot trading system or cease operation of the trading system.[258]

The Commission believes its proposed pilot trading system rule would address many of the concerns raised by commenters.[259] 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.[260] According to one commenter, the rule filing process hinders innovation because registered exchanges do not realize the full competitive benefits of their efforts.[261]

Inherent in the rule filing process is public disclosure of the SROs' business plans for trading systems prior to their operation. This gives SROs' competitors access to their plans for proposed trading systems. 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. The proposed pilot trading system rule is designed to allow 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.

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

B. Proposed Rule 19b–5

Proposed Rule 19b–5 would provide a temporary exemption for SRO proposed rule changes concerning the operation of pilot trading systems to defer the rule filing requirements of Section 19(b) of the Exchange Act.

1. Proposed Definition of a Pilot Trading System

Under paragraph (a) of proposed Rule 19b–5, a trading system operated by an SRO would be a ''pilot trading system'' if it met one of the definitions. First, a trading system would be a ''pilot 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 share 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 share trading volume of all trading systems operated by the SRO.[262] Second, a trading system operated by an SRO for less than two years would also be considered a ''pilot trading system'' if, during at least two of the last four consecutive calendar months it traded no more than five percent of the U.S. average daily share trading volume of each security traded on the trading system, and were independent of any other trading system operated by the same SRO. 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 share trading volume of all trading systems operated by the SRO.[263]

The Commission would consider a trading system to be ''independent'' if it satisfies one of the following criteria. First, a pilot trading system would be deemed independent if it trades securities different from securities traded on any trading system operated by the same SRO that has been approved by the Commission. Second, a pilot trading system would be deemed independent if it does not operate during the same trading hours as any other trading system operated by the same SRO that has been approved by the Commission. Finally, a pilot trading system would be deemed independent provided no specialist or market maker on any other trading system operated by the same SRO trades on the pilot trading system securities in which they are a market maker or specialist.[264]

[255] 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 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).

[256] 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)(B) of the Exchange Act, 15 U.S.C. 78s(b)(2)(B).

[257] *See* Proposed Rule 19b–5(a) for the proposed definition of ''pilot trading system.''

[258] A pilot trading system that exceeds certain volume limits would have to file for permanent approval before the two-year period expires. Proposed Rule 19b–5(d) and (e). *See also infra* Section V.B.

[259] Several commenters specifically supported the Commission's suggestion that SROs be relieved of the rule filing requirement, in some way, when operating a pilot trading system. *See* Peake Letter (7/14/97) at 27–28; Jamieson Letter at 20; CSE Letter at 1–3 (stating expedited treatment of proposed pilot trading system rules would have the added benefit of reducing the costs of uncertainty and easing regulatory burdens on exchanges and the Commission); Weaver Letter at 18; Letter from Leopold Korins, Chairman and Chief Executive Officer, Philadelphia Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Oct. 8, 1997 (''Phlx Letter'') at 5–6; PCX Letter at 37–38 (suggesting minimum requirements for pilot trading systems); SIA Letter (10/3/97) at 9; ABA Letter at 33.

[260] *See* Letter from James F. Duffy, Executive Vice President & General Counsel Legal & Regulatory Policy, American Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Nov. 12, 1997 (''Amex Letter'') at 5–6; CSE Letter at 3; SIA Letter (10/3/97) at 9.

[261] Amex Letter at 5.

[262] Proposed Rule 19b–5(a)(2).

[263] Proposed Rule 19b–5(a)(1).

[264] Proposed Rule 19b–5(b).

If a trading system exceeds the volume thresholds set forth in paragraphs (a)(1) or (a)(2) of proposed Rule 19b–5, it would be allowed to continue to operate for 60 more days under this exemption.[265] During this 60 day period, the Commission expects that an SRO would file for permanent approval of the trading system. The Commission requests comment on its proposed definition of a pilot trading system. Specifically, the Commission would like comment on whether the proposed two-year time period, trading volume limits, and independence criteria are too broad or too narrow. Commenters are asked to provide specific reasons for any concerns about the proposed definition and to suggest alternatives.

2. SROs' Continuing Obligations Regarding Pilot Trading Systems

Based upon the Commission's experience with reviewing new pilot trading system proposals submitted by SROs, the Commission believes that to be consistent with the Exchange Act, SROs operating pilot trading systems should satisfy the requirements discussed below. An SRO's failure to comply with these conditions would compromise its ability to rely on the proposed pilot trading system rule. The Commission seeks comment on whether there are any additional conditions with which SROs should be required to comply in order to be temporarily exempt from the rule filing requirements. The Commission also requests comment on whether any of the conditions described below are unnecessary.

a. Notice and filings to the Commission. Under proposed Rule 19b–5, SROs would be required to provide written notice, and information about the operation of a pilot trading system, to the Commission on new Form PILOT. The SRO could commence operation of the pilot trading system 20 days after this filing is complete.[266] 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 20 days before commencing operation. This 20-day delayed operational date, triggered by the filing date, provides the Commission time to review Form PILOT for compliance by the SRO with the pilot trading system rule. The Commission believes, for example, that an SRO proposing to operate a pilot trading system that provides trading privileges, such as priority of execution, preferential fees or access to trade information to SRO members and not to non-member subscribers, would not be in the public interest nor consistent with the protection of investors. Such proposed rule changes for trading systems, therefore, would not be exempt from section 19(b) of the Exchange Act.[267] The Commission could also determine, after notice to the SRO and 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.

Proposed Form PILOT would require an SRO to provide, as part of the initial operation report, 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 subscribers to the pilot trading system; and (4) the names of entities assisting in the operation of the pilot trading system. An SRO would also have to file an amendment to Form PILOT at least 20 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.

In addition, an SRO would be required to submit a quarterly report on Form PILOT. The quarterly report would include information about the trading volume effected on the pilot trading system during the most recent calendar quarter. Under paragraph (c)(10) of proposed Rule 19b–5, information reported by an SRO on Form PILOT would be deemed confidential.[268] The Commission seeks comment on whether the Commission should deem all information filed on Form PILOT to be confidential. The Commission requests comment on whether additional information should be requested on Form PILOT. The Commission seeks comment on whether an alternative treatment of information filed on Form PILOT, for example, that information on Form PILOT is publicly available unless an SRO specifically requests confidential treatment, would better protect investors.

b. Trading rules and procedures. The SRO would have to adopt and implement trading rules and procedures necessary to operate the pilot trading system in a manner consistent with the Exchange Act. For example, the SRO would have to have appropriate trading rules and procedures to promote the fair and orderly trading of securities on the pilot trading system, including: (1) Position limits and 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. The SRO, however, would not be required to file these trading rules and procedures with the Commission, provided they applied only to trading conducted on the pilot trading system.

c. Surveillance. The SRO would also have to establish procedures for the effective surveillance of trading activity on the pilot trading system. It is important that the SRO be able to obtain information necessary to detect and deter market manipulation, illegal trading, and other trading abuses. To satisfy this requirement, an SRO would 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, there should 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.[269] Such agreements provide a

[265] Proposed Rule 19b–5(a)(3). *See also infra* Section V.C.

[266] Although the Commission would continue to accept paper versions of these documents, the Commission encourages SROs to submit filings on computer diskette in an appropriate word processing format.

[267] Proposed Rule 19b–5(f).

[268] Proposed Rule 19b–5(c)(10).

[269] 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'')

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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'').[270] The ISG was formed to coordinate, among other things, effective surveillance and investigative information sharing arrangements in the stock and options markets.

d. Clearance and settlement. An SRO would have to establish reasonable clearance and settlement procedures for transactions effected on the pilot trading system. The integrity of the trading markets depends on the timely and coordinated clearance and settlement of transactions. For this reason, the Commission believes that an SRO operating a pilot trading system should ensure that the necessary linkages to clearing agencies exist for all pilot trading system users. 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 corporation member through which the user will clear its trades.

e. Types of securities. Because a pilot trading system would be operated by an SRO, it would be limited to trading registered or exempted securities.[271] In addition, a pilot trading system would not be eligible for the exemption if it trades derivative securities, such as options, warrants, or hybrid products, the value of which are based, in whole or in part, on the value of or interest in any security traded on another trading system operated by the SRO. The converse would also be true. A pilot trading system would not be eligible for the exemption if it trades any security or instrument, the derivative of which is traded on another trading system operated by the SRO.[272] SROs contemplating trading systems that would trade these types of derivative securities would have to continue to submit rule filings under section 19(b)(2) of the Exchange Act.

f. Procedures to ensure the confidentiality of trading. An SRO operating a pilot trading system would also have to ensure that it has procedures to prevent the misuse of confidential information regarding trading on the pilot trading system. For example, to the extent that the identity of a person trading on the pilot trading system is confidential, the SRO should limit access to the information. In particular, only employees of the SRO who operate the pilot trading system, or are responsible for the SRO's compliance with applicable law, should have access to confidential information about the identity of persons effecting transactions on the pilot trading system and the trading information itself. The SRO also should implement procedures for its employees regarding trading by employees for their own accounts. Finally, the SRO would have to adopt and implement adequate oversight procedures to ensure that the above safeguards concerning confidentiality are followed.

g. Inspections and examinations. The SRO would have to cooperate with any examination or inspection by the Commission of persons effecting transactions on the pilot trading system. The Commission staff would review SRO compliance with the conditions in proposed Rule 19b–5 through its routine inspections. The Commission notes that if an SRO outsources the development, operation, or maintenance of the operation 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.[273]

In order for the Commission staff to determine whether an SRO has properly relied on the proposed exemption under Rule 19b–5, the SRO would have to 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 proposed exemption from the rule filing requirement.[274]

C. Rule Filing Under Section 19(b)(2) of the Exchange Act Required Within Two Years

Within two years of a pilot trading systems' commencement of operation, an SRO would have to 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. After a formal notice and comment period, the Commission would approve the pilot trading system for operation on a permanent basis or institute proceedings to determine whether to disapprove the proposed rule change. Simultaneous with its request for Commission approval under 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.[275]

D. Compliance With Other Federal Securities Laws

The Commission notes that Proposed Rule 19b–5 does not relieve SROs from any other obligation under the federal securities laws, except the requirement to file a proposed rule change with the Commission prior to commencing operation of a pilot trading system. For example, an SRO that fails to provide fair access to its pilot trading system would not be operating in a manner consistent with the Exchange Act. In addition, the SRO would have to ensure that securities listed and traded on the pilot trading system comply with, among other things, the registration requirements of the Exchange Act.[276] An SRO would also continue to be required to enforce compliance with its own rules and the federal securities laws, including members' compliance with the Order Handling Rules.[277]

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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.

[270] *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.

[271] Securities traded on a pilot trading system would be limited to those securities listed on the sponsoring SRO, or traded on the SRO pursuant to unlisted trading privileges. 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. 15 U.S.C. 78*l*(f). For example, exchanges are permitted to trade certain over-the-counter securities pursaunt to a Commission order or rule. *See* Securities Exchange Act Release No. 39505 (Dec. 31, 1997), 63 FR 1515 (Jan. 9, 1998). This ensures that securities traded on the pilot trading system have provided adequate disclosure to investors and that all relevant trading activity in a security is reported to, and surveilled by, the SRO on which the security is listed.

[272] Proposed Rule 19b–5(c)(6).

[273] Proposed Rule 19b–5(c)(8).

[274] Proposed Rule 19b–5(c)(9).

[275] Proposed Rule 19b–5(e).

[276] *See supra* notes 271–272 and accompanying text.

[277] *See* Section 6(b)(2) of the Exchange Act. *See also* Order Handling Rules Adopting Release, *supra* note 88.

E. Request for Comment on Proposed Rule 19b–5

The Commission seeks comments on proposed Rule 19b–5 under the Exchange Act. Comments should address whether the proposed temporary exemption of SRO proposed rule changes relating to the operation of pilot trading systems provides appropriate regulation of such pilot trading systems. The Commission also requests comment on whether this proposed temporary exemption would help to level the competitive playing field between SROs and alternative trading systems.

As an alternative to the temporary exemption proposed today, the Commission requests comment on the benefits or disadvantages of allowing SROs to file proposed rule changes relating to pilot trading systems under the expedited approval process under section 19(b)(3)(A) of the Exchange Act. The Commission could allow an SRO to submit, under section 19(b)(3)(A) of the Exchange Act, the proposed rule changes concerning pilot trading systems. An SRO could then begin operating the pilot trading system immediately after filing. Under this alternate framework, an SRO proposed rule change would be published for comment and could be abrogated by the Commission. Specifically, the Commission asks commenters whether the public disclosure required in the proposed rules filed under section 19(b)(3)(A) of the Exchange Act would achieve the purpose of encouraging SRO pilot trading systems.

VI. The Commission's Interpretation of the "Exchange" Definition

A. The Commission's Interpretation in Delta

Congress drafted the statutory language defining the term exchange to be broad, permitting the Commission to apply the definition flexibly as the securities markets evolve over time.[278] 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.[279]

Although the Exchange Act definition of "exchange" is quite broad, in the 1990 *Delta Release,*[280] the Commission interpreted the definition to include only those organizations that are "designed, whether through trading rules, operational procedures or business incentives, to centralize trading and provide buy and sell quotations on a regular or continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations." [281] Based on the interpretation upheld by the Seventh Circuit, 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.[282] The *Delta Release,* nonetheless, 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)." [283]

In explaining why the Commission interpreted the exchange definition relatively narrowly, in 1990 the Commission expressed the concern that "including (Delta) within 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." [284] The Commission indicated, however, that the Exchange Act itself does not preclude a proprietary trading system such as Delta from coming within the exchange definition.[285] Moreover, the Commission recognized, however, that its interpretation of the exchange definition in 1990 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." [286]

The United States Court of Appeals for the Seventh Circuit Court affirmed the Commission's decision that Delta was not an exchange within the meaning of section 3(a)(1) of the Exchange Act. Significantly, the court thought the language of the statute broad enough "to embrace the Delta system," but concluded that the Commission was not compelled to interpret it to do so.[287]

While the Delta interpretation provided an appropriate interpretation at the time, its emphasis on the "expectation" of regular execution of

[278] 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.")

[279] 15 U.S.C. 78c(a)(1).

[280] *Delta Release, supra* note 10.

[281] *See Delta Release, supra* note 10, at 1900. 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. *See Delta Release, supra* note 10.

[282] 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 8363, 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).

[283] *See Delta Release, supra* note 10, at 1899.

[284] *Id.* at 1899. As discussed below, the Commission's new general exemptive authority has increased the Commission's flexibility in this regard.

[285] *See Delta Release, supra* note 10, at 1900.

[286] *Delta Release, supra* note 10, at 1895 (quoting *Delta I, supra* note 281, at 535).

[287] *Delta II, supra* note 171, 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.

orders at quoted prices may no longer reflect changing market structures. Moreover, the Delta approach has resulted in the anomaly of small volume entities being found to raise an expectation of liquidity and being regulated as exchanges (such as the Arizona Stock Exchange),[288] while larger volume entities that avoid certain design features are found not to raise this expectation and are regulated as broker-dealers (such as Instinet).[289] In addition, 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.[290] 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 NMS has had a negative impact on the quality and pricing efficiency of secondary markets.[291]

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.[292] In the Concept 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[293] 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 40 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.

The securities markets rely on centralized sources of trading opportunities and trading information. Exchange regulation is designed to protect this centralization function and to make the opportunity to obtain trading information and to access trading interest accessible to the general public. As more alternative trading systems develop and offer varying services to diverse customer bases, the availability of trading information and the accessibility of trading opportunities may become increasingly fragmented.

C. The Proposed Reinterpretation 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.[294] Although the Commission has considered many characteristics of the modern exchange in revising its interpretation, it believes two elements most accurately reflect the functions and uses of today's exchange markets. Under the interpretation proposed in Rule 3b–12, the first essential element of an exchange would be the consolidation of orders of multiple parties. This reflects the statutory concept of bringing together purchasers and sellers and also reflects the idea of a marketplace where supply and demand originate from a variety of sources, not simply from individual brokers and dealers. The second essential element would be that trading on an exchange is guided by stated 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.[295]

D. Other Practical Reasons for Revising the Current Interpretation

1. Additional Flexibility Provided by the National Securities Markets Improvement Act of 1996

One principal reason the Commission, to date, 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.[296] The recent enactment of NSMIA,[297] however, alleviates the concern that an expanded interpretation of the term exchange would inhibit innovation.[298]

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[288] *See* Securities Exchange Act Release No. 28899 (Feb. 20, 1991), 56 FR 8377 (Feb. 28, 1991).

[289] *See* Letter from Richard G. Ketchum to Daniel T. Brooks, Cadwalader, Wickersham & Taft (Aug. 8, 1986) (stating the Commission staff would not recommend Instinet for an enforcement action if it did not register with the Commission as a national securities exchange).

[290] *See* Concept Release, *supra* note 2, at Section II.B.2.

[291] 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 84.

[292] *See* DIVISION OF MARKET REGULATION, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS APP IV (1994) ("MARKET 2000 STUDY").

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

[294] The Exchange Act, coupled with relevant legislative history, appears to provide the Commission with ample authority to revise its interpretation of an exchange, *See, e.g., supra* Section VI.A. Courts have also 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).

[295] The elements of the interpretation are discussed in greater detail in Sections II.A. and II.B., *supra.*

[296] 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 10.

[297] Pub. L. 104–290, 110 Stat. 3416 (1996). 15 U.S.C. 78mm.

[298] Throughout the past 60 years, the Commission has attempted to accommodate market innovations within the existing statutory framework to the extent possible in light of investor protection concerns, without imposing regulation that would stifle or threaten the commercial viability of such

Specifically, 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.[299]

Prior to adoption of NSMIA, the Commission's authority under the Exchange Act to reduce or eliminate certain consequences of exchange registration was limited.[300] 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.[301] The Commission is proposing Rule 3a1–1 under the Exchange Act, which would exempt from the definition of ''exchange'' systems that are registered as broker-dealers and in compliance with Regulation ATS.[302] This exemption, together with the revised interpretation of ''exchange,'' would provide a choice to alternative trading systems to register as national securities exchanges or as broker-dealers.[303]

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 proposal would eliminate 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 proposed revised interpretation of the term exchange, in combination with the proposal to allow alternative trading systems to register as broker-dealers in accordance with proposed Regulation ATS,[304] is consistent with other goals and provisions of the Exchange Act. The proposed revised interpretation of ''exchange'' should avoid the need for the Commission to draw arbitrary distinctions between organizations that perform similar functions. This should avoid classifying an alternative trading system in a manner that does not fit the structure of the system, nor squarely addresses the regulatory concerns raised by the system. Another significant advantage of the proposed revised interpretation of ''exchange'' is that it will allow exchanges to be organized as proprietary systems, thereby accommodating recent market developments.[305]

Moreover, the Commission's proposal would help 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 would be 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 would 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.[306]

VII. Approaches Not Proposed

A. Tiered Exchange Approach

In the Concept Release, the Commission explored the possibility of expanding the interpretation of ''exchange'' to capture the majority of alternative trading systems operating today, and then to adopt differing levels of regulation for three different classes of ''exchanges.''[307] The classes, or ''tiers,'' would vary depending on the size and significance of the trading systems included in each class. The first tier would have consisted of those that have limited volume or do not establish trading prices. This tier would include most alternative trading systems. The Commission suggested that systems included in this tier could be exempted from most traditional exchange requirements.

The second tier of exchanges under this approach would have consisted of alternative trading systems that resemble traditional exchanges because of their significant volume of trading and active price discovery. The Commission discussed whether these systems should be regulated as national securities exchanges, with some exemptions from traditional exchange regulation to eliminate barriers that would make it difficult for these non-traditional markets to comply with full exchange regulation, such as the membership and access requirements.

Finally, a third tier of exchanges would have encompassed traditional membership exchanges. The Commission suggested that these exchanges continue to be regulated as national securities exchanges, with some accommodations to reduce unnecessary regulatory requirements that make it difficult for currently registered exchanges to remain competitive in a changing business environment. The Commission suggested, for example, further

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).

[299] 15 U.S.C. 78mm(a)(1).

[300] 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.

[301] *See* S. Rep. No. 104–293, 104th Cong. 2d Sess. 15 (1996).

[302] Proposed Rule 3a1–1 would also exempt from the definition of ''exchange,'' any system that is operated by a national securities association. *See supra* Section II.D.

[303] *See supra* Section II.D.

[304] *See supra* Section III.A.

[305] *See supra* Section III.B.3.

[306] *See supra* Section III.A.2.c., d., and e.

[307] *See* Concept Release, *supra* note 2, at Section IV.B.

accelerating rule filing and approval procedures.

While comments varied with respect to the tiered approach, commenters generally opposed this approach, fearing that it would weaken competition by alternative trading systems and discourage growth and innovation. Some commenters noted that the burdens of exchange regulation would be heavy for many alternative trading systems, and that the tiered approach would require the Commission to draw arbitrary lines between different systems, which could result in systems that perform virtually identical functions being subject to different regulatory requirements. Commenters also disagreed on how distinctions should be drawn between the tiers. In this vein, some commenters thought that the tiered approach would inhibit the full development of innovative systems if such growth would cause the system to be regulated under a more burdensome regulatory tier. A few commenters also suggested that it would be inappropriate to relax standards for smaller start-up trading systems because investors may need more protection with respect to these systems than for larger more established systems.

For these reasons, the Commission has decided not to pursue the tiered exchange regulation approach discussed in the Concept Release. The Commission believes that the approach it is proposing is preferable because it will enable trading systems to elect the regulation most appropriate for the services they provide, and takes into account size in applying particular requirements. This approach can foster innovation while concurrently regulating trading systems in a manner more fitting to their respective market roles.

B. SIP Approach

The Division also considered an alternative that would require all or some portion of alternative trading systems to register as securities information processors (''SIPs'') under section 11A of the Exchange Act.[308] The 1975 Amendments create a framework for regulating SIPs, which are defined as persons engaged in the business of:

(i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security * * * or (ii) distributing or publishing * * * on a current and continuous basis, information with respect to such transactions or quotations.[309]

To implement this alternative, the Commission would have to adopt rules designed to address the transparency, capacity, access, and surveillance of the systems classified as SIPs. Like the exchange approach, the Commission has determined that the SIP approach would not be as workable as the approach proposed today. In many respects, the rules the Commission would have to adopt under the SIP approach would parallel exchange regulatory requirements, but would not be able to address all of the concerns regarding alternative trading systems' activities. For example, markets regulated as SIPs would not be required to enforce participants' compliance with the securities laws. In addition, alternative trading systems would continue to be only partially integrated into the NMS because SIPs are not required to join market-wide plans, such as the CQS, CTA, ITS, and OPRA. Finally, because SIPs and exchanges are defined in the Exchange Act as mutually exclusive categories, a market classified as a SIP could not elect to register as an exchange, even if that market's volume exceeded that of registered exchanges.

VIII. Request for Public Comments

The Commission seeks comments on adopting the proposals as described in this release. In addition to the requests for comments throughout the release, the Commission asks commenters to address whether the proposed amendments and rules provide appropriate regulation of alternative trading systems. Commenters should also address whether the proposed amendments and rules provide a feasible regulatory structure for alternative trading systems registered as broker-dealers and national securities exchanges. Commenters may also wish to discuss whether there are any legal or policy reasons why the Commission should consider a different approach. In addition to responding to the specific issues presented in this release, the Commission encourages commenters to provide any information to supplement the information and assumptions contained herein regarding the functioning of secondary markets, the roles of market participants, the advantages and disadvantages of the proposed reforms and the expectations of investors. The Commission also invites commenters to provide views and data as to the costs and benefits associated with the proposed changes discussed above in comparison to the costs and benefits of the statutory framework. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is also requesting information regarding the potential impact of the proposed amendments and rules on the economy on an annual basis. If possible, commenters should provide empirical data to support their views. Comments should be submitted by July 28, 1998.

IX. Costs and Benefits of the Proposed Rules and Amendments

The growing significance of alternative trading systems has caused the Commission to reconsider its oversight of such systems through existing broker-dealer regulation. Even though they perform the functions of a market, alternative trading systems that trade a significant volume of securities currently are not obligated to surveil their markets for manipulative activity, to make all of their quotes public, to treat participants fairly, or to maintain adequate systems capacity to prevent outages. As a result, the existing regulatory approach has resulted in inferior or denied access for investors to the best prices, incomplete audit trails and surveillance of trading on alternative trading systems, and market disruption due to systems outages.

The Commission is proposing to allow alternative trading systems to choose between broker-dealer regulation or exchange regulation. In addition, to enable registered exchanges to better compete with alternative trading systems regulated as broker-dealers, the Commission is proposing that SROs be permitted to operate pilot trading systems for a limited period of time before undergoing the full notice, comment, and approval process required for an SRO rule change. The Commission preliminarily believes that any costs associated with this proposal would be offset by benefits to investors and other market participants such as reducing market fragmentation, enhancing investor access to the best prices, and encouraging market innovation. The Commission has identified below certain costs[310] and benefits associated with its proposed changes and encourages commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs or benefits.

[308] 15 U.S.C. 78k–1.

[309] Section 3(a)(22)(A) of the Exchange Act, 15 U.S.C. 78c(a)(22)(A).

[310] The Commission's cost estimates in Section IX are derived from its experience with similar reporting and recordkeeping requirements as reflected in a number of submissions made pursuant to the paperwork Reduction Act of 1995. 44 U.S.C. 3501 *et seq.*

A. Costs and Benefits of the Proposals Regarding Alternative Trading Systems

1. Benefits

a. Improved surveillance on alternative trading systems. The Commission's proposal would 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 would improve because the proposals clarify the relationship between SROs and alternative trading systems.

The proposed notice, reporting, and recordkeeping requirements under Regulation ATS would 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 would 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 would 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 would 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 national best bid and offer (''NBBO'') spreads for the sole purpose of trading through a broker-dealer's automatic execution system at the artificial prices.[311] The Commission and the SROs would be able to more readily detect such activity through enhanced surveillance. The Commission believes that this more direct oversight of trading activities would therefore benefit investors and the market generally by helping to prevent fraud and manipulation.

b. Improved market transparency. The Commission's proposal would 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 NMS 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 is proposing to improve the transparency of orders in systems that account for a significant portion of the trading volume in any security. The proposed rules would help to incorporate alternative trading system quotes into the NMS, thus reducing fragmentation, improving liquidity, facilitating price discovery, and narrowing the quoted spread. In particular, the Commission believes that the current proposal would extend the transparency improvements achieved through the implementation of the Order Handling Rules. Since the adoption of the Order Handling Rules in January 1997, quoted spreads have decreased by an average of 41%, ECNs were alone at the inside quote approximately 11% of the time, and the average daily number of quote updates attributable to ECNs was about 68% of the number of quote updates attributable to market makers, with ECNs accounting for 272,427 quote updates as compared to 403,233 for market makers.[312] The success of the Order Handling Rules indicates that the Commission's current proposal, which would achieve similar transparency for a greater number of orders in alternative trading systems, could further enhance liquidity and price improvement opportunities. 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 would improve the NBBO. For example, of all orders by non-market maker broker-dealers and institutions that could improve the NBBO if included in the public quote stream, only 6% of those orders were actually entered into the public quote stream. Consequently, about 94% of those orders that could have improved the NBBO were not included in the public quote stream and thus did not improve the NBBO. The Commission requests comment on how often the display of non-market maker broker-dealer and institutional orders could improve the NBBO.

The transparency of trading on alternative trading systems that choose to register as exchanges would also improve. All registered exchanges are expected to participate in the NMS plans, such as the CTA, CQS, and ITS. These plans form an integral part of the NMS, 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 would benefit investors by reducing inefficiency and trading fragmentation.

c. Fair access. The Commission believes that its proposal to require alternative trading systems with significant volume to notify investors denied access of their right to appeal that denial, and to provide regulatory redress for unfair denials of access, would help ensure that market participants are provided a fair opportunity to participate in alternative trading systems. Fair 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 would be required to provide access to orders that it is required to display in the public quote stream, there are other benefits to participation on an alternative trading system that the Commission believes an alternative trading system should not unfairly discriminate in granting access. 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.

Under the current regulatory approach, there is no regulatory redress for unfair denials or limitations of access by alternative trading systems. The availability of redress for such actions may not be critical when market participants are able to substitute the services of one alternative trading

[311] *See e.g. At Deadline: New Age Bandits,* Traders Magazine, February, 1997, at 6.

[312] *See* Market Quality Monitoring: Overview of 1997 Market Changes, NASD Economic Research, at 2.

system with those of another. However, when an alternative trading system has a significantly large percentage of the volume of trading, discriminatory actions hurt investors lacking access to the system. The proposals would 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 proposal regarding systems capacity, integrity, and security of alternative trading systems would 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 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.

The Commission's proposals would 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 would benefit from the proposals because significant systems would be less likely to shut down as a result of systems failures and would 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 would benefit investors and the public markets generally. The Commission also believes that by ensuring that significant alternative trading systems maintain sufficient security measures from unauthorized access, investors would benefit from robust system security.

All currently registered exchanges participate in the Commission's automated review program. Alternative trading systems that choose to register as exchanges would 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, would 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 proposals 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 would not have sufficient volume to trigger those thresholds and would therefore not have to comply with those provisions. The recordkeeping and reporting requirements with which smaller, lower volume alternative trading systems would 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.

a. Notice, reporting, and recordkeeping. All alternative trading systems that would be subject to notice, reporting, and recordkeeping requirements under the Commission's proposal are currently subject to similar requirements under Rule 17a–23. The requirements proposed today under Regulation ATS would, however, require some additional information that is not currently required under Rule 17a–23.

Under proposed Regulation ATS, alternative trading systems would file an initial operation report, notices of material systems changes, and quarterly reports. The proposals also include new Forms ATS and ATS–R to standardize reporting of such information and make it more useful for the Commission. The proposed rules would 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.

Proposed Regulation ATS would require 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 would be necessary to gather and file this information. Most of the information, however, already exists. Alternative trading systems would only be required to gather this information and supply it in the required format to the Commission. The periodic updating requirements would also require staff time over the life of the alternative trading system to comply with the proposed rules.

The Commission estimates that there are currently about 43 alternative trading systems that would be required to register as exchanges or register as broker-dealers and comply with Regulation ATS.[313] The Commission also estimates that, over time, there would be approximately 3 new alternative trading systems each year that choose to register as broker-dealers and comply with Regulation ATS.[314] The Commission also estimates that, over time, there would be approximately 3 alternative trading systems that file cessation of operations reports each year. Thus, the Commission anticipates that, over time, if all 43 current alternative trading systems choose to register as broker-dealers and comply with Regulation ATS, there would be approximately 43 alternative trading systems operating each year.

The Commission estimates that the average burden per respondent to file the initial operations report on Form ATS would be 20 hours. This burden is computed by estimating that completing the report would require an average of 13 hours of professional work and 7 hours of clerical work.[315] The

[313] This estimate is based on filings made with the Commission under Rule 17a–23.

[314] Based on the Commission's experience over the last 3 years with Rule 17a–23, it appears that there are more than 3 new alternative trading systems per year. However, we expect that in the steady state over time, there would be approximately 3 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.

[315] This estimate for burden hours of filing Form ATS is based on burdens associated with filing

Commission estimates that the average cost per response would be $1,019 representing the 20 hours and cost of supplies.[316] If all 43 alternative trading systems opted 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 $43,817.[317] The Commission also estimates that, over time, approximately 3 new alternative trading systems will register as broker-dealers per year, incurring an annual aggregate burden of 60 hours for an average total cost of $3,057 after the first year following adoption of Regulation ATS.[318]

In addition, the proposed rules would require alternative trading systems to amend their initial operations report to notify the Commission of material systems changes and other changes to the information contained in the initial operations report. The Commission estimates that each respondent would file 6 such amendments per year.[319] The Commission estimates that each respondent would incur an average burden of 2 hours per response and incur an average cost of $111.50 for each amendment to the initial operation report that it submits.[320] If all 43 alternative trading systems opted 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 $28,767.[321]

Alternative trading systems registering as broker-dealers would 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 estimates that the quarterly reports would 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.[322] The annual burden per respondent would be $892.[323] If all 43 alternative trading systems opted to register as broker-dealers and comply with Regulation ATS, the total cost per year to comply with the proposed requirement to file quarterly reports is estimated to be $38,356.[324]

Finally, alternative trading systems registered as broker-dealers would be required to submit a notice and a report on Form ATS when they cease operations. The Commission anticipates a total of 3 such filings per year. The Commission estimates that individual respondents would incur a burden of 2 hours to file the cessation notice. The Commission estimates that individual respondents would incur a cost of $111.50 to file the cessation of operations report on Form ATS.[325] The annual aggregate burden for 3 alternative trading systems to file cessation of operations reports is estimated to be $334.50.[326]

The proposed recordkeeping requirements under Regulation ATS would require alternative trading systems registered as broker-dealers to keep and make available to the Commission and the appropriate SRO, upon request, records of: (1) The identities of subscribers to the system; (2) daily summaries of trading in the system; (3) time-sequenced records of specified order information in the system; (4) all notices provided to subscribers; and (5) all documents relating to the system's compliance with the capacity, security, and integrity standards set forth in Proposed Rule 301(b)(6) under Regulation ATS.[327] The Commission estimates that each alternative trading system that chooses to register as a broker-dealer would be required to expend an average of 40 hours per year, at an estimated average cost of $1,923.20, to comply with these proposed recordkeeping requirements.[328] If all 43 alternative trading systems opted to register as broker-dealers, rather than as exchanges, the total cost for both recordkeeping and record preservation is estimated to be $82,697.60 per year.[329] The Commission notes that it is soliciting comment on the feasibility of permitting alternative trading systems to file all reports electronically, which could ease the burdens on alternative trading systems.

b. Public display of orders and equal execution access. Proposed Regulation ATS would require some market participants to modify their current quotation dissemination systems. Because alternative trading systems would be required to display the best bid and offer regardless of the party entering the order, additional burdens could possibly be imposed on institutions choosing to use different order entry methods to avoid display. Accordingly, the possibility exists that alternative trading systems could suffer decreased liquidity if institutional customers reduced their reliance on alternative trading systems for trading activities. The Commission believes that its proposals reduce the likelihood of this occurrence. Moreover, the Commission preliminarily believes that any costs would be offset by the benefits enjoyed by the public market as a whole in the form of less fragmentation, increased liquidity, and the equal opportunity to obtain the best bids and

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.

[316] The estimated average cost per response of $1,019 is composed of $650 for in-house professional work (13 hours at $50 per hour), $105 for clerical work (7 hours at $15 per hour) and $264 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

[317] This estimated cost of $43,817 is derived from 43 alternative trading systems filing at a cost of $1,019 each.

[318] This estimated cost of $3,057 is derived from 3 new alternative trading systems filing at a cost of $1,019 each.

[319] This estimate is based on the Commission's experience with collection of similar information under Rule 17a–23.

[320] 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 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

[321] This estimated cost of $28,767 is composed of $111.50 cost per amendment for 43 alternative trading systems filing 6 times per year.

[322] The estimated cost of $223 per response is composed of $150 for in-house professional work (3 hours at $50 per hour), $15 for clerical work (1 hour at $15 per hour) and $58 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

[323] The estimated annual cost of $892 to file Form ATS–R is derived from 4 quarterly reports at an estimated annual cost of $223 per filing.

[324] This estimated cost of $38,356 is derived from 43 alternative trading systems with an estimated annual filing cost for each of $892.

[325] 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 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

[326] The estimated cost of $334.50 is derived from an average of 3 alternative trading systems filing 1 cessation of operations report per year on Form ATS at an estimated cost of $111.50 each.

[327] Proposed Rules 301(b)(8), 302, and 303(a)(1).

[328] The estimated cost of $1,923.20 is derived from an average of 40 hours of compliance time at $48.04 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). The estimate of 40 hours encompasses an estimated 36 burden hours for recordkeeping requirements under proposed Rule 302 and an estimated 4 burden hours for record preservation requirements under proposed Rule 303.

[329] This estimated cost of $82,697.60 is derived from 43 alternative trading systems incurring an annual cost of $1,923.20 each.

offers in the market. The Commission estimates that 3 alternative trading systems would be required to comply with the display provisions of proposed Regulation ATS due to their significant volume.

c. Fair access. The proposal would require alternative trading systems to provide fair access and to notify investors denied access that they can appeal this denial to the Commission and that investors are able to appeal denials to the Commission. These requirements would likely impose little additional cost on most alternative trading systems. First, only alternative trading systems with significant volume would be subject to this requirement. Second, as long as a significant alternative trading system establishes legitimate criteria for participation and applies those criteria consistently, there would be few, if any fair access complaints. Nevertheless, in the event investors are denied access, there may be some additional costs to alternative trading systems associated with notifying investors of their right to appeal this action to the Commission, and potentially from defending appeals. The Commission, however, preliminarily believes that the benefits of fair access outweigh the potential costs. The Commission believes that without redress for denials of access, alternative trading systems could deny access unfairly.

Under proposed Regulation ATS, alternative trading systems with significant volume would be required to establish and maintain standards for granting access to their system and keep records of such standards. The Commission estimates that each respondent obligated to establish and maintain such records would incur a burden of 5 hours per year to make and keep standards for granting access for a total cost of $337.50.[330]

Based on the Commission's experience with denials of access to markets, the Commission estimates that alternative trading systems would, on average, deny or limit access 27 times annually. The Commission estimates that respondents would incur a burden of 1 hour for each required notice to investors for an estimated annual cost to each respondent of $546.75.[331] The Commission estimates that approximately 2 alternative trading systems would be required to comply with the fair access requirements due to their significant volume. The estimated aggregate burden for these alternative trading systems to comply with the fair access requirements under Regulation ATS would be 64 hours for a total average aggregate cost of $1,768.50.[332] The Commission requests comment on the costs described above with respect to the fair access provision of proposed Regulation ATS.

d. Systems capacity, integrity, and security. The Commission does not believe that its proposals to require alternative trading systems to meet certain systems related standards would impose significant costs. The standards the Commission is proposing are general standards that are consistent with good business practices. In addition, smaller alternative trading systems would not be subject to the proposed requirements. For those alternative trading systems that would not, for business reasons alone, ensure adequate capacity, integrity, and security of their systems, there would be costs associated with complying with the proposed 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 would incur costs associated with the independent review of their systems on an annual basis. The review must be performed by independent reviewers, but those reviewers may be employees of the alternative trading system, or third party reviewers. 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. Accordingly, the Commission is requesting comment on the costs that may be associated with both internal and external reviews. Alternative trading systems would also be subject to recordkeeping requirements to document the steps taken to comply with proposed Regulation ATS. These requirements would be necessary for the Commission and the appropriate SROs to ensure compliance with systems related requirements. In addition, keeping such records would permit 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 would 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 Commission estimates that each respondent would incur an average annual burden of 15 hours to comply with the recordkeeping requirements associated with the systems capacity, integrity, and security provisions of proposed Regulation ATS. The Commission estimates that each respondent would make an average of 5 system outage notices per year, for an estimated average burden of 1.25 hours per year.[333] The Commission estimates that the total estimated average cost of compliance for each respondent would be $85 per year.[334] Such alternative trading systems would 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 estimates that each respondent would incur a burden of 10 hours per year to comply with such recordkeeping requirements for a total cost of $675 per year.[335] The Commission estimates that 2 alternative trading systems would be required to comply with the systems

[330] The estimated cost of $337.50 to establish and maintain standards for granting access is composed of $250 for in-house professional work (5 hours at $50 per hour) and $87.50 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

[331] The estimated cost of $20.25 per response is composed of $15 for clerical work (1 hour at $15 per hour) and $5.25 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973). The estimated annual cost of $546.75 is derived from 27 notices at $20.25 per notice.

[332] The estimated aggregate burden of 64 hours is derived from 32 hours per respondent. The burden of 32 hours per respondent is composed of 5 hours for recordkeeping and 27 hours for notice requirements. The estimated aggregate cost of $1,768.50 is derived from 2 alternative trading systems each incurring an estimated annual burden of $884.25 ($546.75 for notice requirements and $337.50 for recordkeeping requirements).

[333] 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 estimates only 0.25 hours per notice would be required.

[334] 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 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973). The estimated annual cost of $85 is derived from 5 notices at $17 per notice.

[335] The total estimated cost of $675 is composed of $500 for in-house professional work (10 hours at $50 per hour) and $175 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

capacity, integrity, and security provisions of proposed 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 would be $1,520.[336] The Commission requests comment on the costs and benefits associated with systems capacity, integrity, and security.

e. Costs of exchange registration. The proposed framework 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, these costs would be assumed voluntarily.

For example, exchange-registered alternative trading systems would have to be organized to, and have the capacity to be able 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 would have to establish appropriate surveillance and disciplinary mechanisms. In addition, newly registered exchanges would incur certain start-up costs associated with this obligation, such as writing rule manuals. This is the same standard that currently registered exchanges meet. Because the costs associated with these requirements may vary dramatically, the Commission is seeking comment on the estimated costs for compliance with these requirements.

The costs of exchange registration would also include filing a Form 1 pursuant to Rule 6a-1 under the Exchange Act[337] and complying with other filing obligations under Rules 6a-2[338] and 6a-3 under the Exchange Act.[339] In addition, national securities exchanges incur costs in the preparation of proposed rule changes for submission to the Commission for approval.[340] Section 19(b) of the Exchange Act requires an SRO to file with the Commission proposed amendments to its constitution, articles of incorporation, by-laws, rules, and other similar instruments or interpretations of these instruments. Registered exchanges are also required to maintain certain records pursuant to Rule 17a–1 under the Exchange Act.[341]

As registered exchanges, alternative trading systems would also be subject to more frequent inspection by the Commission. As broker-dealers, alternative trading systems would 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 would be inspected more regularly by Commission staff, but would—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 would be examined for other programs they may operate, such as index programs. Each type of examination would 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. Therefore, the Commission is not able to quantify a meaningful average cost to the SROs for compliance with the Commission examination program, and requests comment on the specific costs that may be involved.

In addition, there would also be costs associated in meeting the obligations set forth in section 11A of the Exchange Act and the rules thereunder. These costs would 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 would be offset by the right to share in the revenues generated by these plans. For example, to join the CTA plan, applicants would 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

[336] The estimated aggregate cost of $1,520 is derived from 2 alternative trading systems incurring an estimated annual cost of $760 each ($85 for providing systems outage notices and $675 for recordkeeping requirements).

[337] Rule 6a-1 currently requires that Form 1 be filed with the Commission upon registration with the Commission as a national securities exchange or upon applying for an exemption from registration. This is the only time a Form 1 is filed. The estimated average cost per response of $3,719 is composed of $2,000 for professional work (20 hours at $100 per hour), $500 for in-house professional work (10 hours at $50 per hour), $255 for clerical work (17 hours at $15 per hour) and $964 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

[338] As proposed to be amended, Rule 6a-2 would require that an exchange, whether registered as a national securities exchange or exempted from registration, file with the Commission a new Form 1 to reflect amendments to those items contained in the previously filed Form 1. The Commission believes that the proposed amendments to Rule 6a-2 would reduce the filing obligations for all respondents. *See supra* Section III.B.3.b. The Commission estimates that the average cost per response, as reduced by the proposed amendments to Rule 6a–2, would be $1,215. This estimate is composed of $750 for in-house professional work (15 hours at $50 per hour), $150 for clerical work (10 hours at $15 per hour) and $315 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

[339] Rule 6a-3 currently requires that an exchange, whether registered as a national securities exchange or exempted from registration, file with the Commission information regarding any material issued or made generally available to members of, or participants or subscribers to, the exchange, and a monthly report detailing the number of shares of stocks, bonds, rights, and warrants traded on the exchange's facilities and the aggregate dollar amount of such securities. The Commission is proposing to amend Rule 6a-3, but only to simplify the language of the rule. The proposed amendments would not change the material terms of the rule. *See supra* Section III.B.3.b. The Commission receives approximately 25 filings pursuant to Rule 6a-3 per year from 9 respondents, for a total of 225 responses. 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 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973). The total annual average cost for 225 responses is estimated to be $2,137.50.

[340] *See also* Rule 19b–4 under the Exchange Act and Form 19b–4. The Commission currently receives approximately 600 rule filings per year from approximately 25 respondents. The estimated average cost per response of $1,890 is composed of $1,250 for in-house professional work (25 hours at $50 per hour), $150 for clerical work (10 hours at $15 per hour), and $490 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973). Major rule filings can cost substantially more than $1,890, but account for less than approximately one percent of the total annual rule filings. The Commission estimated that these rule filings can cost up to approximately $10,000 to $15,000 per filing.

[341] The estimated average cost per respondent is $2,500, which is composed of 50 hours of in-house professional work per year at $50 per hour. There are currently 8 registered national securities exchanges and 1 national securities association that are subject to Rule 17a–1, for an annual estimated 450 burden hours and a cost of $22,500. Other entities, such as registered clearing agencies and the Municipal Securities Rulemaking Board are also subject to the rule, but have not been reflected in this estimate because the changes proposed in this release would not affect those entities.

the CTA plan that would be available to the applicant.[342] Similarly, new participants in ITS would 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.[343] These costs would also include the costs of complying with Rule 11Ac1–1(b) under the Exchange Act,[344] 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.[345] These costs will vary depending on the nature and size of the systems involved, and the Commission requests comment on the costs involved.

The Commission notes that the remaining costs would at least partially be offset because the alternative trading systems assuming the costs of exchange registration would no longer be regulated as broker-dealers. Consequently, they would 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 would 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, the right to establish trading and conduct rules, the right to establish fee schedules, the ability to directly participate in the NMS mechanisms, and the right to share in the profits and benefits produced by the NMS mechanisms such as the CQS, CTA, ITS and OTC–UTP plans.[346]

B. Proposed Amendments to Application and Related Rules for Registration as an Exchange

The Commission is proposing amendments to Rules 6a–1, 6a–2, and 6a–3 under the Exchange Act,[347] which require exchanges that elect to register to file Form 1 and comply with certain information updating and monthly reporting requirements. The proposed amendments would describe the filing requirements for national securities exchanges in a more clear and concise manner.

1. Benefits

The Commission believes that the proposed amendments would provide benefits to organizations that are currently registered, or in the future apply for registration, as a national securities exchange. First, the proposed amendments to Rules 6a–1, 6a–2, and 6a–3 would 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 would be better able to understand the rules' requirements and comply with them. Much of the information required on Form 1 would not change, but the revised form would recast the questions and exhibits in a different format that would ease compliance and make the responses more relevant to investors and the Commission. While national securities exchanges have traditionally been membership-owned, Form 1 would also be revised to accommodate proprietary national securities exchanges.

Second, the proposed amendments would 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 would 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 would 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 would reduce expenses associated with clerical time, postage, and copying.

The proposed amended rules would 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 proposed amendments would eliminate exchanges' requirement to submit changes to their constitution, their rules, or the securities listed on the exchange within 10 days. The proposed amendments would also permit exchanges to file certain information regarding subsidiaries and affiliates every three years rather than annually. These proposed amendments would conserve registered exchanges' staff time to comply with the rules.

The Commission estimates that the proposals would specifically reduce the annual burdens that each respondent would incur to comply with Rule 6a–2 by approximately 5 hours. Thus, the Commission anticipates that respondents would spend an average of 25 hours on an annual basis to comply with amended Rule 6a–2.[348] The estimated average benefit to each individual respondent is $75 per year.[349] These estimates represent a decrease of the estimated burden that currently exists, so exchanges would benefit from reduced filing burdens.

2. Costs

The proposed rules are intended to simplify the filing requirements and reduce the compliance burdens for national securities exchanges and would likely impose few additional costs on

[342] *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 and restated March 1980 and December 1995, at 8–9. 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. 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.

[343] *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.

[344] 17 CFR 240.11Ac1–1.

[345] 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). 17 CFR 240.11Ac1–1(b).

[346] *See supra* Section III.B.1.

[347] 17 CFR 240.6a–1; 17 CFR 240.6a–2; 17 CFR 240.6a–3.

[348] These estimates are based on the Commission's experience with Rule 6a–2 and Form 1–A filings. The Commission expects the current filing burdens of 30 hours to be lessened under the proposed rules, thus the estimated burden of hours required has been adjusted downward. The Commission notes that the proposed rules will eliminate Form 1–A and incorporate the updating obligations into the revised Form 1.

[349] The estimated average annual benefit for each respondent of $75 is composed of the savings of 5 hours of clerical work at $15 per hour.

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 proposed simplified requirements would 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 notes that it is soliciting comment on the feasibility of permitting the filings required under the proposed amendments to be filed electronically, which would further reduce the compliance burdens and costs.

The Commission estimates that each respondent would incur an average burden of 47 hours to comply with Rule 6a–1 and file an initial application for registration on Form 1. This represents a 2 hour increase from the current average burden due to the estimated additional burden of the added exhibits. The Commission estimates that the average additional cost per response would be approximately $30.[350] Because the Commission receives applications for registration as exchanges on Form 1 from time to time, it cannot estimate the annual aggregate costs and burden hours associated with such filings. The Commission therefore requests comment on such costs and burden hours.

The Commission anticipates that the proposals would not change the burdens associated with complying with Rule 6a–3. The Commission estimates 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 would file supplemental information under Rule 6a–3 approximately 25 times per year. The estimated average cost per response for each individual respondent is $9.50, resulting in an estimated annual average burden for each respondent of $237.50.[351]

C. Costs and Benefits of the Proposed Repeal of Rule 17a–23 and the Proposed Amendments to Rules 17a–3 and 17a–4

Rule 17a–23 currently imposes certain recordkeeping and reporting requirements on broker-dealer trading systems. In conjunction with its other proposals, the Commission is proposing to repeal Rule 17a–23 and amend Rules 17a–3 and 17a–4 under the Exchange Act[352] to eliminate all reporting requirements under Rule 17a–23 and to transfer certain recordkeeping requirements from Rule 17a–23 to Rules 17a–3(a)(16) and 17a–4(b)(10).

The new recordkeeping requirements under Rules 17a–3(a)(16) and 17a–4(b)(10) would apply solely to a limited group of broker-dealer systems, defined in the proposed amendment to Rule 17a–3 as ''internal broker-dealer systems.'' These are systems that would not be encompassed under proposed Rule 3b–12 under the Exchange Act. Systems that would be alternative trading systems under the Commission's proposals in this release would not be subject to the recordkeeping requirements under amended Rules 17a–3 and 17a–4. Moreover, the reporting obligations currently under Rule 17a–23 would be eliminated entirely.

1. Benefits

Approximately 43 of the broker-dealer trading systems currently filing reports under Rule 17a–23 would be alternative trading systems under the proposals in this release. These trading systems would not fall within the proposed definition of ''internal broker-dealer system,'' and would, therefore, not be required to maintain records under the new provisions of Rules 17a–3(a)(16) and 17a–4(b)(10). Accordingly, the Commission estimates that the annual aggregate costs and annual aggregate burden for the recordkeeping obligations under Rule 17a–23 would be reduced by $19,350 and 1,290 hours, respectively.[353] In addition, all reporting requirements under Rule 17a–23 would be eliminated. The Commission estimates that the annual aggregate costs and annual aggregate burden for the reporting obligations under Rule 17a–23 of $15,764 and 2,252 hours, respectively, would, therefore, be eliminated.[354] The Commission notes, however, that alternative trading systems would be subject to recordkeeping requirements under proposed Regulation ATS.[355]

2. Costs

No additional recordkeeping burdens would be imposed on internal broker-dealer systems under the proposed amendments to Rules 17a–3 and 17a–4. The proposed amendments would apply only to systems that are presently subject to the recordkeeping requirements of Rule 17a–23. Because the Commission is proposing to repeal Rule 17a–23 and amend 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 would be associated with proposed Rule 17a–3(a)(16) and 17a–4(b)(10). The Commission estimates that there would be approximately 94 broker-dealers operating 123 internal broker-dealer systems that would have to keep the records described in proposed Rules 17a–3(a)(16) and 17a–4(b)(10). The Commission estimates that each respondent would spend approximately 27 hours keeping the required records under Rule 17a–3(a)(16). The Commission also estimates that each respondent would spend approximately 3 hours to preserve the required records under Rule 17a–4(b)(10). Thus, the Commission estimates that each respondent would incur a burden of 30 hours per year complying with Rules 17a–3(a)(16) and

[350] The estimated average additional cost per response of $30 is derived from 2 additional hours of clerical work at $15 per hour.

[351] 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 35% of the total labor costs). The Commission estimates overhead based on 35% 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 25 annual filings at a cost of $9.50 per filing.

[352] 17 CFR 240.17a–3; 17 CFR 240.17a–4.

[353] The estimated average benefit for alternative trading systems of $19,350 is composed of 43 alternative trading systems saving 30 hours of clerical work at $15 per hour. The estimated average benefit for alternative trading systems of 1,290 hours is composed of 43 alternative trading systems saving 30 hours each. The cost per hour and per filing is derived from the Commission's review of the Form 17A–23 supplied by the broker-dealers currently subject to Rule 17a–23.

The Commission notes, however, that alternative trading systems would be subject to recordkeeping requirements under Proposed Regulation ATS. *See supra* Section IX.A.2.a.

[354] The estimated aggregate burden of 2,252 is composed of 528 hours for initial reports (22 initial reports at 24 hours each), 1,716 hours for quarterly reports (143 quarterly reports at 12 hours per year—4 quarters at 3 hours each) and 8 hours for cessation reports (4 cessation reports at 2 hours each). The estimated total cost of $33,780 is composed of 2,252 hours of clerical work at $15 per hour. The Commission notes, however, that alternative trading systems would be subject to reporting requirements under proposed Regulation ATS. *See supra* Section IX.A.2.a.

[355] The costs and benefits associated with these recordkeeping requirements are discussed in Section IX.A.2.a. *supra.*

17a–4(b)(10) and an annual cost of $1,442.40.[356]

D. SRO Pilot Trading System

Under proposed Rule 19b–5, SRO rule changes to operate pilot trading systems would be temporarily exempt from the rule filing requirement of section 19(b) of the Exchange Act.[357]

1. Benefits

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 preliminarily believes that proposed Rule 19b–5 would benefit SROs and investors. As proposed, Rule 19b–5 would enhance competition in the trading markets without imposing significant SRO compliance burdens.[358] Proposed Rule 19b–5 would permit the timely implementation of pilot trading systems without the widespread dissemination of critical business information. Therefore, the proposal should reduce SRO costs associated with the Commission approval process and improve the competitive balance between SROs and alternative trading systems that are regulated as broker-dealers.[359] Moreover, the Commission believes that proposed Rule 19b–5 would foster innovation and create a streamlined procedure for SROs to operate pilot trading systems and would reduce filing costs for SROs pilot trading systems.

2. Costs

The Commission anticipates receiving approximately 6 notices per year regarding pilot trading systems on proposed Form PILOT.[360] An SRO would be required to submit a Form PILOT providing detailed operational data and update this information quarterly. The Commission estimates that an SRO would expend 24 hours to file an initial operation report and 3 hours to file a quarterly report and a systems change notice.[361] The Commission also estimates that an SRO would file 2 amendments per year to report changes to the system.[362] The Commission estimates that an SRO would expend $1,242 per initial Form PILOT filing and $155 for each quarterly Form PILOT and system change notice filed.[363] Thus, the total estimated annual burden for SROs to comply with proposed Rule 19b–5 by filing an initial notice on Form PILOT is estimated to be 144 hours for a total average cost of $7,452.[364] The total estimated annual burden for SROs to file systems change notices and quarterly reports on Form PILOT is estimated to be 108 hours for a total average cost of $5,580.[365]

E. Request for Comment

The Commission requests data to quantify the costs and the value of the benefits described above. The Commission seeks estimates of these costs and benefits, as well as any costs and benefits not already defined, that may result from the adoption of these proposed amendments and rules.

The Commission requests comment on the estimate of the number of alternative trading systems that would be permitted to register as broker-dealers and comply with Regulation ATS, the number of new alternative trading systems that would choose to register as broker-dealers and comply with Regulation ATS each year in the future, and the number of alternative trading systems registered as broker-dealers that file cessation of operations reports each year.

In addition, the Commission requests comment on the costs and benefits associated with the Commission's proposals with respect to notice, reporting, and recordkeeping for alternative trading systems choosing to register as broker-dealers. The Commission specifically requests comment on the costs and benefits for all market participants associated with the filing requirements on Form ATS and ATS–R and the feasibility of permitting such forms to be filed electronically.

The Commission also requests comment on the costs and benefits associated with the Commission's proposals to improve surveillance on alternative trading systems. The Commission specifically requests comment on the benefits for all market participants associated with preventing fraud and manipulation on alternative trading systems.

The Commission requests comment on the costs associated with the Commission's proposals to improve market transparency and equal execution access, and the benefits associated with improving transparency, reducing market fragmentation, and meeting NMS goals.

The Commission requests comment on the costs associated with the Commission's proposals to ensure fair access to alternative trading systems registered as broker-dealers, as well as the benefits associated with preventing discriminatory denials of access and providing the avenue of appeal to the Commission for investors denied access to such systems.

The Commission requests comment on the costs and benefits associated

[356] The Commission estimates 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 $1,442.40 is derived from 30 burden hours per respondent at $48.08 per hour.

[357] *See also supra* note 340.

[358] 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 of 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 35% of the value of legal work. *See GAS Guide to Estimating Reporting Costs* (1973).

[359] The Commission estimates that under current procedures, a proposed 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 proposed expedited treatment of SRO rule changes for pilot trading systems permits SROs to operate a pilot trading system 20 days after submitting an initial operation report on proposed Form PILOT, so long as such product complies with proposed Rule 19b–5 under the Exchange Act.

[360] This estimate is based on a review of past SRO filings under Section 19(b) of the Exchange Act. The Commission estimates that approximately 6 rule filings per year in the past could have been filed under the proposed Rule 19b–5.

[361] 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.

[362] This estimate is based on the Commission's experience with collection of similar information under Rule 17a–23.

[363] The estimated average cost of $1,242 to file an initial Form PILOT is composed of $800 for in-house professional work (16 hours at $50 per hour), $120 for clerical work (8 hours at $15 per hour) and $322 for printing, supplies, copying, and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

The 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 (2 hours at $50 per hour), $15 for clerical work (1 hour at $15 per hour) and $40 for printing, supplies, copying and postage (approximately 35% of the total labor costs). The Commission estimates overhead based on 35% of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

[364] The estimated average burden of 144 hours is derived from 6 SRO respondents incurring an average burden of 24 hours per filing. The estimated average cost of $7,452 is derived from 6 SRO respondents making 6 initial Form PILOT filings at $1,242 per filing.

[365] The estimated average burden of 108 hours is derived from 6 SRO respondents filing 4 quarterly reports and 2 systems change notices at 3 burden hours per filing. The estimated average cost of $5,580 is derived from 6 SRO respondents filing 4 quarterly reports and 2 systems change notices at $155 per filing.

with the Commission's proposals to improve systems capacity, integrity, and security. The Commission specifically requests comment on the costs associated with maintaining adequate systems related procedures, safeguards, and documentation.

The Commission requests comment on the costs and benefits associated with exchange registration. The Commission specifically requests comment on the costs and benefits associated with providing alternative trading systems with the option to register as national securities exchanges under sections 5 and 6 of the Exchange Act.

The Commission requests comment on the costs and benefits associated with the Commission's proposed amendments to Rules 17a–3, 17a–4, and repeal of Rule 17a–23. The Commission specifically requests comment on the costs to internal broker-dealer systems of continuing to maintain records under Rules 17a–3(a)(16) and 17a–4(b)(10), and the benefits of eliminating the reporting requirements.

The Commission requests comment on the costs and benefits associated with the Commission's proposal to temporarily exempt SRO pilot trading systems from section 19(b) rule filing requirements. The Commission specifically requests comment on the costs and benefits for all market participants associated with such a temporary exemption from rule filing and the associated filing requirements on Form PILOT.

The Commission generally requests comment on the competitive benefits or anticompetitive effects that may impact any market participants if the proposals are adopted as proposed. The Commission also requests comment on what impact the proposals, if adopted, would have on efficiency and capital formation. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposal.

X. Effects on Efficiency, Competition, and Capital Formation

Section 23(a) of the Exchange Act [366] requires that the Commission, when promulgating rules under the Exchange Act, to consider the anti-competitive effects of such rules, if any, and to balance any impact against the regulatory benefits gained in furtherance of the purposes of the Act. Section 3(f) of the Exchange Act requires the Commission, when engaged in rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, and whether the action would promote efficiency, competition, and capital formation.[367] The Commission has considered the proposed rules and amendments in light of these standards and preliminarily believes that they would not impose any significant burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The rules and amendments are intended to provide a choice between registering as a broker-dealer and registering as an exchange for markets operated as alternative trading systems. By using volume thresholds to trigger fair access, market transparency, and coordination, and systems capacity, integrity, and security requirements, the Commission's proposals would not unduly burden small, start-up alternative trading systems, and would therefore foster competition. The proposals would also improve surveillance and recordkeeping for all alternative trading systems, which would improve investor confidence in such systems and help maintain fair and orderly markets. Moreover, the proposals offer SROs the opportunity to develop and operate pilot trading systems with less cost and time delay. This would help to foster innovation and create benefits for investors. Nonetheless, the Commission solicits comments on the impact of the proposed rules and amendments on competition. Specifically, the Commission requests 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. Finally, commenters should consider the proposed amendments' and rules' effect on efficiency and capital formation.

XI. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with the Regulatory Flexibility Act (''RFA'') [368] regarding proposed new Rules 3a1–1, 3b–12, 19b–5, Regulation ATS, new Forms ATS, ATS–R and PILOT, and amended Rules 6a–1, 6a–2, 6a–3, 17a–3, 17a–4, the Commission's Rules of Practice, amendments to Form 1 and the repeal of Rule 17a–23. The following summarizes the IRFA.

As set forth in greater detail in the IRFA, the proposed rules create the option for an alternative trading system to register as a national securities exchange or as a broker-dealer and comply with additional requirements depending on their activities and trading volume. The IRFA also states that proposed amendments will exclude pilot trading systems operated by national securities exchanges or national securities associations from rule filing requirements.

The IRFA sets forth the statutory authority for the proposed rules. The IRFA also discusses the effect of the proposed rules on small entities.[369] The IRFA states that the proposed rules would not affect small entities, as the Commission expects that alternative trading systems will generally be broker-dealers with total capital of at least $500,000. The Commission estimates that there are approximately forty-three total alternative trading systems presently in existence, with 5 of those estimated to be small entities.

The IRFA recognizes that, in order to provide a reasonable option to registration as a national securities exchange, any Commission proposals must strike a balance between fostering innovation and providing real investor protections. In order to assure that alternative trading systems are adequately organized and fairly operated, the Commission believes it is necessary and reasonable to require any alternative trading system to supply basic, descriptive information before it starts operating and periodically to supply aggregate transaction data to the Commission. The Commission expects relatively few small entities to start such enterprises, but believes that the regulatory burdens established in the proposed rules are reasonable.

In addition, by utilizing volume thresholds to trigger additional requirements the Commission anticipates that starting and developing alternative trading systems would not be unduly burdened by the proposed filing requirements. Once an alternative trading system achieves significant market influence, it is reasonable to expect those systems to comply with fair access, order display, and systems

[366] 15 U.S.C. 78w(a)(2).

[367] 15 U.S.C. 78c(f).

[368] 5 U.S.C. 603.

[369] Small entities are considered broker-dealers with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) under the Exchange Act, 17 CFR 240.17a–5(d) or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. 17 CFR 240.0–10(c).

capacity, integrity, and security requirements in order to protect investors and assure a fair secondary market.

The proposed rules would require all alternative trading systems to file an initial notice on Form ATS. Alternative trading systems would have periodic reporting requirements to amend Form ATS as the information changes over time. The IRFA further notes that alternative trading systems would be required to make quarterly transaction reports on Form ATS–R. The IRFA states that alternative trading systems would also be required to maintain records relating to trading activities and, if meeting certain volume thresholds, records relating to systems capacity, integrity and security, fair access and order display. The Commission believes that these filing requirements are offset by the benefits to investors, the market as a whole and the Commission's ability to keep up with market developments and changes.

The initial notice requirement on Form ATS is a one-time filing and the transaction reports required on Form ATS–R are only required four times per year. The proposed rules will require alternative trading systems to file some information not currently required under Rule 17a–23. This information will include quarterly reports describing the securities traded through the system and subscribers to the system. Additionally, the proposed rules will require alternative trading systems to file more detailed information concerning the characteristics of the system than is currently required. The Commission believes that the additional burdens created by these requirements will be offset by eliminating the filing requirements under Rule 17a–23. Small entities are unlikely to meet the volume thresholds that would require additional recordkeeping and filing requirements for fair access and systems capacity, integrity and security.

The proposed rules would exempt pilot trading systems operated by national securities exchanges and national securities associations from rule filing requirements. The IRFA further states that the proposed rule changes will reduce the filing burdens associated with filing an initial Form 1 and the required subsequent amendments. The Commission believes that these changes reduce the filing burdens on national securities exchanges and exchanges exempt from registration under section 5 based on the limited volume of transactions effected on such exchanges. All national securities exchanges are too large to be considered small entities. For exchanges exempt from registration under section 5 pursuant to the limited volume of transactions effected on such exchanges, the proposed rules will help to reduce the filing burdens by clarifying current filing requirements and supplying additional means of compliance.

As explained further in the IRFA, the Commission has considered other alternatives to the proposed rules. The Commission believes that it would be inconsistent with the purposes of the Act to exempt small entities from the proposed rules.

The IRFA includes information concerning the solicitation of comments with respect to the IRFA generally, and in particular, the number of small entities that would be affected by the proposed rules. Cost-benefit information reflected in the ''Costs and Benefits of the Proposed Rules and Amendments'' and ''Effects on Efficiency, Competition and Capital Formation'' sections of this Release is also reflected in the IRFA. A copy of the IRFA may be obtained by contacting Kevin Ehrlich, Division of Market Regulation, Securities Exchange Commission, 450 Fifth Street, NW., Washington, DC. 20549.

XII. Paperwork Reduction Act

Certain provisions of the proposed 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.*), and the Commission has submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collections of information are: ''Form 1, Rules 6a–1 and 6a–2'' ''Rule 6a–3,'' ''Rule 17a–3(a)(16),'' ''Rule 17a–4(b)(10),'' ''Rule 19b–5 and Form PILOT,'' ''Rule 301, Form ATS and Form ATS–R,'' ''Rule 302,'' ''Rule 303,'' all under the Exchange Act. ''Form 1, Rules 6a–1 and 6a–2'' and ''Rule 6a–3,'' which the Commission is proposing to amend, contain currently approved collections of information under OMB control numbers 3235–0017 and 3235–0021. The proposed rules and rule amendments are necessary 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. An agency may not sponsor, conduct, or require response to an information collection unless a currently valid OMB control number is displayed.

A. Form 1, Rules 6a–1 and 6a–2

Rule 6a–1 and Form 1 currently require any organization seeking to operate as a national securities exchange, or as an exchange exempt from registration based on limited volume to file a Form 1. Form 1 requires the organization to describe its operation. The amendments to Rule 6a–1 would simplify and clarify the requirements to make them easier to understand. The revised Form 1 introduces a fill-in-the-blank format, reconfigures the exhibits for clarity, and updates the requests for information to accommodate new organizational models of exchanges. The collection of information would be necessary to permit the Commission to determine that an exchange applying for registration complies with the provisions of the Exchange Act governing exchange registration and statutory requirements for registration. The Commission requires such information to protect investors and the public interest. There are no other means of obtaining this information and it is not available in consolidated form in any other location. The respondents to this information collection are those entities wishing to become registered as an exchange. Applications for registration on Form 1 are made on a one-time basis. The Commission receives Form 1 filings from time to time. For purposes of the Paperwork Reduction Act, the staff assumes that a maximum of one filing per year would be made, imposing a burden of 47 hours per response and a cost of $2,000.

The Commission also proposes to amend Rule 6a–2 which contains requirements for exchanges to file amendments updating the information initially filed on Form 1. Proposed Rule 6a–2 revises the filing requirements to ease the frequency of filing certain exhibits and offer the choice of making certain information publicly available on the Internet in lieu of making paper filings. The collection of information would be necessary to permit the Commission to determine whether the exchanges are complying with the Exchange Act and keeping such information consolidated and current. The information is also made available to members of the public who may wish to comment on the information provided. The likely respondents to this information collection are those entities registered as an exchange or exempt from registration under section 5 based on the limited volume of transactions effected on those exchanges. Currently, eight exchanges and one exempt exchange make such filings. The

Commission estimates that revised Rule 6a–2 would decrease the filing burden for each respondent by 5 hours for an average burden for each respondent of 25 hours per filing. The Commission estimates that each exchange would respond 1 time per year and incur an average burden of 25 hours. The Commission estimates that the aggregate burden for all exchanges to comply with Rule 6a–2 would be 225 hours. The Commission bases its projections on its prior experience with exchange filings pursuant to Rules 6a–1 and 6a–2. The total estimated burden for Form 1 would be 272 hours (47 hours for one initial filing and 225 hours for nine amendments).

For exchanges that choose to register and operate as a national securities exchange, the provisions of Rules 6a–1 and 6a–2 as well as the requirements of Form 1 are mandatory. All filings made with the Commission pursuant to Rules 6a–1 and 6a–2 on Form 1 are not confidential and are available to the public. National securities exchanges would still be obligated by Rule 17a–1 to preserve records for 5 years, the first 2 years in an easily accessible place. The Commission notes that it is imposing no additional recordkeeping requirements under proposed Rules 6a–1 or 6a–2, but is only reiterating currently existing obligations.

B. Rule 6a–3

Rule 6a–3 currently requires that registered exchanges file with the Commission copies of information made available to the members, subscribers, or participants. The collection of information is necessary to permit the Commission to determine whether exchanges are complying with the Exchange Act and to enable the Commission to carry out its statutory obligations and protect investors. The proposed rule changes would help simplify the rule language and provide registered exchanges with the option of making the information available on the Internet in lieu of paper filings. Further, the proposed rule also recognizes that modern exchanges may have participants or subscribers rather than members. The respondents are exchanges or exchanges exempt from registration based on limited volume. Currently, eight exchanges and one exchange exempt from registration based on limited volume are required to comply with the rule. The Commission expects no additional filing burdens as a result of this proposed rule change. The estimated burden for each exchange is 0.5 hours for each submission pursuant to Rule 6a–3. The Commission anticipates that each respondent would file 25 amendments per year for a total burden of 12.5 hours per year for each respondent. The Commission anticipates that the total estimated aggregate annual burden for 9 respondents would be 112.5 hours. The Commission does not anticipate that the burdens associated with Rule 6a–3 would change in a material manner.

For exchanges that choose to register and operate as a national securities exchange, the provisions of Rule 6a–3 are mandatory. All filings made with the Commission pursuant to Rule 6a–3 are not confidential and are available to the public. National securities exchanges would still be obligated by Rule 17a–1 to preserve records for 5 years, the first 2 in an easily accessible place.

C. Rule 17a–3(a)(16)

The proposed amendments to Rule 17a–3 would require a broker-dealer that operates an internal broker-dealer system to make certain records regarding the daily trading activity of that system. The collection of information would be necessary to permit the Commission and SROs to determine whether broker-dealers are complying with the Commission's financial responsibility programs, antifraud and antimanipulation rules, as well as other Commission and SRO rules. The Commission cannot obtain such information by any other means because broker-dealers are the only entities that produce, and have access to, such information. Broker-dealers currently comply with substantially similar recordkeeping requirements under current Rule 17a–23, so there would be no net additional burden on broker-dealer respondents. The Commission estimates that there would be 94 respondents affected. Based on the Commission's prior experience with the burdens associated with Rule 17a–23, for the purposes of the proposed amendments to Rule 17a–3, the Commission estimates that each respondent would incur a burden of 27 hours to comply with the recordkeeping requirements. Thus, the total aggregate burden for broker-dealers operating internal broker-dealer systems to comply with the proposed recordkeeping requirements under amended Rule 17a–3 would be 2,538 hours.

For alternative trading systems that choose to register as a broker-dealer, the proposed amendments to Rule 17a–3 are mandatory. The records required to be made are considered confidential and are not available to the public. All records required under the proposed amendment to Rule 17a–3 would be preserved for not less than 3 years, the first 2 in an easily accessible place.

D. Rule 17a–4(b)(10)

The proposed amendments to Rule 17a–4 would require a broker-dealer that operates an internal broker-dealer system to keep records it makes pursuant to under Rule 17a–3(a)(16). The proposed amendments would also require broker-dealers to keep information that is supplied to subscribers, such as system notices. The Commission estimates that there are 94 broker-dealers that would be affected. Based on the Commission's prior experience with the burdens associated with Rule 17a–23, for purposes of the proposed amendments to Rule 17a–4, the Commission estimates that each respondent would incur an annual burden of 3 hours to comply with the record preservation requirements. Thus, the total aggregate burden for broker-dealers operating internal broker-dealer systems to comply with the record preservation requirements under amended Rule 17a–4(b)(10) would be 282 hours.

For alternative trading systems that choose to register as a broker-dealer, the proposed amendments to Rule 17a–4 are mandatory. The records required to be preserved are considered confidential and are not available to the public. All records required under the proposed amendments to Rule 17a–4 would be preserved for not less than 3 years, the first 2 years in an easily accessible place.

E. Rule 19b–5 and Form PILOT

Proposed Rule 19b–5 contains a requirement that SROs file a Form PILOT to notify the Commission of their intent to operate a pilot trading system. Proposed Rule 19b–5 also requires that SROs keep records containing the rules and procedures relating to each pilot trading system. SROs would be temporarily exempt from the rule filing requirements under section 19(b) of the Exchange Act for any rule changes associated with the pilot trading system. Because such systems can have an impact on the market, this collection of information would be necessary to inform the Commission of the existence and manner of operation of such pilot trading systems. The Commission has proposed that the SROs also must meet certain criteria in order to operate a pilot trading system. Notice to the Commission on Form PILOT is necessary to determine whether the SROs are meeting those criteria. Additionally, the recordkeeping requirement is necessary because the Commission would need to review this

information during an examination to determine compliance by the SRO with the federal securities laws. By permitting SROs to merely keep such information on hand instead of affirmatively filing it, the Commission believes it balances the need for access to the information with minimizing burdens on SROs. The respondents to this information collection would be SROs who wish to develop and introduce pilot trading systems.

Respondents would be required to file one initial Form PILOT before commencing operation of each pilot trading system. Respondents would also be required to file quarterly reports and systems change notices on Form PILOT. Based on the Commission's experience with section 19(b) rule filings, the Commission estimates that there would be 6 such respondents per year. Under Rule 19b–5, each respondent would file one initial Form PILOT filing before commencing operation of the pilot trading system and 4 quarterly reports on Form PILOT. In addition, the Commission anticipates that each respondent would file 2 systems change notices each year on Form PILOT. Based on the Commission's experience with similar section 19(b) rule filings, the Commission estimates that each respondent would incur a burden of 24 hours to file an initial operation report and an annual burden of 12 hours to file quarterly reports on Form PILOT. The Commission also estimates that each respondent would incur an annual burden of 6 hours to file 2 systems change notices on Form PILOT. Thus, the aggregate burden for respondents to file initial reports on Form PILOT would be 144 hours and the annual aggregate burden for respondents to file quarterly reports and systems change notices on Form PILOT would be 108 hours. Thus, the Commission estimates that the total aggregate burden for respondents under proposed Rule 19b–5 would be 252 hours.

For SROs that choose to operate pilot trading systems and avail themselves to the provisions of Rule 19b–5, compliance with Rule 19b–5 and the filings required on Form PILOT are mandatory. Proposed Rule 19b–5 reiterates SROs' existing recordkeeping obligations under Rule 17a–1, which requires that such records be kept for not less than 5 years, the first 2 years in an easily accessible place.

F. Rule 301, Form ATS and Form ATS–R

Proposed Rule 301 requires alternative trading systems that do not register as national securities exchanges to meet certain requirements. Specifically, alternative trading systems would be required to file an initial notice prior to operating, supply notices of material changes to the system operation prior to implementing those changes, file quarterly amendments notifying the Commission of changes to the system that have not been reflected in an earlier amendment and when it ceases operations as an alternative trading system. Alternative trading systems would also be required to file quarterly transaction reports on Form ATS–R detailing the type and volume of securities traded through the alternative trading system. An alternative trading system that meets certain volume thresholds would be required to notify investors denied or permitted only limited access to the system that they have a right to appeal the alternative trading systems' action to the Commission. In addition, the proposed rule would require alternative trading systems that meet certain volume thresholds to notify the Commission of systems outages and keep any records made in the process of complying with the systems capacity, integrity and security requirements under Rule 301.

The Commission estimates that there would be 43 alternative trading systems that would be respondents under the proposed rule. The Commission also estimates that, over time, approximately 3 new alternative trading systems would choose to register as a broker-dealer and comply with Regulation ATS each year and that 3 alternative trading systems would file cessation of operations reports on Form ATS and cease operating. Thus, the Commission anticipates that approximately 43 alternative trading systems will incur burdens each year under proposed Regulation ATS. Each would file a one-time notice of initial operation report on Form ATS. The Commission estimates that alternative trading systems would file 2 amendments per year to reflect material changes to information on Form ATS and 4 quarterly amendments to reflect other changes. In addition, alternative trading systems would be required to file 4 reports per year on Form ATS–R. The Commission also estimates that 3 alternative trading systems would file cessation of operations reports on Form ATS on an annual basis.

The Commission estimates that 2 alternative trading systems would meet the volume thresholds that trigger fair access obligations and would, therefore, be required to maintain records of its access standards and provide notice to investors denied or limited access to the system of their right to appear a denial or limitation of access to the Commission. Based on the Commission's experience with denials of access to markets, the Commission estimates that such systems would have to send 27 denial or limitation of access notices per year. The Commission also believes that 2 alternative trading systems would meet the trading volume thresholds that trigger the systems capacity, integrity and security requirements and would, therefore, be required to maintain records relating to these requirements and notify the Commission of system outages. Based on the Commission's experience with systems' outages in the markets, the Commission anticipates that such systems would provide 5 systems' outage notices per year.

The Commission's estimates for burden hours associated with filing Form ATS are based on the Commission's experience with filings made pursuant to Rules 6a–1, 6a–2, 6a–3 and 17a–23. While the burden estimates have been based on prior Commission experience, they have been adjusted to reflect the specific nature of each requirement.

The Commission estimates that each respondent filing an initial operation report on Form ATS would incur an average burden of 20 hours. Thus, the aggregate burden for 3 alternative trading systems to file initial operations reports on Form ATS would be 60 hours.

The Commission estimates that each respondent filing an amendment on Form ATS would incur an average annual burden of 12 hours. Thus, the average annual aggregate burden for 43 alternative trading systems to file 6 amendments each to the initial operation report on Form ATS would be 1,032 hours.

The Commission estimates that each respondent filing quarterly reports on Form ATS–R would incur an average annual burden of 16 hours. Thus, the average annual aggregate burden for 43 alternative trading systems to file quarterly reports on Form ATS–R would be 688 hours.

The Commission estimates that each respondent filing a cessation of operation report on Form ATS would incur an average burden of 2 hours. Thus, the average annual aggregate burden for 3 alternative trading systems to file cessation of operations reports on Form ATS would be 6 hours.

The Commission estimates that each respondent obligated to establish and keep standards for granting access to its system would incur a burden of 5 hours. Thus, the average annual aggregate burden for 2 alternative trading systems to establish and keep standards for

granting access to its system to comply with such standards would be 10 hours.

The Commission estimates that each respondent obligated to provide notices to investors denied or limited access to such system would incur a burden of 1 hour per notice, or 27 hours per year. Thus, the annual aggregate burden for 2 alternative trading systems to provide investors notice of a denial or limitation decision and their right of appeal to the Commission would be 54 hours.

The Commission estimates that each respondent obligated to comply with the systems capacity, integrity and security requirements would incur an average burden of 10 hours. Thus, the annual aggregate burden for 2 alternative trading systems to make records relating to steps taken to comply with the systems capacity, integrity and security requirements would be 20 hours.

The Commission estimates that each respondent obligated to provide systems' outage notices to the Commission would provide 5 such notices per year and that such systems would incur a burden of 0.25 hours per notice, or 1.25 hours per year. Thus, the annual aggregate burden for 2 alternative trading systems to provide investors notice of a denial or limitation decision and their right of appeal to the Commission would be 2.5 hours.

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 proposed Rule would be preserved for 3 years, the first 2 years in an easily accessible place.

G. Rule 302

Proposed Rule 302 would require alternative trading systems to make certain records with respect to trading activity through the alternative trading systems. This collection of information would 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. The Commission estimates 43 alternative trading systems would be required to comply with this proposed rule. The Commission believes that most alternative trading systems will keep such information in the course of business, so the additional burdens of compliance would be minimal. Based on the Commission's experience with the burdens associated with recordkeeping requirements under Rule 17a–23, the Commission estimates that the annual burden for each respondent to comply with the recordkeeping requirements under proposed Rule 302 would be 36 hours and that the annual aggregate burden for 43 alternative trading systems to comply with Rule 302 would be 1,548 hours.

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 proposed Rule would be preserved for 3 years, the first 2 years in an easily accessible place.

H. Rule 303

Proposed 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 would not be required to file such information, but merely retain it in an organized manner and make it available to the Commission upon request. The Commission believes that most alternative trading systems will keep such information in the course of business, so the additional burdens of compliance would be minimal. The Commission estimates that 43 such alternative trading systems would be required to comply with Rule 303. Based on the Commission's experience with the burdens associated with record preservation requirements under Rule 17a–23, the Commission estimates that the annual burden for each respondent to comply with the recordkeeping requirements under proposed Rule 303 would be 4 hours and that the annual aggregate cost for 43 alternative trading systems to comply with Rule 303 would be 1,172 hours.

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 proposed Rule would be preserved for 3 years, the first 2 years in an easily accessible place.

I. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

(i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;

(ii) Evaluate the accuracy of the agency's estimate of the burden of the proposed collections of information;

(iii) Enhance the quality, utility, and clarity of the information to be collected;

(iv) Minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549 with reference to File No. S7–12–98. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

XIII. Statutory Authority

The proposed rules and rule amendments in this release are being proposed pursuant to 15 U.S.C. 78a *et seq.*, particularly sections 3(b), 5, 6, 11A, 15, 17(a), 17(b), 19(b), 23(a), and 36 of the Exchange Act, 15 U.S.C. 78c, 78e, 78f, 78k–1, 78*o*, 78q(a), 78q(b), 78s(b), 78w(a), and 78mm.

List of Subjects

17 CFR Part 201

Administrative practice and procedure, Equal access to justice, 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 proposed to be amended as follows.

PART 201—RULES OF PRACTICE

1. The authority citation for part 201 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77h–1, 77j, 77s, 77u, 78c(b), 78d–1, 78d–2, 78*l*, 78m, 78n, 78*o*(d), 78*o*–3, 78s, 78u–2, 78u–3, 78v, 78w, 79c, 79s, 79t, 79z–5a, 77sss, 77ttt, 80a–8, 80a–9, 80a–37, 80a–38, 80a–39, 80a–40, 80a–41, 80a–44, 80b–3, 80b–9, 80b–11, and 80b–12 unless otherwise noted.

2. Paragraph (a)(9) of § 201.101 is revised to read as follows:

§ 201.101 Definitions.

(a) * * *

(9) *Proceeding* means any agency process initiated by an order instituting proceedings; or by the filing, pursuant to § 201.410, of a petition for review of an initial decision by a hearing officer; or by the filing, pursuant to § 201.420, of an application for review of a self-regulatory organization or an alternative trading system determination; or by the filing pursuant to § 201.430, of a notice of intention to file a petition for review of a determination made pursuant to delegated authority;

* * * * *

3. The introductory text of paragraph (a) of § 201.202 is revised to read as follows:

§ 201.202 Specifications of procedures by parties in certain proceedings.

(a) *Motion to specify procedures.* In any proceeding other than an enforcement or disciplinary proceeding or a proceeding to review a determination by a self-regulatory organization or an alternative trading system pursuant to §§ 201.420 and 201.421, a party may, at any time up to 20 days prior to the start of a hearing, make a motion to specify the procedures necessary or appropriate for the proceeding, with particular reference to:

* * * * *

4. Paragraph (a)(1) of § 201.210 is revised to read as follows:

§ 201.210 Parties, limited participants and amici curiae.

(a) *Parties in an enforcement or disciplinary proceeding or a proceeding to review a self-regulatory organization or an alternative trading system determination.* (1) *Generally.* No person shall be granted leave to become a party or a non-party participant on a limited basis in an enforcement or disciplinary proceeding or a proceeding to review a determination by a self-regulatory organization or an alternative trading system pursuant to §§ 201.420 and 201.421.

* * * * *

5. Paragraph (d)(1) of § 201.401 is revised to read as follows:

§ 201.401 Issuance of stays.

* * * * *

(d) * * * (1) *Availability.* A motion for a stay of an action by a self-regulatory organization for which the Commission is the appropriate regulatory agency or a limitation or prohibition of access by an alternative trading system, for which action review may be sought pursuant to § 201.420, may be made by any person aggrieved thereby.

* * * * *

6. Section 201.420 is revised to read as follows:

§ 201.420 Appeal of determinations by self-regulatory organizations and alternative trading systems.

(a) *Application for review; when available.* (1) An application for review by the Commission may be filed by any person who is aggrieved by a self-regulatory organization determination as to which a notice is required to be filed with the Commission pursuant to section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1). Such determinations include any:

(i) Final disciplinary sanction;

(ii) Denial or conditioning of membership or participation;

(iii) Prohibition or limitation in respect to access to services offered by that self-regulatory organization or a member thereof; or

(iv) Bar from association.

(2) An application for review by the Commission may be filed by any person who is aggrieved by an alternative trading system determination as to which a notice is required to be filed with the Commission pursuant to paragraph (a)(5) of § 242.301 of this chapter (Regulation ATS). Such determination includes any prohibition or limitation in respect to access to services offered by the alternative trading system.

(b) *Procedure.* An application for review may be filed with the Commission pursuant to § 201.151 within 30 days after notice of the determination was filed with the Commission pursuant to sections 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1) or paragraph (a)(5) of § 242.301 of this chapter (Regulation ATS), and received by the aggrieved person applying for review. The application shall be served by the applicant on the self-regulatory organization or the alternative trading system, whichever is applicable. The application shall identify the determination complained of, set forth in summary form a brief statement of alleged errors in the determination and supporting reasons therefor and state an address where the applicant can be served with the record index. The application shall be accompanied by the notice of appearance required by § 201.102(d).

(c) *Determination not stayed.* Filing an application for review with the Commission pursuant to paragraph (b) of this section shall not operate as a stay of the complained of determination made by the self-regulatory organization or the alternative trading system unless the Commission otherwise orders either pursuant to a motion filed in accordance with § 201.401 or on its own motion.

(d) *Certification of the record; service of the index.* Fourteen days after receipt of an application for review or a Commission order for review, the self-regulatory organization or the alternative trading system shall certify and file with the Commission one copy of the record upon which the action complained of was taken, and shall file with the Commission three copies of an index to such record, and shall serve upon each party one copy of the index.

7. The section heading and paragraph (a) of § 201.421 are revised to read as follows:

§ 201.421 Commission consideration of determinations by self-regulatory organizations and alternative trading systems.

(a) *Commission review other than pursuant to a petition for review.* The Commission may, on its own initiative, order review of any determination by a self-regulatory organization or an alternative trading system that could be subject to an application for review pursuant to § 201.420(a) within 40 days after notice thereof was filed with the Commission pursuant to Section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1) or paragraph (a)(5) of § 242.301 of this chapter (Regulation ATS).

* * * * *

8. Paragraph (a)(2)(ii) of § 201.450 is revised to read as follows:

§ 201.450 Briefs filed with the Commission.

(a) * * *

(2) * * *

(ii) Receipt by the Commission of an index to the record of a determination of a self-regulatory organization or an alternative trading system filed pursuant to § 201.420(d);

* * * * *

9. Paragraph (a)(2)(i) of § 201.460 is revised to read as follows:

§ 201.460 Record before the Commission.

* * * * *

(a) * * *

(2) * * *

(i) The record certified pursuant to § 201.420(d) by the self-regulatory

organization or the alternative trading system;

* * * * *

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

10. 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, 78*o*, 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.

* * * * *

11. 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; or

(2) Is an alternative trading system and is in compliance 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) The Commission determines, after notice to the alternative trading system and an opportunity for the alternative trading system to respond, that such an exemption would not be necessary or appropriate in the public interest or consistent with the protection of investors; or

(2) The organization, association, or group of persons is registered as an exchange under section 6 of the Act (15 U.S.C. 78f).

(c) Alternative trading system has the same meaning as under § 242.300(a) of this chapter.

12. Section 240.3b–12 is added before the undesignated center heading ''Registration and Exemption of Exchanges'' to read as follows:

§ 240.3b–12 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) Consolidates orders of multiple parties; and

(2) Sets non-discretionary material conditions (whether by providing a trading facility or by setting rules) under which the parties 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:

(1) Routes orders to a national securities exchange, a market operated by a national securities association, or a broker-dealer;

(2) Displays the quotes of a single dealer and allows persons to enter orders for execution against such dealer's quotes; or

(3) Provides the means for a single broker-dealer to internally manage customers' orders, including crossing or matching such orders with each other, *provided however* that:

(i) Customers' orders are not displayed to any person, other than the broker-dealer and its employees; and

(ii) Customers' orders are not executed according to a predetermined procedure that is communicated to such customers.

(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.

13. 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.

* * * * *

14. 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, 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, 17 CFR 240.249.1, 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 Exhibit C, F, G, I, 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 H, as of the end of the latest fiscal year of the exchange; and

(2) Exhibits J, K, and M and, 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 H. 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.

15. 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.

16. Section 240.11Ac1–1 is amended by redesignating paragraph (c)(5)(ii)(A) as paragraph (c)(5)(ii)(A)(*1*), paragraph (c)(5)(ii)(B) 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*) removing the period and adding in its place ''; or'', and adding 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.

* * * * *

17. 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, in number of trades, number of shares, and total U.S. dollar value;

(*ii*) With respect to debt securities, in total U.S. dollar value; and

(*iii*) With respect to other securities, 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 this paragraph 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.

18. 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), (6), (7), (8), (9), and (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 and reserved]

19. Section 240.17a–23 is removed and reserved.

20. 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 *pilot trading system* shall mean a trading system operated by a self-regulatory organization that is not substantially similar to any 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% of the average daily share 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 share 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 share 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 share 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 (a)(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 (a)(2) of this section no more than 60 days ago.

(b) 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)); or

(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.

(c) 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 a proposed rule change on Form 19b–4, 17 CFR 249.819, if the self-regulatory organization complies with the requirements in this paragraph (c).

(1) *Scope of exemption.* Such proposed rule change relates to the operation of a pilot trading system.

(2) *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.

(3) *Trading rules and procedures and listing standards.* The self-regulatory organization has in place trading rules and procedures and listing standards necessary to operate the pilot trading system.

(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 organization's pilot trading system.

(6) *Types of securities.* The self-regulatory organization:

(i) Permits to trade on the pilot trading system only securities listed on a national securities exchange or to which unlisted trading privileges have been extended pursuant to a rule, regulation, or order of the Commission under section 12(f) of the Act, (15 U.S.C. 78*l*(f));

(ii) Does not permit to trade on the pilot trading system any security or instrument, such as an option, warrant or hybrid product, the value of which is based, in whole or in part, upon the performance of any security that is traded on another 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)); and

(iii) Does not permit to trade on the pilot trading system any security or instrument, such as an equity security, the derivative of which is traded on another 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)).

(7) *Procedures to ensure the confidential treatment of trading information.* The self-regulatory organization has in place adequate safeguards and procedures relating to the treatment of trading information. Such safeguards and procedures shall include:

(i) Limiting access to the confidential information regarding the identity of members, and other persons, effecting transactions on the pilot trading system, as well as such members' and other persons' confidential trading information, to those employees of the self-regulatory organization who are operating the pilot trading system or are responsible for such pilot trading system's compliance with these or any other applicable rules;

(ii) Implementing standards controlling the self-regulatory organization employees' trading for their own accounts; and

(iii) Adopting and implementing adequate oversight procedures to ensure that the safeguards and procedures outlined in paragraphs (c)(7)(i) and (ii) of this section are followed.

(8) *Examinations, inspections, and investigations of subscribers.* The self-regulatory organization and its members cooperate 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) Every notice or amendment filed pursuant to this paragraph (c) 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 report filed pursuant to this paragraph (c) shall be deemed to be confidential.

(d) A self-regulatory organization shall request Commission approval, pursuant to section 19(b)(2) of the Act, (15 U.S.C. 78s(b)), 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.

(e) 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.

(f) Notwithstanding paragraph (c) 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) 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 changes would not be necessary or appropriate in the public interest or consistent with the protection of investors.

PART 242—REGULATIONS M AND ATS

21. 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, 78 mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 80a–23, 80a–29, and 80a–37.

22. The part heading for part 242 is revised as set forth above.

23. 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 that are not national securities exchanges.
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–12 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% or more of a class of voting security or has the power to sell or direct the sale of 25% 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% 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) *Corporate debt security* shall mean any security, other than an exempted security, that evidences a liability of the issuer and that has a maturity date that is at least one year following the date of issuance.

§ 242.301 Requirements for alternative trading systems that are not national securities exchanges.

(a) *Scope of section.* An alternative trading system shall comply with the requirements in paragraph (b) of this section, unless such alternative trading system is:

(1) Registered as an exchange under section 6 of the Act, (15 U.S.C. 78f);

(2) Exempt from registration as an exchange based on the limited volume of transactions effected;

(3) Operated by a national securities association; or

(4) Registered as a broker-dealer under sections 15(b), or 15C of the Act, (15 U.S.C. 78o(b), and 78o–5), and trades only the following types of securities:

(i) Government securities, as defined in section 3(a)(42) of the Act, (15 U.S.C. 78c(a)(42));

(ii) Debt securities that:

(A) Are issued pursuant to the Brady Plan debt-restructuring program; and

(B) Have all of their principal payments guaranteed by the issuance of government securities; and

(iii) Repurchase and reverse repurchase agreements solely involving securities included within paragraphs (a)(4)(i) and (a)(4)(ii) of this section.

(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 (*effective* date of rule), no later than (60 days following effective date).

(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 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 of which the alternative trading system is a member 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 if, 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 greater than 10% 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:

(A) Provide to a national securities exchange or national securities association (or an exclusive processor acting on behalf of one or more national

securities exchanges or national securities associations) 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 and ensure that such prices and sizes are included in the quotation data made available by the exchange, association or exclusive processor to quotation vendors pursuant to § 240.11Ac1–1 of this chapter; and

(B) Provide to any broker-dealer that has access to a 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:

(*1*) Equivalent to the ability of such member to effect a transaction with other orders displayed on the exchange or by the association; and

(*2*) At the price of the highest priced buy order or lowest priced sell order displayed for the lesser of the cumulative size of such priced orders entered therein at such price, or the size of the execution sought by the member.

(4) *Fees.* The alternative trading system shall not charge any fee to members of a national securities exchange or national securities association for access to the alternative trading system required by paragraph (b)(3)(ii)(B) of this section that is:

(i) In excess of the highest fee the alternative trading system charges a substantial proportion of its broker-dealer subscribers for access made available to subscribers by the alternative trading system; or

(ii) Prohibited by rules of the national securities exchange or national securities association, to which the alternative trading system provides the prices and sizes of orders under paragraph (b)(3)(ii)(B) of this section, that are designed to assure consistency with standards for access to quotations displayed on the market operated by such national securities exchange or national securities association.

(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, greater than 20% of the average daily share volume in that security 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 an equity security that is not a covered security and for which transactions are reported to a self-regulatory organization, greater than 20% of the average daily share volume in that security as calculated by the self-regulatory organization to which such transactions are reported; or

(C) With respect to any category of debt security, including corporate debt securities, greater than 20% of the average daily volume traded in the United States.

(ii) An alternative trading system shall:

(A) Establish 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; and

(C) Within 24 hours of prohibiting or limiting, directly or indirectly, any person's access to any services offered by an alternative trading system, such alternative trading system shall send notice to such person stating that such person has the right to appeal to the Commission the action taken by such alternative trading system.

(iii) If any alternative trading system meeting the standards in paragraph (b)(5)(i) of this section, directly or indirectly, prohibits or limits access to the services offered, any person aggrieved thereby may file with the Commission a written motion for a stay of such prohibition or limitation pursuant to § 201.401 of this chapter.

(iv) Applications to the Commission for review of any prohibition or limitation of access to services offered by an alternative trading system shall be made pursuant to § 201.420 of this chapter.

(v) Every notice filed pursuant to this paragraph (b)(5) shall constitute a ''report'' within the meaning of sections 11A, 17(a), 18(a), and 32(a) (15 U.S.C. 78q(a), 78r(a), and 78ff(a)), and any other applicable provisions, of the Act.

(vi) All reports filed pursuant to this paragraph (b)(5) shall be deemed confidential when filed.

(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 an average daily share volume:

(A) With respect any covered security, greater than 20% of the average daily share 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, greater than 20% of the average daily share volume as calculated by the self-regulatory organization to which such transactions are reported; or

(C) With respect to category of debt security, including corporate debt securities, greater than 20% of the average daily volume traded in the United States.

(ii) With respect to those systems that support order entry, order routing, 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 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.

(7) *Examinations, inspections, and investigations of subscribers.* 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 described in 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 described in 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.* The alternative trading system shall have in place adequate safeguards and procedures to protect subscribers' confidential trading information. Such safeguards and procedures shall include:

(i) 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;

(ii) Implementing standards controlling employees of the alternative trading system trading for their own accounts; and

(iii) Adopting and implementing adequate oversight procedures to ensure that the safeguards and procedures outlined in paragraphs (b)(6)(ii)(A), (B) and (C) 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.''

§ 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);

(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 U.S. dollar value; 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 bonds to which the order applies;

(4) An identification of the order 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) Date and time (expressed in terms of hours, minutes, and seconds) that the order was executed;

(13) Price at which the order was executed;

(14) Size of the order executed (expressed in number of shares or units or principal amount);

(15) 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; 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; 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 paragraphs (b)(2) and (b)(5) of § 242.301.

(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 § 242.303 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), § 242.303 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)(1) of § 242.303.

(d) The records required to be maintained and preserved pursuant to § 242.303 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 maintain and preserve such records and will be surrendered promptly on request of the

alternative trading system and including 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 or 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

24. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a, *et seq.*, unless otherwise noted.

* * * * *

25. 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 Exchange Act, (15 U.S.C. 78e).

BILLING CODE 8010–01–P

Form 1

OMB APPROVAL
OMB Number: 3235-0017 Expires: Estimated Average burden hours per form:

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

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.
   - Form 1 and accompanying exhibits shall be filed in duplicate.
   - 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. **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 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

❑ 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 — 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. If the exchange is a trust, please provide the name of the trust and the trustee(s). For each of the persons listed in the Exhibit J, 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.

§ 249.1a and Form 1–A [Removed]

26. Section 249.1a and Form 1-A are removed.

§ 249.636 and Form ATS [Removed and reserved]

27. Section 249.636 and Form 17A–23 are removed and reserved.

28. 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.

Form ATS

OMB APPROVAL
OMB Number: 3235- Expires: Estimated Average burden hours per form:

INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT AND CESSATION OF OPERATIONS REPORT FOR ALTERNATIVE TRADING SYSTEMS

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. **UPDATING** - 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 which has not been reported to the SEC as a material change to the operation of the alternative trading system.

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, and the filing date on each page.
   - Use only the current version of Form ATS or a reproduction.

5. **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.

6. **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), 78*o*(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 4 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, and file quarterly amendments to Form ATS to reflect changes not previously reported.

   - 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 at set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).

FORM ATS 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-12 under the Exchange Act; and (2) that does not (A) 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 (B) 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. 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: _____

E. Alternative trading system's main street address (Do not use a P.O. Box):

_____

_____

F. Mailing address (if different):

_____

_____

G. Business telephone and facsimile number:

_____

(Telephone) (Facsimile)

H. 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 Securities and Exchange Commission or SRO 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 1E and 1F. 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 Number: _____

Filing date: _____

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.

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 subsequent amendments, and of 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.

29. 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.

Form ATS-R

OMB APPROVAL
OMB Number: 3235- Expires: Estimated Average burden hours per form:

QUARTERLY REPORT OF ALTERNATIVE TRADING SYSTEM ACTIVITIES

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. **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 and report period dates on each page.
   - Use only the current version of Form ATS-R or a reproduction.

3. **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.

4. **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.

5. **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.

6. **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. *See* 15 U.S.C. §§78c(b), 78k-1(a), 78k-1(c), 78*o*(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).

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-12 under the Exchange Act; and (2) that does not (A) 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 (B) discipline subscribers other than by exclusion from trading.

CORPORATE DEBT SECURITIES - Shall mean any security, other than an exempted security, that evidences a liability of the issuer and that has a maturity date that is at least one year following the date of issuance.

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).

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. 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: _____
   E. Alternative trading system's main street address (Do not use a P.O. Box): _____
   F. Mailing address (if different): _____
   G. Business telephone and facsimile number: _____
      (Telephone) (Facsimile)
   H. 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 Securities and Exchange Commission or SRO 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 1D and 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 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 _____

4. Provide the total unit and dollar volume of transactions 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. 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. Corporate debt securities		
K. Government securities		
L. Municipal securities		
M. Mortgage related securities		
N. Debt securities other than any securities included in Items 4J-4M above		

5. A. List the types of equity securities reported in Item 4F above:

_____

_____

_____

B. List the types of debt reported in Item 4N above:

_____

_____

DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY

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 _____

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		

DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY

30. 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 § 204.19b–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 § 240.19b–5 of this chapter.

Form PILOT

OMB APPROVAL
OMB Number: 3235- Expires: Estimated Average burden hours per form:

INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT AND QUARTERLY REPORT FOR PILOT TRADING SYSTEMS OPERATED BY SELF-REGULATORY ORGANIZATIONS

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.

2. **WHEN TO FILE A FORM PILOT** - 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 update information in 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 pilot 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 SRO, pilot trading system and the filing date on each page.
- Use only the current version of Form PILOT or a reproduction.

5. **RECORDKEEPING** - A copy of this Form PILOT, as well as any amendments thereto filed with the SEC, must be retained by the sponsoring SRO at its principal place of business and made available for inspection upon request of the SEC.

6. **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.

- 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 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.

- 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.

- 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 share 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 share trading volume of all trading systems operated by such self-regulatory organization;

(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 share 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 share 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 30 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); or (B) satisfied the definition of "pilot trading system" under paragraph (2) above no more than 30 days ago.

SUBSCRIBER - Shall mean any person, as the term is defined in Section 3(a)(9) of the Exchange Act, that has entered into a contractual agreement with a pilot trading system to access such pilot trading system for the purpose of effecting transactions in securities or for submitting, disseminating or displaying orders on such pilot trading system, including a customer, member, user, or participant in an pilot 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.

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:

_____

B. Full Name of pilot trading system:

_____

C. If this filing makes a name change on behalf of the pilot trading system, enter the previous name. Specify whether the _____ pilot trading system name (1A), or _____ business name (1B) changes:

Previous name: _____

D. Pilot trading system's business address (Do not use a P.O. Box):

_____

_____

E. Business telephone and facsimile number:

_____

(Telephone) (Facsimile)

F. Contact employee:

_____

(Name and Title) (Telephone Number) (Facsimile)

EXECUTION:

The SRO consents that service of any civil action brought by or notice of any proceeding before the Securities and Exchange Commission 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. 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 pilot trading system. 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 pilot 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 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: _____

2. If this is an initial operation report, the date the SRO expects to commence operation of the pilot trading system: _____

3. Attach as Exhibit A:

   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.

   b. A list of the specific subscribers, by name, or if this is an initial operation report, a list of the anticipated subscribers and the classes to which each subscriber or anticipated subscriber belongs.

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 of 1934 ("Exchange Act").

   b. A list of the securities the pilot 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, and 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 subscriber compliance with system guidelines;

   f. The procedures for ensuring subscriber compliance with system guidelines;

   g. A copy of the alternative trading system's subscriber manual and any other materials provided to subscribers; and

   h. A copy of the subscriber agreement.

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. 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. Corporate debt securities		
K. Government securities		
L. Municipal securities		
M. Mortgage related securities		
N. Debt securities other than any securities included in Items 9J-9M above		

10. A. List the types of equity securities reported in Item 9F above: _____

_____

B. List the types of debt reported in Item 9N above: _____

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By the Commission.

Dated: April 21, 1998.

Margaret H. McFarland,

Deptuy Secretary.

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