



Securities Industry Association

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July 31, 1998

Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: Regulation of Exchanges and Alternative Trading Systems
File No. S7-12-98

Dear Mr. Katz:

The Alternative Trading System Subcommittee ("Committee") of the Securities Industry Association¹ ("SIA") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") proposed regulation of exchanges and alternative trading systems ("ATS").² The SEC's regulatory oversight of these technologically advanced trading systems presents important issues for public investors, SIA's membership and the securities industry as a whole. In response to the Proposal Release, SIA assembled a special committee, drawn from SIA's Federal Regulation Committee and other SIA groups and representing a broad range of its members, to study the regulatory issues presented by ATSS.³ The Committee encourages the Commission to incorporate the suggestions offered below in revising its proposal.

I. Summary

The Committee agrees with the Commission that the development of ATSS and their corresponding regulation is an important issue for the securities markets and its participants. Accordingly, the Committee takes this opportunity to respond to the SEC's request for comment on its general approach to regulating ATSS as well the specifics of the rules proposed, as set forth in the Proposal Release. The following summarizes the Committee's primary recommendations regarding the Commission's approach:⁴

A. As a general matter, the Committee believes that the Commission's current regulatory framework has worked successfully to allow the development of innovative trading systems. Because of its positive effect, the Committee believes the better approach would be to continue

the present framework for regulating ATSS. To the extent that the Commission identifies any specific market abuses, it can narrowly tailor specific regulation to address the particular problem.

B. Notwithstanding the Committee's general view, if the Commission opts for the approach set out in the Proposal Release, the Committee recommends the following:

1. The Committee believes that the proposed definition fails to adequately define an "exchange" "as that term is generally understood." Two additional characteristics should be included in the definition to more precisely define an exchange, to appropriately differentiate between broker-dealers and exchanges and to capture the entities intended by the Commission, *i.e.*, significant ATSS which do not perform traditional brokerage functions.
 - a. To draw a bright-line distinction between broker-dealers and exchanges, the Committee advocates including in the definition of an exchange the requirement that an entity which has the discretion to commit capital to a trade is not an exchange. Broker-dealers, but not exchanges, have the discretion and ability to commit capital to transactions.
 - b. The Committee further believes that another significant characteristic of an exchange -- in addition to the proposed structural characteristics of consolidating orders of multiple parties and setting non-discretionary material conditions -- is the purchasers' and sellers' reasonable expectation of the regular execution of their orders at posted prices, where this expectation results from the structural features. Accordingly, we recommend that the Commission add such a requirement to its definition of an exchange.
2. The Committee strongly supports the Commission's decision to exclude from the proposed definition of an exchange those systems that simply perform normal broker-dealer functions. Therefore, the Committee recommends that the Commission exclude from the definition of an exchange those trading systems which have the discretion to commit capital to a trade. In addition, the Committee supports the Commission's proposed exclusions for automated block trading desks, internal execution systems, information vendors, bulletin boards, and most, if not all, inter-dealer broker services from the definition of an exchange. The Committee, however, recommends that the Commission clarify the meaning of each of these exclusions, particularly the meaning of the phrase "predetermined procedure that is communicated to the customer," as used in the internal broker-dealer trading system exclusion.
3. Because of the unique characteristics of debt instruments and their markets, the Committee believes that the systems trading debt securities should not be subject to the enhanced regulation as proposed. In keeping with this view, the Committee applauds the Commission's decision to exclude systems trading government securities, and suggests, at a minimum, that the exclusion be extended to municipal securities as well.

4. With regard to the proposed volume tests in Regulation ATS, the Committee advocates the following:
 - a. To ensure that the increased regulatory requirements are applied to the truly significant market participants, the Committee recommends increasing the Commission's proposed volume thresholds. In particular, where the Commission imposes a 10% threshold for requiring systems to comply with order display, access and fee requirements, the Committee would recommend a 20% threshold. Similarly, the Committee would suggest a 40% volume threshold, in place of the Commission's suggested level of 20%, for the imposition of fair access, capacity, integrity and security requirements.
 - b. The Committee is concerned that applying a basic security-by-security volume test may subject systems, which trade a significant amount of one equity security, but where that business is an extremely minor aspect of the system's overall equity trading activity, to inappropriate or excessive regulation. Therefore, in addition to raising the volume percentages, the Committee suggests that the Commission also require that the trading activity which causes an ATS to cross the percentage threshold also be 20% of the ATS's overall trading activity.
 - c. The Committee advocates keeping the requirement that a system must meet the volume threshold for at least four of the preceding six months before the system is required to comply with certain additional regulatory requirements. The Committee agrees with the Commission that this type of requirement ensures that smaller systems which experience a temporary spike in trading are excluded from the additional regulation.
5. When imposing its fair access standards, the Committee recommends that the Commission reiterate that an ATS may impose any pre-conditions to access of its choosing, provided the designated criteria are not applied in an arbitrary fashion. The Committee believes such standards will satisfy the Commission's goals of fair access, and, therefore, opposes the creation of a new right of action to appeal an ATS's denial of access. Notwithstanding this view, if the Commission decides to implement its proposed right to appeal, the Committee recommends that the Commission's review of denials of access should be limited to adjudicating whether access should be allowed under the ATS's standards, not whether the standards are appropriate.
6. The Committee agrees with the Commission's decision to address competitive burdens on exchanges by proposing a temporary exemption for pilot trading systems. However, the Committee believes that exchanges should continue to publish rule filings for other products and exchange members should continue to have the ability to raise product-related concerns.

II. Success of Current ATS Regulation

The Committee believes that, in drafting the Concept and Proposal Releases, the Commission may be too self-critical of its efforts to regulate ATSs to date.⁵ The case-by-case approach followed today, in which the Commission reviews the specific broker-dealer ATS operations individually and devises appropriate regulatory structures, has allowed many innovative systems to flourish. By careful use of interpretive guidance such as no-action relief, the Commission has resisted the temptation to over-regulate and stifle new, innovative trading systems. The proliferation and vitality of ATSs stands as a testament to the success of the Commission's past efforts.

The Commission now proposes to completely overhaul and re-orient its current approach to regulating ATSs. The Committee does not believe that the Commission has identified any abuses or dangers significant enough to warrant a wholesale revision. Before the Commission substantially alters its effective regulatory policy, the Committee encourages the Commission to identify more clearly the existence of (or potential for) any harm to investors -- rather than administrative inconveniences -- resulting from the current definition of an exchange. Absent such findings, the Committee favors addressing any concerns regarding ATSs within the current regulatory framework.

Instead of identifying market abuses, the Commission's proposal indicates a desire to use its exemptive authority to further the goals articulated in the Securities Acts Amendments of 1975, such as increasing transparency. The Committee disagrees with the Proposal Release's suggestion that broker-dealer regulation is inadequate to address these national market system ("NMS") goals. On the contrary, the Committee believes that the Commission has addressed, and may continue to address, them effectively within the current regulatory framework by engaging in rulemaking that is narrowly tailored to address the specific concerns. For example, the rule proposals demonstrate the Commission's desire to increase transparency by entering more orders into the public quote stream. This may be accomplished by enhancing the current order handling rules and quote display requirements. Likewise, the Commission's concerns about whether ATSs have sufficient system capacity during periods of market volatility could also be solved through the existing broker-dealer structure. In addition, the concern over ATSs unfairly excluding participants or applicants, such as other broker-dealers, from the system may give rise to a number of private liabilities in many situations. If there is evidence that private liability exposure is proving insufficient to prevent unfair denials of access, the Commission could consider using its current regulatory authority over broker-dealers to require reporting of denials of access.

Adjusting the system of broker-dealer regulation under which ATSs are now governed appears much more workable and realistic than building an entirely new regulatory structure to govern ATSs as exchanges. In addition, the specific rulemaking within the proven framework of broker-dealer regulation is a far less invasive technique than expanding the definition of an exchange as proposed in the release. The Committee believes that the approach advocated by the Commission in the Proposal Release would impede the expansion and development of existing or future trading systems by imposing unnecessary costs and burdens on the affected systems. It would be regrettable if an entirely new and complicated regulatory model resulted in the decline or disappearance of innovative trading systems, with investor order flow again being limited to traditional markets, or possibly moving to offshore sites -- particularly, if the additional regulations were not warranted by demonstrated harms.⁶

III. Suggestions regarding the Proposed Regulation of ATSS

If the Commission determines that a more substantial revision of the regulatory regime for ATSS is required despite the Committee's reservations, the Committee would advocate the following with regard to the proposed rules:

A. Definition of an Exchange

The Commission seeks comment on whether Proposed Rule 3b-12 accurately captures the fundamental features of an exchange as that term is commonly understood.⁷ Proposed Rule 3b-12 defines an exchange to mean "any organization, association, or group of persons that: (1) consolidates orders of multiple parties; and (2) sets non-discretionary material conditions (whether by providing a trading facility or by setting rules) under which parties entering such orders agree to the terms of a trade." The Committee does not believe that this definition adequately describes an "organization, association or group of persons . . . performing with respect to securities the functions commonly performed by a stock exchange *as that term is generally understood*,"⁸ as required by the statutory definition of an exchange. To define an exchange with more precision, as well as to differentiate it from a broker-dealer, the Committee would suggest incorporating the following requirements into the proposed definition: (1) an entity which has the discretion to commit capital to a trade is not an exchange and (2) before an entity is classified as an exchange, it must reasonably assure regular order execution at posted prices.

The Committee believes that the proposed definition of an exchange may capture traditional broker-dealer functions, even with the exclusions the Commission provides. This unintended, yet real, result should be clarified. In the Concept Release, the Commission explained that, in defining an exchange, one of its primary goals was to ensure that the definition was not so broad as to capture broker-dealer activities. The Concept Release stated:

[T]he Commission has consistently maintained that the definition of exchange should not be interpreted so broadly as to overlap or interfere with other sections of the Exchange Act, such as those governing broker-dealer activities or securities associations. . . . Therefore, if the Commission decides to broaden its interpretation of "exchange" to encompass alternative trading systems, it would have to take into account the potential effects of such an interpretation on entities regulated under other sections of the Exchange Act. . . . For example, the Commission would not intend any revised interpretation of "exchange" to capture traditional brokerage activities or the internal automation of traditional brokerage activities.⁹

The Committee strongly supports this sentiment. Therefore, the Committee suggests the addition of another factor to the proposed exchange definition to adequately and clearly distinguish broker-dealer activities from market activities -- the requirement that an entity which has the discretion to commit capital to a trade is not an exchange. Because broker-dealers always have the discretion to commit capital to a trade and exchanges never have this ability, such a requirement would prevent traditional dealer activities from being captured by the exchange definition.¹⁰

In addition to the discretionary commitment of capital, the Committee also suggests requiring an exchange to provide a reasonable expectation that investors can regularly execute their orders

at posted prices. Common usage as well as the *Delta* Release¹¹ indicate a statutory "exchange" involves entities that perform such a function. The *Delta* Release defined an exchange as

includ[ing] 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' (emphasis added).¹²

The Commission's proposed definition, however, has ignored the requirement that an exchange reasonably assure regular order execution at quoted prices. At the same time, the proposed definition retains the structural characteristics of the *Delta* definition. For example, the *Delta* requirement that an exchange be "designed, whether through trading rules, operational procedures or business incentives, to centralize trading and provide buy and sell quotations on a regular and continuous basis" is essentially the same as the proposed definitional prong which requires that a system "consolidate orders of multiple parties." Likewise, the proposed requirement that an exchange must "set non-discretionary material conditions . . . under which the parties entering such orders agree to the terms of the trade" merely restates the *Delta* requirement that "purchases and sellers . . . can . . . execute their orders at those price quotations."

In the Committee's opinion, because the proposed definition fails to incorporate the important *Delta* requirement of a reasonable expectation of regular order execution at posted prices into the exchange definition and to distinguish adequately between broker-dealers and exchanges, it potentially includes within the exchange definition a variety of systems that are clearly not "generally understood" to be an exchange. The Commission partially rectifies this by explicitly excluding certain systems, like internal broker-dealer systems, from the definition. In addition, within Regulation ATS, the Commission proposes something akin to the *Delta* regular execution standard (a volume test) as a threshold for imposing layers of exchange-type regulations. Rather than complicating the regulatory scheme in such a way, we suggest that the Commission add the capital commitment and reasonable expectation of regular order execution characteristics to the exchange definition. By more accurately defining an exchange, the Commission will focus its proposed regulation on the intended entities, *i.e.*, significant, high-volume ATSs which do not perform traditional brokerage functions, rather than relying on a patchwork of exclusions and exemptions that will lead to a less precise result.

In conclusion, the Committee would have the definition of an exchange read as follows:

any organization, association, or group of persons that: (1) consolidates orders of multiple parties; (2) sets non-discretionary material conditions (whether by providing a trading facility or by setting rules) under which parties entering such orders¹³ agree to the terms of a trade; (3) does not have discretion to commit capital to a trade; and (4) provides purchasers and sellers a reasonable expectation that they can regularly execute their orders at quoted prices .¹⁴

The Committee believes that such a definition more accurately defines an exchange, while still capturing significant ATSs within the limits of the definition, as the Commission intended.

B. Exclusions from the Definition of an Exchange for Traditional Broker-Dealer Functions

The Committee strongly agrees with the Commission's decision to exclude from the proposed definition of an exchange those systems that simply perform normal broker-dealer functions. However, the Committee is concerned that the wording of the rules could result in some confusion in practical application. Therefore, to provide the regulated entities with better guidance as to their duties under the Exchange Act, the Committee strongly suggests that the Commission clarify the rules.¹⁵

To ensure that the Commission does not include traditional broker-dealer systems in the definition of an exchange, the Committee urges the Commission to add an additional exclusion to Rule 3b-12(b) which excludes those systems which have the discretion to commit capital to a trade from the definition of an exchange. As discussed above, the Committee believes that such an exclusion would distinguish between broker-dealers and exchanges and, therefore, prevent the inappropriate inclusion of broker-dealers in the definition of an exchange. While we urge the Commission to incorporate such a distinction between exchanges and broker-dealers in the actual definition of an exchange as described in Section III(A), the Committee would also support an exclusion for trading systems which have the discretion to commit capital.

In addition to the Committee's recommended exclusion for systems which have the discretion to commit capital, the Committee advocates preserving in the final rules the existing exclusions in proposed Rule 3b-12(b). In that proposed rule, the Commission excludes from the exchange definition (1) systems that merely route orders to other execution facilities; (2) systems that allow customers of a dealer to execute solely against the dealer's quotes; and (3) internal broker-dealer order management execution systems, *i.e.*, systems that allow a broker-dealer to cross or match customer orders internally at the broker-dealer's discretion. In so doing, the Commission responded favorably to SIA's recommendations in its comment letter on the Concept Release¹⁶ that broker-dealer activities like automated block trading, as well as internal execution systems, information vendors, bulletin boards, and most, if not all, inter-dealer broker services, should not be subject to regulation as an exchange. The Committee agrees with the Commission that these exclusions are necessary to prevent the application of exchange regulation to broker-dealer activities.

The Committee, however, suggests that the Commission clarify the language excluding internal broker-dealer trading systems from the definition of an exchange. Under the proposed rules, a system that provides the means for a single broker-dealer to internally manage its customers' orders would be specifically excluded from the definition of an exchange if: (1) no orders were displayed to persons other than the broker-dealer's employees; and (2) customer orders were not executed according to a predetermined procedure that is communicated to the customer.¹⁷

The Commission introduces two new and undefined phrases in this exclusion: "predetermined procedures" and "communicated to the customer." To accurately describe the intended entities, the Committee believes that the Commission should clarify the meaning of the phrase "predetermined procedure that is communicated to customer" by modifying the proposed rule or by providing a full and complete explanation of the term in the adopting release. Specifically, a broker-dealer that follows a standardized execution protocol and is prepared to inform its customers of that protocol should not, therefore, become an exchange. In particular, the

Committee recommends that the Commission explain that a broker-dealer has not adopted "predetermined procedures," as that term relates to the definition of an exchange, if it promulgates procedures to comply with its best execution obligations, its SRO's rules or other regulatory requirements, or to meet the business demands of its customers. Similarly, the exclusion's requirement that procedures not be communicated to customers may have the unintended effect of forcing broker-dealers that disclose their internal procedures for crossing customer orders to their customers to be deemed an exchange. The Committee suggests that the Commission clarify that a trader's explanation of a system's internal procedures to a customer, who is entitled to know how his/her orders will be handled, will not result in an internal system losing this exclusion.¹⁸ The Committee also suggests that the Commission clarify in any adopting release that the exclusion applies to any automated internal broker-dealer system that merely disseminates to customers the broker-dealer's indications of interest in purchasing or selling securities.

The Committee also has some concerns with ambiguities in the exclusion for systems that display the quotes of a single dealer and allow for execution against those quotes. While proposed Rule 3b-12(b)(2) states that the exclusion applies with regard to execution by any "person," there is language in the Proposal Release indicating that the exclusion applies only to "customers."¹⁹ This creates some ambiguity as to whether the exclusion applies to systems that permit execution against the broker-dealer's quotes by another broker-dealer. We urge the Commission, in any adopting release, to clarify that this exclusion applies to such systems.

C. Exclusion for Systems Trading Debt Securities²⁰

As stated in SIA's letter on the Concept Release,²¹ the Committee is troubled by the Proposal Release's intention to subject systems trading debt securities, other than government securities, to the proposed enhanced ATS regulation. The substantive and trading characteristics of debt securities vastly differ from those of equity securities. Therefore, the Committee believes the application of similar regulatory requirements to the very different instruments and their markets may prove unworkable for the debt securities. Excluding ATSS trading debt securities from the proposed regulation and separately addressing any specific regulatory issues related to the debt markets is a more viable approach.

The Committee applauds the Commission for following SIA's recommended approach in drafting the proposed rules, at least with regard to government securities. The Commission agreed that government securities deserve special treatment because they are also subject to non-SEC regulatory requirements that reflect their particular importance in implementing domestic financial policy. The Committee agrees with the Commission's statements in the Concept Release that the same argument applies with equal weight to municipal securities.²² Therefore, the Committee recommends that, at a minimum, the exclusion for ATSS trading government securities should be expanded to include municipal securities.

D. Volume Calculations

As a general matter, the Committee is concerned about the tiered approach the Commission has proposed for regulating ATSS. SIA articulated the potential adverse affects of such an approach in its comment letter on the Concept Release: "[B]y imposing new regulatory requirements on ATSS once they reach a certain 'critical mass' of volume and liquidity, ATSS may face a powerful disincentive from growing too large, which would reduce their effectiveness

as a competitor for other market centers. . . . ATSS falling below the minimum threshold for the lowest tier would have reason not to want to cross that threshold, while ATSS in the lowest tier would likewise have reasons not to want to grow into the next tier, and so on."²³ In addition, the adverse effects on competition may be exacerbated by the imposition of substantially different regulatory requirements on competitors of essentially the same size simply because one has barely crossed the threshold.

In keeping with the Committee's reservations about the suggested use of volume thresholds, the Committee would recommend several changes to the volume tests to reduce possible adverse effects. These are set forth below.

1. Volume Percentages

The Committee encourages the Commission to reconsider its chosen percentage thresholds for applying additional regulation and to raise the percentages to more appropriate levels. Proposed Regulation ATS would impose order display, access and fee requirements on ATSS trading NMS securities which have a trading volume of 10% of the relevant market. The Committee believes that setting the volume level at 10% has the potential of capturing insignificant market players. Therefore, the Committee recommends increasing the percentage to 20%.²⁴

Similarly, the Commission asserts in the Proposal Release that an ATS with a trading volume greater than 20% of the relevant market in equity and debt securities is an important enough market participant that these ATSS must satisfy fair access, capacity, integrity and security requirements. The Commission proposes a 20% threshold for the imposition of fair access requirements because "[f]air treatment by alternative trading systems of potential and current subscribers is particularly important when an alternative trading system captures a large percentage of trading volume in a security, because viable alternatives to trading on such a system are limited."²⁵ Likewise, the Commission agrees that reaching the 20% threshold would also demand meeting capacity requirements. The Commission sees a system which reaches the 20% as a significant enough system that a system failure would have the potential to disrupt seriously the securities markets.²⁶ The Committee disagrees with the selected 20% threshold. The Committee believes that an ATS would not reach a significant market share, which would demand such investor protections, until it has captured 40% of the relevant market.

2. Calculating Volume Over a Period of Time

In proposed Regulation ATS, a system must reach the appropriate volume threshold during at least four of the preceding six months before the system is required to comply with certain additional regulatory requirements.²⁷ The Committee agrees with the Commission that any volume test must be calculated over a period of time to avoid the potential problem of capturing a smaller system which has experienced an isolated period of uncharacteristically large trading volume. Therefore, the Committee advocates the retention of such a requirement in any final rulemaking involving a volume test.

3. Calculating Equity Volume Security-by-Security

In the Proposal Release, the Commission explains that the additional requirements, like fair access and order display requirements, which are imposed at the 10% or 20% thresholds (or,

20% or 40%, as recommended by this Committee) on systems trading equity securities, would be applied on a security-by-security basis. For example, with respect to order display, an ATS would not have to display the best order for any securities in which its trade volume accounted for less than 10% of the total volume for such security.

The Committee believes that relying on a simple security-by-security test may capture inappropriately within the regulatory net systems which trade a significant amount of one security, where that particular trading is an extremely minor aspect of the system's overall trading activity and market impact. Therefore, in addition to raising the basic volume thresholds to 20% and 40%, the Committee recommends that the Commission institute an additional protection against unnecessarily imposing significant regulation on systems with minimal overall market share. The Committee suggests that the trading activity which causes an ATS to cross the percentage threshold also be 20% or more of the ATS's overall trading activity (e.g., all equity trading on the ATS).

Also with regard to the proposed security-by-security standard, the Committee suggests that, despite the clear statement of purpose in the Proposal Release, the rules which apply the security-by-security standard could be misinterpreted to mean that, if the ATS reaches the volume threshold in one security, all securities traded on the ATS must be displayed or subject to the order display, fair access or capacity requirements. Therefore, the Committee recommends that the Commission clarify that the increased regulatory requirements apply only to that security which crosses the percentage threshold. As a necessary corollary to its position, the Committee does not recommend that the Commission require an ATS to comply with the additional requirements for all securities it trades when it reaches the percentage threshold in one security.

E. Access

The Commission proposes to require ATSs which meet the stated volume threshold to establish standards for granting access to trading on its system. The Committee recommends that the Commission reiterate its commitment to allow ATSs to limit access to any category of its choosing, provided the designated criteria are not applied in a discriminatory fashion. In essence, the ATS should be permitted to select its standards, publish them and apply them as stated in a non-discriminatory manner. The Committee understands that the Commission would allow ATSs to continue limiting access to the class of participants with whom it currently does business. The Committee believes the Commission does not intend to impose an affirmative duty to deal on the ATSs by the imposition of its fair access requirement.

To further the fair access goal, the Commission also proposes to create a right to appeal an ATS's denial of access. The Committee respectfully suggests that there is neither a need for such a new right of action, nor a reason for the Commission to burden itself with the costs of administering and adjudicating proceedings that this approach would entail. As SIA's comment letter on the Concept Release pointed out:

[u]nreasonable denials already may give rise to a number of private liabilities in many situations (e.g., breach of contract, securities fraud claims or antitrust claims). If there is evidence that private liability exposure is proving insufficient to prevent unfair denials of access, the Commission could consider using its current regulatory authority over broker-dealers to require reporting of denials of access. Sunlight is

still the best disinfectant, and to the extent that unfair denials of access are a problem, mandated public disclosure of access denials would very likely lead to a market solution.²⁸

If the Commission decides to implement its proposed right of appeal, we recommend that the Commission ensure that the appellate process does not become a means to dictate with whom a proprietary system may contract. Instead, the Committee recommends that the available relief be limited to granting or denying access to the ATS in accordance with the ATS's published standards. The Committee believes that the allowable relief should not be so expansive as to allow the Commission to alter the ATS's published access standards. This limitation will protect the market participants from unfair denials of access while also protecting the ATS from unwarranted interference with its business decisions.

F. Exchanges and Facilitating Competition

As expressed in its earlier comment letter, the Committee is also concerned about reducing the competitive burdens on exchanges.²⁹ Under the current regulatory regime, an exchange's efforts to develop and implement new products is significantly hampered by the Commission's review process. The required rule filings alert competitors to an exchange's innovative actions and allows the competitor to appropriate the exchange's idea and launch the new product while the exchange waits for approval. The Commission recognized these disadvantages experienced by registered exchanges competing with ATSs in the Proposal Release and sought to address them by proposing the temporary exemption for pilot trading systems.³⁰ The Committee commends the Commission for addressing the competitive concerns in this focused manner. The Committee believes, however, that exchanges, otherwise, should be required to continue publishing rule filings for their products. In addition, exchange members should continue to be able to raise product-related concerns, especially if the concerns involve anti-competitive behavior. Likewise, the Committee believes the Commission should continue to ensure that SROs do not misuse their authority to disadvantage broker-dealers and their competing products.

IV. Conclusion

The Committee would like to reiterate its appreciation for the opportunity to comment upon the proposed rules. The Committee hopes that the comments and suggestions provided herein will assist the Commission in approaching any regulatory issues presented by ATSs. If the Committee can provide further information or assistance, please contact either of the undersigned, the Committee's staff adviser, George Kramer, at 202-296-9410, or the Committee's outside counsel, Brandon Becker and Cherie Macauley of Wilmer, Cutler & Pickering, at 202-663-6000.

Sincerely,

Lee B. Spencer, Jr.
Chairman, SIA Federal Regulation
Committee

Perry L. Taylor, Jr.
Chairman, SIA Alternative Trading System
Subcommittee

cc: The Honorable Arthur Levitt, Chairman
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
The Honorable Paul A. Carey, Commissioner
The Honorable Laura S. Unger, Commissioner
Harvey J. Goldschmid, General Counsel, Office of General Counsel
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Kevin Ehrlich, Special Counsel, Division of Market Regulation
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Appendix A

In addition to the Committee's recommendations set forth in the body of the letter, the Committee supplies the following responses to certain other specific questions posed by the Commission in the Proposal Release:

I. ATS Execution Access Fees

A. The Commission requested comment "on whether there are any reasons that alternative trading systems should be allowed to charge higher fees to non-participants than would be allowed under the proposed rule."³¹ To prevent fees from discouraging equal access, the proposed rule states that the highest fee an ATS would be permitted to charge non-subscribers would be the lesser of the fee charged by the ATS to a substantial portion of its existing broker-dealer subscribers or the fee permitted under the rules of the applicable national securities exchange.³² The Committee agrees with the Commission that ATSS charging non-subscribers access fees raises a variety of important procedural, structural and policy issues, many of which go beyond the present proposal. The Committee believes that these issues deserve separate public consideration, and recommends that the Commission make them the subject of a new release. By proceeding in this manner, both the Commission and commenters can give these issues more particularized attention, apart from the issues raised in this Release.

II. Form ATS

A. The Commission solicited comment on the notice requirements in proposed Form ATS.³³ Under proposed Regulation ATS, ATSS would be required to file an initial operation report with the Commission on Form ATS at least 20 days prior to commencing operation.³⁴ Similarly, an ATS must notify the Commission of material changes to its operation by filing an amendment to Form ATS at least 20 calendar days prior to implementing such changes.³⁵ Based on our members' experience with current Rule 17a-23, the Committee recommends that the proposed rule be changed to allow for the filing of the initial operation report and any subsequent material changes within 20 days after commencing operation or implementing such a change. The

Committee believes such a minor rule amendment would ease the regulatory burden of these filings since the time-lines for implementing any new systems or significant changes to systems are often uncertain from a business perspective. In addition, the recommended change would prevent the delayed start of any new, innovative system or aspect of a system on account of a regulatory filing. Therefore, requiring the filing within 20 days after the system change, rather than before, encourages innovation, without affecting Commission oversight, given that this is merely a notice filing.

B. For the purposes of amending Form ATS as a result of a material change to an ATS's operation, the Commission described a "material change" as including, among other things, any change to the operating platform of an ATS, to the types of securities traded on an ATS and to the types of subscribers to an ATS.³⁶ The Committee requests that the Commission provide more specific guidance as to what would constitute a material change.

C. The Commission also sought "comment on whether it would be appropriate to permit or to require electronic filing of Form ATS and all subsequent amendments."³⁷ The Committee strongly supports permitting the electronic filing of all aspects of Form ATS. Such flexibility in the use of current technology can only serve to lessen the regulatory burdens of Form ATS.

D. The proposed rules would keep confidential the initial operation report, any amendments, and the report filed when an alternative trading system ceases operation. The Committee agrees with the Commission's proposal that this information be kept confidential.³⁸

Footnotes:

¹ The Securities Industry Association brings together the shared interests of more than 770 securities firms throughout North America to accomplish common goals. SIA members -- including investment banks, broker-dealer and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the U.S., SIA members collectively account for approximately 90 percent, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. More information about SIA is available at our Internet web-site, <http://www.sia.com>.

² Securities Exchange Act Release No. 39884 (Apr. 17, 1998), 63 Fed. Reg. 23504 (Apr. 29, 1998) ("Proposal Release").

³ A roster of the Committee is attached as Appendix B. A similarly diverse group of SIA members took part in our response to the Commission's 1997 Concept Release. Securities Exchange Act Release No. 38672 (May 23, 1997), 62 Fed. Reg. 30485 (June 4, 1997) ("Concept Release").

⁴ In addition to the Committee's recommendations set forth in the body of the letter, Appendix A contains the Committee's responses to additional questions posed in the Proposal Release.

⁵ See *generally* Letter from SIA, to Jonathan G. Katz, re Concept Release (Oct 6, 1997).

⁶ The Commission makes a few allusions to possible abuses in its Proposal Release, but those several statements do not provide fair notice for us to comment or provide an adequate basis for regulation of this scope.

⁷ Proposal Release, 63 Fed. Reg. 23510.

⁸ Securities Exchange Act of 1934, §3(a)(1) (emphasis added).

⁹ Concept Release, 62 Fed. Reg. 30507, 30508.

¹⁰ By suggesting this clarifying requirement, we do not mean to suggest that brokerage activities are any more exchange-like than dealer activities. Indeed, as discussed further in Section III B. below, the Committee believes that it is critical that the exchange definition clearly excludes brokerage activities, such as internal order routing systems and other brokerage functions.

¹¹ Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 Fed. Reg. 1890 (Jan. 19, 1990) ("*Delta* Release").

¹² *Delta* Release, 55 Fed. Reg. 1900.

¹³ The term "order" as used in the exchange definition should not be so broad as to include negotiable prices, *i.e.*, quotes which are not firm. The Committee believes the Commission intended this result when it defined order because it stated in the release that AutEx does not "consolidate orders of multiple parties" because "AutEx does not require that the price and quantity quoted on the screen be firm." Proposal Release, 63 Fed. Reg. 23508, fn. 24. Therefore, to avoid any confusion, the Committee suggests that the Commission clarify that it did not intend to include negotiable prices in its definition of an exchange.

¹⁴ If the Commission decides against such a definition, the Committee would suggest that the Commission consider drafting a Preliminary Note to proposed Rule 3b-12 which incorporates the ideas suggested. See, *e.g.*, Rule 144A (containing a Preliminary Note to the rule). This would clarify that the Commission does not wish to include broker-dealer activities, automated or otherwise, in the definition of exchanges, nor does it wish to include systems which fail to provide a reasonable expectation that orders will be executed regularly at quoted prices.

¹⁵ In addition, the Committee strongly suggests that the Commission incorporate its explanatory comments in the Proposal Release about each of the Rule 3b-12(b) exclusions into a Preliminary Note to the rule. See *generally* Proposal Release, 63 Fed. Reg. 23509-23511.

¹⁶ SIA Letter (Oct. 6, 1997) at 11-12.

¹⁷ Proposed Rule 3b-12(b)(3).

¹⁸ In this regard, we believe that correspondent clearing relationships do not raise exchange registration concerns, nor do we believe agreements among and between broker-dealers to handle their respective order flow raise such concerns, even if such broker-dealers develop routing switches or filters to direct such order flow.

¹⁹ Proposal Release, 63 Fed. Reg. 23510.

²⁰ The Committee endorses the positions taken by The Bond Market Association, as set forth in the Association's comment letter on the ATS proposals, advocating the exclusion for all debt securities from the proposed regulation. See Letter from The Bond Market Association, to Jonathan G. Katz, re Proposal Release (July 28, 1998).

²¹ SIA Letter (Oct. 6, 1997) at 12.

²² Concept Release, 62 Fed. Reg. 30510, 30511.

²³ SIA Letter (Oct. 6, 1997) at 15.

²⁴ It would assist our understanding of these issues if the Commission would make public how it anticipates these volume standards apply to particular entities. Absent such disclosure, the commentators are at a disadvantage in providing a response to the proposals.

²⁵ Proposal Release, 63 Fed. Reg. 23519.

²⁶ Proposal Release, 63 Fed. Reg. 23520.

²⁷ Proposed Rule 301(b)(3), (5) & (6).

²⁸ SIA Letter (Oct. 6, 1997) at 10.

²⁹ SIA Letter (Oct. 6, 1997) at 9.

³⁰ Proposal Release, 63 Fed Reg. 23531-23534.

³¹ Proposal Release, 63 Fed. Reg. 23518.

³² Proposed Rule 301(b)(4).

³³ Proposal Release, 63 Fed. Reg. 23513.

³⁴ Proposed Rule 301(b)(2)(i) and proposed Form ATS.

³⁵ Proposed Rule 301(b)(2)(ii).

³⁶ Proposal Release, 63 Fed. Reg. 23514.

³⁷ *Id.*

³⁸ *Id.*

Appendix B

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