Legal Developments in the Electronic Securities Markets: Online Trading Systems and the Use of Websites for Offshore Internet Offers

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PART ONE
ONLINE TRADING SYSTEMS

I. Overview

A. Introduction

1. Impact on SEC. The implementation of new technology in the secondary markets presents the Securities and Exchange Commission ("SEC" or "Commission") with three challenges: a) to accommodate innovative applications of technology; b) to ensure investor confidence in the marketplace as it is transformed by the application of technology; and c) to minimize the disruption of existing markets.

2. Components of online trading systems. This outline uses the term "online trading system" to encompass a range of data communication systems that facilitate the secondary trading of securities. Viewed schematically, 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 ("Exchange Act") is an evolving issue and the subject of this outline.

B. Characterizing Online Trading Systems

1. Regulatory Categories. In fulfilling its investor protection and market oversight roles, the SEC traditionally has focused its efforts on the regulation of broker-dealers and organized markets. Online trading systems do not

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Footnotes:

1/ Part One of this outline summarizes and updates the material in Brandon Becker, David A. Westbrook, Soo J. Yim, Online Trading: Issuers, Broker-Dealers and SROs, in SECURITIES IN THE ELECTRONIC AGE: A PRACTICAL GUIDE, 3-1 (John F. Olson & Harvey Pitt, eds., 1998).

2/ Securities, of course, may be offered as well as traded online. Indeed, the same system may be used for both issuance and secondary trading. See, e.g., Niphix Investments Inc., SEC No-Action Letter, 1997 WL 209335 (Apr. 18, 1997).

completely fit into either category. Consequently, the SEC long has wrestled with the issue of whether the operation of various online trading systems constitutes a) broker-dealer activity, or b) operating an exchange, or c) some other regulated activity.

a. **Broker-Dealer Activity.** To date, the question of whether the sponsorship of a particular online trading system is broker-dealer activity generally has been answered in the affirmative. In most cases, it is a straightforward issue: whether a person is facilitating securities transactions for the account of others in return for transaction-based compensation. Many online trading systems are designed to facilitate just this business. Moreover, the vast majority of online trading systems have been sponsored by entities that already are registered broker-dealers, or are SROs composed of broker-dealers. The primary exception to such arrangements has been the sponsorship of issuer bulletin boards.

b. **Operating an Exchange.** The second and third questions, however, have been far more problematic.

i. **Delta Release.** Following a court case over the regulatory status or the Delta System, an online trading system for the trading of options contracts written on U.S. Treasury debt obligations, the SEC issued the Delta Release. The Commission examined a variety of characteristics of traditional exchanges, many of which the Delta System included. Ultimately, however, the Commission decided that "the central focus of the Commission's inquiry should be whether the system is designed . . . 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." In short, under the logic of the Delta Release, a reasonable expectation of regular executions at quoted prices is the key to exchange status.

The third question raised by online trading systems, i.e., whether the system should be characterized as some other type of regulated entities, such as a clearing agency or information processor, generally has been addressed in the context of determining whether or not exchange regulation is necessary.


Id. at 1900.
ii. **Concept Release.** In its Concept Release,\(^1\) however, the Commission suggested that it should "expand its current interpretation of 'exchange' to encompass many more trading systems than are currently considered 'exchanges.'\(^1\)\(^2\) The Commission noted that the narrow definition of exchange adopted in the Delta Release "effectively excluded most alternative trading systems from exchange regulation."\(^3\) Instead, the Commission proposed that an exchange should be defined as "any organization that both (1) consolidates orders of multiple parties and (2) provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of a trade."\(^4\)

3. **Functional Analysis.** The proliferation of online trading systems requires functional -- as opposed to institutional -- thinking about how securities regulation works. Approaching regulation of online trading systems from a functional perspective, this outline devotes considerable attention to the technical capabilities of various online trading systems. Operational information about online trading systems will be important in understanding the nature of communications made through the medium of online trading system. For many years, the SEC has regulated some, but not all, communications concerning the secondary trading of securities. Online trading systems are regulated only insofar as they facilitate such regulated communications. Accordingly, understanding regulatory obligations requires understanding the nature of communication carried by online trading systems.\(^5\)


\(^2\) See id. at 30505.

\(^3\) Id.

\(^4\) Id. at 30507. At the same time, however, as discussed below, the Concept Release also makes it clear that broadening the definition of exchange as suggested is likely to raise substantial market structure concerns.

\(^5\) We have some doubt about the durability of this approach. Contemporary regulation of online trading assumes that a given system will be regulated in one way or another because of functional limitations in the online trading system -- e.g., a system will not fulfill some link(s) in the transaccional chain. Such limitations have no technical basis. It seems unlikely to expect a business culture that is growing increasingly accustomed to (continued...).
II. Online Trading Systems Sponsored by Entities Not Registered Under the Exchange Act

A. Electronic Bulletin Boards

The most straightforward example of an online trading system is an electronic bulletin board, accessible via the Internet, used to communicate trading interest.

B. Issuer Bulletin Boards

So-called "issuer bulletin boards" allow stockholders to advertise interest in buying or selling securities of the issuer sponsoring the bulletin board. A number of issuers have received SEC confirmation that their proposed bulletin boards do not require the issuer to register as a broker-dealer, or the bulletin board to be registered as an exchange. Such bulletin boards generally facilitate trading of the sponsoring issuer's securities by providing information about prospective buyers and sellers. Actual transactions, however, are effected outside the system by interested parties who contact each other directly.

C. Internet Capital Corporation

The SEC granted no-action assurance to Internet Capital Corporation that establishment of its passive bulletin board would not subject Internet Capital to enforcement actions.

Internet Capital sought to charge registered but thinly-traded companies for posting information about themselves on the site. The bulletin board would allow parties, not affiliated with Internet Capital, to post messages regarding trading interest. Actual trades would be consummated off-site. Postings would not be deemed to be offers or firm quotes; two-sided quotes would be prohibited. Internet Capital successfully argued that it was not offering or trading securities, it was not acting as a broker, dealer, or investment adviser, and the site itself was not an exchange.

Internet Capital escapes the bifurcation between broker-dealer activity and the conduct of an exchange that has structured so much trading regulation.


III. Online Trading Systems Sponsored by Broker-Dealers

A. Overview

1. Terminology. The Commission has used a number of overlapping terms to refer to the various online trading systems sponsored by broker-dealers.

a. Proprietary Trading System ("PTS"). The term "PTS" has come to mean an online trading system sponsored by a broker-dealer that does not have to register as an exchange.

b. Broker-Dealer Trading System ("BDTS"). The term "BDTS" is defined by Exchange Act Rule 17a-23 (requiring reporting by broker-dealers who sponsor certain online trading systems) as any "facility that provides a mechanism, automated in full or in part, for: (i) collecting, receiving, or displaying system orders; and (ii) matching, crossing, or executing system orders, or otherwise facilitating agreement to the basic terms of a purchase or sale of a security between system participants, or between a system participant and the system sponsor, through use of the system or the system sponsor."\(^\text{14}\)

c. Electronic Communications Network ("ECN"). The term ECN is defined by Exchange Act Rule 11Ac1-1 ("Quote Rule") as "[a]ny electronic system that widely disseminates to third parties orders entered therein by an exchange market maker or [over-the-counter] market maker, and permits such orders to be executed against in whole or in part," with some exceptions. The term "ECN" does not include crossing systems or broker-dealer internal order routing systems.\(^\text{15}\)

d. Alternative Trading System. The term Alternative Trading System is used in the Commission's recent Concept Release "to refer generally to automated systems that centralize, display, match, cross, or otherwise execute trading interest, but that are not currently registered

\(^{14}\) See 17 C.F.R. § 240.17a-23.

\(^{15}\) These systems are not deemed ECNs because they do not communicate to multiple market participants the prices at which system subscribers are willing to trade. See Exchange Act Release No. 37619A (Sept. 6, 1996), 61 Fed. Reg. 48290, 48313 (September 12, 1996) ("Order Handling Release").
with the Commission as national securities exchanges or operated by a registered securities association.\textsuperscript{16}

2. Order Routing. Electronic order routing systems are most commonly used by institutional investors. Over the last few years, however, a number of broker-dealers have begun to offer electronic order routing services to retail investors. These systems generally have been viewed by the SEC as an extension of broker-dealer services, rather than as new electronic marketplaces that replicate an exchange marketplace, because they perform traditional brokerage activities (\textit{i.e.}, routing orders to a market of which the broker-dealer is a member for execution), thereby obviating the need to handle customer orders manually.\textsuperscript{17}

3. Schwab No-Action Letters. The discount broker Charles Schwab & Co., Inc. ("Schwab") sought to sponsor an online trading system that would include certain linkages with three well-established Internet service providers ("ISP").\textsuperscript{18} Schwab proposed to have the ISPs provide limited communication services (in particular order transmission) between investors and Schwab and sought no-action assurance from the Commission staff that this arrangement would not subject the ISPs to regulation as broker-dealers. In Schwab I, the Commission indicated it would not recommend enforcement action if Schwab paid the ISPs a nominal, flat, per order fee in return for the communication services. Schwab later sought to provide its customers, through Schwab's website, with data and research from Standard & Poor's and First Call Individual Investor Services (the "content providers").\textsuperscript{19} Schwab sought similar no-action assurance from the Commission staff that this arrangement would not subject the content providers to regulation as broker-dealers. In Schwab II, the Commission indicated it would not recommend enforcement action if Schwab paid the content providers the greater of a base monthly fee or a variable fee calculated by multiplying the number of active customer households times a nominal fixed-dollar amount. A customer household is viewed as active if it has engaged in at least one on-line securities trade in a

\textsuperscript{16} See Concept Release, 62 Fed. Reg. at 30487 n. 3.


\textsuperscript{19} Charles Schwab & Co., Inc., SEC No-Action Letter (July 17, 1997) ("Schwab II").
given month. The main point of concern in Schwab I and II was the fee arrangement, because transaction-based compensation is traditionally one of the factors assessed in requiring an entity to register as a broker-dealer. In granting no-action assurance, the Commission focused on the absence of significant contact between Schwab's customers and the ISPs and content providers.

4. **Automatic Execution.** Some electronic order routing systems sponsored by broker-dealers include automatic execution functions, usually for small orders. Typically, transactions are executed by the sponsoring broker-dealer against its own account on a principal basis, causing these systems to be viewed as broker-dealer activity. As recently described by the SEC, these types of automatic execution systems "merely provide a more efficient means of communicating the trading interest of separate customers to one dealer and thus would not be considered exchange activities."\(^{20}\)

5. **Blind Brokerage Systems.** Some online trading systems offer so-called "blind brokerage" services to participants in the government and municipal securities markets. Also known as inter-dealer brokers, these blind brokerage systems permit the sponsoring broker-dealer (commonly referred to as a "broker's broker") to receive indications of trading interest from other broker-dealers or institutional customers and re-broadcast such interest over its network.\(^{21}\) Until recently, the SEC has regarded these systems as distinct from the securities business conducted on exchanges or over-the-counter. In the Concept Release, however, the Commission suggests that, depending on the degree of automation and centralization, some blind brokerage or inter-dealer broker systems may be encompassed in the more functional understanding of the term "exchange."\(^{22}\) The Concept Release further suggests that even if these systems were characterized as exchanges, the Commission would exempt them from many of the regulatory burdens associated with that status.\(^{23}\)

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\(^{21}\) The Delta Government Options System also provides clearing and settlement services. See Delta Release, 55 Fed. Reg. at 1898.

\(^{22}\) See id. at 30511.
B. Broker-Dealer Trading Systems

1. Exchange Act Rule 17a-23. Rule 17a-23 imposes certain recordkeeping and reporting requirements on broker-dealers that sponsor a BDTS. The Rule is intended to help the Commission monitor and assess the effect of BDTSs on the secondary market; it does not address the issue whether a particular BDTS is required to register as an exchange. Through the Rule’s definitional terms, the SEC has sought to prevent any circumvention of the Rule’s requirements by those that seek to operate a BDTS without registering as a broker-dealer.

2. Recordkeeping Requirements. The sponsoring broker-dealer must maintain the following records: a) daily summaries of trading, including the number of "system orders," that provide the most accurate assessment of participant trading interest; b) identity of the parties using the system (including any affiliations between those participants and the sponsor; c) time-sequenced records of each transaction executed; and d) notices from the sponsor disseminated to users in general.

3. Reporting Requirements. The sponsoring broker-dealer must file Form 17A-23, which calls for the following information: a) operation reports describing the system and its procedures for reviewing capacity, security and contingency planning, which must be filed at least 20 days prior to initial operation or subsequent implementation of a material change; b) quarterly reports of summary trading information; and c) a final report after terminating the system.

4. Exemptions. The SEC has granted an exemption, pursuant to paragraph (i) of Rule 17a-23, to four major broker-dealers (Merrill Lynch, PaineWebber, Prudential Securities, and Smith Barney) in connection with operating certain automated order routing and inventory systems. The Commission took the position that, when operated together, these systems can

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comprise a BDTS as defined by Rule 17a-23. Nevertheless, because a trader must view each order prior to its execution, and because the order has opportunities for price improvement as does an order transmitted through more traditional means, the Commission determined that these particular systems do not significantly alter traditional trading functions or the manner of execution of trades, affect the market structure, or pose novel surveillance issues.

C. Proprietary Trading Systems

1. In General. Certain online trading systems that are currently subject to the BDTS recordkeeping and reporting requirements under Rule 17a-23 are also commonly referred to as PTSs. This sub-group of BDTSs link together third parties who may trade among one another, via the system, in an anonymous and confidential manner. PTSs collect indications of interest, quotations, or orders to purchase or sell securities, and also provide procedures for executing or settling transactions. Access is limited to subscribers of the system, who typically are required to be creditworthy market professionals such as institutional investors, broker-dealers, and specialists.22/

2. Nature of Regulation. The SEC has been confronted with the question of whether sponsorship of a PTS should be regulated as a broker-dealer activity, or whether the PTS should be deemed to constitute an exchange and be regulated accordingly. Under the most recent version of Rule 15c2-10 proposed by the SEC in 1989, certain "proprietary trading systems such as Instinet and POSIT" would not be considered exchanges because they were "not inter-dealer quotation or transaction mechanisms, in which participants enter two-sided quotations on a regular or continuous basis, thus ensuring a liquid market."23/ Although Rule 15c2-10 was not adopted, it remains influential, because it reflects the policy rationale behind the no-action letters issued by the Division of Market Regulation to the sponsors of PTSs for the last twenty years.24/


24/ Since the early 1980s, the Division of Market Regulation has issued over 20 letters to the sponsors of PTSs, assuring them that the staff would not recommend (continued...
3. PTSs in Use. Below are brief discussions of four PTSs currently in use: Instinet, Portfolio System for Institutional Trading ("POSIT"), the Arizona Stock Exchange ("AZX"), and the most recent addition, TradeWeb.

a. Instinet

i. Description. The real-time trading service operated by Instinet Corporation ("Instinet") provides an alternative to dealer-intermediated trades for both Nasdaq and exchange listed securities by permitting subscribers to enter buy and sell orders into a network of computer terminals. Limit orders of subscribers are maintained in the Instinet book, where potential buyers and sellers can find each other and either negotiate electronically in private or trade automatically against the best contra side order displayed throughout the system. Acting as agent, Instinet, a registered broker-dealer, executes matched orders on behalf of the buyer and the seller and then reports the security price and size of the transaction to both subscribers and to the clearing broker or bank. More trading volume now occurs on Instinet than on any organized U.S. stock market other than the NYSE and Nasdaq.

ii. Regulatory Status. In requesting no-action relief, the company contended that it essentially does what many broker-dealer firms do in the upstairs block market, except that Instinet performs these tasks electronically. Faced with the alternative of regulating Instinet as another SRO, the SEC concluded that


\[\text{The interactive nature of price setting on Instinet contrasts sharply with the passive pricing of systems, such as POSIT, in which orders are executed at predetermined prices.}

\[\text{[See Instinet Letter.}]\]

\[\text{[ See Order Handling Release, 62 Fed. Reg. at 48308.]}\]
Instinet could be regulated properly as a broker-dealer, subject to certain reporting requirements.26

b. POSIT

i. Description. POSIT is an electronic crossing system in which subscribers may buy and sell securities at a price derived from the primary market in which the security is traded.27 Although originally designed to accommodate portfolio trading, POSIT now also handles orders consisting of only a single stock. POSIT currently matches orders four times during the trading day. Investment Technology Group ("ITG"), a registered broker-dealer, executes orders matched by POSIT at the mid-point between the best bid quotation and the best ask quotation prevailing in the security's primary market at the predetermined time. Any "residual" unmatched portion of customer orders may be either canceled, retained for future crossing in POSIT, or sent to other markets such as the New York Stock Exchange.28

ii. Regulatory Status. In seeking a no-action position from the SEC, POSIT argued that it merely acts as a facility for efficient order routing. The Commission concluded that POSIT, whose sponsor is already regulated as a broker-dealer, need not register as a national exchange. As in the case of Instinet, the staff's response was conditional on POSIT's compliance with certain requirements to provide information to the SEC.29

26 More recently, however, the SEC has noted that "Instinet (and similar systems) provides to its customers ECN services that are significantly different from the services provided by other broker-dealers to their customers. Specifically, Instinet, without discretion, publicizes subscriber orders and enables other subscribers to trade with these orders at their stated price." See Order Handling Release, 61 Fed. Reg. at 48310 n.239.


28 See Market 2000 Study, Appendix IV.

29 See POSIT Letter.
c. **AZX**

i. **Description.** AZX is an electronic call market facility that brings together supply and demand for a security at a particular point in time and finds an equilibrium price. AZX currently operates two auctions a day, at 9:15 a.m. (EST) for all Nasdaq issues and at 5:00 p.m. (EST), after the close of normal trading hours, for both listed and over-the-counter stocks. A registered broker-dealer (formerly BT Brokerage Corporation, currently ITG) executes orders that are electronically matched by AZX at the auction price.

ii. **Regulatory Status.** Because the price at which orders are executed is set by the interaction of the buy and sell orders entered by AZX's participants (both broker-dealers and institutional investors), the Commission determined that AZX is an exchange under Section 3(a)(1) of the Exchange Act. Because of its limited volume, however, the Commission exempted AZX from the requirement to register as a national securities exchange, subject to a number of terms and conditions. To date, AZX is the only recent exchange to qualify for the limited volume exemption. In approving AZX's continuing operations on that basis, the Commission emphasized that AZX's exemption depends on having an average daily

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41 See AZX Release I.

42 Under Section 5 of the Exchange Act, the Commission has the authority to exempt any exchange with a limited volume of transactions from registration as a national securities exchange, provided that it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require registration. See 15 U.S.C. § 78e. 
volume less than the average daily volume of any of the fully regulated national securities exchanges.\textsuperscript{43\textsuperscript{i}}

d. TradeWeb

i. Description. TradeWeb allows its users, which consist of government securities dealers and the institutional and broker-dealer customers of those dealers, to simultaneously access information and request bids and offers concerning money market instruments, United States Treasury securities, other United States Government Securities, and repurchase agreements relating to these instruments.\textsuperscript{44\textsuperscript{i}} The system is accessible via dedicated telephone line or over the Internet. Customers must meet certain criteria and are only authorized to transact with and receive research information from dealers with whom they have a customer agreement. TradeWeb does not participate in the clearance or settlement of trades facilitated by its system.

ii. Regulatory Status. The Commission granted no-action relief to TradeWeb, concluding that TradeWeb, whose sponsor is regulated as a broker-dealer, need not register as a national exchange. As in the case of Instinet and POSIT, the staff’s response was conditional on TradeWeb’s compliance with certain requirements to provide information to the SEC.\textsuperscript{45\textsuperscript{i}}

D. Electronic Communications Networks (ECNs)

1. In General. All ECNs are BDTSs, as defined in Rule 17a-23. For example, Instinet, which is the most important ECN in terms of its size, continues to be regulated as a broker-dealer. As a particular type of BDTS, each ECN is designed to disseminate widely market maker trading interest and facilitate execution against such interest. In recently adopting the Order Handling Rules, the SEC recognized that, although ECNs are regulated as broker-dealers, “in providing a mechanism by which system subscribers can (1) broadcast prices to other system subscribers and (2) trade with one another

\textsuperscript{43\textsuperscript{i}} See AZX Release II, 61 Fed. Reg. at 29147 n.21 (stating that the Phlx is currently the lowest volume national securities exchange and finding that AZX’s average daily volume is “well below” that of the Phlx).

\textsuperscript{44\textsuperscript{i}} TradeWeb, LLC, SEC No-Action Letter, 1997 WL 65960 (Oct. 23, 1997) (“TradeWeb Letter”)

\textsuperscript{45\textsuperscript{i}} Id.
at those prices, these systems also function as securities markets. This statement suggests that while ECNs may not be required to register as exchanges under the existing framework governing the operation of PTSs, the SEC is concerned about any regulatory gaps created as a result.

2. Examples of ECNs. In the past year, several new ECNs have been launched to compete with Instinet in the secondary trading of Nasdaq securities. They include the Bloomberg Tradebook, Island, TONTO, and REDI. These ECNs operate in a manner similar to Instinet, providing their subscribers with the means for wide dissemination of their trading interest and execution against displayed interest on a "hit-or-take" basis. Trading on these systems accounts for about 20% of daily Nasdaq executions.

3. ECN Display Alternative. Under the Order Handling Rules, an ECN is permitted to submit, on behalf of participant market makers, the best bids and offers entered into the ECN by these participants to an SRO for inclusion into the public quotation stream ("ECN Display Alternative"). Specifically, the revised Quote Rule provides that the ECN Display Alternative will be deemed to satisfy the obligations of market makers to include all superior prices shown through an ECN in their quotes if the price entered into the ECN is provided by the ECN to an exchange or association for inclusion in the public quotation system and if the ECN provides access to non-subscriber

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47 See Concept Release, 62 Fed. Reg. at 30490 (discussing various inadequacies of the existing regulatory approach). Note that while all ECNs may be viewed as PTSs, there are PTSs, such as POSIT or AZX, which do not qualify as ECNs, because they do not widely disseminate priced orders entered by their subscribers and permit such orders to be executed through the system.
broker-dealers to trade at that price. Note that the ECN Display Alternative addresses trading conducted by market makers and specialists only, and not trading by institutional investors. Activity of these participants on ECNs is disclosed to the public market on a voluntary basis.

4. ECNs Satisfying Requirements of ECN Display Alternative. As of December 31, 1997, five online trading systems have received temporary no-action assurance from the SEC staff that, by virtue of their linkage to Nasdaq, they are in compliance with the ECN Display Alternative: Instinet, Island System, TONTO, Bloomberg Tradebook, and REDI. These ECNs differ in how they handle orders entered into the system by non-market makers. Instinet, for example, displays to the public only orders of market makers and those institutional customers that affirmatively choose to have their orders so displayed, while Island displays to the public the best prices of any orders entered into their systems (whether from market makers or institutional customers). All four ECNs, however, share various operational features. Each utilizes an electronic communication linkage with Nasdaq via the SelectNet system. In the SEC staff’s letters to these ECNs, they have all been reminded of their obligation to provide equal access to both subscribers that enter orders directly into the ECN and non-subscribers that enter orders through the SelectNet system.

SEC Rule 11Ac1-1(c)(5)(ii).


SelectNet is an online trading service offered by the NASD to its members that may be utilized to buy or sell purchase or sell Nasdaq-listed securities.

IV. Online Trading Systems Sponsored by Self-Regulatory Organizations

A. General

While the use of online systems to handle execution, market information and comparison services has improved substantially the efficiency of SRO markets, the SEC has been concerned about the vulnerability of these systems to operational problems during periods of extremely high volume, such as the October 1987 Market Break. Accordingly, in 1989, the SEC adopted an Automation Review Policy ("ARP") recommending that SROs should, on a voluntary basis, establish comprehensive planning and assessment programs to determine the capacity and vulnerability of online trading systems sponsored by the SRO.31

B. Exchanges

1. Primary Exchanges

   a. SuperDot. The NYSE operates an electronic order routing system initially called the Designated Order Turnaround System, now known as "SuperDot," which allows member firms and institutional investors to send orders to the trading floor via computers.32 SuperDot routes market and limit orders directly to the specialist post where each stock is traded, or to the member firm's booth on the trading floors. SuperDot also streamlines the post-trade reconciliation process. Once an order is executed, the trade is submitted to the comparison cycle on a locked-in basis, thereby reducing the manual processing costs associated with post-trade clearing and settlement.33 While SuperDot represents a significant step toward computerizing the exchange's order routing and delivery processes, it does not provide for automatic execution of orders. Once orders are delivered electronically via SuperDot to the trading floor, they still require manual action by the specialist at the point of trade.


33 See ARP Release I.

34 The Amex operates an electronic order routing system called Automated Post Execution Reporting System, or AutoPERs. See ARP Release I.
b. Regional Exchange Order Systems. The four regional exchanges each operate systems, similar to SuperDot, that route and also execute small-size retail customer orders.  

c. After-Hours Trading. The NYSE's Off-Hours Trading ("OHT") facility automates the execution of single stock orders and baskets of securities, based on prices derived from the exchange's closing price. The OHT facility operates through two trading sessions. "Crossing Session I," which executes single-stock, single-sided closing-price orders and crosses of single-stock, coupled closing-price buy and sell orders, and "Crossing Session II," which executes crosses of multiple-stock aggregate-price buy and sell orders. The NYSE's OHT facility currently generates only a limited amount of volume, well below that of POSIT.  

The Amex offers a similar after-hours automated trade execution service. In response to these after-hours trading systems, the regional exchanges have adopted programs that provide for executions of securities at prices that reflect after-hours trading activity on the NYSE and Amex.

d. Cincinnati Stock Exchange. The CSE is a fully automated exchange on which members effect transactions from computers located in their offices. CSE members enter agency or principal orders into the National Securities Trading System, which are stored, queued, and executed by the system according to price and time priorities.

e. Pacific Exchange ("PCX") OptiMark System. The SEC recently approved the PCX's OptiMark system. The system will allow PCX members and their customers to submit certain visual depictions of trading interest known as "Profiles" to the OptiMark

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61/ The BSE, CHX, Phlx, and PCX (commonly known as regional exchanges) operate, respectively, BEACON, MAX, PACE, and P/COAST. See ARP Release I.


System from their own computer terminals. At specified times throughout the trading day, the system will conduct trade optimization calculations against such expressions of interest in order to specify orders capable of execution. Unless routed to other markets as Intermarket Trading System commitments, the resulting orders will be executed on the PCX.

2. National Association of Securities Dealers

a. Nasdaq. The Nasdaq system consolidates the trading interest of market makers registered with the NASD and displays such interest in real-time to the NASD member subscribers on a computer screen. The system also permits market makers to update their displayed quotations. The Nasdaq system does not, however, provide for automatic execution of orders within the system itself. Transactions in the Nasdaq stock market typically are executed by calling a market maker and arranging the terms over the telephone.

b. SelectNet. SelectNet allows market makers and other order-entry firms to negotiate securities transactions in NASDAQ securities through computer communications rather than relying on the telephone. To enter an order in SelectNet, a participant directs the usual trade information (security symbol, transaction size, and price) to a particular market maker, or broadcasts it to others on an anonymous basis. By permitting participants to enter orders above or below the inside bid or ask, SelectNet provides an opportunity to negotiate electronically for a price superior to the current quote through an exchange of counter-offers until an agreement is reached. Once agreement is reached, the execution is "locked-in" and reported to the tape.

c. Small Order Execution System ("SOES"). The NASD sponsors an automated trade execution system for transactions of limited size in active Nasdaq securities called the Small Order Execution System ("SOES"). A qualifying SOES order is executed

61/ The system will provide automatic order formulation, matching and execution capabilities in the equity securities listed or traded on the PCX.


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against the account of a participating market maker at the Nasdaq inside price -- that is, the execution price of a buy order is set equal to the lowest offer price while a sell order's execution price is set equal to the highest bid price. Notification of each trade execution is sent immediately to both the order entry and market maker firm.

d. Proposed System

(i) In general. On March 12, 1998, the SEC published for comment a proposal by the NASD to build a new integrated order delivery and execution system ("System") for Nasdaq.\footnote{Exchange Act Rel. No. 39718 (Mar. 4, 1998), 63 Fed. Reg. 12124 (Mar. 12, 1998) ("Rule Filing").} As proposed, the System (which has no official name yet) would replace completely the two electronic trading mechanisms currently in place, SOES and SelectNet, and provide one integrated trading platform instead.

(ii) Double execution risk. Operating SOES and SelectNet side-by-side creates problems for market makers. Because a market maker is generally obligated to execute orders presented at its displayed quote under the firm quote rule, the market maker may be subject to double execution when faced simultaneously with automatic executions from SOES and delivery of orders from SelectNet. The proposed System seeks to reduce this exposure through an integrated trading platform.

(iii) Level playing field. The NASD is also concerned that ECNs may enjoy a competitive advantage over market makers, which are required to participate in SOES. Quotes of ECNs linked to SelectNet under the ECN Display Alternative are accessible through SelectNet only, and are not accessible through SOES. The System is intended to place all providers of liquidity in the Nasdaq market on the same footing for purposes of order execution.

(iv) Enhanced Access. In addition, the System would feature a voluntary limit order book ("Limit Order File") and
permit direct access by non-members under qualifying market makers' sponsorship.

(v) Comment. It seems inevitable that the Nasdaq systems evolve in order to meet the trading community's need to respond to the proliferation of electronic communications technology. In addition, regulatory experiences over the past few years, particularly implementation of the order handling and firm quote rules, have contributed to the impetus for change. While regulators and market participants seem to agree that the current operation of SelectNet and SOES is less than optimal, there is much room for disagreement as to what sort of changes are needed, and how fast. As of the date of this writing, comments are officially due May 5, 1998.

V. The Concept Release

A. Alternative Trading Systems

1. Inadequacies of the Current Regulatory Structure. The Commission's recent Concept Release examines, and solicits comments on, various areas in which current regulation is perceived to be inadequately. The Commission maintains that the regulation of ATSs as broker-dealers on an ad hoc basis has had unintended and deleterious effects on three fundamental policies. First, the broker-dealer regulatory scheme, at least as it currently exists, is not well suited to ATSs, and consequently secondary market activity conducted within ATSs is underregulated in some ways, and overregulated in others. Second, broker-dealers are themselves regulated by the SROs of which they are members. Competition among trading systems may be stifled.

One of the areas discussed in the Concept Release is the proposed regulation of U.S. investor participation in foreign securities markets, which falls outside the scope of this outline. We note in passing, however, that national regulation of activity conducted via the Internet is likely to be difficult, and perhaps impossible, without substantial international consensus.

by the interests of the SROs. Third, the proliferation of ATSs "has impeded
effective integration, surveillance, enforcement, and regulation of the U.S.
markets as a whole" -- that is, ATS activities under the existing regulatory
framework may undermine the Commission's effort to build a National Market
System. To address these concerns, the Concept Release invites comment on
two possible approaches to regulating alternative trading systems: expanding
the scope of broker-dealer regulation, or expanding the scope of exchange
regulation.

2. Broker-Dealer Regulation of ATSs ("Broker-Dealer Plus"). The
Concept Release suggests the possibility of extending broker-dealer regulation
to address the market, as opposed to brokerage, activities of ATSs. Under this
approach, these systems would continue to be regulated as broker-dealers.
The broker-dealer regulatory regime, however, would be modified to achieve
the goals of exchange regulation. The SEC is doubtful, however, about this
approach. Insofar as ATSs are proprietary systems, with customers rather
than members, it will be difficult to achieve the same levels of procedural
fairness and transparency that membership organizations can attain.
Moreover, ATSs may continue to be subject to brokerage regulation that is
costly but irrelevant to their business.

3. Regulation of ATSs as Exchanges ("Exchange Minus"). The
Concept Release also solicits views on expanding the definition of the term
"exchange" to include "any organization that both (1) consolidates orders of
multiple parties and (2) provides a facility through which, or sets material
conditions under which, participants entering such orders may agree to the
terms of a trade." Depending on the degree of centralization and automation
of their business, established broker-dealers, organized dealer markets,
information vendors and bulletin boards, and broker's brokers could all be
deemed exchanges. The Commission does not envision that all of these
entities would be regulated in the same way. It has suggested a "three-tiered"
approach based on the volume of trading and level of price discovery for some
systems (first and second tier) and a third tier for systems sponsored by
existing exchanges, or the NASD, with traditional SRO structures. The
Commission also recognized, however, that broadening the definition of

\[\text{Id.}\]
\[\text{Id. at 30497-30499.}\]
\[\text{Id. at 30507.}\]
"exchange" in order to regulate ATSs creates a host of conflicts between the business of ATSs and the requirements imposed on exchanges.  

B. Regulation of Online Trading Systems Sponsored by SROs

The Concept Release solicits comment on how regulatory requirements for SROs might be expedited or reduced to allow greater flexibility for innovation. It also asks for suggestions on how to reduce the costs associated with SRO surveillance and enforcement by permitting certain allocations of oversight obligations among the registered exchanges and any newly created automated exchanges.

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25 Id. at 30511-30516.

26 Id. at 30516.