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THE REGULATION OF ALTERNATIVE TRADING SYSTEMS: MARKET FRAGMENTATION AND THE NEW MARKET STRUCTURE

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THE REGULATION OF ALTERNATIVE TRADING SYSTEMS: MARKET FRAGMENTATION AND THE NEW MARKET STRUCTURE

> We are at a unique moment in our markets' history - a point of passage between what they have been and what they will become. In the next few years, they will undergo a transformation like we have never witnessed before. And, it is these changes that will define the marketplace for the 21st century. We have an opportunity today that we may not have again in our lifetime – to realize the vision for a true national market system – one that embraces our future as much as it honors our past.[1]

I. INTRODUCTION

Online trading provides the investing public with lower transactional costs and faster access to the securities markets.[2] It also provides the Securities and Exchange Commission (the "SEC" or "Commission") with a unique regulatory challenge. The Commission is faced with the difficult task of encouraging the innovation needed to keep the industry on the cutting edge, while maintaining efficient markets, providing investor protection against fraud and manipulation, and encouraging adequate disclosure to the investing public.[3] As Internet use grows exponentially,[4] innovative market participants introduce

1. Arthur Levitt, Chairman, Securities and Exchange Commission, Address at Columbia Law School (Sept. 23, 1999), *at* http://www.sec.gov/news/speeches/spch295.htm.

2. *See* Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 71 SEC Docket 1702, at 1703 (Feb. 23, 2000).

3. *See* Jane Kaufman Winn, *Regulating the Use of the Internet in Securities Markets*, 54 BUS. LAW. 443, 453 (1998) ("The SEC is attempting to insure that innovation is not stifled, while at the same time preserving established features of the U.S. securities markets, such as market stability, price accuracy, capacity adequacy, and fair and impartial term accessibility."); *see also* Paul D. Cohen, *Securities Trading Via the Internet*, 4 STAN. J. L. BUS. & FIN. 1, 13 (1999) ("[T]he SEC must craft regulation that encourages market transparency. However, it must also remain sensitive to the fragility of the new technology.").

4. The U.S. has a projected 110 million Internet users at year-end 1999 (259 million worldwide). It is projected that there will be over 490 million Internet users at year-end 2002 and over 765 million users by year-end 2005. Press Release, Computer

new products and services to tap into a market of online investors who seek to reap the benefits of a booming economy.[5]

This note is intended to provide a glimpse into one of the many areas of securities law affected by the advent of the Internet—the regulation of Alternative Trading Systems.[6] Part II of this note discusses some of the different types of systems employed in the trading of securities online. Part III discusses the historical development of the SEC's attempt to provide regulatory oversight of the new medium. Part IV surveys the new regulatory framework embodied in Regulation ATS. And finally, Part V addresses Regulation ATS in light of the growing concern over market fragmentation.

II. Online Trading Systems and the Current Order of Cyberspace

In 1998, online trading systems handled more than twenty percent of orders for trading in NASDAQ[7] securities[8] and more than four percent of securities listed on registered exchanges.[9] In addition, online investor accounts have risen from 3.7 million in 1997 to approximately

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Industry Almanac, Inc., U.S. Tops 100 Million Internet Users According to Computer Industry Almanac (Nov. 4, 1999), *at* http://www.c-i-a.com/199911iu.htm.

5. *See* Greg Ip, *Trading Places: The Stock Exchanges, Long Static, Suddenly are Roiled by Change*, WALL ST. J., Jul. 27, 1999, at A1.

6. The Commission incorporated the term "Alternative Trading Systems" in its Regulation of Exchanges Concept Release, dated June 4, 1997:

> Trading systems not registered as exchanges have been referred to in previous Commission releases as "proprietary trading systems," "broker-dealer trading systems," and "electronic communications networks." The term "alternative trading systems" will be used throughout this release to refer generally to automated systems that centralize, display, match, cross, or otherwise execute trading interest, but that are not currently registered with the Commission as national securities exchanges or operated by a registered securities association.

Regulation of Exchanges, Concept Release, Exchange Act Release No. 38672, 62 Fed. Reg. 30485, at 30486 n.1 (Jun. 4, 1997). For a codified definition of alternative trading systems adopted under Regulation ATS, see Regulations M and ATS, 17 C.F.R § 242.300(a) (2000).

7. The National Association of Securities Dealers Automated Quotation system (NASDAQ) is a registered exchange under §6 of the Securities Exchange Act of 1934 and operates as a subsidiary of the National Association of Securities Dealers (NASD), the largest securities-industry, self-regulatory organization (SRO) in the U.S. *See* The Nasdaq Stock Market, *at* http://www.nasdaq.com.

8. Under the Securities Exchange Act of 1934, the term "security" includes "any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement." 15 U.S.C. § 78c(a)(3)(B)(10) (1994).

9. Winn, *supra* note 3, at 453.

12 million in 2000.[10] Both the increase of online investor accounts and the advent of new market systems online have resulted in record setting trading volumes.[11] The overall market structure, therefore, has evolved to incorporate a new venue for trading securities, namely, online trading systems.

"Online trading system" is the generic term referring to a host of multifaceted trading systems found on the Internet:

> The term 'online trading system' encompasses a range of data communication applications that facilitate the secondary trading of securities. Typically, online trading systems share three basic components: a) computer terminals that allow users to send and receive transaction communications; b) a central processing host facility that receives orders and either displays, matches, crosses or otherwise facilitates trade executions; and c) a network that serves as a communications link between the users and the central processing host. In practice, different online trading systems have different capabilities. Their regulatory status under the Securities Exchange Act of 1934 is an evolving issue.[12]

These online trading systems generally take the form of either company-sponsored bulletin boards, Internet-based crossing systems, or matching systems.[13]

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10. *See* Laura S. Unger, SEC Commissioner, Investing in the Internet Age: What You Should Know and What Your Computer May Not Tell You, Address Before the Association of Retired Persons National Legislative Council Annual Meeting (February 3, 2000), *at* http://www.sec.gov/news/speeches/spch342.htm.

11. Preliminary volume figures showed that more than 2.230 billion shares changed hands on March 1, 2000 and the average daily trading in NASDAQ securities was up 70% for the first two months of 2000 as compared to the same time period in 1999. *See* NASDAQ Breaks Single-Day Share Volume and Composite Index Records for Second Trading Session in a Row, *at* http://www.nasdaq.com/reference/sn_nasdaq_breaks_single-day_shrvol_record_000301.stm.

12. Brandon Becker & Soo J. Yim, *Trading Securities Online: Internet and other Electronic Media, in* Securities Law & The Internet: Doing business in a Rapidly Changing Marketplace 295, 297 (Practicing Law Institute, ed. 1999).

13. *See* Cohen, *supra* note 3, at 6. These trading systems differ from the increasingly popular home pages of brokerage companies. Online brokerage companies merely offer a new method of access to traditional markets. Investors place trades over the Internet via a broker who effects the trade on the relevant exchange. *See also* Leslie Eaton, *Wall Street Without Walls*, N.Y. TIMES, Nov. 11, 1996, at A1.

A. *Company-Sponsored Bulletin Boards*

These bulletin boards are usually developed by issuers[14] in order to enhance liquidity in their thinly traded securities.[15] The issuing company adopts a passive role in the transaction by providing a "room" on the Internet for parties to post indications of interest.[16] When a match occurs between a prospective buyer and a prospective seller, the transaction is effected via an independent intermediary, e.g., a bank or escrow agent.[17] A key feature of these bulletin board systems is their passive nature. Each transaction is effected only by direct contact between those parties who use the system.[18] The sponsor of the system does not receive any compensation for creating or maintaining the system.[19] By providing an alternative venue for buying and selling sponsor-issued stock, the benefit to the sponsor lies in the enhanced liquidity of the sponsor's securities.[20]

B. *Internet-based Crossing Systems*

Internet-based crossing systems allow for automated execution of transactions in New York Stock Exchange (NYSE) listed securities and NASDAQ securities by allowing "investors to enter their own buy and sell orders in an open order book accessible through the Internet, where the orders are posted anonymously. . . .The systems automatically execute trades at the midpoint of the best bid and ask price, thereby permitting investors to split the spread."[21]

14. The Securities Exchange Act of 1934 defines an "issuer" as "any person who issues or proposes to issue any security." 15 U.S.C. § 78c(a)(3)(B)(8) (1994).

15. Cohen, *supra* note 3, at 7. *See also* Spring Street Brewing Company, SEC No-Action Letter, *available at* 1996 SEC No-Act. LEXIS 435 (April 17, 1996) (explaining how to sell thinly traded securities on the Internet).

16. Information posted usually includes: (i) the names, addresses, and telephone numbers (or other contact mechanisms, such as electronic mail addresses) of interested buyers and sellers; (ii) the number of shares offered for sale or desired to be purchased; (iii) the price at which the shares are desired to be purchased or sold; and (iv) the date on which the information was entered into the system. *See*, Cohen, *supra* note 3, at 7.

17. *See id.* (giving hypothetical example of a bulletin board transaction).

18. *See id.*

19. *See id.*

20. *See id.*

21. *See* Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 71 SEC Docket 1702, at 1707 n.20 (Feb. 23, 2000). The term "spread" refers to the difference between the best displayed bid and the best displayed offer in a given security. For example, if the best offer for a given security is \$10 and the best bid is \$10 1/2, the spread is 1/4 or \$0.25. *See id.*

C. *Matching Systems*

Matching systems, as their name indicates, allow participants to enter priced limit orders[22] and match those orders with others in the system.[23] Generally, the system participants are able to view unmatched limit orders in the system's book.[24] When orders are matched, the system sponsor or a dealer firm typically acts as a riskless principal in the transaction or the system sponsor contracts with a broker-dealer[25] to perform this function.[26]

III. Regulatory Development as Online Trading Grows

> Technological changes often outpace the ability of regulators to keep up with the industries they regulate.[27]

The increasing use of the Internet as a means of trading securities has been closely monitored by the SEC.[28] The Commission has taken an encouraging stance on innovation in the securities markets; however, the Commission consistently stressed to investors the need for them to exercise caution in online transactions.[29] The need for re-

22. Limit orders are orders to buy and sell a given security at a specified price or better as opposed to market orders which direct brokers to buy or sell at the best price reasonably available in the market at the time the order is submitted. *See id.* at 1707. Limit orders

> enable investors to control the prices at which they are willing to trade. For example, use of a limit order can assure that investors do not receive an execution at a price that is far different from what they expected if the market moves rapidly between the time the order is placed and the time the order is executed.

Id.

23. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70852 (Dec. 22, 1998) [hereinafter Adoption Release].

24. *See id.*

25. Section 78(c)(3)(a)(4) of the Securities Exchange Act of 1934 defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others," and §73(c)(3)(a)(5) defines "dealer" as "any person engaged in the business of buying and selling securities for his own account." 15 U.S.C. § 78(c) (1994).

26. *See* Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70852 (Dec. 22, 1998).

27. Denis T. Rice, *The Regulatory Response to the New World of Cybersecurities*, 51 ADMIN. L. REV. 901, 902 (1999).

28. *See* discussion *infra* notes 33-56 and accompanying text.

29. *See* Arthur Levitt, Chairman, Securities and Exchange Commission, Concerning Online Trading (Jan. 27, 1999), *at* http://www.sec.gov/news/press/99-9.txt.

regulation to properly address the new technologies is an issue the SEC has been dealing with for many years.[30]

The central issue posed to the SEC was the determination of the regulatory mechanism to be employed for these new trading systems.[31] Under the then current regulatory framework, most online trading systems were subject to regulation as an "exchange," which was defined under the Securities Exchange Act of 1934 (the "Exchange Act").[32]

In a 1990 release[33] (the "Delta Release"), the SEC stated that the focus of the Commission's inquiry in regulating these systems would be centralized trading, continuous two-sided quotations, the expectation of liquidity and the standardization of terms.[34] This effectively provided for a narrow interpretation of the definition of "exchange," which excluded most online trading systems from exchange regulation and allowed for a progression of passive regulation through the issuance of no-action letters.[35]

The SEC continued to struggle with its regulatory challenge. As the market environment became increasingly influenced by online trading systems, the SEC questioned the validity of its narrow interpre-

30. SEC Chairman Arthur Levitt wrote

> the Commission is aggressively monitoring the technological advances in the nation's securities markets. *** While this new trading does not alter risks associated with investing in the stock market, it has raised some new issues that need to be brought to the attention of investors. I also believe that our regulations, as well as our examination and enforcement programs, need to adapt to the changes in the way securities business is conducted.

Chairman Arthur Levitt's Response to the Committee on Commerce Regarding Online Trading (March 8, 1999), *in* SECURITIES LAW & THE INTERNET: DOING BUSINESS IN A RAPIDLY CHANGING MARKETPLACE 883, 885 (Practicing Law Institute, ed. 1999).

31. *Id.*

32. 15 U.S.C. §78(c)(a)(1) (1994).

33. Delta Government Options Corp., Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 27611, 55 Fed. Reg. 1890 (Jan. 12, 1990) [hereinafter Delta Release]. The Delta Release was issued in the aftermath of Board of Trade of Chicago v. SEC, 923 F.2d 1270 (1991), in which the Seventh Circuit deferred to the Commission in determining that an electronic system designed to trade options on federal government securities should not be considered an "exchange."

34. RICHARD W. JENNINGS, ET AL., SECURITIES REGULATION: CASES AND MATERIALS 612 (8th ed. 1998).

35. *See* Real Goods Trading Corp., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) 77,226 (June 24, 1996); PerfectData Corp., SEC No-Action Letter, *available at* 1996 WL 480429 (S.E.C.) (Aug 5, 1996); The Flamemaster Corp., SEC No-Action Letter, *available at* 1996 SEC No-Act. LEXIS 972 (Oct. 29, 1996).

tation of "exchange" under the Delta Release.[36] In a 1997 release[37] (hereinafter the Concept Release), the SEC sought public commentary on whether it should expand its then current definition of "exchange" to encompass trading systems that were not regulated as exchanges.[38] The SEC proposed a three-tiered approach to exchange regulation.[39] The lowest tier would essentially exempt small or "low impact" markets from exchange regulation requirements.[40] "Tier 2 would regulate larger, non-traditional exchanges as exchanges, but exempt them from regulatory requirements that conflict with corporate structure and technological operations."[41] The third tier would require exchange regulation for an alternative trading system[42] (ATS) that "both (1) consolidates orders of multiple parties and (2) provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of the trade."[43]

The three-tiered approach to exchange regulation received plenty of criticism from market participants.[44] Notably, the approach under the Concept Release was said to "require extensive use of the Commission's exemptive authority to address regulatory inconsistencies, expensive investments by ATS operators to assume increased regulatory responsibilities, and incalculable modifications to existing national

36. *See* Regulation of Exchanges, Concept Release, Exchange Act Release No. 38672, 62 Fed. Reg. 30485 (Jun. 4, 1997). "Alternative Trading System" is defined in 17 C.F.R. 242.300(a) (2000).

37. *See* Regulation of Exchanges, Concept Release, Exchange Act Release No. 38672, 62 Fed. Reg. 30485 (Jun. 4, 1997).

38. *Id.*

39. *Id.* at 30487.

40. *Id.*

41. Joan Conley, Secretary NASD, Nasdaq, and NASD Regulation, Letter to the SEC in Response to Concept Release (Oct. 10, 1997), *at* http://www.sec.gov/rules/concept/s71697/conley1.htm.

42. The Commission incorporated the term "Alternative Trading Systems" in the Concept Release:

> Trading systems not registered as exchanges have been referred to in previous Commission releases as "proprietary trading systems," "broker-dealer trading systems," and "electronic communications networks." The term "alternative trading systems" will be used throughout this release to refer generally to automated systems that centralize, display, match, cross, or otherwise execute trading interest, but that are not currently registered with the Commission as national securities exchanges or operated by a registered securities association.

See Regulation of Exchanges, Concept Release, Exchange Act Release No. 38672, 62 Fed. Reg. 30485, at 30486 n.1 (Jun. 4, 1997).

43. *Id.* at 30507.

44. *See, e.g.*, Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at nn.10, 11, 15, 17 (Dec. 22, 1998).

market system structures."[45] Commenters expressed the need for flexibility in the regulatory mechanism that would better suit the proprietary goals of ATS operators and the benefits of ATS presence in the market system.[46] Essentially, market participants asserted the need for minimal regulatory interference with market structure innovation.[47]

The Commission noted the advice of the market participants and followed the Concept Release with a set of proposed rules governing alternative trading systems.[48] In a 1998 release[49] (the "Proposal Release"), the SEC sought to provide broader regulatory oversight by expanding the definition of "exchange" while providing flexibility in regulatory status by allowing registration options for ATS operators who came under the expanded definition of exchange.[50] Subsequently, the SEC adopted a new regulatory framework (announced in the Adoption Release and embodied in Regulation ATS) largely adhering to the regulatory structure announced in the Proposal Release.[51] Thus, almost nine years after the Delta Release[52] and with the assistance of extensive public debate over the issue, the Commission attempted to fulfill its mission of encouraging innovation while ensuring basic investor protections.[53] The Regulation of Exchanges and Alternative Trading Systems (Regulation ATS or Reg ATS) became effective April 21, 1999 and is the current law governing systems which provide a means for trading securities online.[54]

IV. Regulation of Alternative Trading Systems

The Commission, in adopting Regulation ATS,[55] expressly relied on its new exemptive authority under the National Securities Markets

45. Sam Scott Miller, et al., *Tethering Technology: The SEC's Market Structure Concept*, 11 INSIGHTS 7, 8 (1997). "Under the guise of modernizing U.S. securities laws for the twenty first century, the Commission is suggesting a regulatory tack reminiscent of the sweeping regulatory protectionism of the New Deal." *Id.* at 7.

46. *See* Becker & Yim, *supra* note 12, at 299.

47. Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 23504, at 23506 (Apr. 29, 1998) (discussing SEC review of comment letters received in response from the Concept Release) [hereinafter Proposal Release].

48. *See id.*

49. *See id.*

50. *See id. See also* Becker & Yim, *supra* note 12, at 299.

51. Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844 (Dec. 22, 1998).

52. *See supra* note 33 and accompanying text.

53. *See* Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70854 (Dec. 22, 1998).

54. *Id.* at 70901.

55. 17 C.F.R §242.300 through §242.303 (1999).

Improvement Act (NSMIA) of 1996.[56] The Commission abandoned the tedious and burdensome no-action review process which it had to date relied upon.[57] The Commission noted that, under NSMIA, the Commission has greater flexibility to ensure that a broader definition of "exchange" does not inhibit or stifle innovation by imposing "unnecessary and burdensome regulatory obligations on small and emerging trading systems."[58] The NSMIA added §78mm(a)(1) to the Exchange Act which states:

> 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.[59]

What follows is a survey of the regulatory mechanism instituted under Regulation ATS.

A. *Definition of "Exchange"*

The central feature of the new regulatory framework is the new interpretation of the term "exchange" as defined in §78c(a)(1) of the Exchange Act.[60] New technologies and the advancement of online trading have eroded both the distinctions between regulatory classifications and those between requirements of exchange systems and broker-dealer systems.[61]

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56. National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996) (codified as 15 U.S.C. § 78mm (1996)).

57. *See* Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70901 (Dec. 22, 1998). The Commission noted that the increasing volume of no-action requests made the case-by-case review of alternative trading systems impracticable. *Id.*

58. Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70900 (Dec. 22, 1998).

59. 15 U.S.C. § 78mm(a)(1) (1996).

60. 15 U.S.C. § 78c(a)(1) (1994).

61. *See* Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70848 (Dec. 22, 1998). "Alternative trading systems are often providing services more akin of exchange functions than broker-dealer functions, such as matching counterparties' orders, executing trades, operating limit order books, and facilitating active price discovery." *Id.*

> In response to commenters' concerns and suggestions, the Commission has carefully revised Rule 3b-16 to define [exchange] to mean any organization, association, or group of persons that: (1) brings together the orders of multiple buyers and sellers; and (2) uses established non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.[62]

The SEC hopes that the new interpretation of "exchange" 'adapts to the concept of what is "generally understood" to be an exchange to reflect changes in the markets brought about by automated trading.'[63]

1. Brings Together the Orders of Multiple Buyers and Sellers

Each component of Rule 3b-16 was expanded upon in the Adoption Release.[64] Notably, a system "brings together" orders if it displays or represents trading interests entered on the system to system subscribers or users.[65] In addition, the SEC expressly employed the expression "multiple parties," rejecting the proposed use of "multiple buyers & sellers," to clarify the intended exclusion of systems through which securities are offered by a single seller, as well as systems designed for the purpose of executing orders against a single counterparty, i.e., a dealer-operated system.[66] Finally, Rule 3b-16 defines order to include "any firm indication of a willingness to buy or sell a security, as either a principal or agent, including any bid or offer quotation, market order, limit order, or any other priced order."[67]

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62. *See supra* note 61, at 70847.

63. *Id.* at 70848.

64. *See id.* at 70848-70858

65. *Id.* at 70849. Included in this definition are consolidated quote screens (e.g., Nasdaq), crossing systems, matching systems and interdealer broker systems. *See id.* at 70848-58.

66. *See id.* at 70849. However, a system that uses a designated counterparty as a "riskless principal for settlement purposes, after the purchasing and selling counterparties to a trade have been matched, would not by itself mean that the system does not have multiple buyers and sellers." *See* Brandon Becker and Cherie Macauley, *Regulation of Alternative Trading Systems, at* http://www/wilmer/com/docs/news_items/trading.pdf. (unpublished article from the law firm of Wilmer, Cutler & Pickering, Wash. D.C.) (1999).

67. 17 C.F.R. § 240.3b-16(c) (1999).

2. Established, Non-discretionary Methods

A system uses "established, non-discretionary methods" either by providing a trading facility or by setting rules governing trading among subscribers.[68] Such methods include a traditional exchanges' rules of priority, parity and precedence, electronic trading systems' algorithms as well as system rules which "determine the trading price at some designated future date on the basis of pre-established criteria (such as the weighted average trading price for the security on the specified date in a specified market or markets)."[69] Note that neither subsequent conditions to execute the trade[70] nor the separation of system functions among collected entities[71] elude the interpretation of this element.[72]

B. Exemption from the Definition of Exchange

The regulatory mechanism employed under Regulation ATS is essentially two-fold. The Commission expanded the definition of exchange, as discussed above in Section A, while concurrently crafting, under its NSMIA exemptive authority,[73] an elaborate exemption for Alternative Trading Systems.[74] The Commission also conditions an ATS's exemption on the absence of a Commission determination that the exemption, in that particular case, is not "necessary or appropriate

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68. *See* Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70850 (Dec. 22, 1998).

69. *Id.* at 70850-51.

70. For example, approval of a general partner in the sale of Limited Partnership units. *Id.* at 70851.

71. The Commission states, "If an organization arranges for separate entities to provide different pieces of the trading system, which together meet the definition contained in paragraph (a) of Rule 3b-16, the organization responsible for arranging the collective efforts will be deemed to have established a trading facility." Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70852 (Dec. 22, 1998).

72. *See id.*

73. *See supra* notes 55-58 and accompanying text.

74. 17 C.F.R. § 240.3a1-1(a) (2000). The statute reads:

> An organization, association, or group of persons shall be exempt from the definition of the term "exchange". . .if such organization, association, or group of persons:
>
> (1) Is operated by a national securities association;
>
> (2) Is in compliance with Regulation ATS ***; or
>
> (3) Pursuant to paragraph (a) of §242.301 of Regulation ATS. . .is not required to comply with Regulation ATS. . .

Id.

in the public interest or consistent with the protection of investors."[75] The Commission, in adopting the two-fold regulatory mechanism, stated the concept behind the regulation:

> The Commission intends for the exemption provided by Rule 3a1-1 to make clear that alternative trading systems that register as broker-dealers and comply with Regulation ATS not be regulated as national securities exchanges. The Commission believes that the requirements in Regulation ATS as adopted will address the market-like functions of alternative trading systems without imposing requirements applicable to exchanges that might not fit comfortably with certain alternative trading systems' structures and businesses.[76]

C. Scope of Regulation ATS

1. Definition of Alternative Trading System

An important aspect of the new definition of an ATS[77] was the choice to preclude trading systems that perform self-regulatory functions from registering as broker-dealers, rather than as exchanges. An Alternative Trading System is defined as 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

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75. 17 C.F.R. § 240.3a1-1(b) (2000).

76. *See* Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70857 (Dec. 22, 1998).

77. For the former definition of ATS, see Regulation of Exchanges, Concept Release, Exchange Act Release No. 38672, 62 Fed. Reg. 30485, at 30486 n.1 (Jun. 4, 1997); *see also* text accompanying note 41.

(ii) Discipline subscribers other than by exclusion from trading.[78]

The Commission felt that any system using its market power to regulate its subscribers (e.g., prohibiting subscribers from placing orders on its system at prices inferior to those posted on other systems) should be regulated as a Self Regulatory Organization (SRO).[79] Otherwise, the system's regulatory authority could be misapplied for anti-competitive purposes.[80]

2. Systems excluded from the definition of Alternative Trading System

As a method of enhancing the flexibility of the Regulation ATS, the Commission provided for several exclusions from the scope of Regulation ATS.[81] Excluded from the scope of Regulation ATS are alternative trading systems that: (1) are registered as exchanges under §6 of the Exchange Act;[82] (2) are exempted from registration as an exchange based on limited trading volume;[83] (3) are operated by a national securities association; or (4) are registered as broker-dealers and limit trading activity to government securities.[84] The Commission crafted these exclusions on the basis that these excluded systems are already subject to sufficient regulatory oversight and further regulation was not necessary for the protection of investors and the public inter-

78. 17 C.F.R. § 242.300(a) (2000).

79. *See* Adoption Release, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70859 (Dec. 22, 1998). "The term 'self regulatory organization' means any national securities exchange, registered securities association, or registered clearing agency." 15 U.S.C. § 78c(a)(26) (1994).

80. For example, surveillance activities by an SRO might, in fact, be driven by a desire to impede or injure an alternative trading system which could be competing for order flow with the SRO. See JENNINGS, *supra* note 34, at 622.

81. 17 C.F.R. § 242.301(a) (2000).

82. 15 U.S.C. § 78(f) (1994).

83. The low volume exception is intended to exclude from Regulation ATS low volume exchanges which, for example, discipline its members or provide other self-regulatory functions and, therefore, would preclude it from registering as an ATS broker-dealer. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70859 (Dec. 22, 1998).

84. The term "government security" is defined in §78(a)(42) of the Securities Exchange Act of 1934. 15 U.S.C. § 78c(a)(42) (1994). This exclusion incorporates transactions in government securities, including repurchase and reverse repurchase agreements, as well as certain put, call, straddle, option or privilege on a government security. 17 C.F.R. § 242.301(a)(4)(ii) (2000). The Commission also included trading limited to commercial paper under this exclusion. *Id.*

est.[85] Most importantly, the Commission may exempt an alternative trading system, upon application, from one or more of the requirements of Regulation ATS.[86]

D. Requirements of Regulation ATS

As discussed above in Section IV.B, the regulatory mechanism employed under Regulation ATS allows for alternative trading systems, which comply with the requirements of Regulation ATS, to elude the burdensome and costly regulation as exchanges. The following is a synopsis of the requirements imposed under Regulation ATS on alternative trading systems which choose not to register as an exchange under §6 of the Exchange Act. It is important to note that the requirements of Regulation ATS are, like most regulatory mechanisms, extremely complex and detailed. This synopsis is intended to provide the reader with a general background in the regulatory concepts implemented by the Commission in its attempt to protect investors while, at the same time, encouraging innovation. It should, therefore, not be read as an exhaustive description of the requirements under Regulation ATS.

1. Broker-Dealer Registration

The alternative trading system must register with the Commission as a broker-dealer under §15 of the Exchange Act.[87] As a result, the ATS must comply with broker-dealer requirements as well as Reg ATS requirements.[88] Most notably, the Commission thereby delegates a substantial portion of oversight responsibilities to the self-regulatory

85. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70858 (Dec. 22, 1998). For an overview of SRO regulatory requirements see §15A of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3 (1994).

86. 17 C.F.R. § 242.301(a)(5)(2000). The Commission may provide for such an exemption if it deems such an exemption is "consistent with the public interest, the protection of investors, and the removal of impediments to, and the protection of the mechanisms of, a national market system." *Id.* Although this discretionary exemption is a key element in the flexibility of the application of Regulation ATS, the Commission "expects to issues such orders only in unusual circumstances." Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70863 (Dec. 22, 1998).

87. 17 C.F.R. § 242.301(b)(1) (2000).

88. *See* 15 U.S.C. §78o (1994).

organization (SRO), of which the ATS is required to become a member pursuant to §15(b)(8) of the Exchange Act.[89]

2. Notice

The ATS must file with the Commission an initial operating report[90] which includes a detailed description of operations, prospective subscribers, and securities it intends to trade, as well as procedures for reviewing systems capacity, and security and contingency planning.[91] This report is subject to amendment in case material changes in operation or inaccuracies are discovered.[92]

3. Order Display and Execution Access

This requirement only applies to an ATS, which displays its orders to non-employees and has an average daily trading volume of 5% or more in any covered security[93] during at least four of the preceding six months.[94] In such circumstances, the ATS is required to disclose its best priced orders in those securities to a national securities exchange or national securities association. The size and price of orders in those securities are then to be included in quotation data made available to quotation vendors by the exchange or association.[95] In addition, the ATS must provide broker-dealers who have access to such exchanges or associations with equivalent access and ability to transact orders based on such a display.[96]

4. Fees

The ATS is prohibited from charging fees inconsistent with the equivalent access concept discussed above.[97] In addition, the ATS

89. 15 U.S.C. § 78o(b)(8) (1994).

90. 17 C.F.R. § 242.301(b)(2) (2000).

91. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70863 (Dec. 22, 1998). The Commission notes that this is a notice requirement and not an application hinging on approval by the Commission. *See id.*

92. 17 C.F.R. § 242.301(b)(2) (2000).

93. 17 C.F.R. § 240.11Ac1-1 (2000). "[A]ny reported security by and any other security for which a transaction report, last sale data, or quotation information is disseminated through an automated quotation system." 17 C.F.R. § 240.11Ac1-1(a)(b) (2000).

94. 17 C.F.R. § 242.301(b)(3)(i)(b) (2000).

95. 17 C.F.R. § 242.301(b)(3)(ii) (2000).

96. 17 C.F.R. § 242.301(b)(3)(iii) (2000).

97. 17 C.F.R. § 242.301(b)(4) (2000).

must "comply with the rules or standards governing fees established by the national securities exchange or national securities association through which non-subscribers have access."[98]

5. Fair Access

Much like the equivalent access element of Regulation ATS,[99] the fair access component is only applicable once an ATS has satisfied a threshold requirement of average daily trading volume in a relevant security.[100] An ATS shall comply with the fair access requirement if, during at least four out of the preceding six months, the ATS had 20% or more of the average daily trading volume of the relevant security.[101] Analysis of this requirement is to be conducted on a security-by-security basis.[102] Once an ATS has crossed the threshold, the Commission deems it necessary to enforce fair access requirements in addition to the public display and equivalent access requirements.[103] An ATS subject to the fair access requirement must "establish written standards for granting access to trading on its system"[104] and is prohibited from applying these standards "in an unfair or discriminatory manner."[105] In addition, the ATS must maintain extensive recordkeeping of grants, denials and limitations of access to its system.[106]

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98. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70871 (Dec. 22, 1998).

99. *See* Section V.D.iii

100. *See* 17 C.F.R. § 242.301(b)(5)(i) (2000). Relevant securities include covered securities, equity securities not included under covered securities, municipal securities, investment grade corporate debt, and non-investment grade corporate debt. *Id.*

101. *Id.*

102. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70873 (Dec. 22, 1998).

103. *See supra* text accompanying notes 93-96. The Commission feels that

> when an alternative trading system has a significantly large percentage of the volume of trading, unfairly discriminatory actions hurt investors lacking access to the system. Fair treatment by alternative trading systems of potential and current subscribers is particularly important when an alternative trading system captures a large percentage of trading volume in a security, because viable alternative to trading on such a system are limited.

See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70872 (Dec. 22, 1998).

104. 17 C.F.R. § 242.301(b)(5)(ii)(A) (2000).

105. 17 C.F.R. § 242.301(b)(5)(ii)(B) (2000).

106. 17 C.F.R. § 242.301(b)(5)(ii)(C) (2000).

6. Capacity, Integrity and Security of Automated Systems

As with the fair access requirement, an ATS is subject to requirements regarding capacity, integrity and security only once it has reached the threshold trading volume in equity securities or certain debt securities.[107] The Commission believes that an ATS with an average daily trading volume of 20% or more in a relevant security creates a potential to disrupt the securities markets as much as failures of SROs' automated systems.[108]

> An alternative trading system that meets these volume thresholds will be required to: (1) establish reasonable current and future capacity estimates; (2) conduct periodic capacity stress tests of critical systems to determine such system's ability to process transactions in an accurate, timely, and efficient manner; (3) develop and implement reasonable procedures to monitor system development and methodology; (4) review the vulnerability of its systems and data center computer operations to internal and external threats, physical hazards, and natural disasters; and (5) establish adequate contingency and disaster recovery plans.[109]

In addition, such an ATS must conduct annual reviews of procedures implemented in compliance with the above requirements[110] and notify the Commission of any material systems outages and significant systems changes.[111]

7. Examinations, Inspections and Investigations

Every alternative trading system is required to permit examinations, inspections and investigations, regardless of whether they are conducted by the Commission or an SRO.[112] Each ATS is also expected to cooperate in examinations, inspections, and investigations into ATS subscribers.[113]

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107. 17 C.F.R. § 242.301(b)(6) (2000).

108. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70875 (Dec. 22, 1998).

109. *Id.* at 70876.

110. 17 C.F.R. § 242.301(b)(6)(ii)(F) (2000).

111. 17 C.F.R. § 242.301(b)(6)(ii)(G) (2000).

112. 17 C.F.R. § 242.301(b)(7) (2000).

113. *Id.*

8. Recordkeeping and Reporting

The Commission has required that ATS "make and keep records necessary to create a meaningful audit trail."[114] Such records include daily summaries of trading, time-sequenced records of order information, number of trades, number of shares traded, total settlement value in terms of U.S. dollars, and notices provided to subscribers.[115] In addition, these records must be kept for a minimum of three years.[116] Finally, alternative trading systems are required to file quarterly reports with the Commission on Form ATS-R.[117]

V. Market Fragmentation and Price Transparency

As a result of Regulation ATS and its flexible regulatory mechanism, the overall market structure has taken on a new identity.[118] For example, nine alternative trading systems were collectively responsible for 26.2% of the total dollar volume of NASDAQ securities in January 2000.[119] Investors now have the choice to execute their orders in a multitude of different market centers.[120] As a result, the issue of market fragmentation has moved to the forefront of investor issues.[121]

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114. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844, at 70876 (Dec. 22, 1998).

115. 17 C.F.R. § 242.302 (2000).

116. 17 C.F.R. § 242.303 (2000).

117. 17 C.F.R. § 249.638 (2000).

118. *See supra* notes 7-11 and accompanying text (discussion on the increase in online investing via alternative trading systems).

119. *See Market Quality Statistics, at* http://www.marketdata.nasdaq.com/mr6d.html. The nine alternative trading systems include Instinet, Island, Archipelago, Redi-Book, B-Trade, Brut, Strike, NexTrade, and Attain. This same group of systems are also responsible for 19.6% of the Nasdaq share volume and 24.6% of the trades executed on Nasdaq for the same time period. *See id.*

120. The term "market centers" refers to traditional exchanges, alternative trading systems and over-the-counter markets. *See* Stock markets agree to distinguish after-hours and regular session trades with "T" modifer, SEC News Release, Oct. 4, 2000, *available at* 2000 WL 1470642 *1; NYSE's Rescission of Rule 390 and commission's request for comment on market fragmentation (Summary of Rel. No. 34-42450) Feb 23, 2000 *available at* 2000 WL 220245*1.

121. *See* Mark Klock, *The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753, 761 (1999); Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 71 SEC Docket 1702 (Feb. 23, 2000).

Section 11A of the Exchange Act sets guidelines for the Commission in its attempt to develop a National Market System.[122]

> For purposes of evaluating market structure, these findings and objectives can be summed up in two fundamental principles: (1) the interests of investors (both large and small) are preeminent, especially the efficient execution of their securities transactions at prices established *by vigorous competition*; and (2) investor interests are best served by a market structure that, to the greatest extent possible, maintains the benefits of both an opportunity for *interaction of all buying and selling interest* in individual securities and fair competition among all types of market centers seeking to provide a forum for the execution of securities transactions.[123]

Critical to these stated principles is the need for vigorous competition and interaction of all buying and selling interests. Without these factors, market fragmentation—the trading of orders in multiple locations without interaction among those orders—will have detrimental effects on the investing public and market efficiency.[124]

Regulation ATS appears to foster competition among market centers by instituting fair access and quotation display requirements for alternative trading systems with certain average daily trading volumes.[125] These provisions are essential considering the broad discretion brokers often have in choosing where to market their orders.[126] The fair access and quotation display provisions foster the sought after market competition; however, the provisions fall short of the desired effect. The inadequacy lies in the anti-competitive distribution mechanisms employed to determine which markets receive customer order flow (procedures used to determine which market will be

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122. 15 U.S.C. §78k-1 (1994) (emphasis added). *See also,* JENNINGS, *supra* note 34, at 652-661. Chairman Levitt has emphasized the need to develop four interdependent elements—competition among markets; transparency of pricing; better linkages between market centers; and best execution of customer orders—to move towards a true National Market System. Arthur Levitt, Chairman, Securities and Exchange Commission, *Best Execution: Promise of Integrity, Guardian of Competition,* Speech Before the Securities Industry Association, *at* http://www.sec.gov/news/speeches/spch315.htm.

123. Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 71 SEC Docket 1702, at 1706-07 (Feb. 23, 2000).

124. *See id.*

125. *See infra* Part IV.D.

126. Non-institutional, non-daytraders rarely direct brokers to execute their orders on specific markets. *See* Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 71 SEC Docket 1702, at 1703 (Feb. 23, 2000).

the forum for order execution)—mechanisms not addressed by Regulation ATS.

A fundamental aspect of the current market structure is the broker's duty of best execution.[127] The duty protects investors in a multimarket environment by requiring a broker "to seek the most favorable terms reasonably available under the circumstances for a customer's transaction."[128] Best execution is effected with the support of price transparency provisions.[129] Each significant market, including alternative trading systems meeting threshold trading volumes,[130] is required to display their best bid and offer prices and the size of the orders associated with those prices.[131] This information is then consolidated into the national best bid and best offer (NBBO).[132] If the market with the best price display would necessarily receive the order flow for market orders in the given security, price competition among market centers would exist to the benefit of the investor. For example, if the NBBO for Stock A is $10 and $10^1/_2$, a better offer (or bid in this case) of $10^1/_4$ in any market center would result in orders being routed to that market for execution. However, current market structure

> allows price-matching rather than requiring that orders be routed to the market center displaying the best price, thereby isolating the orders of different market centers. . . .Thus, the market participant (whether investor or dealer) who publicly displays an order at a better price than anyone else is offering is not entitled to any assurance that the order or quotation will interact with the next trading interest on the other side of the market.[133]

In the example of Stock A, the investor seeking to liquidate Stock A, and offering a better-than-NBBO price of $10^1/_4$, would not have an incentive to offer the better price unless she was sufficiently assured that the market center where she places the offer is sufficiently active in Stock A trading to ensure that the trade will be executed against a

127. *See supra* note 126, at 1712.

128. *Id.*

129. *See id* at 1711.

130. *See* discussion *supra* Part IV.D.

131. *See id.* (citing Securities Exchange Act of 1934, Rule 11Acl-1, 17 C.F.R 240.11Acl-1 (2000); Securities Exchange Act of 1934, Rule 11Acl-4, 17 C.F.R 240.11Acl-4 (2000); NASD Rule 4613; NYSE Rule 60).

132. *See* JENNINGS, *supra* note 34, at 659-660.

133. Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 71 SEC Docket 1702, at 1711-12 (Feb. 23, 2000).

contrary interest. The result is isolation of orders and a disincentive for price improvement.

Two other order flow distribution mechanisms that thwart the price competition among markets are internalization and payment for order flow. Internalization involves the routing of order flow by a broker to a market maker that is affiliated with the broker, e.g., a broker-dealer firm that sends its orders to the firm's market maker desk.[134] Thus, the routing of the order flow is not based on price competition but on corporate affiliation. Similarly, payment for order flow agreements involve just that—order routing based on economic inducements in the form of commission or profit-sharing.[135] Therefore, internalization, payment for order flow agreements and inadequate order routing mechanisms contribute to order isolation and anti-competitive pricing practices.

VI. CONCLUSION

Rapid Internet growth and technological advancements are changing the shape and structure of securities markets. This technological revolution brings with it a regulatory challenge to promote innovation and growth while maintaining investor protections.

While Regulation ATS encourages the creation of new market centers by providing less burdensome regulation for alternative trading systems and exemptive relief from exchange status regulation, it fails to functionally integrate the new markets with participation in the distribution of order flow. A multiple-market structure may benefit investors through price competition, reduced transactional costs, and faster trade execution. However, these benefits are contingent on the new markets having the ability to compete for and participate in order flow distribution.

VII. POSTSCRIPT

Between submission of this note for publication and publication itself, the Commission announced its adoption of new rules designed to combat the increasing problems associated with market fragmenta-

134. *Id.* at 1710. A "market maker" is an intermediary whose function is to "preserve trading continuity and prevent excessive intra-day price volatility." JENNINGS, *supra* note 34, at 661.

135. *See* Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 71 SEC Docket 1702, at 1710 (Feb. 23, 2000).

tion.[136] In line with the overall market regulatory structure, these new rules require increased disclosure to the public—namely, on the part of brokers and market centers.[137] Under the new rules, market centers are required to make monthly electronic disclosures reflecting, among other things, the quality of executions on a stock-by-stock basis and "the extent to which they provide executions at prices better than the public quotes to investors using limit orders."[138] In addition, brokers will be required to disclose on a quarterly basis "the identity of the market centers to which they route a significant percentage of their orders" as well as "the nature of their relationships with such market centers, including any internalization or payment for order flow arrangements, that could represent a conflict of interest between the broker and its customers."[139] The rules take effect on April 2, 2001.[140] Through such improved disclosure, the Commission hopes to "enhance investor protection and further competition for retail orders by enabling investors and their fiduciaries to evaluate more effectively the market centers to which their orders are routed."[141] These new rules, in conjunction with the Regulation of Alternative Trading Systems and many other regulatory mechanisms, become part of a web of SEC regulatory supervision aimed at spurring competition in the U.S. capital markets and protecting the investing public through disclosure-based regulations.

Gabriel Matus

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136. *See* Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 34-43950, 67 Fed. Reg. 75414 (Dec. 1, 2000) [hereinafter Execution and Routing Release]; Greg Ip, *New SEC Rules on Execution Disclosure Will Tell Investors of Hidden Trade Costs*, WALL ST. J., Nov. 16, 2000, at C1.

137. *See* Execution and Routing Release, 67 Fed. Reg. 75414, at Part III.A. *See also* Fact Sheet: Market Structure Rules, New Rules Requiring Public Disclosure of Order Execution and Routing Practices, Nov. 15, 2000, *available at* http://www.sec.gov/news/extra/faqmstrc.htm.

138. *See id.*

139. *Id.*

140. *See* Execution and Routing Release, 67 Fed. Reg. 75414, at 75428.

141. Execution and Routing Release, 67 Fed. Reg. 75414, at 75417 (quoting a comment letter from the Knight Trading Group).