

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

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

Finally, the Commission recognizes that domestic markets must compete with less regulated foreign markets and broker-dealers. The Commission agrees with commenters that excessive regulation of traditional exchanges, alternative trading systems, or other

markets hinders these exchanges' ability to compete and survive in the global arena. The pilot trading system rule responds to SROs' need for a more balanced competitive playing field.

#### B. Rule 19b-5

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

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

###### a. Definition of Pilot Trading System.

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

If at any time within the two-year period a pilot trading system exceeds the volume thresholds, it would be allowed to continue to operate for 60 more days under this exemption.<sup>466</sup> During this 60 day period, if the SRO intended to continue operating the

trading system, it would have to file for permanent approval under Section 19(b) of the Exchange Act of the rules related to the trading system.

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

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

The NYSE commented that the specific provisions of proposed Rule

<sup>457</sup> Rule 19b-5(f)(1) and (f)(2), 17 CFR 240.19b-5(f)(1) and (f)(2). See also *infra* Section VI.C.

<sup>458</sup> Rule 19b-5(c)(3), 17 CFR 240.19b-5(c)(3).

<sup>459</sup> See *infra* Section VI.B.

<sup>460</sup> See Proposing Release, *supra* note 3, at ns.256-61 and accompanying text.

<sup>461</sup> See Proposing Release, *supra* note 3, at n.261.

<sup>462</sup> See Ashton Letter at 2; SIA Letter at 15; CME Letter at 3; Amex Letter at 1; Bloomberg Letter at 6.

<sup>463</sup> Rule 19b-5(c)(2), 17 CFR 240.19b-5(c)(2).

<sup>464</sup> A pilot trading system is "independent" of other trading systems if it meets one of the standards set forth in paragraph (d) of Rule 19b-5.

<sup>465</sup> Rule 19b-5(c)(1), 17 CFR 240.19b-5(c)(1).

<sup>466</sup> Rule 19b-5(c)(3), 17 CFR 240.19b-5(c)(3). See also *infra* Section VI.C.

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

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

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

system that could occur by removing securities from the system that exceeded a specified threshold.<sup>474</sup>

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

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

Similarly, through the independence criteria, the Commission identified characteristics that render pilot trading

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

## 2. Scope of Pilot Trading Rule Exemption

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

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

<sup>468</sup> NYSE Letter at 9.

<sup>469</sup> ICI Letter at 5.

<sup>470</sup> See CBOE Letter at 2, 9; CHX Letter at 11; CME Letter at 4; PCX Letter at 8-10.

<sup>471</sup> See CME Letter at 4; PCX Letter at 9-10.

<sup>472</sup> See NASD Letter at 13; PCX Letter at 9-10.

<sup>473</sup> PCX Letter at 9-10.

<sup>474</sup> Amex Letter at 1, 3.

<sup>475</sup> See CBOE Letter at 9; CHX Letter at 11.

<sup>476</sup> See CBOE Letter at 9; NASD Letter at 2, 14.

<sup>477</sup> CHX Letter at 11.

<sup>478</sup> 15 U.S.C. 78f(b)(5).

<sup>479</sup> See *supra* note 467 and accompanying text.

<sup>480</sup> Rule 19b-5(b), 17 CFR 240.19b-5(b).

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

### 3. SROs' Continuing Obligations Regarding Pilot Trading Systems

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

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

In the Proposing Release, the Commission stated that SROs would have to "ensure" that these conditions were satisfied in order to rely on the temporary exemption under proposed Rule 19b-5. One commenter raised concerns regarding the requirement that SROs "ensure" that the conditions were met in order to rely on the proposed pilot trading system rule. Specifically

the CBOE requested that an SRO be allowed to rely on proposed Rule 19b-5 if the SRO acts in good faith in determining that the requirements of the pilot trading system rule have been met.<sup>485</sup> Based upon the Commission's experience with reviewing new pilot trading system proposals submitted by SROs, the Commission continues to believe that SROs operating pilot trading systems should satisfy the proposed requirements in order to operate such systems in a manner consistent with the Exchange Act. Nonetheless, the Commission recognizes that full compliance with some of the conditions may be beyond the SROs' control. The Commission agrees it is not practical to hold SROs strictly liable for the failure of unaffiliated entities to satisfy certain requirements of the proposed pilot trading system rule. Therefore, the Commission will consider an SRO exempt from rule filing requirements under Rule 19b-5 if the SRO acts in good faith in determining that the operation of the pilot trading system meets the conditions set out in paragraph (e) of that rule, and in operating the pilot trading system.

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

The twenty day period following an SRO's filing of Form PILOT is intended to provide the Commission with time to review the form for compliance by the SRO with the pilot trading system rule. In addition, after reviewing Form PILOT

the Commission may determine, after notice to the SRO and an opportunity for the SRO to respond, that the operation of a particular pilot trading system would not be necessary or appropriate in the public interest or consistent with the protection of investors without the SRO filing proposed rule changes under section 19(b) of the Exchange Act.<sup>488</sup>

The Commission also proposed to require an SRO to file an amendment to Form PILOT at least twenty days before it implements any material change to the operation of the pilot trading system. The Commission would consider a material change to the pilot trading system to include the addition of new types of securities, or a new date for commencing operation of the pilot trading system. The Commission proposed that an SRO also submit quarterly reports on Form PILOT that would include information about the trading volume effected on the pilot trading system during the most recent calendar quarter. The Commission received no comments on these requirements and is adopting them as proposed.<sup>489</sup>

The Commission proposed that all notices and reports filed on Form PILOT be kept confidential. The Commission, however, requested comment on whether all information on Form PILOT should be publicly available or whether, as an alternative, information on Form PILOT should be publicly available, unless an SRO specifically requests confidential treatment. The Commission received several comments on the confidential treatment of information on Form PILOT. The CBOE recommended that all information about a pilot trading system filed quarterly on Form PILOT be deemed confidential.<sup>490</sup> The NYSE suggested only limited confidentiality for filings on Form PILOT, that is, pilot trading system information should be publicly available shortly prior to, or on the date of, launch of a new system.<sup>491</sup> Another commenter offered that the Commission make public only certain information on Form PILOT.<sup>492</sup> One commenter suggested that the confidential treatment of Form PILOT information be at the filer's discretion.<sup>493</sup>

<sup>481</sup> See *supra* notes 504-505 and accompanying text.

<sup>482</sup> See Section 6(b)(2) of the Exchange Act, 15 U.S.C. 78f(2). See also Order Handling Rules Adopting Release, *supra* note.

<sup>483</sup> The Commission is not adopting the requirement concerning the procedures to ensure the confidential treatment of trading information because SROs are not currently required to do this with regard to their other trading systems.

<sup>484</sup> See discussion *infra* VI.B.3.i.

<sup>485</sup> CBOE Letter at 10.

<sup>486</sup> Examples include computer companies that design and maintain systems and clearing agencies.

<sup>487</sup> Rule 19b-5(e)(1), 17 CFR 240.19b-5(e)(1).

<sup>488</sup> Rule 19b-5(g), 17 CFR 240.19b-5(g).

<sup>489</sup> Rule 19b-5(e)(1), 17 CFR 240.19b-5(e)(1). The Commission requires that SROs identify filings made pursuant to Rule 19b-5 by including a file number on Form PILOT that appears as follows: PILOT—name of SRO—year—file number.

<sup>490</sup> CBOE Letter at 9.

<sup>491</sup> NYSE Letter at 9.

<sup>492</sup> Amex Letter, p. 2.

<sup>493</sup> American Century Letter, p. 6.

After considering commenters' suggestions, the Commission has determined that the confidential treatment of Form PILOT information is an important element in reducing the disparate regulatory treatment of SROs and alternative trading systems and that such confidentiality is critical in the period prior to a pilot trading system commencing operations. However, the Commission also considers important the public's interest in having access to accurate information about the pilot trading system. Accordingly, the Commission is modifying proposed Rule 19b-5, so that information reported by an SRO on Form PILOT is confidential until the pilot trading system commences operation.<sup>494</sup> Thereafter, Form PILOT information will be made available to the public. b. Fair Access

b. *Fair Access.* Because information and access advantages of certain SRO members could subvert the fair and orderly trading of securities on a pilot trading system or the primary market, the Commission is adding a specific condition to the pilot trading system rule requiring that the SRO provide fair access to the pilot trading system to all members of the SRO. The Commission is adding this fair access requirement in order to ensure that markets treat their members fairly.<sup>495</sup> In particular, the SRO shall establish written standards for granting access to the pilot trading system and apply those standards fairly to all members. Fair access does not require an SRO to allow every member to trade on a pilot trading system or to give each member trading on the pilot trading system the same privileges. However, this requirement does prohibit an SRO from unfairly discriminating in the access it does give its members to the pilot trading system. In addition, the SRO must ensure that information regarding orders on the pilot trading system is equally available to all members of the SRO with access to the pilot trading system.<sup>496</sup> However, a specialist may have preferred access to information regarding orders it represents in its capacity as specialist

on the pilot trading system.<sup>497</sup> This means that such SRO rules need not require a member acting as a specialist on the pilot trading system to expose its orders to all members, that is maintain an "open book." Such rules established by the SRO will be considered part of the pilot trading system for purposes of the temporary exemption.<sup>498</sup>

c. *Trading Rules and Procedures.* The Commission proposed to require SROs operating pilot trading systems under Rule 19b-5 to adopt and implement trading rules and procedures necessary to operate the pilot trading system in a manner consistent with the Exchange Act. The Commission received no comments specifically addressing this condition and is adopting it substantially as proposed. As adopted, an SRO must have appropriate trading rules and procedures to promote the fair and orderly trading of securities on the pilot trading system, including: (1) Margin requirements; (2) listing standards; (3) sales practice guidelines, such as rules regarding communications with the public; and (4) disclosure requirements. The trading rules and procedures should be appropriate for, and ensure the fair and orderly trading of, each type of security to be traded on the pilot trading system.<sup>499</sup>

d. *Surveillance.* Under the proposal, an SRO would have to establish procedures for the effective surveillance of trading activity on a pilot trading system. In the Proposing Release, the Commission noted the importance of an SRO being able to obtain information necessary to detect and deter market manipulation, illegal trading, and other trading abuses. To satisfy this requirement, the Commission proposed that an SRO have to develop and implement internal surveillance procedures to monitor transactions effected on the pilot trading system, and obtain surveillance information from other markets, both domestic and foreign.

Specifically, in the Proposing Release, the Commission discussed its expectation that there be a comprehensive information sharing agreement ("ISA") in place between the SRO operating a pilot trading system and any other market trading the securities, or trading the underlying securities of derivative securities products, traded on such pilot trading system.<sup>500</sup> Such agreements provide a

necessary deterrent to manipulation because they facilitate the availability of information needed to fully investigate a potential manipulation. An SRO operating a pilot trading system trading U.S. securities, or new derivative securities products overlying U.S. securities, would have to continue to ensure that all exchanges on which the U.S. securities trade are members of the Intermarket Surveillance Group ("ISG").<sup>501</sup> The ISG was formed to coordinate, among other things, effective surveillance and investigative information sharing arrangements in the stock and options markets.

The Commission received no comments specifically addressing the surveillance requirement under the proposed pilot trading system rule. The Commission continues to believe that in order for an SRO to operate a pilot trading system in a manner consistent with the Exchange Act, the SRO must be able to obtain information necessary to detect and deter market manipulation, illegal trading, and other trading abuses. Therefore, the Commission is adopting, as proposed, the requirement that an SRO develop and implement internal surveillance procedures to monitor transactions effected on the pilot trading system, and obtain surveillance information from other markets, both

to each other, upon request, information about market trading, clearing activity, and the identity of the ultimate purchasers and sellers of securities. See Securities Exchange Act Release No. 31529 (Nov. 27, 1992), 57 FR 57248 (Dec. 3, 1992). Similarly, an SRO that operates a pilot trading system that trades securities, or derivatives of securities that are listed or traded on a foreign market, should have a comprehensive ISA with such foreign markets. In addition, the SRO should ensure there are no blocking or secrecy laws in the foreign country that would prevent or interfere with the transfer of information under the comprehensive ISA. If securing a comprehensive ISA is not possible, the SRO should contact the Commission. In such instances, the Commission may determine that it is appropriate instead to rely on a Memorandum of Understanding ("MOU") between the Commission and the foreign regulator. Generally, the Commission has permitted an SRO to rely on an MOU in the absence of a comprehensive ISA only if the SRO receives an assurance from the Commission that such an MOU can be relied on for surveillance purposes and includes, at a minimum, the transaction, clearing, and customer information necessary to conduct an investigation. See Securities Exchange Act Release No. 35184 (Dec. 30, 1994), 60 FR 2616 (Jan. 10, 1995). In addition, an SRO should endeavor to develop comprehensive ISAs with foreign exchanges even if the SRO receives prior Commission approval to rely on an MOU in place of a comprehensive ISA.

<sup>501</sup> 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.

<sup>494</sup> Rule 19b-5(e)(11), 17 CFR 240.19b-5(e)(11).

<sup>495</sup> The Commission notes that registered exchanges and national securities associations already have obligations to ensure that their markets treat investors and other market participants fairly. The Exchange Act requires registered exchanges and national securities associations to consider the public interest in administering their markets and to establish rules designed to admit members fairly. Sections 6(b)(2) and 6(c) of the Exchange Act, 15 U.S.C. 78f(b)(2) and (c); section 15A(b)(8) of the Exchange Act, 15 U.S.C. 78o-3(b)(8). See also *supra* notes 241-244 and accompanying text.

<sup>496</sup> Rule 19b-5(e)(2)(i), 17 CFR 240.19b-5(e)(2)(i).

<sup>497</sup> Rule 19b-5(e)(2)(ii), 17 CFR 240.19b-5(e)(2)(ii).

<sup>498</sup> Rule 19b-5(e)(2)(iii), 17 CFR 240.19b-5(e)(2)(iii).

<sup>499</sup> Rule 19b-5(e)(3), 17 CFR 240.19b-5(e)(3).

<sup>500</sup> The Commission believes that a comprehensive ISA requires that the parties provide

domestic and foreign by means of an ISA.<sup>502</sup>

e. *Clearance and Settlement.* In the Proposing Release, the Commission observed that the integrity of the trading markets depends on the prompt and accurate clearance and settlement of securities transactions. For this reason, the Commission proposed that, as a condition of the exemption under Rule 19b-5, an SRO establish reasonable clearance and settlement procedures for transactions effected on the pilot trading system. For example, to ensure that adequate linkages have been formed, part of the user agreement should, at a minimum, request information about the name of the clearing agency member through which the user will clear its trades. The Commission received no comments specifically addressing the clearance and settlement requirement under the proposed pilot trading system rule. Therefore, the Commission is adopting as proposed, the requirement that an SRO operating a pilot trading system ensure that the necessary linkages to clearing agencies exist for all pilot trading system users.<sup>503</sup>

f. *Types of Securities.* The Commission proposed to limit the types of securities an SRO could trade on a pilot trading system. Two separate limitations were proposed. First, under the proposal a pilot trading system would only be permitted to trade securities listed on a national securities exchange or to which unlisted trading privileges was extended pursuant to a rule, regulation, or order of the Commission under section 12(f) of the Exchange Act. In general, section 12 of the Exchange Act requires an exchange to trade only those securities that the exchange lists, except that section 12(f) of the Exchange Act provides UTP under certain circumstances.<sup>504</sup> For example, under the OTC-UTP plan, exchanges are permitted to trade certain over-the-counter securities pursuant to a Commission order.<sup>505</sup> As proposed, a pilot trading system operated by a registered exchange or a national securities association would be limited to trading listed securities or securities to which UTP has been extended under section 12(f) of the Exchange Act. Because national securities associations currently trade securities that are neither exchange listed or subject to UTP, this provision was unnecessarily restrictive. Consequently, the Commission is modifying the limitation

on the types of securities a pilot trading system may trade from that proposed. In particular, Rule 19b-5(e)(6), as adopted, only restricts pilot trading systems by requiring that securities traded be registered under section 12 of the Exchange Act.<sup>506</sup> Registered exchanges will still be required to comply with sections 12(a) and 12(f) of the Exchange Act, and therefore, can only trade securities listed on that exchange, or securities it is permitted to trade under the OTC-UTP Plan.

g. *Activities of Specialists.* As proposed, an SRO's pilot trading system would not be eligible for the exemption in Rule 19b-5 if it traded derivative securities, such as options, warrants, or hybrid products, the value of which were based, in whole or in part, upon the performance of any security traded on another trading system operated by that SRO. Similarly, the proposed exemption excluded SRO pilot trading systems that traded any security or instrument, such as an equity security, the derivative of which traded on another trading system operated by that SRO. The Commission, in proposing these limitations, intended to preclude an SRO from relying on the temporary exemption if a pilot trading system simultaneously traded a security overlying or underlying a security traded on that SRO's primary market. The Commission has always considered this type of trading to raise special concerns that should be resolved through the normal rule filing process.<sup>507</sup>

In commenting on proposed Rule 19b-5, the CBOE and the Amex considered these limitations overly restrictive. The Amex suggested removing this limitation and instead requiring SROs to specify on Form PILOT their rules and procedures for trading such securities on the pilot trading system.<sup>508</sup> The CBOE suggested an alternative to the limitation that pilot trading systems may not trade securities

that overlie or underlie securities traded on another trading system operated by the same SRO. In particular, the CBOE suggested requiring the SRO to create firewalls or other safeguards between persons trading the derivative and the underlying or overlying securities, rather than flatly prohibiting it.<sup>509</sup>

After considering the commenters' recommendations, the Commission has determined that SROs may operate pilot trading systems under Rule 19b-5 that simultaneously trade a security that is overlying or underlying a security traded on another trading system operated by that market, provided that such trading remains separate. This means that, as part of the SRO's general requirement to have written trading rules and procedures to operate the pilot trading system,<sup>510</sup> an SRO must have adequate rules and procedures to trade related securities simultaneously. In addition, the Commission is adopting a more narrow prohibition than it proposed, which prohibits a member firm that is a specialist in a security from acting as a specialist on a pilot trading system operating during the same hours in a related security.<sup>511</sup> For example, a member firm may not be a specialist in a security, such as an equity security, on the pilot trading system when it is also a specialist in a derivative of that security, such as an option or equity-linked note, whose value, in whole or significant part, is based on the performance of that security.<sup>512</sup> The Commission would not consider listed options in a single underlying instrument to be related securities, for purposes of the pilot trading system exemption. The

<sup>509</sup> CBOE Letter at 10.

<sup>510</sup> Rule 19b-5(e)(3), 17 CFR 240.19b-5(e)(3).

<sup>511</sup> Rule 19b-5(e)(7)(iii), 17 CFR 240.19b-5(e)(7)(iii), defines related securities to mean any two securities in which the value of one security is determined, in whole or significant part, by the performance of the other security; or the value of both securities is determined, in whole or significant part, by the performance of a third security, combination of securities, index, indicator, interest rate or other common factor.

<sup>512</sup> A specialist, for purposes of the pilot trading system rule, means any member that is subject to an SRO requirement to regularly maintain a market in a particular security. Rule 19b-5(a), 17 CFR 240.19b-5(a). The definition of specialist is meant to preclude member firms with exclusive information about buy and sell orders from using unfairly such non-public material market information to their competitive advantage. For instance, a member acting as a specialist on the NYSE also could not simultaneously act as a specialist in related securities on a pilot trading system sponsored by the NYSE. Similarly, a member acting as a designated primary market maker on the CBOE also could not simultaneously act as a designated primary market maker in related securities on a pilot trading system sponsored by the CBOE.

<sup>506</sup> Rule 19b-5(e)(6), 17 CFR 240.19b-5(e)(6).

<sup>507</sup> See, e.g., Securities Exchange Act Release Nos. 21759 (Feb. 14, 1985), 50 FR 7250 (Feb. 21, 1985) (order approving NYSE proposal to trade options on NYSE-listed stocks in a separate physical location from the equity trading floor); 26147 (Oct. 3, 1988), 53 FR 39556 (Oct. 7, 1988) (order approving the trading on the Amex of options on Amex-listed stocks, concluding that side-by-side trading or integrated market-making issues did not arise because the Amex proposed to trade stocks and related options in physically separate locations); and 28556 (Oct. 19, 1990), 55 FR 43233 (Oct. 26, 1990) (order approving rule changes to establish rules governing the trading of stocks, warrants, and other securities instruments and contracts on the CBOE conditioned on the fact that trading in securities other than options will take place on a trading floor separate from the location where options are traded).

<sup>508</sup> Amex Letter at 4.

<sup>502</sup> Rule 19b-5(e)(4), 17 CFR 240.19b-5(e)(4).

<sup>503</sup> Rule 19b-5(e)(5), 17 CFR 240.19b-5(e)(5).

<sup>504</sup> 15 U.S.C. 78l(f).

<sup>505</sup> See Securities Exchange Act Release No. 39505 (Dec. 31, 1997), 63 FR 1515 (Jan. 9, 1998).

limitation under Rule 19b-5(e)(7)(ii) does not preclude any member firm from being a specialist on a pilot trading system in a security related to a security in which the member firm is a specialist on the SRO's other trading systems, when such related securities trade at different times.<sup>513</sup> Also, a member may be a specialist in related securities that, the Commission, upon application by the SRO, later determines is necessary or appropriate in the public interest and consistent with the protection of investors.<sup>514</sup>

The Commission notes that Rule 19b-5 does not prohibit an SRO from developing a trading system that permits a member firm to be a specialist in related securities that trade simultaneously on trading systems operated by the same SRO. However, the SRO could not avail itself of the Rule 19b-5 temporary exemption, and instead would have to file proposed rule changes with the Commission under Section 19(b) of the Exchange Act for public notice and comment and obtain Commission approval prior to operating such trading system.

*h. Inspections and Examinations.* As a condition to the exemption, the Commission proposed that an SRO cooperate with any examination or inspection by the Commission of persons effecting transactions on the pilot trading system. The Commission received no comments on this requirement and is adopting it as proposed.<sup>515</sup> As adopted, the SRO shall cooperate with the examination, inspection, or investigation by the Commission of transactions effected on the pilot trading system. The Commission staff will review SRO compliance with the conditions in Rule 19b-5 through its routine inspections. In order for the Commission staff to determine whether an SRO has properly relied on the exemption under Rule 19b-5, the SRO must maintain at its principal place of business all relevant records and information pertaining to the pilot trading system and the basis for which the SRO relied on the exemption from the rule filing requirement.<sup>516</sup> The Commission notes that if an SRO outsources the operation or maintenance of any aspect of a pilot trading system, such vendor would be considered to be operating a facility of an SRO and therefore would also be

subject to Commission examination or inspection.

*i. Public Availability of Pilot Trading System Rules.* Although pilot trading system rules do not need to be approved by the Commission, the Commission believes the current trading rules and procedures of the pilot trading system should be publicly available. Accordingly, the Commission is adopting a requirement that the SRO make its trading rules and procedures of the pilot trading system publicly available.<sup>517</sup>

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

Within two years of a pilot trading system commencing operation, an SRO must submit a rule filing under section 19(b)(2) of the Exchange Act to obtain approval for the pilot trading system to operate on a permanent basis.<sup>518</sup> In accordance with section 19(b) of the Exchange Act, after a formal notice and comment period, the Commission will decide whether to approve the proposed rule changes relating to a pilot trading system on a permanent basis or whether to institute proceedings to disapprove the proposed rule changes. Simultaneous with its request for Commission approval under to section 19(b)(2) of the Exchange Act, an SRO may request Commission approval pursuant to Section 19(b)(3)(A) of the Exchange Act, effective immediate upon filing, to continue to operate the trading system for a period not to exceed six months.<sup>519</sup>

## **VII. The Commission's Interpretation of the "Exchange" Definition**

### *A. The Commission's Interpretation in Delta*

In the Exchange Act, Congress provided a broad definition of the term "exchange," permitting the Commission to apply the definition flexibly as the securities markets evolve over time.<sup>520</sup>

<sup>517</sup> Rule 19b-5(e)(10), 17 CFR 240.19b-5(e)(10). This specific requirement is necessary because Rule 6a-2, as amended, requires exchanges to file its trading rules and procedures only once every three years, while national securities associations have no such publication requirement except through the rule filing process under section 19(b) of the Exchange Act.

<sup>518</sup> Rule 19b-5(f)(1), 17 CFR 240.19b-5(f)(1).

<sup>519</sup> Rule 19b-5(f)(1) and (f)(2), 17 CFR 240.19b-5(f)(1) and (f)(2).

<sup>520</sup> 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

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.<sup>521</sup>

Although the statutory definition of "exchange" is quite broad, in the 1990 *Delta Release*,<sup>522</sup> the Commission interpreted the definition narrowly to include only those organizations that are "designed, whether through trading rules, operational procedures or business incentives, to centralize trading and provide buy and sell quotations on a regular or continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations."<sup>523</sup> Based on this

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.")

<sup>521</sup> 15 U.S.C. 78c(a)(1).

<sup>522</sup> *Delta Release*, *supra* note 32. In 1988, the Commission granted Delta temporary registration as a clearing agency to allow it to issue, clear, and settle options executed through a trading system operated by RMJ Securities ("RMJ"). Concurrently, the Commission's Division of Market Regulation issued a letter stating that the Division would not recommend enforcement action against RMJ if its system did not register as a national securities exchange. Subsequently, the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange petitioned the U.S. Court of Appeals for the Seventh Circuit for review of the Commission's actions. Both challenges were premised on the view that RMJ's system unlawfully failed to register as an exchange or obtain an exemption from registration. The Seventh Circuit vacated Delta's temporary registration as a clearing agency, pending publication of a reasoned Commission analysis of whether or not RMJ's system was an exchange within the meaning of the Exchange Act. *Board of Trade of the City of Chicago v. Securities and Exchange Commission*, 883 F.2d 525 (7th Cir. 1989) ("*Delta I*"). In 1989, the Commission solicited comment on the issue, and in 1990 published its interpretation of the term "exchange" and its determination that RMJ's system did not meet that interpretation.

<sup>523</sup> See *Delta Release*, *supra* note 32. The Commission also identified the following factors as supporting the conclusion that the system in *Delta* should not be classified as an exchange. Unlike a traditional exchange, the system (1) was not open to the participation of retail investors on an agency basis; (2) did not offer limit order protection; and (3) provided a forum for trading instruments that lacked certain indicia of standardization. These factors were admittedly outside the Commission's "central focus" in *Delta*. *Id.* Moreover, most alternative trading systems that will fall now under

<sup>513</sup> An SRO also may request an exemption from the limitation under Rule 19b-5(e)(7)(i) by filing an application for an order for exemptive relief under section 36. See 17 CFR 240.0-12.

<sup>514</sup> Rule 19b-5(e)(7), 17 CFR 240.19b-5(e)(7).

<sup>515</sup> Rule 19b-5(e)(8), 17 CFR 240.19b-5(e)(8).

<sup>516</sup> Rule 19b-5(e)(9), 17 CFR 240.19b-5(e)(9).

interpretation, which was upheld by the Seventh Circuit on review,<sup>524</sup> 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.<sup>525</sup>

Several concerns compelled the Commission in 1990 to narrowly interpret the definition of the term "exchange." First, the Commission was concerned that a broad interpretation would place "evolving (alternative) trading systems within the 'strait jacket' of exchange regulation," thus stifling innovation.<sup>526</sup> Second, the Commission was concerned that a broad definition would subject brokers, dealers, and other statutorily defined entities to the regulatory scheme prescribed for exchanges.<sup>527</sup> Third, the Commission was concerned that "an expansive definition of the term 'exchange' would force a non-member, for-profit, proprietary trading system into a regulatory scheme for which it is ill-suited, thus ignoring the Congressional and judicial mandate to apply flexibly the definition of the term 'exchange' to the economic realm."<sup>528</sup> These concerns, however, are largely eliminated by Congress' broad grant of exemptive authority in 1996,<sup>529</sup> which has permitted the Commission to craft a regulatory framework for markets which excludes other statutorily defined entities (e.g., broker-dealers operating internal matching systems) and flexibly regulate markets to accommodate their diverse business structures. In addition, while the Delta interpretation was appropriate at the time, its emphasis on the "expectation" of regular execution of orders at quoted prices no longer reflects today's markets where alternative trading systems compete

the Commission's new interpretation in Rule 3b-16 allow broker-dealer subscribers to act on behalf of retail customers in placing and executing orders on the system; function as limit order books where orders are executed according to time, price, and size priority; and trade standard securities.

<sup>524</sup> *Board of Trade of the City of Chicago v. SEC*, 923 F.2d 1270 (7th Cir. 1991).

<sup>525</sup> For a list of no-action letters issued to system sponsors until the end of 1993 and a short history of the Commission's oversight of such systems, see Securities Exchange Act Release No. 33605, 59 FR 8368, 8369-71 (Feb. 18, 1994). See also Letters from the Division of Market Regulation to: Tradebook (Dec. 3, 1996); The Institutional Real Estate Clearinghouse System (May 28, 1996); Chicago Board Brokerage, Inc. and Clearing Corporation for Options and Securities (Dec. 13, 1995).

<sup>526</sup> *Delta Release*, *supra* note 32, at 1899.

<sup>527</sup> *Id.*

<sup>528</sup> *Id.*

<sup>529</sup> See *supra* note 7.

directly with registered exchanges and Nasdaq. The Delta approach has resulted in the anomaly of regulating as exchanges small volume entities that raise an expectation of liquidity within their system (such as AZX), while regulating as broker-dealers higher volume entities (such as Instinet).

More fundamentally, although traditional exchanges still provide liquidity through two-sided quotations and, hence, raise an expectation of execution at the quoted price, this is no longer the essential characteristic of a securities market where stock and other securities exchange hands. Today's technology enables market participants and investors to tap simultaneous and multiple sources of liquidity from remote locations. Market makers and specialists may be important liquidity providers on a particular exchange, but liquidity now comes from many sources across multiple markets.<sup>530</sup> For example, the public exposure of investor limit orders means that it is now easier to access liquidity in trading venues that do not have market makers or specialists.<sup>531</sup> Today, through their computer terminals and other communication links, brokers acting on behalf of their customers or institutions trading for themselves can see what the quoted price is on an exchange or Nasdaq and check it against the price available for the same security on one or more alternative trading systems.<sup>532</sup>

Notably, in *Delta*, the Commission indicated that the Exchange Act does not preclude an alternative trading system from coming within the "exchange definition."<sup>533</sup> The Commission recognized that its interpretation of the term "exchange" could be subject to change as the securities markets continued to change:

In order to permit the Commission to apply flexibly the (Exchange) Act's definition of the term "exchange" to innovative trading systems in securities, Congress imbued the (Exchange) Act's definition of the term "exchange" with a certain "plasticity" \* \* \*, "it invites reinterpretation as the way the

<sup>530</sup> The rules adopted today reflect and facilitate multiple sources of liquidity. Increasing the linkages among markets where significant trading activity occurs—both exchanges and alternative trading systems—will make the overall market for securities more transparent and liquid.

<sup>531</sup> See Order Handling Rules Adopting Release, *supra* note 177 at Section III.

<sup>532</sup> In fact, an alternative trading system that posts firm orders to buy or sell a security does raise a certain expectation of execution at those quoted prices. The expectation is based on the life of the outstanding orders in the system, rather than on continuous two-sided quotations published by specialists or market makers.

<sup>533</sup> See *Delta Release*, *supra* note 32, at 1900.

term \* \* \* 'generally understood' evolves."<sup>534</sup>

Moreover, on review, although the United States Court of Appeals for the Seventh Circuit Court accepted the Commission's interpretation of the term "exchange" and affirmed the Commission's determination that Delta was not an "exchange," the court nevertheless stated that the "Commission could have interpreted the section to embrace the Delta System" but that it was not compelled to do so.<sup>535</sup>

#### *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.<sup>536</sup> In the Proposing Release, the Commission estimated that, as of the end of 1996, the trading volume on alternative trading systems amounted to almost twenty percent of the trades in Nasdaq stocks, and almost four percent of orders in securities listed on the NYSE.

In addition to the general increase in the volume of trading occurring on alternative trading systems, the actual number of alternative trading systems has skyrocketed. In 1991, the Commission was aware of only a few such systems. Today, over forty such systems are currently operating. The viability of this number of alternative trading systems indicates that these systems account for an increasing proportion of trading and that a growing number of investors use these systems. Moreover, the arrival of trading services on the Internet portends an increasing level of retail interest in alternative means for trading.

As more alternative trading systems have developed to offer varying services to diverse customer bases, the availability of trading information and the accessibility of trading opportunities have become increasingly fragmented. The national market system relies on centralized sources of trading

<sup>534</sup> *Delta Release*, *supra* note 32, at 1895 (quoting *Delta I*, *supra* note 522, at 535).

<sup>535</sup> *Delta II*, *supra* note 348, at 1273. The court held that, because the statutory provision is ambiguous, the Commission had the discretion to interpret the definition the way it did.

<sup>536</sup> See Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments app IV (1994) ("Market 2000 Study").

opportunities and trading information. Exchange regulation is designed to facilitate centralization and enhance the general public's opportunities to obtain trading information and to access trading interest.

The narrow interpretation of the term "exchange" in Delta has eroded the effectiveness of the Commission's oversight of markets. For example, as discussed in the Concept Release, it is clear that regulatory concerns may be raised by entities that constitute a market where buyers and sellers interact, but do not necessarily ensure a two-sided market by design.<sup>537</sup> Moreover, the Commission's traditional approach to broker-dealer regulation is not designed to substitute for market regulation. Consequently, these alternative trading systems are not fully integrated into the mechanisms that promote market fairness, efficiency, and transparency. In addition to raising regulatory fairness concerns, this lack of integration into the national market system has had a negative impact on the quality and pricing efficiency of secondary markets.<sup>538</sup>

### C. The Revised Interpretation of "Exchange"

For purposes of effectively regulating the securities markets, including alternative trading systems, the Commission believes a revised interpretation of what constitutes an exchange is in order.<sup>539</sup> Although the Commission has considered many characteristics of the modern exchange

<sup>537</sup> See Proposing Release, *supra* note 3, at n.290.

<sup>538</sup> For example, the evidence in the Commission's report on the NASD and the Nasdaq market pursuant to section 21(a) of the Exchange Act suggests that widespread use of Instinet by market makers as a private market has had a significant impact on public investors and the operation of the Nasdaq market. See NASD 21(a) Report, *supra* note 4.

<sup>539</sup> Courts have consistently upheld an agency's discretion to revise earlier interpretations when a revision is reasonably warranted by changed circumstances. See, e.g., *Rust v. Sullivan*, 500 U.S. 173, 186 (1991). In *Rust*, the Court stated that "an initial agency interpretation is not instantly carved in stone, and the agency, to engage in informed rulemaking, must consider varying interpretations and the wisdom of its policy on a continuing basis." *Id.* at 186 (quoting *Chevron v. Natural Resources Defense Council*, 467 U.S. 837, 844-45 (1984)). The Court also stated that "an agency is not required to 'establish rules of conduct to last forever,' but rather 'must be given ample latitude to adapt its rules and policies to the demands of changing circumstances.'" *Id.* at 186-87 (quoting *Motor Vehicles Mfrs. Ass'n of United States v. State Farm Mut. Automobile Ins. Co.*, 463 U.S. 29, 42 (1983)). See also *Arkansas AFL-CIO v. FCC*, 11 F.3d 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).

in revising its interpretation,<sup>540</sup> it believes two elements most accurately reflect the functions and uses of today's exchange markets. Under the interpretation in Rule 3b-16, the first essential element of an exchange is the bringing together of orders of multiple buyers and sellers. This reflects the statutory concept of bringing together purchasers and sellers and also reflects the reality of today's marketplace—where supply and demand originate from a variety of sources, not simply from individual brokers and dealers.<sup>541</sup> The second essential element is that trading on an exchange takes place according to established, non-discretionary rules or procedures. As discussed above, an essential indication of the non-discretionary status of rules and procedures is that those rules and procedures are communicated to the system's users. Thus, participants have an expectation regarding the manner of execution—that is, if an order is entered, it will be executed in accordance with those procedures and not at the discretion of a counterparty or intermediary.<sup>542</sup>

Some commenters thought the Commission should retain its current interpretation of an exchange. For example, TBMA advocated a less expansive definition of exchange, and recommended that the Commission continue to regulate alternative trading systems within the broker-dealer framework, crafting appropriate regulations to address particular issues presented by unique operations as they develop.<sup>543</sup> TBMA also raised a question about whether, by eliminating the requirement that a system provide a reasonable expectation of liquidity to be considered an exchange, the Commission's proposal conflicted with the statutory definition of "exchange" because liquidity is "generally understood" to be a fundamental characteristic of an exchange. As noted above, however, today's technology gives market participants the ability to access multiple markets for liquidity at any given time. As a result, assuring liquidity within a single market by

<sup>540</sup> See *Concept Release*, *supra* note 2, at nn.125-133 and accompanying text.

<sup>541</sup> This broad conception of "bringing together" buyers and sellers is consistent with the *Delta Release*, which emphasized that the means employed for bringing together buyers and sellers "may be varied, ranging from a physical floor or trading system \* \* \* to other means of intermediation (such as a formal market making system or systemic procedures such as a consolidated limit order book or regular single price auction)." *Delta Release*, *supra* note 32, at 1899.

<sup>542</sup> The elements of the interpretation are discussed in greater detail in Section III, *supra*.

<sup>543</sup> See TBMA Letter at 3-4.

posting continuous two-sided quotations is no longer the essential characteristic of a market where securities exchange hands.<sup>544</sup>

Accordingly, the Commission believes that new Rule 3b-16 more accurately describes the range of markets that perform exchange functions as understood today. At the same time, the Commission's exemption from the exchange definition for many alternative trading systems provides a flexible framework, permitting each participant to choose the regulatory approach that best serves its own business needs.

### D. Other Practical Reasons for Revising the Current Interpretation

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

As stated above, one principal reason the Commission, to date, has interpreted the term "exchange" narrowly has been to avoid the imposition of unnecessary and burdensome regulatory obligations on small and emerging trading systems, which could stifle innovation.<sup>545</sup> The enactment of NSMIA,<sup>546</sup> however, alleviates the concern that an expanded interpretation of the term exchange will inhibit innovation.<sup>547</sup> Specifically,

<sup>544</sup> The Commission also notes that the statutory definition of "exchange" is written in the disjunctive: facilities for bringing together purchasers and sellers or facilities performing functions commonly performed by stock exchanges. Section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c(a)(1). See TBMA Letter, at 8-9 (recommending that the Commission continue to rely on its interpretation in the *Delta Release*); SIA Letter at 2, 6-7 (a significant characteristic of exchanges is structural features that create a reasonable expectation of the regular execution of orders at posted prices). See also Letter from Christopher J. Carroll, Managing Director, Deutsche Bank Securities, Inc. to Jonathan G. Katz, Secretary, SEC, dated July 31, 1998 ("DBSI Letter") at 2; NYSE Letter at 2-3, 4-5, 8 (commenting that only alternative trading systems meeting the *Delta* interpretation of exchange should have the ability to register with the Commission as an exchange); Instinet Letter at 8 (recommending that the Commission retain its current interpretation of "exchange"); CBB Letter at 3 (recommending that if the Commission believed its current interpretation of "exchange" in the *Delta Release* was inadequate, that the Commission should simply withdraw that interpretation and rely solely on the statutory definition of "exchange").

<sup>545</sup> For example, at the time of the *Delta Release*, the Commission sought to avoid interpreting the term "exchange" in a way that could unintentionally and inappropriately subject many broker-dealers to exchange regulation. One key factor in the Commission's decision not to regulate the *Delta* system as an exchange was the concern that doing so would subject traditional broker-dealer activities to exchange regulation. *Delta Release*, *supra* note 32.

<sup>546</sup> Pub. L. 104-290, 110 Stat. 3416 (1996). 15 U.S.C. 78mm.

<sup>547</sup> Throughout the past 60 years, the Commission has attempted to accommodate market innovations within the existing statutory framework to the

NSMIA added section 36(a)(1) to the Exchange Act, which provides that: the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of (the Exchange Act) or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.<sup>548</sup>

Prior to adoption of NSMIA, the Commission's authority under the Exchange Act to reduce or eliminate certain consequences of exchange registration was limited.<sup>549</sup> 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.<sup>550</sup>

## 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

extent possible in light of investor protection concerns, without imposing regulation that would stifle or threaten the commercial viability of such innovations. For example, at various times, the Commission considered the implications of evolving market conditions on exchange regulation. See Securities Exchange Act Release Nos. 8661 (Aug. 4, 1969), 34 FR 12952 (initially proposing Rule 15c2-10); 11673 (Sept. 23, 1975), 40 FR 45422 (withdrawing then-proposed Rule 15c2-10 and providing for registration of securities information processors); 26708 (Apr. 13, 1989), 54 FR 15429 (reproposing Rule 15c2-10); 33621 (Feb. 14, 1994), 59 FR 8379 (withdrawing proposed Rule 15c2-10).

<sup>548</sup> 15 U.S.C. 78mm(a)(1).

<sup>549</sup> 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.

<sup>550</sup> See S. Rep. No. 104-293, 104th Cong. 2d Sess. 15 (1996).

Commission would have to continue to respond to an increasing volume of no-action requests from developing alternative trading systems that seek to avoid the burdens associated with registration as a national securities exchange. The Commission's revised interpretation eliminates the need for this no-action approach. By codifying a regulatory framework that does not rely on Commission staff review of each novel system development, the Commission believes that technological improvements and enhanced services will become available more rapidly.

## 3. More Rational Treatment of Regulated Entities

The Commission believes that the revised interpretation of the term exchange, in combination with the adoption of Regulation ATS, which allows alternative trading systems to register as broker-dealers,<sup>551</sup> is consistent with other goals and provisions of the Exchange Act. The new regulatory framework, including the revised interpretation of "exchange" avoids the need for the Commission to draw what are now arbitrary distinctions between organizations that perform similar functions, avoids classifying alternative trading systems in a manner that does not fit the structure of these systems, and squarely addresses the regulatory concerns raised by these systems.

Moreover, the Commission's new framework helps assure consistency with existing broker-dealer regulations. For those alternative trading systems that wish to participate in the markets as exchanges, regulation as a national securities exchange is available. However, the Commission expects that many alternative trading systems will not elect to register as national securities exchanges. Under the Commission's proposal, these systems would have to maintain a structure more akin to that of traditional broker-dealers and comply with regulatory obligations more appropriately tailored to their chosen business structure. These obligations include the new requirements for more significant alternative trading systems to address the transparency, fair access, and systems capacity, integrity, and security concerns raised by these particular systems.<sup>552</sup>

## VIII. Effective Dates and Compliance Dates

The rules and rule amendments adopted in this release are effective on

<sup>551</sup> See *supra* Section IV.A.

<sup>552</sup> See *supra* IV.A.2.

April 21, 1999, except for Exchange Act Rules 301(b)(5)(D) and (E) and Rules 301(b)(6)(D) and (E), which shall become effective on April 1, 2000. Alternative trading systems, however, will only have to comply with the public display requirement in Rule 301(b)(3) for fifty percent of the securities subject to this requirements on April 21, 1999. Alternative trading systems will have to comply with Rule 301(b)(3) for all such securities by August 30, 1999.<sup>553</sup> Prior to April 21, 1999, the Commission will publish a schedule of those securities for which alternative trading systems must comply with Rule 301(b)(3) on April 21, 1999.

## IX. Costs and Benefits of the Rules and Amendments

To assist the Commission in its evaluation of the costs and benefits that may result from the rules and amendments, commenters were requested to provide analysis and data, if possible, relating to the costs and benefits associated with the proposals. The Commission initially identified certain costs and benefits associated with its changes in the Proposing Release. Although the Commission received seventy comment letters, as of December 1, 1998 concerning the proposed rules, none of the commenters responded specifically to the request for comment on the cost/benefit analysis. Some commenters did raise related issues and the Commission will address those comments in this analysis. After considering the comments, the Commission continues to believe that the benefits of the rules and amendments justify the associated costs.

### A. Costs and Benefits of the Rules and Amendments Regarding Alternative Trading Systems

The Commission identified several benefits and costs to investors and market participants in the Proposing Release with regard to alternative trading systems. The Commission is not making any changes to the rules or amendments that increase the cost estimates for alternative trading system notice, reporting and recordkeeping obligations. The most significant change

<sup>553</sup> Because the rules and rule amendments regarding Regulation ATS, exchange registration, and Rule 19b-5 constitute "major rules" within the meaning of the Small Business Regulatory Enforcement Act of 1996, 5 U.S.C. 801 *et seq.*, the rules and rule amendments cannot take effect until 60 days after the date of publication in the **Federal Register**. Although the amendments to Rules 17a-3 and 17a-4 and repeal of Rule 17a-23 and Form 17A-23 do not constitute "major rules," they will become effective at the same time as Regulation ATS because they operate in an integrated fashion with Regulation ATS.

the Commission is making in the rules as adopted is to revise the fair access provisions. The rules and amendments in the Proposing Release provided investors with a right of appeal to the Commission and required alternative trading systems to provide investors denied or limited access to the system with notice of that action and their right to appeal the decision to the Commission. The Commission has decided not to adopt the right of appeal provisions and the requirement of notice to investors denied or limited access. Instead, alternative trading systems with significant volume will be required to provide quarterly notices to the Commission on Form ATS-R of all grants, denials, and limitations of access as well as descriptive information regarding those access decisions. The net effect of these changes to the fair access requirements is a decrease, relative to the original proposal, in the burdens on alternative trading systems with significant volume. Several commenters objected to the proposed fair access rules on various grounds.<sup>554</sup>

Several commenters had general comments with regard to the burdens imposed on respondents under Regulation ATS. One commenter argued that the Commission should impose only minimal requirements on start-up or smaller trading systems.<sup>555</sup> The alternative trading system rules have been tailored to minimize their burden on alternative trading systems generally and small systems specifically. Because many of the provisions in the rules are triggered by a volume threshold, the Commission expects that small alternative trading systems will not have sufficient volume to trigger those thresholds and will, therefore, not have to comply with those provisions. The recordkeeping and reporting requirements with which smaller, lower volume alternative trading systems will have to comply under Regulation ATS are substantially similar to those with which alternative trading systems currently comply. Consequently the costs for smaller alternative trading systems should remain unchanged.

One commenter argued that material changes on Form ATS should be reported twenty days after such a change is made rather than twenty days

before.<sup>556</sup> The Commission believes that is important to have some advance notice of significant changes in order to permit it to carry out its market oversight and investor protection functions. By requiring notice before such changes are made, the Commission has an opportunity to make inquiries to clarify any questions that might arise. Currently, alternative trading systems are required to give twenty days prior notice of material changes on Part 1-A of Form 17A-23. This burden remains unchanged under the new rules.

Several commenters pointed out areas for possible reductions of regulatory overlap. One commenter argued that the Commission should eliminate those broker-dealer requirements that would be irrelevant for alternative trading systems.<sup>557</sup> The Commission, however, does not believe that the broker-dealer requirements as they apply to alternative trading systems, are irrelevant or overly burdensome. Another commenter that recordkeeping burdens should be coordinated with the NASD's OATS program.<sup>558</sup> These recordkeeping rules do not specify the manner in which such records must be maintained, but only that they must be made available upon request. Such records may be required for other purposes, but it is important to assure that all alternative trading systems maintain records sufficient to construct an audit trail.

One commenter argued that the Commission's rules and amendments impose costs and burdens on market innovators rather than encouraging such systems.<sup>559</sup> As discussed above, however, the Commission does not intend its new regulatory framework to impose a penalty on systems because of their use of technology. The Commission's new framework is based on the functions performed by a trading system, not on its use of technology.

Finally, a large number of institutional subscribers to alternative trading systems submitted comments within the last two weeks. These commenters expressed a number of concerns about the public display requirement. Among the concerns voiced by these commenters was a concern about decreasing liquidity, limiting a potentially advantageous trading strategy, being able to provide best execution for their clients, and increasing costs to execute trades. The

Commission responds to these concerns below.<sup>560</sup>

The Commission solicited comment on the feasibility of permitting alternative trading systems to file forms electronically. Three commenters supported electronic filing as an option to reduce the burdens on respondents.<sup>561</sup> While not feasible at this time, the Commission intends to make electronic filing an option when it is possible.

Three commenters argued that the Commission's rules should not apply to debt securities, in part, due to the burdens that such requirements would place on a largely decentralized market.<sup>562</sup> Other commenters supported including debt securities within Regulation ATS.<sup>563</sup> The Commission continues to believe that many of the same concerns about the trading of equity securities on alternative trading systems apply equally to the trading of fixed income securities on alternative trading systems. Debt securities are increasingly being traded on alternative trading systems, similar to the way that equity securities are traded. Accordingly, the Commission's new regulatory framework would require alternative trading systems trading debt securities, other than alternative trading systems trading solely government and related securities, to register as an exchange or register as a broker-dealer and comply with Regulation ATS. If an alternative trading system chooses to register as a broker-dealer, Regulation ATS applies the same notice, recordkeeping, and reporting requirements on debt alternative trading systems as apply to equity alternative trading systems. Because of the way the debt market currently operates, however, the transparency provisions do not apply to alternative trading systems that trade debt securities. Only those alternative trading systems that trade at least twenty percent of certain categories of debt are be subject to the fair access requirements<sup>564</sup> and the provisions governing systems capacity, security, and integrity.<sup>565</sup>

Under the rules and amendments in this release, alternative trading systems have a choice between registering as a national securities exchange or registering as a broker-dealer and complying with Regulation ATS. The choice between these two options is

<sup>554</sup> See ICI Letter at 4 (stating that requirements would be overly burdensome for alternative trading systems); IBEX Letter at 13 (arguing that appeal process should begin at the SRO level); Instinet Letter at 19 (stating that a right of appeal to the Commission could lead to frequent frivolous appeals).

<sup>555</sup> TBMA Letter at 16.

<sup>556</sup> SIA Letter at 17-18. *But see* IBEX Letter at 5 (stating that the reporting requirements under proposed Regulation ATS were not inappropriately burdensome).

<sup>557</sup> CBB Letter at 4.

<sup>558</sup> Instinet Letter at 20.

<sup>559</sup> Instinet Letter at 10.

<sup>560</sup> See *supra* Section IV.A.2.c.

<sup>561</sup> See IBEX Letter at 5; SIA Letter at 18; American Century Letter at 6.

<sup>562</sup> See TBMA Letter at 6-7, 21; SIA Letter at 3, 11; DBSI Letter at 1; MSDW Letter at 13.

<sup>563</sup> See NYSE Letter at 6; IBEX Letter at 2-3.

<sup>564</sup> Rule 301(b)(5), 17 CFR 242.301(b)(5).

<sup>565</sup> Rule 301(b)(6), 17 CFR 242.301(b)(6).

complex and each alternative trading system will make a choice based on its business plan and the role it wishes to play in the market. There are several factors that will have an impact on each alternative trading system's decision.

First, the regulatory costs associated with registering and operating as a national securities exchange are higher than the regulatory costs associated with registering as a broker-dealer and complying with Regulation ATS. Second, registered exchanges have national market system obligations that require those exchanges to bear the expenses associated with joining the CTA, CQS, and ITS plans. To offset some of those costs, however, registered exchanges also participate in the revenue generated from the sale of quotation information. Third, registered exchanges are SROs and, therefore, have obligations to surveil trading activity and member conduct on the exchange. These obligations can be significant in terms of time, personnel, and financial resources. However, a significant advantage to a registered exchange of being an SRO is that it is not subject to oversight by a competitor. Fourth, registered exchanges are subject to the statutory requirement to provide fair access, which requires a commitment of resources to consider membership applications and to report denials to the Commission and defend any denial decisions before the Commission if an appeal is made.

Because of the range of obligations of registered exchanges, operation as an exchange requires a significant investment of financial resources. A relatively high volume of trading may be required to justify this financial investment. While the advent of for-profit and non-member owned exchanges may make it easier to raise the financial resources necessary to operate as a registered exchange, the Commission does not expect that many alternative trading systems will choose to register as exchanges.

On the other hand, alternative trading systems that register as broker-dealers must comply with the filing and conduct obligations associated with being a registered broker-dealer including membership in an SRO and compliance with that SRO's rules. They must also comply with Regulation ATS, which includes filing, recordkeeping and reporting obligations. Unlike registered exchanges, alternative trading systems are subject to oversight by an SRO, which may operate a competing market. Regulation ATS is designed to impose few requirements on lower volume alternative trading systems. Only alternative trading systems with

significant volume are required to link to an SRO and publicly display orders, provide investors with fair access, and comply with systems capacity, integrity, and security requirements. These obligations for alternative trading systems with significant volume are similar, although not identical, to obligations of registered exchanges. Therefore, it is more likely that a high volume alternative trading system will consider the costs and benefits of registering as an exchange to be more comparable to the costs and benefits of regulation as a broker-dealer alternative trading system. The costs associated with regulation as a registered exchange, and with operating as a broker-dealer and complying with Regulation ATS are discussed more fully below.

#### 1. Benefits

a. *Improved Market Transparency.* The Commission's amendments and rules enhance transparency of trading on alternative trading systems. Transparency of orders helps ensure that publicly available prices fully reflect overall supply and demand and helps reduce the negative consequences of market fragmentation (e.g., the chance that an order for a security in one market will be executed at a price inferior to that available at the same time in another market). The Commission has been particularly concerned that the development of so-called "hidden markets," in which a market participant privately publishes quotations at prices superior to the quotation information it disseminates publicly, impedes national market system objectives. Some systems that permit this activity have become significant markets in their own right, but are not currently required to integrate their orders into the public quote because they are not registered as national securities exchanges or national securities associations.

For alternative trading systems choosing to register as broker-dealers, the Commission's amendments and rules improve the transparency of orders in systems that account for a significant portion of the trading volume in any security. The amendments and rules help to incorporate alternative trading system quotes into the national market system, thus reducing fragmentation, improving liquidity, facilitating price discovery, and narrowing the quoted spread.<sup>566</sup>

<sup>566</sup> The Office of Management and Budget has recognized that although it may be difficult to quantify the benefits of price transparency, "[t]here is a strong consensus among economists that regulations requiring the disclosure of information about the price and quality of products and services

Because non-market maker broker-dealers and institutions at times enter the best priced orders in an alternative trading system, the Commission expects that display of these orders in the public quote will also improve the NBBO. For example, of all orders on ECNs by non-market maker broker-dealers and institutions that could improve the NBBO if included in the public quote stream, only about six percent of those orders were actually entered into the public quote stream. Consequently, about ninety-four percent of those orders that could have improved the NBBO were not included in the public quote stream and thus did not impact the NBBO. These orders were therefore unavailable to some investors, in particular, retail investors, who do not have direct access to ECNs. The unavailability of these quotes continues to effectively result in a two-tiered market. While the Commission is unable to precisely quantify the market impact of these changes, it does believe that the benefit for investors will be significant based on preliminary estimates.

Based on an analysis of ECN trading activity during a four day period in June 1997 (June 23, 1997 to June 27, 1997), the staff estimates that spreads could decrease by as much as four percent for Nasdaq issues when non-market maker broker-dealer and institutional orders are displayed in the public quote. In making this estimate, the staff has assumed an average spread of 35 cents per share, a maximum increase of eleven percent for the times that ECNs could narrow the inside, and a maximum of 12.5 cents per share improvement. In addition to the effects on the bid-ask spread, retail investors and other non-subscribers will gain access to the liquidity and better prices now available only to alternative trading system subscribers. Moreover, because many broker-dealers offer retail customers automatic execution of their small orders at the publicly quoted price, a better price in the public quote potentially improves the price received by thousands of broker-dealer customers. Larger orders negotiated between institutions and broker-dealers also potentially benefit because the price negotiated will reflect a smaller spread. For these reasons, the Commission believes that new display and access requirements will result in significant benefits to investors.

can produce significant benefits for consumers and improve the functioning of markets when this information would not otherwise be available." Office of Management and Budget, *Draft Report to Congress on the Costs and Benefits of Federal Regulations*, 63 FR 44034 (Aug. 17, 1998).

The above data is consistent with the results of the transparency improvements achieved through the implementation of the Order Handling Rules.<sup>567</sup> The NASD studied the effect of the Order Handling Rules on the Nasdaq market by comparing various measures between a pre-period of twenty days in the beginning of 1997 (December 18, 1997 to January 17, 1998) and a post-period of twenty days in the beginning of 1998 (January 5, 1998 to February 2, 1998). The success of the Order Handling Rules further supports the view that the amendments and rules the Commission is adopting today will further investors' opportunities to trade at the best prices.

In its study, the NASD also found that quoted spreads in the Nasdaq market decreased by an average of forty-one percent. The NASD estimates that this reduction in spreads resulted in annual savings to investors of between \$284 million and \$673 million. Because of the increased market transparency provided by the display of institutional and non-market maker broker-dealer orders, the Commission believes that the rules and amendments in this release will also further shrink spreads.

Finally, the Commission believes that improved transparency of orders in alternative trading systems will reduce the potential for alternative trading system subscribers to manipulate the public market. It has been alleged that institutions and non-market makers intentionally influence the market by displaying an order in an alternative trading system that locks the price displayed in the public market. For example, if the public market is displaying a bid of 20 and an offer of 21, an institution or non-market maker might display an offer of 20 in an alternative trading system. Market participants often then assume that the order in the alternative trading system indicates the direction in which the market is moving and begin selling to market makers bidding 20, pushing the public market lower. The price in the alternative trading system is then canceled and the institution or non-market maker buys securities at a lower price. This type of activity is possible only because institution and non-market maker orders in alternative trading systems are not displayed to the public market. The Commission believes that the integrity of the public markets is threatened when institutions and non-

market makers can affect the public markets without participating in them.

The transparency of trading on alternative trading systems that choose to register as exchanges will also improve. All registered exchanges are expected to participate in the national market system plans, such as the CTA, CQS, and ITS. These plans form an integral part of the national market system, and contribute greatly to the operation of linked, transparent, efficient, and fair markets. In addition to improving transparency, alternative trading system participation in these market-wide mechanisms will benefit investors by reducing trading fragmentation.

b. *Improved Investor Protections.* The Commission's amendments and rules provide benefits to investors by improving the surveillance of trading on alternative trading systems. Adequate surveillance of the trading on alternative trading systems is critical to the continued integrity of our markets. This is particularly the case with regard to alternative trading systems that have a significant percentage of the trading volume in one or many issues of securities. The oversight of trading activities on alternative trading systems that choose to register as broker-dealers will improve because the proposals clarify the relationship between SROs and alternative trading systems.

The notice, reporting, and recordkeeping requirements under Regulation ATS also contribute to the Commission's and the SROs' ability to effectively oversee alternative trading systems regulated as broker-dealers. The Commission believes that these enhancements to the surveillance and oversight of alternative trading systems regulated as broker-dealers benefit the public by helping to prevent fraud and manipulation.

The surveillance of trading on alternative trading systems that choose to register as exchanges under the Commission's proposal will also be improved. All registered exchanges are SROs, which have direct obligations to surveil the trading on their own markets. The Commission believes that, through improved surveillance mechanisms, it will be better able to detect fraud and manipulation that could occur on alternative trading systems. For example, alternative trading systems can be used to artificially narrow the NBBO spreads for the sole purpose of trading through a broker-dealer's automatic execution system at the artificial prices.<sup>568</sup> The Commission and the SROs will be able

to more readily detect such activity through enhanced surveillance. The Commission believes that this more direct oversight of trading activities will therefore benefit investors and the market generally by helping to prevent fraud and manipulation.

c. *Fair Access.* The Commission's rules require alternative trading systems with significant volume to provide a fair opportunity to participate in alternative trading systems. Fair and non-discriminatory treatment of potential and current subscribers by alternative trading systems is important, especially when an alternative trading system captures a large percentage of trading volume in a security. Although an alternative trading system with significant volume is required to provide access to orders that it is required to display in the public quote stream, there are other benefits to direct participation on an alternative trading system. In particular, participation on an alternative trading system allows an investor to enter its own orders, view contingent orders not publicly displayed (such as all or none orders) and use special features of an alternative trading system, such as a negotiation feature or reserve size feature. Accordingly, the rules prevent discriminatory denials of access and ensure that market participants are not prevented from gaining access to significant sources of liquidity.

d. *Systems Capacity, Integrity, and Security.* The Commission believes that its rules regarding systems capacity, integrity, and security of alternative trading systems provide several benefits to the marketplace and to investors. Marketplaces are increasingly reliant on technology and most of their functions are becoming highly automated. Alternative trading systems are subject only to business incentives to avoid system breakdowns that may disrupt the market. In the past, alternative trading system failures have affected the public market, particularly during periods of high trading volume. Some alternative trading systems have had prolonged shut-downs during the busiest trading sessions due to systems problems. For example, during the past year, Instinet, Island, Bloomberg, and Archipelago (operated by Terra Nova) have all experienced systems outages due to problems with their automated systems. On a number of occasions, ECNs have had to stop disseminating market maker quotations in order to keep from closing altogether, including during the market decline of October 1997 when one significant ECN withdrew its quotes from Nasdaq because of lack of capacity. Similarly, a major IDB in non-exempt

<sup>567</sup> See *supra* note 177. Under the Order Handling Rules, market makers who enter orders on ECNs are required to reflect those prices in their public quotations. In the alternative, the ECN can make the best market maker prices publicly available through an SRO.

<sup>568</sup> See *supra* note 5.

securities experienced serious capacity problems in processing the large number of transactions in October 1997 and had to close down temporarily.

The Commission's rules require alternative trading systems that handle a significant volume of trades to establish reasonable capacity estimates, conduct stress tests, implement procedures to monitor system development, review systems vulnerability, and establish adequate contingency plans. Investors will benefit from the rules because significant systems will be less likely to shut down as a result of systems failures and will be better equipped to handle market demand and provide liquidity during periods of market stress. The ability of alternative trading systems to provide more reliable and consistent service in the market benefits investors and the public markets generally. The Commission also believes that investors will benefit from robust system security provided by ensuring that significant alternative trading systems maintain sufficient security measures to prevent unauthorized access.

All currently registered exchanges participate in the Commission's automation review program. Alternative trading systems that choose to register as exchanges will similarly be expected to participate in this program. Under the automation review program, exchanges are expected to maintain sufficient systems capacity to meet current and anticipated volume levels. The benefits to investors and the public generally, as with significant alternative trading systems, will be the assurance that systems are reasonably equipped to handle market demand and provide liquidity during periods of market stress.

## 2. Costs

The alternative trading system rules and amendments have been tailored to minimize their burden on alternative trading systems and especially small systems. Many of the provisions in the rules and amendments are triggered by a volume threshold. The Commission expects that small alternative trading systems will not have sufficient volume to trigger those thresholds and will therefore not have to comply with those provisions. The recordkeeping and reporting requirements with which smaller, lower volume alternative trading systems have to comply under Regulation ATS are substantially similar to those with which alternative trading systems currently comply. Consequently the costs for smaller alternative trading systems should remain materially unchanged. The paperwork, filing, and

recordkeeping costs are discussed in the Paperwork Reduction Act section below.

a. *Notice, Reporting, and Recordkeeping.* All alternative trading systems that will be subject to notice, reporting, and recordkeeping requirements under the Commission's new rules are currently subject to similar requirements under Rule 17a-23. The requirements under Regulation ATS, however, require some additional information that is not currently required under Rule 17a-23.

Under Regulation ATS, alternative trading systems file an initial operation report, notices of material systems changes, and quarterly reports. The rules also include new Forms ATS and ATS-R to standardize reporting of such information and make it more useful for the Commission. The rules require information that is not currently required under Rule 17a-23, such as greater detail about the system operations, the volume and types of securities traded, criteria for granting access to subscribers, procedures governing order execution, reporting, clearance and settlement, procedures for reviewing systems capacity and contingency procedures, and the identity of any other entities involved in operating the system.

Regulation ATS requires staff time to comply with the initial notice and amendment requirements. While the Commission has designed the requirements in an effort to balance the costs of filing with the benefits to be gained from the information, some effort will be necessary to gather and file this information. Most of the information, however, already exists. Alternative trading systems will only be required to gather this information and supply it in the required format to the Commission. The periodic updating requirements will also require staff time over the life of the alternative trading system to comply with the rules.

The Commission estimates that there are currently about forty-five alternative trading systems that will be required to register as exchanges or register as broker-dealers and comply with Regulation ATS.<sup>569</sup> The Commission also estimates that, over time, there will be approximately three new alternative trading systems each year that choose to register as broker-dealers and comply

<sup>569</sup> This estimate is based on filings made with the Commission under Rule 17a-23. At the time of the Proposing Release, the Commission estimated that forty-three alternative trading systems would be required to register as exchanges or broker-dealers and comply with Regulation ATS. The Commission now estimates that there are forty-five alternative trading systems operating.

with Regulation ATS.<sup>570</sup> The Commission also estimates that, over time, there will be approximately three alternative trading systems that file cessation of operations reports each year. Thus, the Commission anticipates that, over time, if all forty-five current alternative trading systems choose to register as broker-dealers and comply with Regulation ATS, there will be approximately forty-five alternative trading systems operating each year.

b. *Public Display of Orders and Equal Execution Access.* Regulation ATS requires that alternative trading systems with significant volume display their best-priced orders for securities in which they have 5 percent or more of total trading volume in the public quote. The Commission identified the anticipated benefits of this requirement above. Below is a discussion of possible costs associated with this requirement.

One possible cost is the impact on institutional order flow to alternative trading systems generally. Institutions have several options available to them to execute trades. They can send orders to block trading desks, a number of different types of alternative trading systems, or directly to registered exchanges through broker-dealer give-ups. Although not currently displayed to the public, orders sent to an alternative trading system by institutions are displayed to other alternative trading system subscribers.<sup>571</sup> Thus, placing large orders, or a series of successive small orders, in an alternative trading system signals to a large number of sophisticated market participants the interest in a particular security.

The Commission is not persuaded by commenters that suggest that institutions currently willing to use alternative trading systems to display their orders to other alternative trading system subscribers, including other institutions, market-makers, and broker-dealers, will be less willing to use alternative trading systems that must display those orders to the public market. Our reasons are as follows. The primary group of market participants

<sup>570</sup> Based on the Commission's experience over the last three years with Rule 17a-23, it appears that there are more than three new alternative trading systems per year. However, we expect that in the future, there will be approximately three new alternative trading systems per year. The rapid growth experienced over the last several years is unlikely to continue in perpetuity.

<sup>571</sup> A number of ECNs, however, currently display the best order in their system in the public quote, regardless of whether that order is entered by an institution, market maker or another broker-dealer although the Commission's Order Handling Rules only require the display of market maker orders. Thus, institutional orders sent to these systems are already displayed to the public.

that will benefit from the public display of institutional orders is retail investors. Retail investors are not currently alternative trading system subscribers. To avoid market impact, institutions try to avoid signaling other institutions and market professionals, not retail investors. Almost all market professionals and a significant number of institutions already subscribe to alternative trading systems. Thus, the Commission believes that the additional exposure to the market should not affect institutions' use of alternative trading systems. Moreover, to the extent that institutions want to display small sized orders in the public market, rather than their entire order, they will still be able to make use of an alternative trading system's "reserve size" feature. This will enable institutions to avoid exposing the total size of their order to the public market.

Nonetheless, assuming institutions do have a preference for showing their sized orders to other alternative trading system subscribers but not the public market, there may be two reactions by institutions. First, institutions could choose to move their orders to more opaque venues, such as block trading desks. The cost of this movement of orders would be a loss of transparency to the limited group of alternative trading system subscribers who now benefit from the display of institutional orders on alternative trading systems, and the loss of business to alternative trading systems. While block trading desks would benefit from the increased business, it likely would increase institutions' transaction costs. For this reason, as well as those discussed above, the Commission believes it unlikely for institutions to react this way. Second, because the public display requirement only applies to alternative trading systems with five percent or more of the volume in a particular security, there is a possibility that institutions may move their order flow to smaller alternative trading systems in order to avoid the public display requirement. Such movements of order flow could benefit some alternative trading systems in the form of increased revenue and be a cost to other alternative trading systems who lose revenue.

Currently, alternative trading systems are able to attract subscribers because prices in their systems are often better than the prices available in the public markets. Because alternative trading systems are now required to publicly display their best priced orders for securities in which they represent five percent or more of the trading volume, the best priced orders for certain

securities will also be available through the public markets. Alternative trading systems will no longer be able to provide subscribers with the unlimited ability to avoid public display in the NBBO and possible interaction with non-subscribers. Consequently, some subscribers could leave an alternative trading system if they think there are fewer advantages than before in having direct access to the alternative trading system.

However, the growth of ECNs since the Order Handling Rules were implemented indicates that alternative trading systems can, and are, attracting subscribers.<sup>572</sup> As mentioned above, there are still significant benefits to being a subscriber to an alternative trading system, including, but not limited to: the ability to enter orders and the use of such features as a negotiation feature or a "reserve size" feature; the ability to access the best priced orders for securities in which an alternative trading system represents less than 5 percent of the trading volume and therefore is not subject to the transparency requirements; and access to the entire "book," not merely the "top of the book," that contains important real-time market information regarding depth of trading interest. All of these benefits will be retained under the new display requirement.

Despite the impact on high volume alternative trading systems, integrating their best-priced orders into the public market is critical to the national market system. Section 11A of the Exchange Act directs the Commission to facilitate a national market system and to carry out Congress' objectives of, among other things, assuring "the practicability of brokers executing investors' orders in the best market."<sup>573</sup> The public display requirement adopted today furthers the objectives in Section 11A of the Exchange Act by ensuring that the public markets reflect the best priced orders displayed in alternative trading systems that have a significant trading market in particular securities.

Several commenters also expressed concern about whether or not alternative trading systems will be permitted to continue charging fees to non-subscribers that access alternative trading systems publicly displayed orders. Currently, alternative trading systems charge a range of fees to subscribers. In particular, alternative

trading systems may allow institutional subscribers to select higher fees and then have soft-dollars rebated in an amount equal to the excess above the actual cost for execution of a trade. Because of the presence of soft dollars, it is difficult to estimate the amount of revenue that alternative trading systems receive from institutional subscribers. The Commission notes, however, that it is not requiring alternative trading systems to change their fee structures. The Commission is merely limiting alternative trading systems to charging non-subscribers fees that are consistent with equivalent access.<sup>574</sup> The Commission does not believe that such limitations will substantially affect an alternative trading system's revenues. In fact, some alternative trading systems may have increased revenues from the fees charged to non-subscribers.

The rules the Commission is adopting today prohibit an alternative trading system from charging fees that would effectively deny non-subscribers equivalent access to an alternative trading system's publicly displayed orders. As long as a fee does not deny equivalent access, it would be permissible under these rules. The SROs will be able to establish rules to ensure that alternative trading system fees are not inconsistent with the standard of equivalent access. Any SRO rule impacting an alternative trading system's access fees would have to be filed with the Commission for public comment, review, and approval. The Commission cannot approve any SRO rule unless it finds that such rule is consistent with the Exchange Act, including whether the rule will promote "efficiency, competition, and capital formation."<sup>575</sup>

As discussed above, one of the expected benefits of displaying the best-priced orders in alternative trading systems to all investors is that spreads will shrink. The success of the Order Handling Rules indicates that the Commission's current proposal should further enhance liquidity and price improvement opportunities in the public markets. Because non-market maker broker-dealers and institutions at times enter the best priced orders in an alternative trading system, the Commission expects that display of these orders in the public quote will improve the NBBO. As a result, some market makers may experience a loss of revenue. For example, a market maker

<sup>572</sup> When the Order Handling Rules were implemented on January 17, 1997, four ECNs linked to Nasdaq. Today there are a total of nine ECNs linked to the public quote stream. See *supra* note 178.

<sup>573</sup> Section 11A(a)(1)(C) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(C).

<sup>574</sup> Under the Order Handling Rules, ECNs are limited to charging non-subscribers fees consistent with equivalent access.

<sup>575</sup> Section 3(f) of the Exchange Act, 15 U.S.C. 78c(f).

may currently be at the NBBO even when an alternative trading system is better than that market maker's bid or offer. Accordingly, if the better priced institutional or non-market maker broker-dealer order were displayed in the public quote, that market maker would not execute an order unless it improved its quote. While reduced spreads may represent a cost to market makers, as discussed above, it represents a corresponding benefit to investors. Moreover, reduced spreads make the overall market more efficient by reducing transaction costs. If trading is less expensive, all other things being equal, investors can be expected to trade more.

The staff also notes that a market maker is not required to execute a customer order at the NBBO if the best available price is represented by an alternative trading system quote. Instead, a market maker may attempt to execute that customer order against the alternative trading system quote. If the market maker acts as agent in effecting the customer's trade, it may be entitled to a brokerage fee. Therefore, market makers may be able to offset, at least partially, the loss of trading profits with additional brokerage revenues.

c. *Fair Access.* Under Regulation ATS, alternative trading systems with significant volume are required to establish and maintain standards for granting access to their system and keep records of such standards. In addition, such alternative trading systems must apply those standards in a fair and non-discriminatory manner and submit certain information regarding grants, denials, and limitations of access with their quarterly reports on Form ATS-R. Based on current volume estimates, at most two alternative trading systems will be initially subject to this requirement. The Paperwork Reduction Act section of this release summarizes the filing and recordkeeping costs associated with the fair access requirement.

The fair access requirement, as adopted, differs from that proposed. The proposal would have provided market participants who believe they had been unfairly denied or limited access to an alternative trading system subject to the fair access requirement with a right to appeal that alternative trading system's action to the Commission. Alternative trading systems subject to the fair access requirement would also have been required to provide investors with notice of a denial or limitation of access and their right to appeal that action to the Commission. The fair access requirement being adopted today does not include any right to appeal an

alternative trading system's access decisions to the Commission. Instead, the Commission intends to enforce the prohibition on alternative trading systems with significant volume unfairly denying access through its inspection and enforcement authority. The Commission believes the fair access requirement it is adopting will be less costly to alternative trading systems than the one proposed because alternative trading systems will not be required to defend their access decisions in appeals before the Commission. Moreover, the requirement adopted does not require alternative trading systems to send notice of their decisions to market participants.

d. *Systems Capacity, Integrity, and Security.* The Commission does not believe that its amendments and rules requiring alternative trading systems to meet certain systems related standards imposes significant costs. The standards the Commission is adopting are general standards that are consistent with good business practices. In addition, smaller alternative trading systems will not be subject to the proposed requirements. For those alternative trading systems that do not, for business reasons alone, ensure adequate capacity, integrity, and security of their systems, there will be costs associated with complying with the requirements. The costs associated with upgrading systems to an adequate level may include, for example, investing in computer hardware and software. In addition, alternative trading systems will incur costs associated with the independent review of their systems on an annual basis. An independent review should be performed by competent, independent audit personnel following established audit procedures and standards. If internal auditors are used by an alternative trading system to complete the review, these auditors should comply with the standards of the EDPA. If external auditors are used, they should comply with the standards of the AICPA and the EDPA. The review must be conducted according to established procedures and standards. The costs involved may vary widely depending on the business of the alternative trading system. Alternative trading systems will also be subject to paperwork burdens and recordkeeping and reporting requirements. These requirements are necessary for the Commission and the appropriate SROs to ensure compliance with systems related requirements. In addition, keeping such records permits alternative trading systems to effectively analyze systems problems that occur. While alternative trading systems are not

required to file such documentation with the Commission on a regular basis, the Commission recognizes that generating and maintaining such documentation will impose some additional costs.

The notification requirement for material systems outages should impose relatively little additional costs on alternative trading systems. Moreover, the Commission believes that this small burden is justified by the need to keep Commission staff abreast of systems' developments and problems. The Paperwork Reduction Act section of this release summarizes the costs associated with the recordkeeping and reporting burdens of compliance with the systems capacity, integrity, and security requirements.

e. *Costs of Exchange Registration.* The framework the Commission is adopting today for alternative trading systems is designed to allow such systems the option of registering as national securities exchanges. If an alternative trading system chooses to register as an exchange, corresponding regulatory obligations could impose costs on such systems, however, the elective nature of exchange regulation under the framework the Commission is adopting today ensures that only those entities for whom it is cost-effective will choose exchange registration and therefore bear the costs.

For example, exchange-registered alternative trading systems will have to be organized to, and have the capacity to, carry out the purposes of the Exchange Act, including their own compliance and the ability to enforce member compliance with the securities laws. Consequently, any newly registered exchange will have to establish appropriate surveillance and disciplinary mechanisms. In addition, newly registered exchanges will incur certain start-up costs associated with this obligation, such as writing rule manuals.

National securities exchanges currently operating have significant assets and expenses in order to carry out their functions. The cost of acquiring the necessary assets and the operating funds required to carry out the day-to-day functions of a national securities exchange are significant. For example, for the fiscal year 1997, the NYSE had total assets of \$1,174,887,000 and total expenses of \$488,811,000. The Cincinnati Stock Exchange ("CSE"), currently the only completely automated national securities exchange, had total assets of \$13,124,585 and total expenses of \$5,343,403. Due to these costs, it appears that an alternative trading system will need to have

significant volume in order to make the benefits of exchange registration outweigh the costs.

As registered exchanges, alternative trading systems will also be subject to more frequent inspection by the Commission. As broker-dealers, alternative trading systems will be inspected on a regular basis by any SRO of which they are a member, and by the Commission only on an intermittent basis. As registered exchanges, these systems will be inspected more regularly by Commission staff, but will, of course, no longer be subject to examinations by SROs.

The Commission inspects different SRO programs on independent review cycles. For example, separate inspections are conducted for an SRO's surveillance, arbitration, listings, and financial soundness programs. Where appropriate, SROs will be examined for other programs they may operate, such as index programs. Each type of examination will be performed at regular intervals, which are typically two to three years. An SRO, however, may expect several examinations throughout a particular year, each in a different program. Each examination typically involves three to four attorneys and/or accountants from the Commission, who spend one week at the SRO, or up to two weeks for particularly large programs, to examine records and interview SRO personnel. In order to comply with section 17(b) under the Exchange Act, an SRO must expend resources to provide copies of relevant documents to, and answer questions from, the Commission staff. The cost to an SRO of each examination varies greatly depending on the scope of the examination and the size or complexity of the SRO's particular program.

In addition, there will also be costs associated with meeting the obligations set forth in section 11A of the Exchange Act and the rules thereunder. These costs include the costs of joining, or creating new, market-wide plans, such as the CQS, CTA, ITS, and OTC-UTP, although some of these costs will be offset by the right to share in the revenues generated by these plans. For example, to join the CTA plan, applicants will be asked to pay, as a condition to entry into the plan, an amount that reflects the value of the tangible and intangible assets created by the CTA plan that will be available to the applicant.<sup>576</sup> Similarly, new

<sup>576</sup> 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

participants in ITS will have to pay a share of the development costs, which will reflect a share of the initial development costs, which were \$721,631, and a share of costs incurred after June 30, 1978.<sup>577</sup> These costs will also include the costs of complying with Rule 11Ac1-1(b) under the Exchange Act,<sup>578</sup> 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.<sup>579</sup>

The Commission notes that the remaining costs will be partially offset because the alternative trading systems assuming the costs of exchange registration will no longer be regulated as broker-dealers. Consequently, they will no longer be obligated to comply with the broker-dealer requirements, such as filing and updating Form BD, maintaining books and records in accordance with Rules 17a-3 and 17a-4 under the Exchange Act, and paying fees for membership in an SRO. In addition, because exchange-registered alternative trading systems share the responsibilities of self-regulation, the regulatory burden carried by currently registered exchanges should be reduced. Other benefits include the freedom from oversight by a competing SRO, no obligation to comply with net capital requirements, the right to establish trading and conduct rules, the right to establish fee schedules, the ability to

to the plan by existing members, the estimated usage of the plan facilities by the applicant, costs for anticipated system modifications to accommodate the applicant, and other relevant factors as determined by the current participants. *CTA Plan: Second Restatement of Plan Submitted to the Securities and Exchange Commission Pursuant to Rule 11Aa3-1 under the Securities Exchange Act of 1934*, May 1974 as restated March 1980 and December 1995, at 8-9. See *supra* note 391. The terms of the CQ plan are substantially similar with respect to the assessment of a payment upon entry into the system. *CQ Plan: Restatement of Plan Submitted to the Securities and Exchange Commission Pursuant to Rule 11Ac1-1 under the Securities Exchange Act of 1934*, July 1978, as restated December 1995, at 8-9. See *supra* note 392.

<sup>577</sup> *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.

<sup>578</sup> 17 CFR 240.11Ac1-1.

<sup>579</sup> The Commission estimates that each national securities exchange or national securities association will submit information to vendors approximately 24,266,000 times per year, which reporting is generally done through automated facilities that conduct the reporting on a continuous basis. Due to the continuous nature of the information feeds, the Commission does not believe that it is feasible to estimate the average cost per response or annual burdens hours involved in complying with Rule 11Ac1-1(b) for a new registered exchange. 17 CFR 240.11Ac1-1(b).

directly participate in the national market system mechanisms, and the right to share in the profits and benefits produced by the national market system mechanisms such as the CQS, CTA, ITS and OTC-UTP plans.<sup>580</sup>

The costs of exchange registration also include certain paperwork, filing, and recordkeeping requirements. These costs are discussed in the Paperwork Reduction Act section below.

The Commission anticipates that only a few of the existing alternative trading systems would consider registering as a national securities exchange. For most of the alternative trading systems currently in existence, the Commission believes that the costs and obligations discussed above potentially make registering as a national securities exchange less commercially viable than registering as a broker-dealer and complying with Regulation ATS.

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

The Commission identified several costs and benefits to investors and market participants in the Proposing Release with respect to amendments to the application and rules for exchange registration. Only two commenters identified areas of concern regarding exchange registration. These commenters suggested that the Commission was seeking to reimpose annual filing requirements previously eliminated in 1994.<sup>581</sup> In response, the Commission has made technical modifications to Rule 6a-2 to clarify the operation of the rule. The Commission does not believe that these filing burdens are reimposed under the rules as adopted. These commenters also questioned the value of requiring exchanges to compile and submit amendments to Form 1 that contain information that has been provided to the Commission throughout the year in other contexts. The Commission continues to believe that it is important to have all the required information gathered in one place in order to make it useful for Commission staff. In addition, the additional costs should be minimal because the respondents are required only to compile existing documents rather than generate new material.

#### 1. Benefits

The Commission believes that the amendments provide benefits to organizations that are currently

<sup>580</sup> See *supra* Section III.B.1.

<sup>581</sup> See NYSE Letter at 10; Amex Letter at 5-6.

registered, or in the future will apply for registration, as national securities exchanges. Generally, the Commission expects that the regulatory framework discussed in this release accommodates automated and for-profit exchanges and makes registering as a national securities exchange more commercially viable for possible future exchanges.<sup>582</sup> First, the amendments to Rules 6a-1, 6a-2, and 6a-3 ease compliance burdens by simplifying the rule. By simplifying the rule language itself, the Commission anticipates that parties attempting to comply with Rules 6a-1, 6a-2, and 6a-3 will be better able to understand the rules' requirements and comply with them. Much of the information required on Form 1 will not change, but the revised form recasts the questions and exhibits in a different format that will ease compliance and make the responses more relevant to investors and the Commission. While national securities exchanges have traditionally been membership-owned, Form 1 also is revised to accommodate proprietary national securities exchanges.

Second, the amendments give national securities exchanges the option of complying with certain ongoing filing requirements by posting information on an Internet web site and supplying the location to the Commission, instead of filing a complete paper copy with the Commission. The Commission anticipates that exchanges will choose to use the Internet to comply with Rules 6a-2 and 6a-3 rather than filing many exhibits on paper. The availability of such information on the Internet will also provide the public with easier and less expensive access to the information than requesting paper copies from the Commission or the national securities exchanges as currently required. In addition, permitting exchanges to use the Internet as a means of compliance will reduce expenses associated with clerical time, postage, and copying.

The amended rules also reduce the frequency of certain ongoing filings to update the information in Form 1, directly reducing the compliance burden on national securities exchanges while still meeting investors' and the Commission's need for reasonably current information. Specifically, the amendments eliminate exchanges'

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

## 2. Costs

The amendments are intended to simplify the filing requirements and reduce the compliance burdens for national securities exchanges and will likely impose few additional costs on national securities exchanges. Initially, there may be some additional personnel costs required to review the proposed rules and revised Form 1, but the Commission believes that the simplified requirements will reduce overall compliance burdens and costs over time. Reducing the frequency of filings for some requirements may result in some information being less current. The Commission, however, believes that much of this type of information does not change frequently. Moreover, the option of posting such information on an Internet web site should encourage more frequent updating of current information. Compliance with Rules 6a-1, 6a-2, and 6a-3 also include certain paperwork costs, which are discussed as "burdens" in the Paperwork Reduction Act section below.

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

The Commission identified several costs and benefits to investors and market participants in the Proposing Release with respect to Rules 17a-23, 17a-3, and 17a-4. One commenter stated that the transfer of recordkeeping burdens would impose no additional burdens.<sup>583</sup>

Approximately forty-five of the broker-dealer trading systems currently filing reports under Rule 17a-23 will be alternative trading systems under the amendments and rules in this release. These trading systems will not fall within the definition of "internal broker-dealer system," and will, therefore, not be required to maintain records under the new provisions of Rules 17a-3(a)(16) and 17a-4(b)(10). In its Paperwork Reduction Act analysis, the Commission notes that annual aggregate burdens for the recordkeeping obligations under Rule 17a-23 will be eliminated. Although the reporting requirements under Rule 17a-23 will be

eliminated, alternative trading systems will be subject to similar recordkeeping requirements under Regulation ATS.<sup>584</sup> These paperwork "burdens" are discussed below in the Paperwork Reduction Act section.

### D. SRO Pilot Trading System

The Commission identified several costs and benefits to investors and market participants in the Proposing Release with respect to Rule 19b-5. While the Commission solicited comment on the costs and benefits of Rule 19b-5, no comments were received specifically on that point. Several commenters did, however, address the Commission's proposal. One commenter agreed that Rule 19b-5 would reduce regulatory costs and encourage innovation, but believed that the rule's limitations should be reduced.<sup>585</sup> Two other commenters expressed support for the goals of Rule 19b-5, but argued that burdens wouldn't be reduced as a practical matter due to the limitations of the rule.<sup>586</sup> In response, the Commission notes that it has adopted the rule with some changes that should permit SROs more flexibility in taking advantage of the temporary exemption from rule filing requirements.

By permitting SROs to begin operating eligible pilot trading systems immediately and to continue operating for two years under a flexible regulatory scheme, the Commission believes that Rule 19b-5 will benefit SROs and investors. Rule 19b-5 will enhance competition in the trading markets without imposing significant SRO compliance burdens.<sup>587</sup> Rule 19b-5 will permit the timely implementation of pilot trading systems without the widespread dissemination of critical business information. Therefore, Rule 19b-5 will reduce SRO costs associated with the Commission approval process and improve the competitive balance between SROs and alternative trading

<sup>584</sup> The costs and benefits associated with these recordkeeping requirements are discussed in Section IX.A.2.a. *supra*.

<sup>585</sup> CBOE Letter at 8-9.

<sup>586</sup> See CME Letter at 3-4; PCX Letter at 8.

<sup>587</sup> The Commission estimates that the current preparation and filing of proposed rule changes pursuant to section 19(b)(2) of the Exchange Act to operate a pilot trading system constitute major market impact filings requiring approximately 100 hours and \$10,000 to \$15,000 of SRO time and money, respectively, for each proposal. This does not include the cost to the SRO of any delay in obtaining Commission approval or in disclosing business information; nor does this include the benefit to an SRO of bringing its new pilot trading system to market in a shorter amount of time. The cost per hour and per filing is derived from information supplied by the SROs. For the purposes of our estimates, we have valued related overhead at thirty-five percent of the value of legal work. See *GSA Guide to Estimating Reporting Costs* (1973).

<sup>582</sup> For example, the International Securities Exchange, which announced its intentions to register as a national securities exchange on November 10, 1998, would not be able to register as a national securities exchange without the changes to the rules as adopted today. See *International Securities Exchange Will be First Fully Electronic Options Exchange in U.S.*, International Securities Exchange Press Release, Nov. 10, 1998.

<sup>583</sup> TBMA Letter at 25-26.

systems that are regulated as broker-dealers.<sup>588</sup> Moreover, the Commission believes that Rule 19b-5 will foster innovation and create a streamlined procedure for SROs to operate pilot trading systems and will reduce filing costs for SROs pilot trading systems.

The costs of complying with Rule 19b-5 includes certain paperwork, filing, and recordkeeping requirements that are discussed below in the Paperwork Reduction Act section.

#### **X. Effects on Competition, Efficiency and Capital Formation**

Section 23(a)(2)<sup>589</sup> of the Act requires that the Commission, when promulgating rules under the Exchange Act, to consider the impact any rule would have on competition and to not adopt any rule that would impose a burden on competition that is not necessary or appropriate in the public interest. In the Proposing Release, the Commission solicited comment on the effects on competition, efficiency and capital formation of the rules and amendments. Specifically, the Commission requested commenters to address how the proposed rules and amendments would affect competition between and among alternative trading systems, broker-dealers, exchanges, investors, and other market participants. The Commission received no comments specifically regarding these issues.

The Commission has considered the rules and rule amendment in light of the standards cited in section 23(a)(2) of the Act and believes they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. As discussed above in the Cost-Benefit Section, the Commission recognizes that some alternative trading systems and their institutional users will be affected competitively by the rules adopted today. Nonetheless, the Commission believes that the rules and amendments will encourage innovation, accommodate the growing role of technology in the securities markets, improve transparency for market participants and ensure the stability of trading systems with a significant role in the markets, thereby furthering the development of a national market

<sup>588</sup> The Commission estimates that under current procedures, a rule filing for a new pilot trading system takes 90 days, on average, from the date of the original submission to be approved. In contrast, the expedited treatment of SRO rule changes for pilot trading systems in this release permits SROs to operate a pilot trading system twenty days after submitting an initial operation report on Form PILOT, so long as such system complies with Rule 19b-5 under the Exchange Act.

<sup>589</sup> 15 U.S.C. 78w(a)(2).

system in accordance with the goals under section 11A of the Exchange Act. In particular, as discussed above in the Cost-Benefit Section, the Commission believes that the rules and amendments will significantly reduce spreads, thereby benefiting all investors.

In adopting these rules and amendments, the Commission has considered whether the action will protect investors, and promote efficiency, competition, and capital formation.<sup>590</sup> The Commission believes that the rules and amendments will allow the Commission to better oversee the activities of alternative trading systems and integrate alternative trading systems into the national market system. The rules and amendments will also better accommodate automated and for-profit exchanges and permit SROs to operate pilot trading systems temporarily without Commission approval. These steps will help to protect investors by preventing discriminatory denials or limitations of access, preventing systems related failures, and permitting access to best-priced orders. In addition, alternative trading systems should continue to compete based on innovation, price, and service rather than access to "hidden markets."

Rules 3a1-1, 3b-16, and Regulation ATS adopted today are intended to provide a choice between registering as a broker-dealer and registering as an exchange for markets operated as alternative trading systems.<sup>591</sup> In addition, the amendments to Rules 6a-1, 6a-2, and 6a-3 adopted today are intended to update the requirements for registered or exempt exchanges in order to accommodate different forms of organization and methods of operation. The Commission believes that these changes will create a more efficient market, encourage competition among alternative trading systems, and stimulate capital formation by making the regulatory framework sufficiently flexible to accommodate new or different approaches to exchange formation and operation, including automated and for-profit exchanges. The Commission further believes that the costs identified in the above analysis are not substantial enough to deter any market participants from attempting to become an alternative trading system.<sup>592</sup>

<sup>590</sup> 15 U.S.C. 78c(f).

<sup>591</sup> The Commission further believes that repealing Rule 17a-23 and amending Rules 17a-3 and 17a-4 under the Act will help to create a more efficient market, encourage competition, and stimulate capital formation innovation.

<sup>592</sup> As previously stated, alternative trading systems are able to attract subscribers because prices in their systems are often better than the

In addition, Rule 19b-5 and Form Pilot are intended to provide SROs the opportunity to develop and operate pilot trading systems with less cost and time delay. As previously stated, currently, SROs are required to submit a rule filing to the Commission and undergo a public notice, comment, and approval process, before they operate a new pilot trading system. Rule 19b-5 would permit SROs that develop pilot trading systems to begin operation shortly after submitting Form PILOT to the Commission. One of the consequences of SROs filing rule changes before implementation is that the rule filing process informs SROs' competitors about the proposed pilot trading system and provides an avenue for those competitors to copy, delay, or obstruct implementation of a pilot trading system before it can be tested in the marketplace. As a result, the Commission believes that proposed Rule 19b-5 and Form Pilot should help create a more efficient market, encourage competition between SROs and alternative trading systems, and stimulate capital formation by creating a streamlined procedure for SROs to operate pilot trading systems and reducing filing costs for SROs generally.

#### **XI. Summary of Final Regulatory Flexibility Analysis**

A Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with section 4 of the Regulatory Flexibility Act ("RFA").<sup>593</sup> The FRFA relates to the adoption of new rules 3a1-1,<sup>594</sup> 3b-16,<sup>595</sup> 19b-5,<sup>596</sup> Regulation ATS,<sup>597</sup> new Forms ATS,<sup>598</sup>

prices available in the public markets. Because alternative trading systems are now required to publicly display their best priced orders for securities in which they represent more than 5 percent of the trading volume, the best priced orders for certain securities will also be available through the public markets. Consequently, some subscribers could leave an alternative trading system if they think there are fewer advantages than before in having direct access to the alternative trading system. However, the growth of ECNs since the Order Handling Rules were implemented indicates that alternative trading systems can, and are, attracting subscribers. As mentioned above, there are still significant benefits to being a subscriber to an alternative trading system, including, but not limited to: the ability to enter orders and the use of such features as a negotiation feature or a "reserve size" feature; the ability to access the best priced orders for securities in which an alternative trading system represents less than 5 percent of the trading volume and therefore is not subject to the transparency requirements; and access to the entire "book," not merely the "top of the book," that contains important real-time market information regarding depth of trading interest.

<sup>593</sup> 5 U.S.C. 604.

<sup>594</sup> 17 CFR 240.3a1-1.

<sup>595</sup> 17 CFR 240.3b-16.

<sup>596</sup> 17 CFR 240.19b-5.

<sup>597</sup> 17 CFR 242.300 *et seq.*

<sup>598</sup> 17 CFR 242.637.

ATS-R,<sup>599</sup> PILOT,<sup>600</sup> amendments to rules 6a-1,<sup>601</sup> 6a-2,<sup>602</sup> 6a-3,<sup>603</sup> 11Ac1-1,<sup>604</sup> 17a-3,<sup>605</sup> 17a-4,<sup>606</sup> the Commission's rules of practice,<sup>607</sup> to Form 1, and the repeal of Rule 17a-23<sup>608</sup> under the Exchange Act.<sup>609</sup> The FRFA notes the potential costs of operation and procedural changes that may be necessary to comply with the new rules and rule amendments ("new regulatory framework"). A summary of the Initial Regulatory Flexibility Analysis ("IRFA") appeared in the Proposing Release.<sup>610</sup>

As more fully discussed in the FRFA, market participants have developed a variety of alternative trading systems that furnish services traditionally provided solely by registered exchanges. Our current regulatory framework, designed more than six decades ago, however, did not foresee many of these trading and business functions. Alternative trading systems now handle twenty percent or more of the orders in securities listed on Nasdaq, and almost four percent of orders in listed securities. Even though these systems provide services that are similar to those provided by the registered exchanges and Nasdaq, the current regulatory framework largely ignores the market functions of alternative trading systems. This creates disparities that affect investor protection, market intermediaries, and other markets. For example, activity on alternative trading systems is not fully disclosed to, or accessible by, public investors and may not be adequately surveilled for market manipulation and fraud. Moreover, these trading systems have no obligation to provide investors a fair opportunity to participate in their systems or to treat their participants fairly. In addition, they do not have an obligation to ensure that their capacity is sufficient to handle trading demand. Because of the increasingly important role of alternative trading systems, these differences call into question not only the fairness of current regulatory requirements, but also the efficacy of the existing national market system structure.

As described in the FRFA, under the new regulatory framework, the

Commission will offer trading systems a choice between broker-dealer regulation and exchange regulation. Specifically, the Commission proposed to allow alternative trading systems to choose whether to register as national securities exchanges, or to register as broker-dealers and comply with additional requirements under proposed Regulation ATS depending on their activities and trading volume. In conjunction with this proposal, the Commission proposed to repeal Rule 17a-23, which currently requires alternative trading systems—as well as broker-dealer trading systems that are not alternative trading systems—to maintain certain records and file reports with the Commission. The Commission also proposed amendments to Form 1, which securities markets file to register as national securities exchanges, and related rules. Finally, to enable registered exchanges and national securities associations to better compete in the fast changing marketplace, the Commission proposed to temporarily exempt certain pilot trading systems operated by such exchanges and associations from the rule filing requirements of the Exchange Act.

In the Proposing Release, the Commission solicited public comment on the proposed new rules and rule amendments which were designed to resolve many of the concerns raised by alternative trading systems. As discussed in the FRFA, commenters generally supported the Commission's proposals and welcomed the regulatory flexibility these proposals offered. While no public comments were received in response to the IRFA, several of the comments were related to the IRFA. Several commenters encouraged the Commission to accept electronic filings as a means of reducing the burden on market participants. The Commission is, in fact, working toward the goal of accepting filings in electronic form. One commenter suggested that the Commission impose only minimal regulatory requirements, if any, on alternative trading systems that trade only minimal volume in order to avoid erecting significant barriers to entry and innovation. The Commission believes that the requirements of Regulation ATS are minimal for new alternative trading systems, especially as compared to the current no-action letter process. Regulation ATS sets forth concrete requirements for a system to operate, imposes only notice filings, and reserves more burdensome requirements for high volume systems. Another commenter stated that the reporting requirements under proposed Regulation ATS are

similar to current Rule 17a-23 and, thus, are not inappropriately burdensome. The Commission agrees and notes that most current potential respondents under Regulation ATS already have experience with the requirements and burdens associated with Rule 17a-23, so Regulation ATS will not impose significant new burdens on currently operating alternative trading systems.

The Commission is adopting new Regulation ATS substantially in the form it was proposed.

The FRFA addresses how the proposal would affect broker-dealers that operate alternative trading systems and internal broker-dealer trading systems that are small entities. As more fully explained in the FRFA, the Commission believes that the improved regulatory framework provided by Regulation ATS justifies the costs incurred by industry participants to comply with Regulation ATS. The FRFA also describes the Commission's consideration of significant alternatives to Regulation ATS. The FRFA concludes that the alternatives, in the context of a new regulatory framework, would not accomplish the stated objectives of Regulation ATS. A copy of the FRFA may be obtained by contacting Denise Landers, Attorney, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 10-1, Washington D.C. 20549.

## XII. Paperwork Reduction Act

As explained in the Proposing Release, certain provisions of the rules and rule amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*) ("PRA"). Accordingly, the Commission submitted the collection of information requirements contained in the rules and rule amendments to the Office of Management and Budget ("OMB") for review and were approved by OMB which assigned the following control numbers: Form 1, Rules 6a-1 and 6a-2, control number 3235-0017; Rule 6a-3, control number 3235-0021; Rule 17a-3(a)(16), control number 3235-0508; Rule 17a-4(b)(10), control number 3235-0506; Rule 19b-5 and Form PILOT, control number 3235-0507; Rule 301, Form ATS and Form ATS-R, control number 3235-0509; Rule 302, control number 3235-0510; and Rule 303, control number 3235-0505. The collections of information are in accordance with Section 3507 of the

<sup>599</sup> 17 CFR 242.638.

<sup>600</sup> 17 CFR 249.821.

<sup>601</sup> 17 CFR 240.6a-1.

<sup>602</sup> 17 CFR 240.6a-2.

<sup>603</sup> 17 CFR 240.6a-3.

<sup>604</sup> 17 CFR 240.11Ac1-1.

<sup>605</sup> 17 CFR 240.17a-3.

<sup>606</sup> 17 CFR 240.17a-4.

<sup>607</sup> 17 CFR 202.3.

<sup>608</sup> 17 CFR 240.17a-23.

<sup>609</sup> 15 U.S.C. 78a *et seq.*

<sup>610</sup> See *supra* note .

PRA.<sup>611</sup> With regard to Rule 301, Form ATS, and Form ATS-R, Rule 302, and Rule 303, the Commission staff has changed its estimate of the paperwork burdens slightly due to an increase in the estimated number of respondents that will be affected and a change to the fair access rules. Accordingly, the Commission has submitted a PRA change worksheet to OMB.<sup>612</sup>

The collection of information obligations imposed by the rules and rule amendments are mandatory. However, it is important to note that an alternative trading system operating as a broker-dealer is optional, operation of a national securities exchange is optional, and operating a pilot trading system is optional. The information collected, retained, and/or filed pursuant to the rules and rule amendments under Regulation ATS will be kept confidential to the extent permitted by the Freedom of Information Act (5 U.S.C. § 552 *et seq.*). The information collected, retained, and/or filed pursuant to the rules for registration as a national securities exchange will not be confidential and will be available to the public. The information collected, retained, and/or filed pursuant to the rules for operation of pilot trading systems will not be confidential and will be made available to the public when the pilot trading system starts to operate. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid OMB control number.

The collections of information are necessary for persons to obtain certain benefits or to comply with certain requirements. As described in the Proposing Release, the rules and rule amendments to which the collections of information are related allow the Commission to respond to the impact of technological developments in the securities markets and permit the Commission to more effectively oversee the growing number of alternative trading systems. The collections of information are also necessary to permit the Commission to effectively oversee SRO pilot trading systems. With the exception of two changes to the final rules, there are no material changes to the rules and amendments as adopted that affect the burden estimates in the Proposing Release. The Commission is adopting different fair access requirements from those it published in the Proposing Release. The Commission

has determined to not adopt the fair access requirements that would have required investors denied or limited access to have a right to appeal to the Commission and alternative trading systems making access denial or limitation decisions to notify such investors of the decision and their right of appeal to the Commission. Instead, the Commission has decided to adopt rules that require alternative trading systems to report quarterly to the Commission a record of all grants, denials, and limitations of access as well as other descriptive information surrounding the decision. These changes eliminate the proposed paperwork burden of providing notice to investors and adds a compliance burden on Form ATS-R to report such information to the Commission. Aggregate paperwork burdens have also been revised to reflect updated information regarding the estimated number of alternative trading systems that will be subject to the rules. In the Proposing Release, the Commission staff estimated that there were approximately forty-three alternative trading systems operating. The Commission staff now estimates that there are forty-five alternative trading systems operating, so the aggregate paperwork burdens have been revised to reflect this change.

The Commission solicited public comment on the collection of information requirements contained in the Proposing Release. While the Commission received no comments that specifically addressed the PRA portion of the release, it did receive several comments that touched on PRA related issues.

Several commenters encouraged the Commission to accept electronic filings as a means of reducing the burden on market participants. The Commission is, in fact, working toward the goal of accepting filings in electronic form. The Commission anticipates that the option of electronic filing will be made available to respondents at some point in the relatively near future. Several commenters also suggested that the Commission reduce the burden on national securities exchanges by relieving them of the obligation to file annual amendments to Form 1 due to the same information being submitted to the Commission in other forms periodically throughout the year. The Commission believes that it is important to have one complete annual filing that compiles all the changes to the information contained on Form 1 throughout the year and all other required SRO information. Additionally, the Commission believes that such a filing represents only a compilation of

existing information, so the additional burden of requiring an annual filing is largely clerical and generally minimal.

One commenter suggested that the Commission impose only minimal regulatory requirements, if any, on alternative trading systems that trade only minimal volume in order to avoid erecting significant barriers to entry and innovation. The Commission believes that the requirements of Regulation ATS are minimal for new alternative trading systems, especially as compared to the current no-action letter process.

Regulation ATS sets forth concrete requirements for a system to operate, imposes only notice filings, and reserves more burdensome requirements for high volume systems. Another commenter stated that the reporting requirements under proposed Regulation ATS are similar to current Rule 17a-23 and, thus, are not inappropriately burdensome. The Commission agrees and notes that most current potential respondents under Regulation ATS already have experience with the requirements and burdens associated with Rule 17a-23, so Regulation ATS will not impose significant new burdens on currently operating alternative trading systems.

As noted above in the Cost-Benefit section, below is a summary of the paperwork burdens that were identified in the Proposing Release. Although not mandated by the PRA, to give regulated entities and others an understanding of the paperwork costs, the discussion below provides dollar estimates assuming certain labor costs.

#### A. Form 1, Rules 6a-1 and 6a-2

These amendments are intended to simplify the filing requirements and reduce the compliance burdens for national securities exchanges and will likely impose few additional costs on national securities exchanges. Initially, there may be some additional personnel costs required to review the proposed rules and revised Form 1, but the Commission believes that the simplified requirements will reduce overall compliance burdens and costs over time. Reducing the frequency of filings for some requirements may result in some information being less current. The Commission, however, believes that much of this type of information does not change frequently. Moreover, the option of posting such information on an Internet web site should encourage more frequent updating of current information.

The Commission staff has estimated that each respondent will incur an average burden of forty-seven hours to comply with Rule 6a-1 and file an

<sup>611</sup> 44 U.S.C. 3507.

<sup>612</sup> For a further discussion of the changes, see the discussions of Rule 301, Form ATS, Form ATS-R, Rule 302, and Rule 303, *infra*.

initial application for registration on Form 1. This represents a two hour increase from the current average burden due to the estimated additional burden of the added exhibits. The Commission staff has estimated that the average additional cost per response will be approximately \$30.<sup>613</sup> Because the Commission receives applications for registration as an exchange on Form 1 from time to time, and not on a predictable basis, it cannot estimate the annual aggregate costs and burden hours associated with such filings.<sup>614</sup>

The Commission notes that it is making no material changes to Rule 6a-1, Rule 6a-2, or Form 1 from the Proposing Release. Thus, the collection of information burdens are not changing from those proposed.

#### B. Rule 6a-3

The Commission anticipates that the amendments will not change the paperwork burden associated with complying with Rule 6a-3. The Commission staff has estimated that the average burden for each respondent to comply with Rule 6a-3 is one-half hour per response because compliance only requires photocopying existing documents. The Commission also estimates that each respondent will file supplemental information under Rule 6a-3 approximately twenty-five times per year. The estimated average cost per response for each individual respondent is \$9.50, resulting in an estimated annual average cost burden for each respondent of \$237.50.<sup>615</sup>

#### C. Rule 17a-3(a)(16)

No additional recordkeeping burdens will be imposed on internal broker-dealer systems under the amendments to Rule 17a-3. The amendments apply only to systems that are presently subject to the recordkeeping requirements of Rule 17a-23. Because the Commission is repealing Rule 17a-23 and amending Rules 17a-3 and 17a-4 by transferring the recordkeeping

requirements from Rule 17a-23, the Commission does not anticipate any new recordkeeping costs or burdens for respondents.

Based on Commission experience with the burdens associated with Rule 17a-23, the Commission has estimated the burdens that will be associated with Rule 17a-3(a)(16). The Commission staff has estimated that there will be approximately ninety-four broker-dealers operating one hundred twenty-three internal broker-dealer systems that will have to make the records described in Rule 17a-3(a)(16). The Commission staff has estimated that each respondent will spend approximately twenty-seven hours per year keeping the required records under Rule 17a-3(a)(16) at an annual cost of \$1,298.16.<sup>616</sup> The aggregate burden for approximately ninety-four broker-dealers operating internal broker-dealer trading systems is estimated to be 2,619 hours for a total average cost of \$122,027.04.<sup>617</sup>

#### D. Rule 17a-4(b)(10)

No additional recordkeeping burdens will be imposed on internal broker-dealer systems under the amendments to Rule 17a-4. The amendments apply only to systems that are presently subject to the recordkeeping requirements of Rule 17a-23. Because the Commission is repealing Rule 17a-23 and amending Rules 17a-3 and 17a-4 by transferring the recordkeeping requirements from Rule 17a-23, the Commission does not anticipate any new recordkeeping costs or burdens for respondents.

Based on Commission experience with the burdens associated with Rule 17a-23, the Commission has estimated the burdens that will be associated with Rule 17a-4(b)(10). The Commission staff has estimated that there will be approximately ninety-four broker-dealers operating one hundred twenty-three internal broker-dealer systems that will have to keep the records described in Rule 17a-4(b)(10). The Commission staff has estimated that each respondent will spend approximately three hours to preserve the required records under

Rule 17a-4(b)(10) at an annual cost of \$144.24.<sup>618</sup> The aggregate burden for approximately ninety-four broker-dealers operating internal broker-dealer trading systems is estimated to be two hundred eighty two hours for a total average cost of \$13,558.56.<sup>619</sup>

#### E. Rule 19b-5 and Form PILOT

For SROs that choose to operate pilot trading systems and avail themselves of the provisions of Rule 19b-5, compliance with Rule 19b-5 and the filings required on Form PILOT are mandatory. Initial filings on Form PILOT are confidential until the pilot system is operational and subsequent filings are not confidential. Thus, after a pilot trading system starts to operate, all filings on Form PILOT are available to the public. Rule 19b-5 reiterates SROs' existing recordkeeping obligations under Rule 17a-1, which requires that such records be kept for not less than five years, the first two years in an easily accessible place.

The Commission anticipates receiving approximately 6 notices per year regarding pilot trading systems on Form PILOT.<sup>620</sup> An SRO will be required to submit a Form PILOT providing detailed operational data and update this information quarterly. The Commission staff has estimated that an SRO will expend twenty-four hours to file an initial operation report and three hours to file a quarterly report and a systems change notice.<sup>621</sup> The Commission also estimates that an SRO will file two amendments per year to report changes to the system.<sup>622</sup> The Commission staff has estimated that an SRO will expend \$1,242 per initial Form PILOT filing and \$155 for each quarterly Form PILOT and system

<sup>618</sup> The Commission staff has estimated that an employee of a broker-dealer charged to ensure compliance with Commission regulations receives annual compensation of \$100,000. This compensation is the equivalent of \$48.08 per hour (\$100,000 divided by 2,080 payroll hours per year). The estimated annual cost of \$144.24 is derived from three burden hours per respondent at \$48.08 per hour.

<sup>619</sup> The estimated aggregate burden of two hundred eighty-two hours is derived from ninety-four broker-dealer respondents incurring an average burden of three hours each. The estimated aggregate cost of \$13,558.56 is derived from ninety-four broker-dealer respondents incurring an average burden of \$144.24 each.

<sup>620</sup> This estimate is based on a review of past SRO filings under section 19(b) of the Exchange Act. The Commission staff has estimated that approximately 6 rule filings per year in the past could have been filed under Rule 19b-5.

<sup>621</sup> 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.

<sup>622</sup> This estimate is based on the Commission's experience with collection of similar information under Rule 17a-23.

<sup>613</sup> The estimated average additional cost per response of \$30 is derived from two additional hours of clerical work at \$15 per hour.

<sup>614</sup> Since 1991, the Commission has received three total applications for registration as a national securities exchange.

<sup>615</sup> The estimated average cost per response of \$9.50 is composed of \$7.50 for clerical work (0.5 hours at \$15 per hour) and \$2 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs). The Commission staff has estimated overhead for this collection of information burden, and all other collection of information burdens discussed below, based on thirty-five percent of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973). The estimated average annual cost of \$237.50 is derived from twenty-five annual filings at a cost of \$9.50 per filing.

<sup>616</sup> The Commission staff has estimated that an employee of a broker-dealer charged to ensure compliance with Commission regulations receives annual compensation of \$100,000. This compensation is the equivalent of \$48.08 per hour (\$100,000 divided by 2,080 payroll hours per year). The estimated annual cost of \$1,298.16 is derived from twenty-seven burden hours per respondent at \$48.08 per hour.

<sup>617</sup> The estimated aggregate burden of 2,619 hours is derived from ninety-four broker-dealer respondents incurring an average burden of twenty-seven hours each. The estimated aggregate cost of \$122,027.04 is derived from ninety-four broker-dealer respondents incurring an average burden of \$1,298.16 each.

change notice filed.<sup>623</sup> Thus, the total estimated annual burden for SROs to comply with Rule 19b-5 by filing an initial notice on Form PILOT is estimated to be one hundred forty-four hours for a total average cost of \$7,452.<sup>624</sup> The total estimated annual burden for SROs to file systems change notices and quarterly reports on Form PILOT is estimated to be one hundred eight hours for a total average cost of \$5,580.<sup>625</sup>

#### *F. Rule 301, Form ATS and Form ATS-R*

For alternative trading systems that choose to register as a broker-dealer, the requirements of Rule 301, Form ATS and Form ATS-R are mandatory. All filings required under Rule 301, Form ATS and Form ATS-R are considered confidential and are not available to the public. All records required to be made under the Rule are required to be preserved for three years, the first two years in an easily accessible place.

The alternative trading system amendments and rules have been tailored to minimize their burden on alternative trading systems and especially small systems. Many of the provisions in the proposed rules are triggered by a volume threshold. The Commission expects that small alternative trading systems will not have sufficient volume to trigger those thresholds and will therefore not have to comply with those provisions. The recordkeeping and reporting requirements with which smaller, lower volume alternative trading systems have to comply under proposed Regulation ATS are substantially similar to those with which alternative trading systems currently comply. Consequently the

<sup>623</sup> The estimated average cost of \$1,242 to file an initial Form PILOT is composed of \$800 for in-house professional work (sixteen hours at \$50 per hour), \$120 for clerical work (eight hours at \$15 per hour) and \$322 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

The total estimated average cost of \$155 to file quarterly reports and system change notices on Form PILOT is composed of \$100 for in-house professional work (two hours at \$50 per hour), \$15 for clerical work (one hour at \$15 per hour) and \$40 for printing, supplies, copying and postage (approximately thirty-five percent of the total labor costs).

<sup>624</sup> The estimated average burden of one hundred forty-four hours is derived from six SRO respondents incurring an average burden of twenty-four hours per filing. The estimated average cost of \$7,452 is derived from six SRO respondents making six initial Form PILOT filings at \$1,242 per filing.

<sup>625</sup> The estimated average burden of one hundred eight hours is derived from six SRO respondents filing four quarterly reports and two systems change notices at three burden hours per filing. The estimated average cost of \$5,580 is derived from six SRO respondents filing four quarterly reports and two systems change notices at \$155 per filing.

costs for smaller alternative trading systems should remain unchanged.

#### 1. Notice, Reporting, and Recordkeeping

All alternative trading systems that will be subject to notice, reporting, and recordkeeping requirements under the Commission's rules as adopted today are currently subject to similar requirements under Rule 17a-23. The requirements under Regulation ATS, however, require some additional information that is not currently required under Rule 17a-23.

Under Regulation ATS, alternative trading systems file an initial operation report, notices of material systems changes, and quarterly reports. The rules also include new Forms ATS and ATS-R to standardize reporting of such information and make it more useful for the Commission. The rules require information that is not currently required under Rule 17a-23, such as greater detail about the system operations, the volume and types of securities traded, criteria for granting access to subscribers, procedures governing order execution, reporting, clearance and settlement, procedures for reviewing systems capacity and contingency procedures, and the identity of any other entities involved in operating the system.

Regulation ATS requires staff time to comply with the initial notice and amendment requirements. While the Commission has designed the requirements in an effort to balance the costs of filing with the benefits to be gained from the information, some effort will be necessary to gather and file this information. Most of the information, however, already exists. Alternative trading systems will only be required to gather this information and supply it in the required format to the Commission. The periodic updating requirements will also require staff time over the life of the alternative trading system to comply with the rules.

The Commission staff has estimated that there are currently about forty-five alternative trading systems that will be required to register as exchanges or register as broker-dealers and comply with Regulation ATS.<sup>626</sup> The Commission also estimates that, over time, there will be approximately three new alternative trading systems each year that choose to register as broker-

<sup>626</sup> This estimate is based on filings made with the Commission under Rule 17a-23. At the time of the Proposing Release, the Commission estimated that forty-three alternative trading systems would be required to register as exchanges or broker-dealers and comply with Regulation ATS. Since that time, two such alternative trading systems have started to operate.

dealers and comply with Regulation ATS.<sup>627</sup>

The Commission also estimates that, over time, there will be approximately three alternative trading systems that file cessation of operations reports each year. Thus, the Commission anticipates that, over time, if all forty-five current alternative trading systems choose to register as broker-dealers and comply with Regulation ATS, there will be approximately forty-five alternative trading systems operating each year.

The Commission staff has estimated that the average burden per respondent to file the initial operations report on Form ATS will be twenty hours. This burden is computed by estimating that completing the report will require an average of thirteen hours of professional work and seven hours of clerical work.<sup>628</sup> The Commission staff has estimated that the average cost per response will be \$1,019 representing the twenty hours and cost of supplies.<sup>629</sup> If all forty-five alternative trading systems opt to register as broker-dealers and comply with Regulation ATS, the total, one time cost to comply with the proposed requirements to file initial operation reports is estimated to be \$45,855.<sup>630</sup> The Commission also estimates that, over time, approximately three new alternative trading systems will register as broker-dealers per year, incurring an annual aggregate burden of sixty hours for an average total cost of \$3,057 after the first year following adoption of Regulation ATS.<sup>631</sup>

In addition, the rules require alternative trading systems to amend their initial operations report to notify the Commission of material systems changes and other changes to the

<sup>627</sup> Based on the Commission's experience over the last three years with Rule 17a-23, it appears that there are more than three new alternative trading systems per year. However, we expect that in the steady state over time, there will be approximately three new alternative trading systems per year. The rapid growth experienced over the last several years is unlikely to continue at such a high rate in perpetuity.

<sup>628</sup> This estimate for burden hours of filing Form ATS is based on the burdens associated with filing Form 1, adjusted for differences between Form 1 and Form ATS. The division between professional and clerical time is based on estimates of the proportions used in the estimates of burdens for filing Form 1.

<sup>629</sup> The estimated average cost per response of \$1,019 is composed of \$650 for in-house professional work (thirteen hours at \$50 per hour), \$105 for clerical work (seven hours at \$15 per hour) and \$264 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

<sup>630</sup> This estimated cost of \$45,855 is derived from forty-five alternative trading systems filing at an average cost of \$1,019 each.

<sup>631</sup> This estimated cost of \$3,057 is derived from three new alternative trading systems filing at an average cost of \$1,019 each.

information contained in the initial operations report. The Commission staff has estimated that each respondent will file six such amendments per year.<sup>632</sup> The Commission staff has estimated that each respondent will incur an average burden of two hours per response and incur an average cost of \$111.50 for each amendment to the initial operation report that it submits.<sup>633</sup> If all forty-five alternative trading systems opt to comply with Regulation ATS rather than to register as exchanges, the total aggregate cost per year to comply with the proposed requirement to file amendments to the initial operation reports is estimated to be \$30,105.<sup>634</sup>

Alternative trading systems registering as broker-dealers will also be required to file quarterly reports on Form ATS-R, reporting participating system subscribers, the securities traded on the system, and aggregate volume information. The Commission staff has estimated that the quarterly reports will cause each respondent to incur an average burden of 4 hours per response and incur an average cost of \$223 for each Form ATS-R that it submits.<sup>635</sup> The annual burden per respondent is estimated to be \$892.<sup>636</sup> If all forty-five alternative trading systems opt to register as broker-dealers and comply with Regulation ATS, the total cost per year to comply with the requirement to file quarterly reports is estimated to be \$40,140.<sup>637</sup>

Finally, alternative trading systems registered as broker-dealers will be required to submit a notice and a report on Form ATS when they cease operations. The Commission anticipates a total of three such filings per year. The Commission staff has estimated that individual respondents will incur a burden of two hours to file the cessation notice. The Commission staff has

estimated that individual respondents will incur a cost of \$111.50 to file the cessation of operations report on Form ATS.<sup>638</sup> The annual aggregate burden for three alternative trading systems to file cessation of operations reports is estimated to be \$334.50.<sup>639</sup>

## 2. Fair Access

Under Regulation ATS, alternative trading systems with significant volume are required to establish and maintain standards for granting access to their system and keep records of such standards. In addition, alternative trading systems with significant volume are required to submit certain information regarding grants, denials, and limitations of access with their quarterly reports on Form ATS-R. The Commission staff has estimated that each respondent obligated to establish and maintain such records will incur a burden of seventeen hours per year to make and keep standards for granting access for a total estimated cost of \$958.50.<sup>640</sup>

Although these estimates reflect a program change from the Proposing Release, the total burdens on respondents are decreasing slightly as a result of the program changes. The Commission is eliminating the proposal to require alternative trading systems that deny investors access to the system to provide them with notice of the denial and their right of appeal to the Commission. Under the rules as adopted, there is no right of appeal to the Commission. In the Proposing Release, the Commission estimated that

the burden to comply with the notice requirement would be approximately twenty-seven hours per year for each respondent. Under the rules as adopted, such alternative trading systems are required to submit fair access information on Form ATS-R on a quarterly basis. The burden for this requirement is only twelve hours per year for each respondent. Thus, the changes from the Proposing Release are anticipated to reduce the burden on each respondent by approximately fifteen hours per year. The Commission staff has estimated that only two respondents will be affected by this program change, resulting in an aggregate reduction of thirty burden hours for all respondents. This reduction, however, is offset by an increase in the estimated number of respondents. Specifically, the aggregate paperwork burden for Rule 301, Form ATS, and Form ATS-R is increasing by one hundred sixty hours due to updating the estimate of the number of potential respondents from forty-three in the Proposing Release to forty-five currently.

## 3. Systems Capacity, Integrity, and Security

The notification requirement for material systems outages should impose relatively little additional costs on alternative trading systems. Moreover, the Commission believes that this small burden is justified by the need to keep Commission staff abreast of systems' developments and problems.

The Commission staff has estimated that each respondent will incur an average annual burden of fifteen hours to comply with the recordkeeping requirements associated with the systems capacity, integrity, and security provisions of Regulation ATS. The Commission staff has estimated that each respondent will make an average of five system outage notices per year, for an estimated average burden of 1.25 hours per year.<sup>641</sup> The Commission staff has estimated that the total estimated average cost of compliance for each respondent will be \$85 per year.<sup>642</sup> Such alternative trading systems will

<sup>632</sup> This estimate is based on the Commission's experience with collection of similar information under Rule 17a-23.

<sup>633</sup> The estimated average cost per response of \$111.50 is composed of \$75 for in-house professional work (1.5 hours at \$50 per hour), \$7.50 for clerical work (0.5 hours at \$15 per hour), and \$29 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

<sup>634</sup> This estimated cost of \$30,105 is composed of \$111.50 cost per amendment for forty-five alternative trading systems filing six times per year.

<sup>635</sup> The estimated cost of \$223 per response is composed of \$150 for in-house professional work (three hours at \$50 per hour), \$15 for clerical work (one hour at \$15 per hour) and \$58 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

<sup>636</sup> The estimated annual cost of \$892 to file Form ATS-R is derived from four quarterly reports at an estimated annual cost of \$223 per filing.

<sup>637</sup> This estimated cost of \$40,140 is derived from forty-five alternative trading systems with an estimated annual filing cost for each of \$892.

<sup>638</sup> The estimated cost of \$111.50 per response is composed of \$75 for in-house professional work (1.5 hours at \$50 per hour), \$7.50 for clerical work (0.5 hours at \$15 per hour), and \$29 for printing, supplies, copying and postage (approximately thirty-five percent of the total labor costs).

<sup>639</sup> The estimated cost of \$334.50 is derived from an average of three alternative trading systems filing one cessation of operations report per year on Form ATS at an estimated cost of \$111.50 each.

<sup>640</sup> The estimated burden of seventeen hours is derived from five hours for establishing and maintaining standards for fair access and twelve hours to report fair access information on Form ATS-R on a quarterly basis (four responses at three hours per response). The estimated cost of \$958.50 is derived from \$650 for professional work (thirteen hours at \$50 per hour), \$60 for clerical work (four hours at \$15 per hour), and \$248.50 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs). The Commission staff has estimated overhead based on thirty-five percent of total labor costs based on the *GSA Guide to Estimating Reporting Costs* (1973).

The estimated burden of thirteen hours of professional work is derived from five hours for establishing and maintaining standards for fair access and eight hours (two hours for four quarterly reports on Form ATS-R) to compile and report fair access information. The estimated burden of four hours of clerical work is derived from one hour per quarter to compile and send information on Form ATS-R.

<sup>641</sup> The Commission notes that compliance with the notice provision can be achieved by a telephone call, so the burden for each notice is minimal. The Commission staff has estimated only 0.25 hours per notice will be required. The estimate of five system outage notices per year is based on the Commission's experience with the Automated Review Program.

<sup>642</sup> The estimated average cost per response of \$17 is composed of \$12.50 for in-house professional work (0.25 hours at \$50 per hour) and \$4.50 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs). The estimated annual cost of \$85 is derived from five notices at \$17 per notice.

also be required to keep records relating to the steps taken to comply with systems capacity, integrity, and security requirements under Regulation ATS. The Commission staff has estimated that each respondent will incur a burden of ten hours per year to comply with such recordkeeping requirements for a total estimated cost of \$675 per year.<sup>643</sup> The Commission staff has estimated that two alternative trading systems will be required to comply with the systems capacity, integrity, and security provisions of Regulation ATS due to their significant volume. The estimated aggregate cost for these alternative trading systems chose to comply with the systems capacity, integrity, and security requirements is \$1,520.<sup>644</sup>

#### G. Rule 302

Rule 302 requires alternative trading systems to make certain records with respect to trading activity through the alternative trading systems. This collection of information will permit the Commission to detect and investigate potential market irregularities and to ensure investor protection. Such information is not available in any other form from any other sources.

For alternative trading systems that choose to register as a broker-dealer, the requirements of Rule 302 are mandatory. All records required to be made under Rule 302 are considered confidential and are not available to the public. All records required to be made under the Rule are required to be preserved for three years, the first two years in an easily accessible place.

The Commission staff has estimated that each alternative trading system that chooses to register as a broker-dealer will be required to expend an average of thirty-six hours to comply with Rule 302 at an average cost of \$1,730.88.<sup>645</sup> If all forty-five alternative trading systems opt to register as broker-dealers, rather than as exchanges, the total cost

for recordkeeping under Rule 302 is estimated to be \$77,889.60 per year.<sup>646</sup>

The Commission notes that it is making no material changes to Rule 302 from the Proposing Release. The collection of information burdens are increasing slightly due to an updated estimate of the number of respondents and not due to any changes to the rule as proposed.

#### H. Rule 303

Rule 303 requires alternative trading systems registered as broker-dealers to preserve certain records produced under Rule 302, as well as standards for granting access to the system and records generated in complying with the systems capacity, integrity and security requirements for alternative trading systems with significant trading volume. Alternative trading systems registered as broker-dealers are not required to file such information, but merely to retain it in an organized manner and make it available to the Commission upon request.

For alternative trading systems that choose to register as a broker-dealer, the requirements of Rule 303 are mandatory. All records required to be made under Rule 303 are considered confidential and are not available to the public. All records required to be made under the Rule are required to be preserved for three years, the first two years in an easily accessible place.

The Commission staff has estimated that each alternative trading system that chooses to register as a broker-dealer will be required to expend an average of four hours per year to comply with Rule 303 at an average cost of \$192.32.<sup>647</sup> If all forty-five alternative trading systems opt to register as broker-dealers, rather than as exchanges, the total cost for record preservation is estimated to be \$8,654.40 per year.<sup>648</sup>

The Commission notes that it is making no material changes to Rule 302 from the Proposing Release. The collection of information burdens are increasing slightly due to an updated estimate of the number of respondents and not due to any changes to the rule as proposed.

<sup>646</sup> This estimated cost of \$77,889.60 is derived from forty-five alternative trading systems incurring an annual cost of \$1,730.88 each.

<sup>647</sup> The estimated cost of \$192.32 is derived from an average of four hours of compliance time at \$48.08 per hour. The value of compliance time is estimated as follows: An employee of a broker-dealer charged to ensure compliance with Commission regulations receives estimated annual compensation of \$100,000. This compensation is the equivalent of \$48.08 per hour (\$100,000 divided by 2,080 payroll hours per year).

<sup>648</sup> This estimated cost of \$8,654.40 is derived from forty-five alternative trading systems incurring an annual cost of \$192.32 each.

### XIII. Statutory Authority

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

#### List of Subjects

##### 17 CFR Part 202

Administrative practice and procedure, Securities.

##### 17 CFR Part 240

Brokers-dealers, Fraud, Issuers, Reporting and recordkeeping requirements, Securities.

##### 17 CFR Part 242

Securities.

##### 17 CFR Part 249

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows.

### PART 202—INFORMAL AND OTHER PROCEDURES

1. The authority citation for part 202 continues to read in part as follows:

**Authority:** 15 U.S.C. 77s, 77t, 78d-1, 78u, 78w, 7811(d), 79r, 79t, 77sss, 77uuu, 80a-37, 80a-41, 80b-9, and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Paragraph (b) of § 202.3 is revised to read as follows:

#### § 202.3 Processing of filings.

(a) \* \* \*

(b)(1) Applications for registration as brokers, dealers, investment advisers, municipal securities dealers and transfer agents are submitted to the Office of Filings and Information Services where they are examined to determine whether all necessary information has been supplied and whether all required financial statements and other documents have been furnished in proper form. Defective applications may be returned with a request for correction or held until corrected before being accepted as a filing. The files of the Commission and other sources of information are considered to determine whether any person connected with the applicant appears to have engaged in activities which would warrant commencement of proceedings on the question of denial of registration. The staff confers with applicants and makes suggestions in

<sup>643</sup> The total estimated cost of \$675 is composed of \$500 for in-house professional work (ten hours at \$50 per hour) and \$175 for printing, supplies, copying, and postage (approximately thirty-five percent of the total labor costs).

<sup>644</sup> The estimated aggregate cost of \$1,520 is derived from two alternative trading systems incurring an estimated annual cost of \$760 each (\$85 for providing systems outage notices and \$675 for recordkeeping requirements).

<sup>645</sup> The estimated cost of \$1,730.88 is derived from an average of thirty-six hours of compliance time at \$48.08 per hour. The value of compliance time is estimated as follows: an employee of a broker-dealer charged to ensure compliance with Commission regulations receives estimated annual compensation of \$100,000. This compensation is the equivalent of \$48.08 per hour (\$100,000 divided by 2,080 payroll hours per year).

appropriate cases for amendments and supplemental information. Where it appears appropriate in the public interest and where a basis therefore exists, denial proceedings may be instituted. Within forty-five days of the date of the filing of a broker-dealer, investment adviser or municipal securities dealer application (or within such longer period as to which the applicant consents), the Commission shall by order grant registration or institute proceedings to determine whether registration should be denied. An application for registration as a transfer agent shall become effective within 30 days after receipt of the application (or within such shorter period as the Commission may determine). The Office of Filings and Information Services is also responsible for the processing and substantive examination of statements of beneficial ownership of securities and changes in such ownership filed under the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940, and for the examination of reports filed pursuant to § 230.144 of this chapter.

(2) Applications for registration as national securities exchanges, or exemption from registration as exchanges by reason of such exchanges' limited volume of transactions filed with the Commission are routed to the Division of Market Regulation, which examines these applications to determine whether all necessary information has been supplied and whether all required financial statements and other documents have been furnished in proper form. Defective applications may be returned with a request for correction or held until corrected before being accepted as a filing. The files of the Commission and other sources of information are considered to determine whether any person connected with the applicant appears to have engaged in activities which would warrant commencement of proceedings on the question of denial of registration. The staff confers with applicants and makes suggestions in appropriate cases for amendments and supplemental information. Where it appears appropriate in the public interest and where a basis therefore exists, denial proceedings may be instituted. Within 90 days of the date of the filing of an application for registration as a national securities exchange, or exemption from registration by reason of such exchanges' limited volume of transactions (or within such longer

period as to which the applicant consents), the Commission shall by order grant registration, or institute proceedings to determine whether registration should be denied as provided in § 240.19(a)(1) of this chapter.

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

3. The authority citation for part 240 continues to read in part as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll(d), 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

\* \* \* \* \*

4. Section 240.3a1-1 is added before the undesignated center heading "Definition of 'Equity Security' as Used in Sections 12(g) and 16" to read as follows:

#### **§ 240.3a1-1 Exemption from the definition of "Exchange" under Section 3(a)(1) of the Act.**

(a) An organization, association, or group of persons shall be exempt from the definition of the term "exchange" under section 3(a)(1) of the Act, (15 U.S.C. 78c(a)(1)), if such organization, association, or group of persons:

(1) Is operated by a national securities association;

(2) Is in compliance with Regulation ATS, 17 CFR 242.300 through 242.303; or

(3) Pursuant to paragraph (a) of § 242.301 of Regulation ATS, 17 CFR 242.301(a), is not required to comply with Regulation ATS, 17 CFR 242.300 through 242.303.

(b) Notwithstanding paragraph (a) of this section, an organization, association, or group of persons shall not be exempt under this section from the definition of "exchange," if:

(1) During three of the preceding four calendar quarters such organization, association, or group of persons had:

(i) Fifty percent or more of the average daily dollar trading volume in any security and five percent or more of the average daily dollar trading volume in any class of securities; or

(ii) Forty percent or more of the average daily dollar trading volume in any class of securities; and

(2) The Commission determines, after notice to the organization, association, or group of persons, and an opportunity for such organization, association, or group of persons to respond, that such an exemption would not be necessary or appropriate in the public interest or

consistent with the protection of investors taking into account the requirements for exchange registration under section 6 of the Act, (15 U.S.C. 78f), and the objectives of the national market system under section 11A of the Act, (15 U.S.C 78k-1).

(3) For purposes of paragraph (b) of this section, each of the following shall be considered a "class of securities":

(i) Equity securities, which shall have the same meaning as in § 240.3a11-1;

(ii) Listed options, which shall mean any options traded on a national securities exchange or automated facility of a national securities exchange;

(iii) Unlisted options, which shall mean any options other than those traded on a national securities exchange or automated facility of a national securities association;

(iv) Municipal securities, which shall have the same meaning as in section 3(a)(29) of the Act, (15 U.S.C. 78c(a)(29));

(v) Investment grade corporate debt securities, which shall mean any security that:

(A) Evidences a liability of the issuer of such security;

(B) Has a fixed maturity date that is at least one year following the date of issuance;

(C) Is rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and

(D) Is not an exempted security, as defined in section 3(a)(12) of the Act, (15 U.S.C. 78c(a)(12));

(vi) Non-investment grade corporate debt securities, which shall mean any security that:

(A) Evidences a liability of the issuer of such security;

(B) Has a fixed maturity date that is at least one year following the date of issuance;

(C) Is not rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and

(D) Is not an exempted security, as defined in section 3(a)(12) of the Act, (15 U.S.C. 78o);

(vii) Foreign corporate debt securities, which shall mean any security that:

(A) Evidences a liability of the issuer of such debt security;

(B) Is issued by a corporation or other organization incorporated or organized under the laws of any foreign country; and

(C) Has a fixed maturity date that is at least one year following the date of issuance; and

(viii) Foreign sovereign debt securities, which shall mean any security that:

(A) Evidences a liability of the issuer of such debt security;

(B) Is issued or guaranteed by the government of a foreign country, any political subdivision of a foreign country, or any supranational entity; and

(C) Does not have a maturity date of a year or less following the date of issuance.

5. Section 240.3b-16 is added before the undesignated center heading "Registration and Exemption of Exchanges" to read as follows:

**§ 240.3b-16 Definitions of terms used in Section 3(a)(1) of the Act.**

(a) An organization, association, or group of persons shall be considered to constitute, maintain, or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange," as those terms are used in section 3(a)(1) of the Act, (15 U.S.C. 78c(a)(1)), if such organization, association, or group of persons:

(1) Brings together the orders for securities of multiple buyers and sellers; and

(2) Uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.

(b) An organization, association, or group of persons shall not be considered to constitute, maintain, or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange," solely because such organization, association, or group of persons engages in one or more of the following activities:

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

(2) Allows persons to enter orders for execution against the bids and offers of a single dealer; and

(i) As an incidental part of these activities, matches orders that are not displayed to any person other than the dealer and its employees; or

(ii) In the course of acting as a market maker registered with a self-regulatory organization, displays the limit orders of such market maker's, or other broker-dealer's, customers; and

(A) Matches customer orders with such displayed limit orders; and

(B) As an incidental part of its market making activities, crosses or matches orders that are not displayed to any person other than the market maker and its employees.

(c) For purposes of this section the term *order* means any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order.

(d) For the purposes of this section, the terms *bid* and *offer* shall have the same meaning as under § 240.11Ac1-1.

(e) The Commission may conditionally or unconditionally exempt any organization, association, or group of persons from the definition in paragraph (a) of this section.

6. Section 240.6a-1 is amended by revising the section heading and paragraphs (a) and (b) to read as follows:

**§ 240.6a-1 Application for registration as a national securities exchange or exemption from registration based on limited volume.**

(a) An application for registration as a national securities exchange, or for exemption from such registration based on limited volume, shall be filed on Form 1 (§ 249.1 of this chapter), in accordance with the instructions contained therein.

(b) Promptly after the discovery that any information filed on Form 1 was inaccurate when filed, the exchange shall file with the Commission an amendment correcting such inaccuracy.

\* \* \* \* \*

7. Section 240.6a-2 is revised to read as follows:

**§ 240.6a-2 Amendments to application.**

(a) A national securities exchange, or an exchange exempted from such registration based on limited volume, shall file an amendment to Form 1, (§ 249.1 of this chapter), which shall set forth the nature and effective date of the action taken and shall provide any new information and correct any information rendered inaccurate, on Form 1, (§ 249.1 of this chapter), within 10 days after any action is taken that renders inaccurate, or that causes to be incomplete, any of the following:

(1) Information filed on the Execution Page of Form 1, or amendment thereto; or

(2) Information filed as part of Exhibits C, F, G, H, J, K or M, or any amendments thereto.

(b) On or before June 30 of each year, a national securities exchange, or an exchange exempted from such registration based on limited volume, shall file, as an amendment to Form 1, the following:

(1) Exhibits D and I as of the end of the latest fiscal year of the exchange; and

(2) Exhibits K, M, and N, which shall be up to date as of the latest date practicable within 3 months of the date the amendment is filed.

(c) On or before June 30, 2001 and every 3 years thereafter, a national securities exchange, or an exchange exempted from such registration based on limited volume, shall file, as an amendment to Form 1, complete Exhibits A, B, C and J. The information filed under this paragraph (c) shall be current as of the latest practicable date, but shall, at a minimum, be up to date within 3 months as of the date the amendment is filed.

(d)(1) If an exchange, on an annual or more frequent basis, publishes, or cooperates in the publication of, any of the information required to be filed by paragraphs (b)(2) and (c) of this section, in lieu of filing such information, an exchange may:

(i) Identify the publication in which such information is available, the name, address, and telephone number of the person from whom such publication may be obtained, and the price of such publication; and

(ii) Certify to the accuracy of such information as of its publication date.

(2) If an exchange keeps the information required under paragraphs (b)(2) and (c) of this section up to date and makes it available to the Commission and the public upon request, in lieu of filing such information, an exchange may certify that the information is kept up to date and is available to the Commission and the public upon request.

(3) If the information required to be filed under paragraphs (b)(2) and (c) of this section is available continuously on an Internet web site controlled by an exchange, in lieu of filing such information with the Commission, such exchange may:

(i) Indicate the location of the Internet web site where such information may be found; and

(ii) Certify that the information available at such location is accurate as of its date.

(e) The Commission may exempt a national securities exchange, or an exchange exempted from such registration based on limited volume, from filing the amendment required by this section for any affiliate or subsidiary listed in Exhibit C of the exchange's application for registration, as amended, that either:

(1) Is listed in Exhibit C of the application for registration, as amended,

of one or more other national securities exchanges; or

(2) Was an inactive subsidiary throughout the subsidiary's latest fiscal year.

Any such exemption may be granted upon terms and conditions the Commission deems necessary or appropriate in the public interest or for the protection of investors, provided however, that at least one national securities exchange shall be required to file the amendments required by this section for an affiliate or subsidiary described in paragraph (e)(1) of this section.

8. Section 240.6a-3 is revised to read as follows:

**§ 240.6a-3 Supplemental material to be filed by exchanges.**

(a)(1) A national securities exchange, or an exchange exempted from such registration based on limited volume, shall file with the Commission any material (including notices, circulars, bulletins, lists, and periodicals) issued or made generally available to members of, or participants or subscribers to, the exchange. Such material shall be filed with the Commission within 10 days after issuing or making such material available to members, participants or subscribers.

(2) If the information required to be filed under paragraph (a)(1) of this section is available continuously on an Internet web site controlled by an exchange, in lieu of filing such information with the Commission, such exchange may:

(i) Indicate the location of the Internet web site where such information may be found; and

(ii) Certify that the information available at such location is accurate as of its date.

(b) Within 15 days after the end of each calendar month, a national securities exchange or an exchange exempted from such registration based on limited volume, shall file a report concerning the securities sold on such exchange during the calendar month. Such report shall set forth:

(1) The number of shares of stock sold and the aggregate dollar amount of such stock sold;

(2) The principal amount of bonds sold and the aggregate dollar amount of such bonds sold; and

(3) The number of rights and warrants sold and the aggregate dollar amount of such rights and warrants sold.

9. Section 240.11Ac1-1 is amended by redesignating paragraph (c)(5)(ii)(A) as paragraph (c)(5)(ii)(A)(I), paragraph (c)(5)(ii)(B), introductory text, as paragraph (c)(5)(ii)(A)(2), paragraph

(c)(5)(ii)(B)(1) as paragraph (c)(5)(ii)(A)(2)(I), paragraph (c)(5)(ii)(B)(2) as paragraph (c)(5)(ii)(A)(2)(II), in newly designated paragraph (c)(5)(ii)(A)(2)(ii) by removing the period and adding in its place “; or”, and adding new paragraph (c)(5)(ii)(B) to read as follows:

**§ 240.11Ac1-1 Dissemination of quotations.**

\* \* \* \* \*

- (c) \* \* \*
- (5) \* \* \*
- (ii) \* \* \*
- (A)(1) \* \* \*

(B) Is an alternative trading system that:

(1) Displays orders and provides the ability to effect transactions with such orders under § 242.301(b)(3) of this chapter; and

(2) Otherwise is in compliance with Regulation ATS, § 242.300 through § 242.303 of this chapter.

\* \* \* \* \*

10. Section 240.17a-3 is amended by adding paragraph (a)(16) to read as follows:

**§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.**

(a) \* \* \*

(16)(i) The following records regarding any internal broker-dealer system of which such a broker or dealer is the sponsor:

(A) A record of the broker's or dealer's customers that have access to an internal broker-dealer system sponsored by such broker or dealer (identifying any affiliations between such customers and the broker or dealer);

(B) Daily summaries of trading in the internal broker-dealer system, including:

(1) Securities for which transactions have been executed through use of such system; and

(2) Transaction volume (separately stated for trading occurring during hours when consolidated trade reporting facilities are and are not in operation):

(i) With respect to equity securities, stated in number of trades, number of shares, and total U.S. dollar value;

(ii) With respect to debt securities, stated in total settlement value in U.S. dollars; and

(iii) With respect to other securities, stated in number of trades, number of units of securities, and in dollar value, or other appropriate commonly used measure of value of such securities; and

(C) Time-sequenced records of each transaction effected through the internal broker-dealer system, including date and time executed, price, size, security

traded, counterparty identification information, and method of execution (if internal broker-dealer system allows alternative means or locations for execution, such as routing to another market, matching with limit orders, or executing against the quotations of the broker or dealer sponsoring the system).

(ii) For purposes of paragraph (a) of this section, the term:

(A) *Internal broker-dealer system* shall mean any facility, other than a national securities exchange, an exchange exempt from registration based on limited volume, or an alternative trading system as defined in Regulation ATS, §§ 242.300 through 242.303 of this chapter, that provides a mechanism, automated in full or in part, for collecting, receiving, disseminating, or displaying system orders and facilitating agreement to the basic terms of a purchase or sale of a security between a customer and the sponsor, or between two customers of the sponsor, through use of the internal broker-dealer system or through the broker or dealer sponsor of such system;

(B) *Sponsor* shall mean any broker or dealer that organizes, operates, administers, or otherwise directly controls an internal broker-dealer trading system or, if the operator of the internal broker-dealer system is not a registered broker or dealer, any broker or dealer that, pursuant to contract, affiliation, or other agreement with the system operator, is involved on a regular basis with executing transactions in connection with use of the internal broker-dealer system, other than solely for its own account or as a customer with access to the internal broker-dealer system; and

(C) *System order* means any order or other communication or indication submitted by any customer with access to the internal broker-dealer system for entry into a trading system announcing an interest in purchasing or selling a security. The term “system order” does not include inquiries or indications of interest that are not entered into the internal broker-dealer system.

\* \* \* \* \*

11. Section 240.17a-4 is amended by revising paragraph (b)(1) and adding paragraph (b)(10) to read as follows:

**§ 240.17a-4. Records to be preserved by certain exchange members, brokers and dealers.**

\* \* \* \* \*

(b) \* \* \*

(1) All records required to be made pursuant to paragraphs (a)(4), (a)(6), (a)(7), (a)(8), (a)(9), and (a)(10) of § 240.17a-3.

\* \* \* \* \*

(10) All notices relating to an internal broker-dealer system provided to the customers of the broker or dealer that sponsors such internal broker-dealer system, as defined in paragraph (a)(16)(ii)(A) of § 240.17a-3. Notices, whether written or communicated through the internal broker-dealer trading system or other automated means, shall be preserved under this paragraph (b)(10) if they are provided to all customers with access to an internal broker-dealer system, or to one or more classes of customers. Examples of notices to be preserved under this paragraph (b)(10) include, but are not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, and instructions pertaining to access to the internal broker-dealer system.

\* \* \* \* \*

**§ 240.17a-23 [Removed]**

12. Section 240.17a-23 is removed and reserved.

13. Section 240.19b-5 is added to read as follows:

**§ 240.19b-5 Temporary exemption from the filing requirements of Section 19(b) of the Act.**

**Preliminary Notes**

1. The following section provides for a temporary exemption from the rule filing requirement for self-regulatory organizations that file proposed rule changes concerning the operation of a pilot trading system pursuant to section 19(b) of the Act (15 U.S.C. 78s(b), as amended). All other requirements under the Act that are applicable to self-regulatory organizations continue to apply.

2. The disclosures made pursuant to the provisions of this section are in addition to any other applicable disclosure requirements under the federal securities laws.

(a) For purposes of this section, the term *specialist* means any member subject to a requirement of a self-regulatory organization that such member regularly maintain a market in a particular security.

(b) For purposes of this section, the term *trading system* means the rules of a self-regulatory organization that:

(1) Determine how the orders of multiple buyers and sellers are brought together; and

(2) Establish non-discretionary methods under which such orders interact with each other and under which the buyers and sellers entering such orders agree to the terms of trade.

(c) For purposes of this section, the term *pilot trading system* shall mean a

trading system operated by a self-regulatory organization that is not substantially similar to any trading system or pilot trading system operated by such self-regulatory organization at any time during the preceding year, and that:

(1)(i) Has been in operation for less than two years;

(ii) Is independent of any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b));

(iii) With respect to each security traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 5 percent of the average daily trading volume of such security in the United States; and

(iv) With respect to all securities traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 20 percent of the average daily trading volume of all trading systems operated by such self-regulatory organization; or

(2)(i) Has been in operation for less than two years;

(ii) With respect to each security traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 1 percent of the average daily trading volume of such security in the United States; and

(iii) With respect to all securities traded on such pilot trading system, during at least two of the last four consecutive calendar months, has traded no more than 20 percent of the average daily trading volume of all trading systems operated by such self-regulatory organization; or

(3)(i) Has been in operation for less than two years; and

(ii)(A) Satisfied the definition of *pilot trading system* under paragraph (c)(1) of this section no more than 60 days ago, and continues to be independent of any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)); or

(B) Satisfied the definition of *pilot trading system* under paragraph (c)(2) of this section no more than 60 days ago.

(d) A pilot trading system shall be deemed *independent* of any other trading system operated by a self-regulatory organization if:

(1) Such pilot trading system trades securities other than the issues of securities that trade on any other trading system operated by such self-regulatory

organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b));

(2) Such pilot trading system does not operate during the same trading hours as any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)); or

(3) No specialist or market maker on any other trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)), is permitted to effect transactions on the pilot trading system in securities in which they are a specialist or market maker.

(e) A self-regulatory organization shall be exempt temporarily from the requirement under section 19(b) of the Act, (15 U.S.C. 78s(b)), to submit on Form 19b-4, 17 CFR 249.819, proposed rule changes for establishing a pilot trading system, if the self-regulatory organization complies with the following requirements:

(1) *Form PILOT*. The self-regulatory organization:

(i) Files Part I of Form PILOT, 17 CFR 249.821, in accordance with the instructions therein, at least 20 days prior to commencing operation of the pilot trading system;

(ii) Files an amendment on Part I of Form PILOT at least 20 days prior to implementing a material change to the operation of the pilot trading system; and

(iii) Files a quarterly report on Part II of Form PILOT within 30 calendar days after the end of each calendar quarter in which the market has operated after the effective date of this section.

(2) *Fair access*.

(i) The self-regulatory organization has in place written rules to ensure that all members of the self-regulatory organization have fair access to the pilot trading system, and that information regarding orders on the pilot trading system is equally available to all members of the self-regulatory organization with access to such pilot trading system.

(ii) Notwithstanding the requirement in paragraph (e)(2)(i) of this section, a specialist on the pilot trading system may have preferred access to information regarding orders that it represents in its capacity as specialist.

(iii) The rules established by a self-regulatory organization pursuant to paragraph (e)(2)(i) of this section will be considered rules governing the pilot trading system for purposes of the temporary exemption under this section.

(3) *Trading rules and procedures and listing standards.*

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

(ii) The rules established by a self-regulatory organization pursuant to paragraph (e)(3)(i) of this section will be considered rules governing the pilot trading system for purposes of the temporary exemption under this section.

(4) *Surveillance.* The self-regulatory organization establishes internal procedures for the effective surveillance of trading activity on the self-regulatory organization's pilot trading system.

(5) *Clearance and settlement.* The self-regulatory organization establishes reasonable clearance and settlement procedures for transactions effected on the self-regulatory organizations pilot trading system.

(6) *Types of securities.* The self-regulatory organization permits to trade on the pilot trading system only securities registered under section 12 of the Act, (15 U.S.C. 78l).

(7) *Activities of specialists.*

(i) The self-regulatory organization does not permit any member to be a specialist in a security on the pilot trading system and a specialist in a security on a trading system operated by such self-regulatory organization that has been approved by the Commission pursuant to section 19(b) of the Act, (15 U.S.C. 78s(b)), or on another pilot trading system operated by such self-regulatory organization, if such securities are related securities, except that a member may be a specialist in related securities that the Commission, upon application by the self-regulatory organization, later determines is necessary or appropriate in the public interest and consistent with the protection of investors;

(ii) Notwithstanding paragraph (e)(7)(i) of this section, a self-regulatory organization may permit a member to be a specialist in any security on a pilot trading system, if the pilot trading system is operated during trading hours different from the trading hours of the trading system in which such member is a specialist.

(iii) For purposes of paragraph (e)(7) of this section, the term *related securities* means any two securities in which:

(A) The value of one security is determined, in whole or significant part, by the performance of the other security; or

(B) The value of both securities is determined, in whole or significant part,

by the performance of a third security, combination of securities, index, indicator, interest rate or other common factor.

(8) *Examinations, inspections, and investigations.* The self-regulatory organization cooperates with the examination, inspection, or investigation by the Commission of transactions effected on the pilot trading system.

(9) *Recordkeeping.* The self-regulatory organization shall retain at its principal place of business and make available to Commission staff for inspection, all the rules and procedures relating to each pilot trading system operating pursuant to this section for a period of not less than five years, the first two years in an easily accessible place, as prescribed in § 240.17a-1.

(10) *Public availability of pilot trading system rules.* The self-regulatory organization makes publicly available all trading rules and procedures, including those established under paragraphs (e)(2) and (e)(3) of this section.

(11) Every notice or amendment filed pursuant to this paragraph (e) shall constitute a "report" within the meaning of sections 11A, 17(a), 18(a), and 32(a), (15 U.S.C. 78k-1, 78q(a), 78r(a), and 78ff(a)), and any other applicable provisions of the Act. All notices or reports filed pursuant to this paragraph (e) shall be deemed to be confidential until the pilot trading system commences operation.

(f)(1) A self-regulatory organization shall request Commission approval, pursuant to section 19(b)(2) of the Act, (15 U.S.C. 78s(b)(2)), for any rule change relating to the operation of a pilot trading system by submitting Form 19b-4, 17 CFR 249.819, no later than two years after the commencement of operation of such pilot trading system, or shall cease operation of the pilot trading system.

(2) Simultaneous with a request for Commission approval pursuant to section 19(b)(2) of the Act, (15 U.S.C. 78s(b)(2)), a self-regulatory organization may request Commission approval pursuant to section 19(b)(3)(A) of the Act, (15 U.S.C. 78s(b)(3)(A)), for any rule change relating to the operation of a pilot trading system by submitting Form 19b-4, 17 CFR 249.819, effective immediate upon filing, to continue operations of such trading system for a period not to exceed six months.

(g) Notwithstanding paragraph (e) of this section, rule changes with respect to pilot trading systems operated by a self-regulatory organization shall not be exempt from the rule filing requirements of section 19(b)(2) of the

Act, (15 U.S.C. 78s(b)(2)), if the Commission determines, after notice to the SRO and opportunity for the SRO to respond, that exemption of such rule changes is not necessary or appropriate in the public interest or consistent with the protection of investors.

## PART 242—REGULATIONS M AND ATS

14. The authority citation for part 242 is revised to read as follows:

**Authority:** 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78i(a), 78j, 78k-1(c), 78l, 78m, 78mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 80a-23, 80a-29, and 80a-37.

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

16. Part 242 is amended by adding Regulation ATS, §§ 242.300 through 242.303 to read as follows:

### Regulation ATS—Alternative Trading Systems

Sec.

242.300 Definitions.

242.301 Requirements for alternative trading systems.

242.302 Recordkeeping requirements for alternative trading systems.

242.303 Record preservation requirements for alternative trading systems.

### Regulation ATS—Alternative Trading Systems

#### Preliminary Notes

1. An alternative trading system is required to comply with the requirements in this Regulation ATS, unless such alternative trading system:

(a) Is registered as a national securities exchange;

(b) Is exempt from registration as a national securities exchange based on the limited volume of transactions effected on the alternative trading system; or

(c) Trades only government securities and certain other related instruments.

All alternative trading systems must comply with the antifraud, antimanipulation, and other applicable provisions of the federal securities laws.

2. The requirements imposed upon an alternative trading system by Regulation ATS are in addition to any requirements applicable to broker-dealers registered under section 15 of the Act, (15 U.S.C. 78o).

3. An alternative trading system must comply with any applicable state law relating to the offer or sale of securities or the registration or regulation of persons or entities effecting transactions in securities.

4. The disclosures made pursuant to the provisions of this section are in addition to any other disclosure requirements under the federal securities laws.

#### § 242.300 Definitions.

For purposes of this section, the following definitions shall apply:

(a) *Alternative trading system* means any organization, association, person, group of persons, or system:

(1) That constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of § 240.3b-16 of this chapter; and

(2) That does not:

(i) Set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or

(ii) Discipline subscribers other than by exclusion from trading.

(b) *Subscriber* means any person that has entered into a contractual agreement with an alternative trading system to access such alternative trading system for the purpose of effecting transactions in securities or submitting, disseminating, or displaying orders on such alternative trading system, including a customer, member, user, or participant in an alternative trading system. A subscriber, however, shall not include a national securities exchange or national securities association.

(c) *Affiliate of a subscriber* means any person that, directly or indirectly, controls, is under common control with, or is controlled by, the subscriber, including any employee.

(d) *Debt security* shall mean any security other than an equity security, as defined in § 240.3a11-1 of this chapter, as well as non-participatory preferred stock.

(e) *Order* means any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order.

(f) *Control* means the power, directly or indirectly, to direct the management or policies of an alternative trading system, whether through ownership of securities, by contract, or otherwise. A person is presumed to *control* an alternative trading system, if that person:

(1) Is a director, general partner, or officer exercising executive responsibility (or having similar status or performing similar functions);

(2) Directly or indirectly has the right to vote 25 percent or more of a class of voting security or has the power to sell or direct the sale of 25 percent or more of a class of voting securities of the alternative trading system; or

(3) In the case of a partnership, has contributed, or has the right to receive upon dissolution, 25 percent or more of

the capital of the alternative trading system.

(g) *Covered security* shall have the meaning provided in § 240.11Ac1-1(a)(6) of this chapter, *provided, however*, that a debt or convertible debt security shall not be deemed a covered security for purposes of Regulation ATS.

(h) *Effective transaction reporting plan* shall have the meaning provided in § 240.11Aa3-1(a)(3) of this chapter.

(i) *Exchange market maker* shall have the meaning provided in § 240.11Ac1-1(a)(9) of this chapter.

(j) *OTC market maker* shall have the meaning provided in § 240.11Ac1-1(a)(13) of this chapter.

(k) *Investment grade corporate debt security* shall mean any security that:

(1) Evidences a liability of the issuer of such security;

(2) Has a fixed maturity date that is at least one year following the date of issuance;

(3) Is rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and

(4) Is not an exempted security, as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)).

(l) *Non-investment grade corporate debt security* shall mean any security that:

(1) Evidences a liability of the issuer of such security;

(2) Has a fixed maturity date that is at least one year following the date of issuance;

(3) Is not rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and

(4) Is not an exempted security, as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)).

(m) *Commercial paper* shall mean any note, draft, or bill of exchange which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

#### § 242.301 Requirements for alternative trading systems.

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

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

(2) Is exempted by the Commission from registration as an exchange based on the limited volume of transactions effected;

(3) Is operated by a national securities association;

(4)(i) Is registered as a broker-dealer under sections 15(b) or 15C of the Act (15 U.S.C. 78o(b), and 78o-5), or is a bank, and

(ii) Limits its securities activities to the following instruments:

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

(B) Repurchase and reverse repurchase agreements solely involving securities included within paragraph (a)(4)(ii)(A) of this section;

(C) Any put, call, straddle, option, or privilege on a government security, other than a put, call, straddle, option, or privilege that:

(1) Is traded on one or more national securities exchanges; or

(2) For which quotations are disseminated through an automated quotation system operated by a registered securities association; and

(D) Commercial paper.

(5) Is exempted, conditionally or unconditionally, by Commission order, after application by such alternative trading system, from one or more of the requirements of paragraph (b) of this section. The Commission will grant such exemption only after determining that such an order is consistent with the public interest, the protection of investors, and the removal of impediments to, and perfection of the mechanisms of, a national market system.

(b) *Requirements.* Every alternative trading system subject to this Regulation ATS, pursuant to paragraph (a) of this section, shall comply with the requirements in this paragraph (b).

(1) *Broker-dealer registration.* The alternative trading system shall register as a broker-dealer under section 15 of the Act, (15 U.S.C. 78o).

(2) *Notice.* (i) The alternative trading system shall file an initial operation report on Form ATS, § 249.637 of this chapter, in accordance with the instructions therein, at least 20 days prior to commencing operation as an alternative trading system, or if the alternative trading system is operating as of April 21, 1999, no later than May 11, 1999.

(ii) The alternative trading system shall file an amendment on Form ATS at least 20 calendar days prior to implementing a material change to the operation of the alternative trading system.

(iii) If any information contained in the initial operation report filed under paragraph (b)(2)(i) of this section becomes inaccurate for any reason and has not been previously reported to the

Commission as an amendment on Form ATS, the alternative trading system shall file an amendment on Form ATS correcting such information within 30 calendar days after the end of each calendar quarter in which the alternative trading system has operated.

(iv) The alternative trading system shall promptly file an amendment on Form ATS correcting information previously reported on Form ATS after discovery that any information filed under paragraphs (b)(2)(i), (ii) or (iii) of this section was inaccurate when filed.

(v) The alternative trading system shall promptly file a cessation of operations report on Form ATS in accordance with the instructions therein upon ceasing to operate as an alternative trading system.

(vi) Every notice or amendment filed pursuant to this paragraph (b)(2) shall constitute a "report" within the meaning of sections 11A, 17(a), 18(a), and 32(a), (15 U.S.C. 78k-1, 78q(a), 78r(a), and 78ff(a)), and any other applicable provisions of the Act.

(vii) The reports provided for in paragraph (b)(2) of this section shall be considered filed upon receipt by the Division of Market Regulation, Stop 10-2, at the Commission's principal office in Washington, DC. Duplicate originals of the reports provided for in paragraphs (b)(2)(i) through (v) of this section must be filed with surveillance personnel designated as such by any self-regulatory organization that is the designated examining authority for the alternative trading system pursuant to § 240.17d-1 of this chapter simultaneously with filing with the Commission. Duplicates of the reports required by paragraph (b)(9) of this section shall be provided to surveillance personnel of such self-regulatory authority upon request. All reports filed pursuant to this paragraph (b)(2) and paragraph (b)(9) of this section shall be deemed confidential when filed.

(3) *Order display and execution access.* (i) An alternative trading system shall comply with the requirements set forth in paragraph (b)(3)(ii) of this section, with respect to any covered security in which the alternative trading system:

(A) Displays subscriber orders to any person (other than alternative trading system employees); and

(B) During at least 4 of the preceding 6 calendar months, had an average daily trading volume of 5 percent or more of the aggregate average daily share volume for such covered security as reported by an effective transaction reporting plan or disseminated through an automated quotation system as

described in section 3(a)(51)(A)(ii) of the Act, (15 U.S.C. 78c(a)(51)(A)(ii)).

(ii) Such alternative trading system shall provide to a national securities exchange or national securities association the prices and sizes of the orders at the highest buy price and the lowest sell price for such covered security, displayed to more than one person in the alternative trading system, for inclusion in the quotation data made available by the exchange or association to quotation vendors pursuant to § 240.11Ac1-1 of this chapter.

(iii) With respect to any order displayed pursuant to paragraph (b)(3)(ii) of this section, an alternative trading system shall provide to any broker-dealer that has access to the national securities exchange or national securities association to which the alternative trading system provides the prices and sizes of displayed orders pursuant to paragraph (b)(3)(ii)(A) of this section, the ability to effect a transaction with such orders that is:

(A) Equivalent to the ability of such broker-dealer to effect a transaction with other orders displayed on the exchange or by the association; and

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

(4) *Fees.* The alternative trading system shall not charge any fee to broker-dealers that access the alternative trading system through a national securities exchange or national securities association, that is inconsistent with equivalent access to the alternative trading system required by paragraph (b)(3)(iv) of this section. In addition, if the national securities exchange or national securities association to which an alternative trading system provides the prices and sizes of orders under paragraphs (b)(3)(ii) and (b)(3)(iii) of this section establishes rules designed to assure consistency with standards for access to quotations displayed on such national securities exchange, or the market operated by such national securities association, the alternative trading system shall not charge any fee to members that is contrary to, that is not disclosed in the manner required by, or that is inconsistent with any standard of equivalent access established by such rules.

(5) *Fair access.* (i) An alternative trading system shall comply with the requirements in paragraph (b)(5)(ii) of this section, if during at least 4 of the

preceding 6 calendar months, such alternative trading system had:

(A) With respect to any covered security, 20 percent or more of the average daily volume in that security reported by an effective transaction reporting plan or disseminated through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii));

(B) With respect to an equity security that is not a covered security and for which transactions are reported to a self-regulatory organization, 20 percent or more of the average daily volume in that security as calculated by the self-regulatory organization to which such transactions are reported;

(C) With respect to municipal securities, 20 percent or more of the average daily volume traded in the United States;

(D) With respect to investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States;

(E) With respect to non-investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States.

(ii) An alternative trading system shall:

(A) Establish written standards for granting access to trading on its system;

(B) Not unreasonably prohibit or limit any person in respect to access to services offered by such alternative trading system by applying the standards established under paragraph (b)(5)(ii)(A) of this section in an unfair or discriminatory manner; and

(C) Make and keep records of:

(1) All grants of access including, for all subscribers, the reasons for granting such access;

(2) All denials or limitations of access and reasons, for each applicant, for denying or limiting access.

(D) Report the information required on Form ATS-R, § 249.638 of this chapter, regarding grants, denials, and limitations of access.

(iii) Notwithstanding paragraph (b)(5)(i) of this section, an alternative trading system shall not be required to comply with the requirements in paragraph (b)(5)(ii) of this section, if such alternative trading system:

(A) Matches customer orders for a security with other customer orders;

(B) Such customers' orders are not displayed to any person, other than employees of the alternative trading system; and

(C) Such orders are executed at a price for such security disseminated by an effective transaction reporting plan or through an automated quotation system as described in section 3(a)(51)(A)(ii) of

the Act, (15 U.S.C. 78c(a)(51)(A)(ii)), or derived from such prices.

(6) *Capacity, integrity, and security of automated systems.* (i) The alternative trading system shall comply with the requirements in paragraph (b)(6)(ii) of this section, if during at least 4 of the preceding 6 calendar months, such alternative trading system had:

(A) With respect to any covered security, 20 percent or more of the average daily volume reported by the effective transaction reporting plan or disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Act, (15 U.S.C. 78c(a)(51)(A)(ii));

(B) With respect to equity securities that are not covered securities and for which transactions are reported to a self-regulatory organization, 20 percent or more of the average daily volume as calculated by the self-regulatory organization to which such transactions are reported;

(C) With respect to municipal securities, 20 percent or more of the average daily volume traded in the United States;

(D) With respect to investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States;

(E) With respect to non-investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States.

(ii) With respect to those systems that support order entry, order routing, order execution, transaction reporting, and trade comparison, the alternative trading system shall:

(A) Establish reasonable current and future capacity estimates;

(B) Conduct periodic capacity stress tests of critical systems to determine such system's ability to process transactions in an accurate, timely, and efficient manner;

(C) Develop and implement reasonable procedures to review and keep current its system development and testing methodology;

(D) Review the vulnerability of its systems and data center computer operations to internal and external threats, physical hazards, and natural disasters;

(E) Establish adequate contingency and disaster recovery plans;

(F) On an annual basis, perform an independent review, in accordance with established audit procedures and standards, of such alternative trading system's controls for ensuring that paragraphs (b)(6)(ii)(A) through (E) of this section are met, and conduct a review by senior management of a report containing the recommendations

and conclusions of the independent review; and

(G) Promptly notify the Commission staff of material systems outages and significant systems changes.

(iii) Notwithstanding paragraph (b)(6)(i) of this section, an alternative trading system shall not be required to comply with the requirements in paragraph (b)(6)(ii) of this section, if such alternative trading system:

(A) Matches customer orders for a security with other customer orders;

(B) Such customers' orders are not displayed to any person, other than employees of the alternative trading system; and

(C) Such orders are executed at a price for such security disseminated by an effective transaction reporting plan or through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Act, (15 U.S.C. 78c(a)(51)(A)(ii)), or derived from such prices.

(7) *Examinations, inspections, and investigations.* The alternative trading system shall permit the examination and inspection of its premises, systems, and records, and cooperate with the examination, inspection, or investigation of subscribers, whether such examination is being conducted by the Commission or by a self-regulatory organization of which such subscriber is a member.

(8) *Recordkeeping.* The alternative trading system shall:

(i) Make and keep current the records specified in § 242.302; and

(ii) Preserve the records specified in § 242.303.

(9) *Reporting.* The alternative trading system shall:

(i) File the information required by Form ATS-R (§ 249.638 of this chapter) within 30 calendar days after the end of each calendar quarter in which the market has operated after the effective date of this section; and

(ii) File the information required by Form ATS-R within 10 calendar days after an alternative trading system ceases to operate.

(10) *Procedures to ensure the confidential treatment of trading information.*

(i) The alternative trading system shall establish adequate safeguards and procedures to protect subscribers' confidential trading information. Such safeguards and procedures shall include:

(A) Limiting access to the confidential trading information of subscribers to those employees of the alternative trading system who are operating the system or responsible for its compliance with these or any other applicable rules;

(B) Implementing standards controlling employees of the alternative

trading system trading for their own accounts; and

(ii) The alternative trading system shall adopt and implement adequate oversight procedures to ensure that the safeguards and procedures established pursuant to paragraph (b)(10)(i) of this section are followed.

(11) *Name.* The alternative trading system shall not use in its name the word "exchange," or derivations of the word "exchange," such as the term "stock market."

#### § 242.302 Recordkeeping requirements for alternative trading systems.

To comply with the condition set forth in paragraph (b)(8) of § 242.301, an alternative trading system shall make and keep current the following records:

(a) A record of subscribers to such alternative trading system (identifying any affiliations between the alternative trading system and subscribers to the alternative trading system, including common directors, officers, or owners);

(b) Daily summaries of trading in the alternative trading system including:

(1) Securities for which transactions have been executed;

(2) Transaction volume, expressed with respect to equity securities in:

(i) Number of trades;

(ii) Number of shares traded; and

(iii) Total settlement value in terms of U.S. dollars; and

(3) Transaction volume, expressed with respect to debt securities in:

(i) Number of trades; and

(ii) Total U.S. dollar value; and

(c) Time-sequenced records of order information in the alternative trading system, including:

(1) Date and time (expressed in terms of hours, minutes, and seconds) that the order was received;

(2) Identity of the security;

(3) The number of shares, or principal amount of bonds, to which the order applies;

(4) An identification of the order as related to a program trade or an index arbitrage trade as defined in New York Stock Exchange Rule 80A;

(5) The designation of the order as a buy or sell order;

(6) The designation of the order as a short sale order;

(7) The designation of the order as a market order, limit order, stop order, stop limit order, or other type or order;

(8) Any limit or stop price prescribed by the order;

(9) The date on which the order expires and, if the time in force is less than one day, the time when the order expires;

(10) The time limit during which the order is in force;

(11) Any instructions to modify or cancel the order;

(12) The type of account, *i.e.*, retail, wholesale, employee, proprietary, or any other type of account designated by the alternative trading system, for which the order is submitted;

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

(14) Price at which the order was executed;

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

(16) Identity of the parties to the transaction.

**§ 242.303 Record preservation requirements for alternative trading systems.**

(a) To comply with the condition set forth in paragraph (b)(9) of § 242.301, an alternative trading system shall preserve the following records:

(1) For a period of not less than three years, the first two years in an easily accessible place, an alternative trading system shall preserve:

(i) All records required to be made pursuant to § 242.302;

(ii) All notices provided by such alternative trading system to subscribers generally, whether written or communicated through automated means, including, but not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, instructions pertaining to access to the market and denials of, or limitations on, access to the alternative trading system;

(iii) If subject to paragraph (b)(5)(ii) of § 242.301, at least one copy of such alternative trading system's standards for access to trading, all documents relevant to the alternative trading systems decision to grant, deny, or limit access to any person, and all other documents made or received by the alternative trading system in the course of complying with paragraph (b)(5) of § 242.301; and

(iv) At least one copy of all documents made or received by the alternative trading system in the course of complying with paragraph (b)(6) of § 242.301, including all correspondence, memoranda, papers, books, notices, accounts, reports, test scripts, test results, and other similar records.

(2) During the life of the enterprise and of any successor enterprise, an alternative trading system shall preserve:

(i) All partnership articles or, in the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books; and

(ii) Copies of reports filed pursuant to paragraph (b)(2) of § 242.301 of this chapter and records made pursuant to paragraph (b)(5) of § 242.301 of this chapter.

(b) The records required to be maintained and preserved pursuant to paragraph (a) of this section must be produced, reproduced, and maintained in paper form or in any of the forms permitted under § 240.17a-4(f) of this chapter.

(c) Alternative trading systems must comply with any other applicable recordkeeping or reporting requirement in the Act, and the rules and regulations thereunder. If the information in a record required to be made pursuant to this section is preserved in a record made pursuant to § 240.17a-3 or § 240.17a-4 of this chapter, or otherwise preserved by the alternative trading system (whether in summary or some other form), this section shall not require the sponsor to maintain such information in a separate file, provided that the sponsor can promptly sort and retrieve the information as if it had been kept in a separate file as a record made pursuant to this section, and preserves the information in accordance with the time periods specified in paragraph (a) of this section.

(d) The records required to be maintained and preserved pursuant to this section may be prepared or maintained by a service bureau, depository, or other recordkeeping service on behalf of the alternative trading system. An agreement with a service bureau, depository, or other recordkeeping service shall not relieve the alternative trading system from the responsibility to prepare and maintain records as specified in this section. The service bureau, depository, or other recordkeeping service shall file with the Commission a written undertaking in a form acceptable to the Commission, signed by a duly authorized person, to the effect that such records are the property of the alternative trading system required to be maintained and preserved and will be surrendered promptly on request of the alternative

trading system, and shall include the following provision: With respect to any books and records maintained or preserved on behalf of (name of alternative trading system), the undersigned hereby undertakes to permit examination of such books and records at any time, or from time to time, during business hours by representatives or designees of the Securities and Exchange Commission, and to promptly furnish to the Commission or its designee a true, correct, complete and current hard copy of any, all, or any part of, such books and records.

(e) Every alternative trading system shall furnish to any representative of the Commission promptly upon request, legible, true, and complete copies of those records that are required to be preserved under this section.

**PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934**

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

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

\* \* \* \* \*

18. Section 249.1 and Form 1 are revised to read as follows:

**§ 249.1 Form 1, for application for, and amendments to applications for, registration as a national securities exchange or exemption from registration pursuant to Section 5 of the Exchange Act.**

The form shall be used for application for, and amendments to applications for, registration as a national securities exchange or exemption from registration pursuant to Section 5 of the Act, (15 U.S.C. 78e).

**Note:** Form 1 does not and the amendments will not appear in the Code of Federal Regulations.

**OMB APPROVAL**

OMB Number: 3235-0017

Expires: 8/31/2001

Estimated Average burden hours per form: 30

**Form 1—Application for, and Amendments to Application for, Registration as a National Securities Exchange or Exemption From Registration Pursuant to Section 5 of the Exchange Act**

BILLING CODE 8010-01-M

## FORM 1 INSTRUCTIONS

**A. GENERAL INSTRUCTIONS**

1. Form 1 is the application for registration as a national securities exchange or an exchange exempt from registration pursuant to Section 5 of the Securities Exchange Act of 1934 ("Exchange Act").

2. **UPDATING** - A registered exchange or exchange exempt from registration pursuant to Section 5 of the Exchange Act must file amendments to Form 1 in accordance with Exchange Act Rule 6a-2.

3. **CONTACT EMPLOYEE** - The individual listed on the Execution Page (Page 1) of Form 1 as the contact employee must be authorized to receive all contact information, communications and mailings and is responsible for disseminating such information within the applicant's organization.

**4. FORMAT**

- Attach an Execution Page (Page 1) with original manual signatures.
- Please type all information.
- Use only the current version of Form 1 or a reproduction.

5. If the information called for by any Exhibit is available in printed form, the printed material may be filed provided it does not exceed 8 1/2 X 11 inches in size.

6. If any Exhibit required is inapplicable, a statement to that effect shall be furnished in lieu of such Exhibit.

7. An exchange that is filing Form 1 as an application may not satisfy the requirements to provide certain information by means of an Internet web page. All materials must be filed with the Commission in paper.

8. **WHERE TO FILE AND NUMBER OF COPIES** - Submit one original and two copies of Form 1 to: SEC, Division of Market Regulation, Office of Market Supervision, 450 Fifth Street, N.W., Washington, DC 20549.

**9. PAPERWORK REDUCTION ACT DISCLOSURE**

- Form 1 requires an exchange seeking to register as a national securities exchange or seeking an exemption from registration as a national securities exchange pursuant to Section 5 of the Exchange Act to provide the Securities and Exchange Commission ("SEC" or "Commission") with certain information regarding the operation of the exchange. Form 1 also requires national securities exchanges or exchanges exempt from registration based on limited volume to update certain information on a periodic basis.
- An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(a)(1), 5, 6(a) and 23(a) authorize the Commission to collect information on this Form 1 from exchanges. See 15 U.S.C. §§78c(a)(1), 78e, 78f(a) and 78w(a).
- Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form 1 and any suggestions for reducing this burden.
- Form 1 is designed to enable the Commission to determine whether an exchange applying for registration is in compliance with the provisions of Sections 6 and 19 of the Exchange Act. Form 1 is also designed to enable the Commission to determine whether a national securities exchange or exchange exempt from registration based on limited volume is operating in compliance with the Exchange Act.
- It is estimated that an exchange will spend approximately 47 hours completing the initial application on Form 1 pursuant to Rule 6a-1. It is also estimated that each exchange will spend approximately 25 hours to prepare each amendment to Form 1 pursuant to Rule 6a-2.
- Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.
- It is mandatory that an exchange seeking to operate as a national securities exchange or as an exchange exempt from registration based on limited volume file a Form 1 with the Commission. It is also mandatory that national securities exchanges or exchanges exempt from registration based on limited volume file amendments to Form 1 under Rule 6a-2.
- No assurance of confidentiality is given by the Commission with respect to the responses made in Form 1. The public has access to the information contained in Form 1.
- This collection of information has been reviewed by the Office of Management and Budget ("OMB") in accordance with the clearance requirements of 44 U.S.C. §3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records are 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	<b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> <b>WASHINGTON, D.C. 20549</b> <b>APPLICATION FOR, AND AMENDMENTS TO APPLICATION FOR</b> <b>REGISTRATION AS A NATIONAL SECURITIES EXCHANGE OR EXEMPTION</b> <b>FROM REGISTRATION PURSUANT TO SECTION 5 OF THE EXCHANGE ACT</b>	Date filed (MM/DD/YY):	OFFICIAL USE ONLY
WARNING: Failure to keep this form current and to file accurate supplementary information on a timely basis, or the failure to keep accurate books and records or otherwise to comply with the provisions of law applying to the conduct of the applicant would violate the federal securities laws and may result in disciplinary, administrative or criminal action. <b>INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACTS MAY CONSTITUTE CRIMINAL VIOLATIONS</b>			
<input type="checkbox"/> APPLICATION		<input type="checkbox"/> 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: <input type="checkbox"/> Corporation <input type="checkbox"/> Sole Proprietorship <input type="checkbox"/> Partnership <input type="checkbox"/> Limited Liability Company <input type="checkbox"/> 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: _____			
<b>EXECUTION:</b> 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.			
<b>DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY</b>			

Form 1 Page 2	<b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> <b>WASHINGTON, D.C. 20549</b> <b>APPLICATION FOR, AND AMENDMENTS TO APPLICATION FOR, REGISTRATION</b> <b>AS A NATIONAL SECURITIES EXCHANGE OR EXEMPTION FROM REGISTRATION</b> <b>PURSUANT TO SECTION 5 OF THE EXCHANGE ACT</b>	OFFICIAL USE	OFFICIAL USE ONLY
<p><b>EXHIBITS</b></p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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:</p> <ol style="list-style-type: none"> <li>1.     Name and address of organization.</li> <li>2.     Form of organization (e.g., association, corporation, partnership, etc.).</li> <li>3.     Name of state and statute citation under which organized. Date of incorporation in present form.</li> <li>4.     Brief description of nature and extent of affiliation.</li> <li>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.</li> <li>6.     A copy of the constitution.</li> <li>7.     A copy of the articles of incorporation or association including all amendments.</li> <li>8.     A copy of existing by-laws or corresponding rules or instruments.</li> <li>9.     The name and title of the present officers, governors, members of all standing committees or persons performing similar functions.</li> <li>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.</li> </ol> <p>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.</p>			

Form 1 Page 3	<b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> <b>WASHINGTON, D.C. 20549</b> <b>APPLICATION FOR, AND AMENDMENTS TO APPLICATION FOR, REGISTRATION</b> <b>AS A NATIONAL SECURITIES EXCHANGE OR EXEMPTION FROM REGISTRATION</b> <b>PURSUANT TO SECTION 5 OF THE EXCHANGE ACT</b>	OFFICIAL USE	OFFICIAL USE ONLY
<b>EXHIBITS</b>			
Exhibit E	Describe the manner of operation of the System. This description should include the following: <ol style="list-style-type: none"> <li>1. The means of access to the System.</li> <li>2. Procedures governing entry and display of quotations and orders in the System.</li> <li>3. Procedures governing the execution, reporting, clearance and settlement of transactions in connection with the System.</li> <li>4. Proposed fees.</li> <li>5. Procedures for ensuring compliance with System usage guidelines.</li> <li>6. The hours of operation of the System, and the date on which applicant intends to commence operation of the System.</li> <li>7. Attach a copy of the users' manual.</li> <li>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.</li> </ol>		
Exhibit F	A complete set of all forms pertaining to: <ol style="list-style-type: none"> <li>1. Application for membership, participation or subscription to the entity.</li> <li>2. Application for approval as a person associated with a member, participant or subscriber of the entity.</li> <li>3. Any other similar materials.</li> </ol>		
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: <ol style="list-style-type: none"> <li>1. Name.</li> <li>2. Title.</li> <li>3. Dates of commencement and termination of term of office or position.</li> <li>4. Type of business in which each is primarily engaged (e.g. floor broker, specialist, odd lot dealer, etc.).</li> </ol>		

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
<b>EXHIBITS</b>			
Exhibit K	<p>This Exhibit is applicable only to exchanges that have one or more owners, shareholders, or partners that are not also members of the exchange. If the exchange is a corporation, please provide a list of each shareholder that directly owns 5% or more of a class of a voting security of the applicant. If the exchange is a partnership, please provide a list of all general partners and those limited and special partners that have the right to receive upon dissolution, or have contributed, 5% or more of the partnership's capital. For each of the persons listed in the Exhibit K, please provide the following:</p> <ol style="list-style-type: none"> <li>1. Full legal name;</li> <li>2. Title or Status;</li> <li>3. Date title or status was acquired;</li> <li>4. Approximate ownership interest; and</li> <li>5. Whether the person has control, a term that is defined in the instructions to this Form.</li> </ol>		
Exhibit L	<p>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.</p>		
Exhibit M	<p>Provide an alphabetical list of all members, participants, subscribers or other users, including the following information:</p> <ol style="list-style-type: none"> <li>1. Name;</li> <li>2. Date of election to membership or acceptance as a participant, subscriber or other user;</li> <li>3. Principal business address and telephone number;</li> <li>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.);</li> <li>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</li> <li>6. The class of membership, participation or subscription or other access.</li> </ol>		
Exhibit N	<p>Provide a schedule for each of the following:</p> <ol style="list-style-type: none"> <li>1. The securities listed in the exchange, indicating for each the name of the issuer and a description of the security;</li> <li>2. The securities admitted to unlisted trading privileges, indicating for each the name of the issuer and a description of the security;</li> <li>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</li> <li>4. Other securities traded on the exchange, including for each the name of the issuer and a description of the security.</li> </ol>		



**§ 249.1a and Form 1-A [Removed]**

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

**§ 249.636 and Form 17A-23 [Removed and reserved]**

20. Section 249.636 and Form 17A-23 are removed and reserved.

21. Section 249.637 and Form ATS are added to read as follows:

**§ 249.637 Form ATS, information required of alternative trading systems pursuant to § 242.301(b)(2) of this chapter.**

This form shall be used by every alternative trading system to file required notices, reports and amendments under § 242.301(b)(2) of this chapter.

**Note:** Form ATS does not and the amendments will not appear in the Code of Federal Regulations.

## OMB APPROVAL

OMB Number: 3235-0509

Expires: 8/31/2001

Estimated Average burden hours per form: 8

**Form ATS—Initial Operation Report, Amendment to Initial Operation Report and Cessation of Operations Report of Alternative Trading System Activities**

BILLING CODE 8010-01-M

**FORM ATS INSTRUCTIONS****A. GENERAL INSTRUCTIONS**

1. Form ATS is the form an alternative trading system must file to notify the Securities and Exchange Commission ("SEC" or "Commission") of its activities pursuant to Regulation ATS, § 242.300 et seq.

**2. WHEN TO FILE FORM ATS**

- An alternative trading system must file an initial operation report on Form ATS at least 20 days prior to commencing operation.
- The alternative trading system must update Form ATS information by submitting amendments to the initial operation report at least 20 calendar days prior to implementing a material change to the operation of the alternative trading system as described on Form ATS or any amendment thereto. Additionally, the alternative trading system must update Form ATS information by submitting amendments to the initial operation report on Form ATS within 30 calendar days after the end of each calendar quarter in which the alternative trading system has operated, correcting any information contained in any initial operation report or any amendment thereto that has been rendered inaccurate and that has not previously been reported to the SEC.
- An alternative trading system must also file a cessation of operations report on Form ATS promptly upon ceasing to operate.
- Form ATS shall not be considered filed, unless it complies with applicable requirements.

3. **CONTACT EMPLOYEE** - The individual listed on page 1 as the contact employee must be authorized to receive all contact information, communications and mailings and be responsible for disseminating that information within the alternative trading system's organization.

**4. FORMAT**

- Attach an Execution Page (Page 1) with original manual signatures.
- Please type all information.
- Provide the name of the alternative trading system, the CRD number, the SEC File number, and the filing date on each page.
- Use only the current version of Form ATS or a reproduction.

5. **WHERE TO FILE AND NUMBER OF COPIES** - Submit one original and two copies of Form ATS to: SEC, Division of Market Regulation, 450 Fifth Street, N.W., Stop 10-2, Washington D.C. 20549. Simultaneously with the filing of the original with the SEC, file one duplicate copy of Form ATS with surveillance personnel designated by the self-regulatory organization that is the designated examining authority for the alternative trading system pursuant to Rule 17d-1 under the Securities Exchange Act of 1934.

6. **RECORDKEEPING** - A copy of this Form ATS, as well as the forms filed with the SEC, must be retained by the alternative trading system and made available for inspection upon request of the SEC.

**7. PAPERWORK REDUCTION ACT DISCLOSURE**

- Form ATS requires an alternative trading system subject to Regulation ATS to provide the Commission with certain information regarding the operation of the alternative trading system, material and other changes to the operation of the alternative trading system, and notice upon ceasing operation of the alternative trading system.
- An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(b), 11A(a), 11A(c), 15(c), 17(a), 23(a) and 36(a) authorize the Commission to collect information on this Form ATS from alternative trading systems that are subject to Regulation ATS. See 15 U.S.C. §§78c(b), 78k-1(a), 78k-1(c), 78o(c), 78q(a), 78w(a) and 78mm(a).
- Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form ATS and any suggestions for reducing this burden.
- Form ATS is designed to enable the Commission to determine whether an alternative trading system subject to Regulation ATS is in compliance with Regulation ATS and other federal securities laws.
- It is estimated that an alternative trading system will spend approximately 20 hours completing the initial operation report on Form ATS, approximately 2 hours preparing each amendment to Form ATS, and approximately 2 hours preparing a cessation of operations report on Form ATS.
- Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.
- It is mandatory that an alternative trading system subject to Regulation ATS file an initial operation report on Form ATS, file an amendment to Form ATS prior to making a material change, file quarterly amendments to Form ATS to reflect changes not previously reported, and file notice on Form ATS upon ceasing operation of the ATS.

**FORM ATS INSTRUCTIONS**

- All reports provided to the Commission on Form ATS are deemed confidential and will be available only to the examination of Commission staff, state securities authorities and the self-regulatory organizations. Subject to the provisions of the Freedom of Information Act, 5 U.S.C. 522 ("FOIA"), and the Commission's rules thereunder (17 CFR 200.80(b)(4)(iii)), the Commission does not generally publish or make available information contained in any reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of, or in connection with an examination or inspection of the books and records of any person or any other investigation.
- This collection of information has been reviewed by the Office of Management and Budget ("OMB") in accordance with the clearance requirements of 44 U.S.C. §3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records are set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).

**B. EXPLANATION OF TERMS**

**ALTERNATIVE TRADING SYSTEM** - Shall mean any organization, association, person, group of persons, or system: (1) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Rule 3b-16 under the Exchange Act; and (2) that does not (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system, or (ii) discipline subscribers other than by exclusion from trading.

**SUBSCRIBER** - Shall mean any person that has entered into a contractual agreement with an alternative trading system to access such alternative trading system for the purpose of effecting transactions in securities or for submitting, disseminating, or displaying orders on such alternative trading system, including a customer, member, user, or participant in an alternative trading system. A subscriber, however, shall not include a national securities exchange or national securities association.

**ORDER** - Shall mean any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order or other priced order.

Form ATS Page 1 Execution Page	<b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> WASHINGTON, D.C. 20549 <b>INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT AND                  CESSATION OF OPERATIONS REPORT FOR ALTERNATIVE TRADING SYSTEMS</b>	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			
<input type="checkbox"/> INITIAL OPERATION REPORT <input type="checkbox"/> AMENDMENT TO INITIAL OPERATION REPORT <input type="checkbox"/> CESSATION OF OPERATIONS REPORT			
1. Exact name, principal business address, mailing address, if different, and telephone number of alternative trading system:			
A. Full name of alternative trading system (if sole proprietor, last, first and middle name): _____			
B. CRD Number: _____			
C. Name(s) under which business is conducted, if different from Item 1A. _____			
D. SEC File No.: 8- _____			
E. If this filing makes a name change on behalf of the alternative trading system, enter the previous name and specify whether the name change is of the _____ alternative trading system name (1A), or _____ business name (1C): Previous name: _____			
F. Alternative trading system's main street address (Do not use a P.O. Box): _____ _____			
G. Mailing address (if different): _____ _____			
H. Business telephone and facsimile number: _____ (Telephone) (Facsimile)			
I. Contact employee: _____ (Name and Title) (Telephone Number) (Facsimile)			
<b>EXECUTION:</b> The alternative trading system consents that service of any civil action brought by, or notice of any proceeding before, the SEC or a self-regulatory organization in connection with the alternative trading system's activities may be given by registered or certified mail or confirmed telegram, to the alternative trading system's contact employee at the main address, or mailing address if different, given in Items 1F and 1G. The undersigned, being first duly sworn, deposes and says that he/she has executed this form on behalf of, and with the authority of, said alternative trading system. The undersigned and alternative trading system represent that the information and statements contained herein, including exhibits, schedules, or other documents attached hereto, and other information filed herewith, all of which are made a part hereof, are current, true and complete.			
Date: _____ (MM/DD/YY) (Name of alternative trading system)			
By: _____ (Signature) (Printed Name and Title)			
Subscribed and sworn before me this _____ day of _____, _____ by _____ (Month) (Year) (Notary Public)			
My Commission expires _____ County of _____ State of _____			
This page must always be completed in full with original, manual signature and notarization. Affix notary stamp or seal where applicable.			
<b>DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY</b>			

Form ATS Page 2	<b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> <b>WASHINGTON, D.C. 20549</b> <b>INITIAL OPERATION REPORT, AMENDMENT TO INITIAL OPERATION REPORT AND</b> <b>CESSATION OF OPERATIONS REPORT FOR ALTERNATIVE TRADING SYSTEMS</b>	OFFICIAL USE	OFFICIAL USE ONLY
Alternative trading system name: _____ CRD No: _____ Filing date: _____ SEC File No.: 8- _____			
<ol style="list-style-type: none"> <li>2. If this is an initial operation report, the date the alternative trading system expects to commence operation: _____</li> <li>3. Attach as Exhibit A, a description of classes of subscribers (for example, broker-dealer, institution, or retail). Also describe any differences in access to the services offered by the alternative trading system to different groups or classes of subscribers.</li> <li>4. Attach as Exhibit B:           <ol style="list-style-type: none"> <li>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").</li> <li>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.</li> </ol> </li> <li>5. Attach as Exhibit C, the name, address, and telephone number of counsel for the alternative trading system.</li> <li>6. Attach as Exhibit D, a copy of the constitution, articles of incorporation or association, with all amendments, and of the existing by-laws or corresponding rules or instruments, whatever the name, of the alternative trading system. If this information is publicly available on a continuous basis on an Internet site controlled by the alternative trading system, the alternative trading system may indicate the location of the Internet web site where such information may be found in lieu of filing such information with the Commission.</li> <li>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.</li> <li>8. Attach as Exhibit F, the following information:           <ol style="list-style-type: none"> <li>a. The manner of operation of the alternative trading system;</li> <li>b. Procedures governing entry of orders into the alternative trading system;</li> <li>c. The means of access to the alternative trading system;</li> <li>d. The procedures governing execution, reporting, clearance and settlement of transactions effected through the alternative trading system;</li> <li>e. Procedures for ensuring subscriber compliance with system guidelines; and</li> <li>f. A copy of the alternative trading system's subscriber manual and any other materials provided to subscribers.</li> </ol> </li> <li>9. Attach as Exhibit G, a brief description of the alternative trading system's procedures for reviewing system capacity, security and contingency planning procedures.</li> <li>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.</li> <li>11. Attach as Exhibit I, a list providing the full legal name of those direct owners reported on Schedule A of Form BD.</li> </ol>			

## FORM ATS-R INSTRUCTIONS

## A. GENERAL INSTRUCTIONS

1. Form ATS-R must be filed by alternative trading systems subject to Regulation ATS within 30 days after the end of each calendar quarter, or more frequently upon request of the Securities and Exchange Commission ("SEC" or "Commission"). This Form should be prepared as of the last day of each calendar quarter.
2. **WHEN TO FILE A FORM ATS-R** - File Form ATS-R within 30 calendar days after the end of each calendar quarter in which the alternative trading system has operated after the effective date of Regulation ATS. Also file Form ATS-R within 10 calendar days after an alternative trading system ceases to operate.
3. **CONTACT EMPLOYEE** - The individual listed on page 1 as the contact employee must be authorized to receive all contact information, communications and mailings and be responsible for disseminating that information within the alternative trading system's organization.
4. **FORMAT**
  - Attach the Execution Page (Page 1) with every filing of Form ATS-R.
  - Please type all information.
  - Be sure to note the alternative trading system name, CRD number, SEC file number, and report period dates on each page.
  - Use only the current version of Form ATS-R or a reproduction.
5. **WHERE TO FILE AND NUMBER OF COPIES** - Submit one original and two copies of Form ATS-R to: SEC, Division of Market Regulation, 450 Fifth Street, N.W., Stop 10-2, Washington D.C. 20549.
6. **RECORDKEEPING** - A copy of this Form ATS-R, as well as the forms filed with the SEC, must be retained by the alternative trading system and made available for inspection upon request of the SEC.
7. **PAPERWORK REDUCTION ACT DISCLOSURE**
  - Form ATS-R requires an alternative trading system subject to Regulation ATS to provide the Commission with quarterly reports regarding trading activities.
  - An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 3(b), 11A(a), 11A(c), 15(c), 17(a), 23(a) and 36(a) authorize the Commission to collect information on this Form ATS from alternative trading systems that are subject to Regulation ATS. See 15 U.S.C. §§78c(b), 78k-1(a), 78k-1(c), 78o(c), 78q(a), 78w(a) and 78mm(a).
  - Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on the facing page of Form ATS-R and any suggestions for reducing this burden.
  - Form ATS-R is designed to enable the Commission to more effectively track the growth and development of alternative trading systems, as well as to more effectively comply with its statutory obligations with respect to alternative trading systems and improve investor protection.
  - It is estimated that an alternative trading system will spend approximately 4 hours completing Form ATS-R.
  - Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.
  - It is mandatory that an alternative trading system subject to Regulation ATS file quarterly reports on Form ATS-R with the Commission.
  - All reports provided to the Commission on Form ATS-R are deemed confidential and will be available only to the examination of Commission staff, state securities authorities and the self-regulatory organizations. Subject to the provisions of the Freedom of Information Act, 5 U.S.C. 522 ("FOIA"), and the Commission's rules thereunder (17 CFR 200.80(b)(4)(iii)), the Commission does not generally publish or make available information contained in any reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of, or in connection with an examination or inspection of the books and records of any person or any other investigation.
  - This collection of information has been reviewed by the Office of Management and Budget ("OMB") in accordance with the clearance requirements of 44 U.S.C. §3507. The applicable Privacy Act system of records is SEC-2 and the routine uses of the records are set forth at 40 FR 39255 (August 27, 1975) and 41 FR 5318 (February 5, 1976).
8. Only those alternative trading systems subject to the fair access obligations under Rule 301(b)(5) are required to respond to question 7 on Form ATS-R.

## FORM ATS-R INSTRUCTIONS

**B. EXPLANATION OF TERMS**

**ALTERNATIVE TRADING SYSTEM** - Shall mean any organization, association, person, group of persons, or system (1) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Rule 3b-16 under the Exchange Act; and (2) that does not (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system, or (ii) discipline subscribers other than by exclusion from trading.

**INVESTMENT GRADE CORPORATE DEBT SECURITIES** - Shall mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; (3) is rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and (4) is not an exempted security, as defined in §3(a)(12) of the Act (15 U.S.C. 78o).

**NON-INVESTMENT GRADE CORPORATE DEBT SECURITIES** - Shall mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; (3) is not rated in one of the four highest ratings categories by at least one Nationally Recognized Statistical Ratings Organization; and (4) is not an exempted security, as defined in §3(a)(12) of the Act (15 U.S.C. 78o).

**DEBT SECURITIES** - Shall mean any security other than an equity security, as defined in §240.3a11-1.

**EQUITY SECURITIES** - Shall have the same meaning as in §240.3a11-1.

**GOVERNMENT SECURITIES** - Shall have the same meaning as in Exchange Act Section 3(a)(42), including those instruments in paragraph (D) of § 3(a)(42) of the Exchange Act.

**LISTED EQUITY SECURITIES** - Shall mean any equity securities that are listed and registered, or admitted to unlisted trading privileges, on a national securities exchange.

**LISTED OPTIONS** - Shall mean any options traded on a registered national securities exchange or automated facility of a registered national securities association.

**MORTGAGE RELATED SECURITIES** - Shall have the same meaning as in Exchange Act Section 3(a)(41).

**MUNICIPAL SECURITIES** - Shall have the same meaning as in Exchange Act Section 3(a)(29).

**NASDAQ NATIONAL MARKET SECURITIES** - Shall mean any securities designated as Nasdaq National Market Securities by The Nasdaq Stock Market.

**NASDAQ SMALLCAP MARKET SECURITIES** - Shall mean any securities designated as Nasdaq SmallCap Market Securities by The Nasdaq Stock Market.

**PENNY STOCK** - Shall have the same meaning as in Exchange Act Section 3(a)(51).

**SUBSCRIBER** - Shall mean any person that has entered into a contractual agreement with an alternative trading system to access such alternative trading system for the purpose of effecting transactions in securities or to submit, disseminate, or display orders on such alternative trading system, including a customer, member, user, or participant in an alternative trading system. A subscriber, however, shall not include a national securities exchange or national securities association.

**UNLISTED OPTIONS** - Shall mean any options other than those traded on a registered national securities exchange or automated facility of a registered national securities association.

Form ATS-R Page 1 Execution Page	<b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> <b>WASHINGTON, D.C. 20549</b> <b>QUARTERLY REPORT OF ALTERNATIVE TRADING SYSTEM ACTIVITIES</b>	OFFICIAL USE	OFFICIAL USE ONLY
INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACTS MAY CONSTITUTE CRIMINAL VIOLATIONS			
Alternative Trading System Name: _____  Period covered by this report: _____ to _____			
1. Exact name, principal business address, mailing address, if different, and telephone number of alternative trading system: A. Full name of alternative trading system (if sole proprietor, last, first and middle name): _____ B. CRD Number: _____  C. Name(s) under which business is conducted, if different from Item 1A. _____ D. SEC File No.: _____ E. If this filing makes a name change on behalf of the alternative trading system, enter the previous name and specify whether the name change is of the _____ alternative trading system name (1A), or _____ business name (1C): Previous name: _____ F. Alternative trading system's main street address (Do not use a P.O. Box): _____  G. Mailing address (if different): _____  H. Business telephone and facsimile number: _____ (Telephone) _____ (Facsimile) I. Contact employee: _____ (Name and Title) _____ (Telephone) _____ (Facsimile)			
2. Attach as Exhibit A, a list of all subscribers that were participants of the alternative trading system at any time during the period covered by this report.			
3. Attach as Exhibit B, a list of all securities that were traded on the alternative trading system at any time during the period covered by this report.			
<b>EXECUTION:</b> The alternative trading system consents that service of any civil action brought by, or notice of any proceeding before, the SEC or self-regulatory organization in connection with the alternative trading system's activities may be given by registered or certified mail, or confirmed telegram, to the alternative trading system's contact employee at the main address, or mailing address if different, given in Items 1F and 1G. The undersigned, being first duly sworn, deposes and says that he/she has executed this form on behalf of, and with the authority of, said alternative trading system. The undersigned and alternative trading system represent that the information and statements contained herein, including exhibits, schedules, or other documents attached hereto, and other information filed herewith, all of which are made a part hereof, are current, true and complete. Date: _____ (MM/DD/YY) _____ (Name of alternative trading system) By: _____ (Signature) _____ (Printed Name and Title)			
Subscribed and sworn before me this _____ day of _____, _____ 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.			
<b>DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY</b>			

Form ATS-R Page 2	<b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> <b>WASHINGTON, D.C. 20549</b> <b>QUARTERLY REPORT OF ALTERNATIVE TRADING SYSTEM ACTIVITIES</b>	OFFICIAL USE	OFFICIAL USE ONLY
Alternative trading system name: _____ CRD Number: _____ Period covered in this report: _____ to _____ SEC File Number: 8-_____			
4. Provide the total unit and dollar volume of transactions in the following securities. For securities reported in 4J-4N, report total settlement value in U.S. Dollars. Enter "None," "N/A" or "0" where appropriate.			
<i>Category of Securities</i>	<i>Total Unit Volume of Transactions</i>	<i>Total Dollar Volume of Transactions</i>	
A. Listed Equity Securities	<input type="text"/>	<input type="text"/>	
B. Nasdaq National Market Securities	<input type="text"/>	<input type="text"/>	
C. Nasdaq SmallCap Market Securities	<input type="text"/>	<input type="text"/>	
D. Equity securities issued pursuant to Rule 144A of the Securities Act of 1933	<input type="text"/>	<input type="text"/>	
E. Penny Stock, other than any securities included in Items 4A-4D above	<input type="text"/>	<input type="text"/>	
F. Other equity securities not included in Items 4A-4E above	<input type="text"/>	<input type="text"/>	
G. Rights and warrants	<input type="text"/>	<input type="text"/>	
H. Listed options	<input type="text"/>	<input type="text"/>	
I. Unlisted options	<input type="text"/>	<input type="text"/>	
J. Government securities	<input type="text"/>	<input type="text"/>	
K. Municipal securities	<input type="text"/>	<input type="text"/>	
L. Investment grade corporate debt securities	<input type="text"/>	<input type="text"/>	
M. Non-investment grade corporate debt securities	<input type="text"/>	<input type="text"/>	
N. Mortgage related securities	<input type="text"/>	<input type="text"/>	
O. Debt securities other than any securities included in Items 4J-4N above	<input type="text"/>	<input type="text"/>	
<b>DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY</b>			

Form ATS-R Page 3	<b>U.S. SECURITIES AND EXCHANGE COMMISSION</b> <b>WASHINGTON, D.C. 20549</b> <b>QUARTERLY REPORT OF ALTERNATIVE TRADING SYSTEM ACTIVITIES</b>	<b>OFFICIAL USE</b>	<b>OFFICIAL USE ONLY</b>															
Alternative trading system name: _____ CRD Number: _____																		
Period covered in this report: _____ to _____ SEC File Number: 8- _____																		
<p>5. A. List the types of equity securities reported in Item 4F above:</p> <p style="margin-left: 200px;">_____</p> <p style="margin-left: 200px;">_____</p> <p style="margin-left: 200px;">_____</p> <p>B. List the types of debt reported in Item 4O above:</p> <p style="margin-left: 200px;">_____</p> <p style="margin-left: 200px;">_____</p> <p style="margin-left: 200px;">_____</p>																		
<p>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.</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left; border: none;"><i>Category of Securities</i></th> <th style="text-align: center; border: none;"><i>Total Unit Volume of Transactions</i></th> <th style="text-align: center; border: none;"><i>Total Dollar Volume of Transactions</i></th> </tr> </thead> <tbody> <tr> <td style="border: none;">A. Listed Equity Securities</td> <td style="border: 1px solid black; width: 100px; height: 20px;"></td> <td style="border: 1px solid black; width: 100px; height: 20px;"></td> </tr> <tr> <td style="border: none;">B. Nasdaq National Market Securities</td> <td style="border: 1px solid black; width: 100px; height: 20px;"></td> <td style="border: 1px solid black; width: 100px; height: 20px;"></td> </tr> <tr> <td style="border: none;">C. Nasdaq SmallCap Market Securities</td> <td style="border: 1px solid black; width: 100px; height: 20px;"></td> <td style="border: 1px solid black; width: 100px; height: 20px;"></td> </tr> <tr> <td style="border: none;">D. Listed options</td> <td style="border: 1px solid black; width: 100px; height: 20px;"></td> <td style="border: 1px solid black; width: 100px; height: 20px;"></td> </tr> </tbody> </table>				<i>Category of Securities</i>	<i>Total Unit Volume of Transactions</i>	<i>Total Dollar Volume of Transactions</i>	A. Listed Equity Securities			B. Nasdaq National Market Securities			C. Nasdaq SmallCap Market Securities			D. Listed options		
<i>Category of Securities</i>	<i>Total Unit Volume of Transactions</i>	<i>Total Dollar Volume of Transactions</i>																
A. Listed Equity Securities																		
B. Nasdaq National Market Securities																		
C. Nasdaq SmallCap Market Securities																		
D. Listed options																		
<p>7. Attach as Exhibit C, a list of all persons granted, denied, or limited access to the alternative trading system during the period covered by this report, designating for each person (a) whether they were granted, denied, or limited access; (b) the date the alternative trading system took such action; (c) the effective date of such action; and (d) the nature of any denial or limitation of access.</p>																		
<b>DO NOT WRITE BELOW THIS LINE - FOR OFFICIAL USE ONLY</b>																		