What Is An "Exchange? "-Proprietary Electronic Securities Trading Systems And The Statutory Definition Of An Exchange

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ARTICLES

WHAT IS AN "EXCHANGE?"—PROPRIETARY ELECTRONIC SECURITIES TRADING SYSTEMS AND THE STATUTORY DEFINITION OF AN EXCHANGE

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I. INTRODUCTION

As we celebrate the 200th anniversary of the Buttonwillow Agreement of 1792, which established the original New York Stock Exchange among a group of securities dealers in Manhattan,[1] even a casual Wall Street observer will attest that the trading markets of today are in a state of almost constant change.[2] The rate of change, although slow at first,[3] has accelerated dramatically over the past decade[4] or so, and now threatens to overtake the regulators' ability to monitor and regulate the markets in the best interests of the investing public.[5] Although the pace of change has quickened, the effectiveness and efficiency of the secondary trading markets still depend on a fairly straightforward proposition generally referred to as

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1. *See* WALTER WERNER & STEVEN T. SMITH, WALL STREET 20-26 (1991); Robert Steiner, *The Big Board's Bicentennial: 200 Years Later, Small Investors Find Clout at America's Premier Exchange*, WALL ST. J., May 13, 1992, at C1; Victor F. Zonana, *Big Board Blues: Many Analysts Question the NYSE's Future as the World's Largest Exchange Turns 200*, L.A. TIMES, Feb. 9, 1992, at D1.

2. George Anders & Craig Torres, *Computers Bypass Wall Street Middlemen & Stir Controversy*, WALL ST. J., Aug. 28, 1991, at A1; Anne Newman, *Global Trading Via NASDAQ System to Start January 20*, WALL ST. J., Jan. 10, 1992, at C1; William Power, *Regional Exchanges Consider a New Option: Merging*, WALL ST. J., Feb. 8, 1991, at C1; William Power & Sandra Block, *AMEX's New Home for "Start-Ups" Wins SEC's Nod*, WALL ST. J., Mar. 6, 1992, at C1 (describing AMEX's development of so-called Emerging Company Marketplace, lower tier of AMEX that will list securities of smaller, start-up companies); Craig Torres, *Big Board Plans to Start Trades an Hour Earlier*, WALL ST. J., July 5, 1991, at C1.

3. *See infra* notes 151-84 and accompanying text.

4. *See infra* notes 185-204 and accompanying text.

5. *See, e.g.*, Anders & Torres, *supra* note 2, at A1; Kenneth H. Bacon & Kevin G. Salwen, *Summer of Financial Scandals Raises Questions About the Ability of Regulators to Police Markets*, WALL ST. J., Aug. 28, 1991, at A10; Jonathon R. Macey, *The SEC Dinosaur Expands its Turf*, WALL ST. J., Jan. 29, 1992, at A12.

the auction market trading principle.[6] Auction trading of securities is accomplished through the centralization of buying and selling interest into one location. Historically, the exchange floor has provided such a physically central location; no matter where the trading order originated, the order would be transmitted to an exchange, such as the floor of the New York Stock Exchange, where it would be executed, usually at the specialist's post on the floor.[7] Thus, the principle of auction trading lies at the heart of the analysis of what is an exchange as defined in section 3(a)(1)[8] of the Securities Exchange Act of 1934 (1934 Act).[9] Section 3(a)(1) essentially provides that an exchange is any organization that provides a market place for bringing together purchasers and sellers of securities.

Section 5 of the 1934 Act requires all trading systems satisfying the section 3(a)(1) definition of an "exchange" to register with the Securities Exchange Commission (SEC) unless an exemption is available.[10] The requirements that must be satisfied in order for an application for exchange registration to be granted by the SEC are set forth in section 6 of the 1934 Act.[11] These requirements generally reflect the statute's overall objective of assuring adequate protection to the investing public as well as the interests of securities professionals participating in auction trading on the exchanges.[12]

Until quite recently, the section 3(a)(1) definition has been a largely uncontroversial, perhaps even neglected, provision. During the fifty years following adoption of this definition the SEC was asked only occasionally to decide whether a particular trading system must register as an "exchange" under section 3(a)(1); consequently, there is but a meager body of precedent. However, the dawn of the computer age led enterprising market entrepre-

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6. *See* Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883, 889 (1981) (stating that "[t]he markets maintained by the stock exchanges are known as 'auction' markets because buy and sell orders are executed at a central location at the best available price."); Joel Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79, 83 (1984) (stating that "[t]he hallmark of a securities exchange is centralization of trading on an exchange floor"); *see also infra* notes 33-81 and accompanying text (discussing mechanics of executing trade on exchange floor).

7. *See infra* notes 33-81 and accompanying text (discussing mechanics of executing trade on exchange floor). The auction trading principle describes the manner of trading on all of the exchanges registered today with the SEC, including the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX). *See* Craig Torres & William Power, *Sliding Market: Big Board Is Losing Some of Its Influence Over Stock Trading*, WALL ST. J., Apr. 17, 1990, at A1.

8. 15 U.S.C. § 78c(a)(1) (1988). The statutory definition of exchange is:

> any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood.

9. 15 U.S.C. §§ 78a-78kk (1988 & Supp. I 1989 & Supp. II 1990).

10. 15 U.S.C. § 78e (1988).

11. 15 U.S.C. § 78f (1988).

12. *See infra* notes 101-09 and accompanying text.

neurs to adopt this new technology to create automated trading systems. This article demonstrates that the auction trading principle has now been extended to create new proprietary trading systems[13] (PTSs) that do not physically resemble the traditional floor trading of exchanges. Nonetheless, these new PTSs are exchanges within the meaning of section 3(a)(1) because they provide "a market place or facilities for bringing together purchasers or sellers of securities."[14] As such, these new electronic systems for trading securities must be registered as exchanges under section 3(a)(1).

Over the past decade, the SEC has issued several no action letters[15] excusing these new trading systems from the obligation to register as an exchange without squarely confronting the issue of whether the new PTS *is* an exchange within the meaning of the statute. This line of SEC no action rulings culminated in a 1989 decision of the United States Court of Appeals for the Seventh Circuit, *Board of Trade v. SEC* (*Delta I*), which remanded

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13. "Cheap microchips and electronic breakthroughs are undermining traditional ways of trading stocks, bonds and foreign currencies. Major banks, securities firms and money managers are creating vast private networks that put powerful investors in direct electronic contact with one another." Anders & Torres, *supra* note 2, at A1. These computerized trading systems are generically referred to as "PTSs." The SEC has described the term proprietary trading system to refer to a computerized trading system that disseminates indications of interest, quotations, or orders to purchase or sell securities and provides procedures for executing or settling transactions in such securities. *See* Exchange Act Release No. 34-26708, 54 Fed. Reg. 15,429 (1989) (soliciting comment on text of proposed Rule 15c2-10).

14. 15 U.S.C. § 78c(a)(1) (1988).

15. A longstanding practice of the staff of the SEC has been to issue "no action letters," which generally refers to the SEC staff's responses to private requests for a staff determination that a proposed transaction or course of conduct is in compliance with the relevant statutory provisions and rules of the federal securities laws administered by the SEC. This process has been described as follows:

> Since the SEC's creation, its staff has been willing to respond to individual inquiries regarding the staff's interpretation of the federal securities laws' application to a specific transaction. The staff's responses to such inquiries are known as no-action letters, because the key expression in a favorable response to an inquiry states that the staff "will recommend no action to the Commission" if the transaction is carried out as stated in the letter. The no-action letter process is an informal process by which the staff involved with the day-to-day responsibility of administering that provision of the law expresses its opinion and position. It does not represent the official view of the Commission. 17 C.F.R. § 202.1(d). . . . [Thus, the SEC] will not challenge that transaction as a violation of the law if the transaction is completed as represented in the no-action letter request, Securities Act Release No. 4553 (Nov. 6, 1962), [however,] a no-action letter is not binding on private parties, who can challenge the transaction. Also, the predictive value of relying upon a no-action letter obtained by another is seriously weakened by the power of the Commission or its staff to reconsider the position it took in the earlier no-action letter.

JAMES D. COX ET AL., SECURITIES REGULATION: CASES & MATERIALS 23 (1991). The SEC's no action letter process has been the subject of frequent criticism. *See* Louis Loss, *Summary Remarks*, 30 BUS. LAW. 163, 164-65 (Special Issue 1975); *see generally* Lewis D. Lowenfels, *SEC No Action Letters: Conflicts with the Existing Statutes, Cases & Commission Releases*, 59 VA. L. REV. 303 (1973); Harvey L. Pitt & Dixie L. Johnson, *Eviscerating the SEC No-Action Process?*, 5 INSIGHTS 2 (May 1991).

a case involving a new trading system, the Delta Trading System, to the SEC to decide whether this new PTS was an "exchange" within the meaning of section 3(a)(1).[16] On remand, the SEC determined that the automated trading system was *not* an exchange,[17] and the Seventh Circuit upheld the SEC's decision in *Board of Trade v. SEC (Delta II)*,[18] showing extreme deference to the agency's determination.

The Seventh Circuit's decision in *Delta II* is fundamentally flawed in its understanding and application of the relevant express provisions of the 1934 Act, particularly the section 3(a)(1) definition of an exchange. At the outset, deference to the SEC on this basic policy issue is unwarranted. The SEC's authority does not extend beyond the language of the statute;[19] accordingly, the statutory definition must apply here.[20] If the courts permit the SEC to ignore the literal language of the statute, what will limit SEC discretion in future cases? Either the SEC or the courts will have to invent, or in other words *imply*, any such limitations. The Seventh Circuit's unwarranted deference to the SEC's administrative discretion, in complete disregard of the statutory language, will leave courts helpless to limit the SEC's discretion in future cases involving proprietary trading systems.

An even larger policy context also suggests that *Delta II* was wrongly decided because the Seventh Circuit failed to appreciate the benefits of centralized trading inherent in the auction market principle that underlies our nation's securities trading markets[21] and which is reflected in the

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16. 883 F.2d 525 (7th Cir. 1989).

17. Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 34-27611, 55 Fed. Reg. 1890 (1990).

18. 923 F.2d 1270 (7th Cir. 1991).

19. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-14 (1976); Business Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990); *see also* Board of Trade v. SEC, 923 F.2d 1270, 1273 (7th Cir. 1991) (recognizing fundamental precept that SEC's authority does not extend beyond language of statute).

20. As an example, the Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1986), held that the language of the statute controls and therefore the scope of any rule adopted by the SEC pursuant to the statute cannot exceed the power granted the SEC by Congress under the relevant statutory provision. *Hochfelder*, 425 U.S. at 214. This principle of statutory interpretation was acknowledged by the majority in *Delta II*, but was not felt to be controlling in that case. In *Delta II*, the court stated that if the statute were unambiguous, the [Commission] would have to bow . . . [the SEC] has not been given the power of statutory revision. But in this case there is enough play in the statutory joints that [the SEC's] decision must affirmed. *Board of Trade*, 923 F.2d at 1273. The *Delta II* dissent strenuously disagreed with this view of statute stating:

> The [Commission] has wide discretion to interpret the securities laws. But it is not free to disregard an unambiguous provision, and Congress was crystal clear that an organization "bringing together purchasers and sellers of securities" constitutes an exchange. Until Congress concludes that its definition of exchange is antiquated and superfluous, I am not prepared to disregard it.

Id. at 1277.

21. *See* Jonathan Macey & Hideki Kanda, *The Stock Exchange As a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1008 n.5 (1990). The concept of centralized trading is expressed in the section 3(a)(1)

statutory definition of "exchange." Before we abandon the auction trading principle as the core of the statutory definition, Congress should, at a minimum, conduct a thorough study of the trading markets to determine if the current definition of "exchange" is outdated.[22] If there are factors which should be evaluated in deciding whether a new PTS is an exchange, then section 3(a)(1) should be amended following full public review, debate and congressional balancing of the competing policy considerations. Amending the statute is preferable to relying on free-wheeling administrative decisionmaking by the SEC.[23]

"exchange" definition as a "market place for buyers and sellers of securities" to meet. As discussed more fully in section II of this article, electronic trading systems automate but do not displace this essential function of an exchange; nothing in the statutory definition suggests or implies that there must be a *physical* location for centralized trading. *See infra* notes 82-90 and accompanying text.

22. The question of what should be the modern definition of an exchange lies outside the scope of this article. Any such discussion requires a detailed examination of several potentially competing considerations such as the economic underpinnings of the exchanges, the growing institutionalization of secondary market traders and their impact on traditional areas of concern such as market liquidity and depth, as well as the implications of both the trend towards global trading and the growing internationalization of the securities markets. *See, e.g.*, Louis Lowenstein, *The Changing Role of the Stock Market in the United States*, 43 RUTGERS L. REV. 595 (1991); Macey & Kanda, *supra* note 21, at 1007-10. The importance of a well functioning secondary market for trading securities is and has been widely acknowledged. *See, e.g.*, Macey & Kanda, *supra* note 21, at 1007; SECURITIES EXCHANGE COMMISSION, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess. 10-11 (1963) [hereinafter SPECIAL STUDY]. This article, however, recommends that Congress undertake an in-depth, comprehensive study of the existing securities markets that will include a broad range of participation and input from all affected constituencies. Such a study has been suggested by others and its need has even been recognized by Congress:

> The number of remarkable changes and developments which have taken place during this period of time [the last 4 or 5 years] places stress on a regulatory system adopted over 50 years ago. This stress has caused such concern that Congress in ITSFEA [Insider Trading Securities Fraud Enforcement Act] directed the Commission to conduct a new special study to examine existing securities markets and determine what changes are needed to enable the regulatory system to deal effectively with existing conditions. This study is yet to be funded by Congress but such a study would be a valuable asset as one faces the pressures which are expected to be placed upon our regulatory system by the complex financial and securities markets of the 1990s.

James H. Cheek, III, *Securities Regulation System Faces Critical Issues*, BUS. LAW UPDATE 5 (July/Aug. 1991). Section 7 of the Insider Trading Securities Fraud Enforcement Act of 1988 sets forth Congress' concerns leading it to commission a comprehensive study of the securities markets, including an analysis of "impediments to the fairness and orderliness of the securities markets and to improvements in the breadth and depth of the capital available to the securities markets, and additional methods to promote those objectives." Insider Trading Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, 4682 (codified at 15 U.S.C. § 78(b) (1988 & Supp. II 1990)). The SEC has recently announced its intention to commence a comprehensive study of the structure of U.S. trading markets and to analyze the challenges posed for the trading markets as we approach the 21st century. *See Release on Securities Market Study Expected Within 3 Mos., SEC's Heyman Says*, Sec. Reg. & L. Rep. (BNA) No. 24, at 302-03 (Mar. 6, 1992).

23. To the extent that the existing statutory formulation of the exchange definition has

Section II of this article provides a brief description of the securities trading markets as necessary background to a full understanding of Congress' definition of exchange. The text of the section 3(a)(1) definition is examined in the remainder of Section II, including a discussion of the impact of Congress' enactment of the landmark 1975 legislation establishing a National Market System (NMS).[24] Section III discusses the limited body of SEC no action letters that have interpreted and applied the section 3(a)(1) definition of "exchange." Section IV describes the *Delta* litigation that led the case to visit the Seventh Circuit twice, including a description of the no action letters issued by the SEC in that matter. The bulk of Section IV is devoted to a critical examination of the Seventh Circuit's decision in *Delta II* and its implications. The article concludes in section V by recommending that Congress mandate an in-depth study of the structure of the securities trading markets and determine what changes, including proposals for legislation, are necessary to enable the SEC (or some other administrative agency) to regulate the secondary securities trading markets effectively, now and into the twenty-first century.

Because the auction trading principle reflected in the current exchange definition has continuing vitality, it should not be lightly dismissed as the continuing focus of the statutory definition of exchange.[25] Therefore, any amendment to the statutory definition should reflect Congress' ordering of

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been rendered obsolete by the technological advancements of the intervening fifty-five years, the definition may well need retooling so as not to stifle innovation in the market place for trading securities. Any such changes, however, must originate with Congress. But, with respect to the development of PTSs, the trend has been to rely on administrative action—or inaction, as the case may be. This article maintains that continued reliance on administrative development of the definition of an exchange, through the ad hoc approach of the no action letter process, is not supported by the language of the statute nor in the best interests of the investing public from a policy perspective. Rather, the SEC should be required to apply and enforce the statutory definition of the term "exchange" as written by Congress—unless and until Congress takes action to modify this definition.

24. Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified at 15 U.S.C. § 78k-1(a) (1988)) [hereinafter referred to as the "1975 Amendments" or the "NMS legislation"]. Congress enacted this legislation to foster the establishment of a national market system (NMS) for the trading of securities "by linking existing market centers through communication and data processing facilities. The purpose of this linkage is to insure that all buying and selling interest in the subject securities can participate and be represented in a competitive market system." David A. Lipton, *Best Execution: The National Market System's Missing Ingredient*, 57 NOTRE DAME LAW. 449, 449 n.1 (1982). *See infra* notes 110-54 and accompanying text (discussing NMS legislation and developments that led to its passage by Congress).

25. Alternatively, further study of the structure of the markets may well indicate that the better approach is to continue to rely on the auction trading principle to define the section 3(a)(1) concept of an "exchange," but to expand the SEC's authority to grant exemptions from the burdens of the section 6 registration obligation. *See infra* note 103 and accompanying text (discussing scope of existing exemption authority delegated to SEC). Perhaps many of the policy concerns that led the SEC to conclude that the Delta Trading System and other PTSs were not exchanges can be adequately addressed through exemptions properly framed by Congress.

policy priorities, as opposed to the clear abdication of any such limitations on the delegated authority of the SEC that arises from the Seventh Circuit decision in *Delta II*. In this way, a clear congressional mandate can be provided to the SEC, following an open and vigorous debate culminating in congressional identification of, and guidance on, the appropriate balancing of the conflicting interests inherently involved in making any such statutory change in the definition of "exchange."[26] Through legislative action, the express language of the statute will continue to act as a meaningful limitation on the scope of the SEC's regulatory authority.[27]

II. Section 3(a)(1): The Statutory Definition of "Exchange"

At the time Congress adopted the 1934 Act and continuing until today, an investor could trade securities in one of two types of trading markets: the exchange market or the over-the-counter (OTC) market. This section describes these two types of markets, the differences between them, and the manner in which they trade securities. With this background established, the article then examines the section 3(a)(1) definition of exchange. This discussion demonstrates that the core of the statutory definition reflects the auction trading principle; in addition, the definition recognizes that auction trading may be performed in a fashion that is physically different than the trading markets of 1934. Accordingly, Congress gave the definition sufficient elasticity so as to embrace any organization—no matter what its structure—that "provides a market place for buyers and sellers of securities."[28] Finally, this section will show that nothing in the subsequent amendments to the 1934 Act undermines this understanding of the section 3(a)(1) definition. Indeed, the landmark 1975 legislation wherein Congress adopted the SEC's proposal for a National Market System, if anything, strengthened the auction trading principle.

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26. As an example, the proposed study should examine the competing interests presented by the development of innovative new trading strategies by the PTSs which seek to avoid the burdens of exchange registration versus the desire of the established, registered exchanges to compete by developing their own new computerized trading strategies but without incurring the continued costs of seeking and maintaining § 6 exchange registration for any such new system. These competing interests were in clear conflict in the litigation over the Delta Trading System. See Board of Trade v. SEC, 883 F.2d 525, 532-33 (7th Cir. 1989), wherein the Seventh Circuit describes the interests of the registered exchanges versus the "underdog" interests of the sponsors of new PTS's who often present a challenge to the vested interests of these registered exchanges.

27. There is currently considerable controversy over whether Congress can rise to the occasion and put aside the politics of constituency interests to forge this kind of overall national policy strategy. *See, e.g.*, Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 Wash. & Lee L. Rev. 527 (1990); Jonathan R. Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 Emory L.J. 1 (1984). However, if Congress does not do this, then who will? The unelected, unaccountable appointees of "independent agencies," such as the SEC? Further discussion of this concern, however, lies outside the scope of this article.

28. 15 U.S.C. § 78c(a)(1) (1988).

A. *Overview of the Trading Markets*

The term "securities markets" embraces both: (i) the distribution market which allows business enterprises to raise capital through the initial sale of their securities to the public, typically through syndicates of underwriters and dealers; and (ii) the secondary markets or trading markets, which provide a market place for the purchase and sale of these securities after they have been issued.[29] The economic function of the trading markets is to create liquidity, generally defined to mean that transactions in shares are immediately available,[30] permitting the execution of customers' orders to buy or sell securities at a price reasonably related to the price of the preceding transaction.[31] The distribution market depends on the efficient functioning of the secondary trading markets where prospective purchasers will buy new issues of securities only if they have a reasonable assurance of liquidity.[32]

1. The Stock Exchange Markets

A stock exchange provides a physical place (generally referred to as the "floor") and organized rules and procedures reflected in the exchanges' governing document for buying and selling securities that have been admitted to trading on the exchange (generally referred to as "listed" or "exchange-traded" securities).[33] Only exchange members[34] may trade on the exchange

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29. *See* HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK 31-35 (1991-92 ed.); SPECIAL STUDY, *supra* note 22, at 9.

30. *See* James L. Hamilton, *Market Place Organization and Marketability: NASDAQ, the Stock Exchange and the National Market System*, 33 J. FIN. 487 n.1 (May 1978) (stating that marketability of stock issue means that transactions of its shares are immediately available).

31. *See* ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 417 (1989); Poser, *supra* note 6, at 886.

32. *See* Poser, *supra* note 6, at 886; SPECIAL STUDY, *supra* note 22, at 9-10.

33. The traditional organizational structure of the stock exchanges has been described as follows:

> A stock exchange provides a place and organized rules and procedures for buying and selling securities that have been admitted to trading. . . . There is no bar to a company's listing its securities on more than one stock exchange. For a class of a company's securities to be listed on a given exchange, the company must apply and be accepted for listing. To be accepted, the company and the securities must meet the exchange's listing standards, which typically relate to matters such as share distribution, amount of assets, and history of earnings. Stock exchange rules governing listing standards, like other exchange rules, are subject to approval by the SEC.
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> The securities of a company may also be traded on a stock exchange even though the company has not applied to the stock exchange for a listing and actually opposes being listed. This occurs when a stock exchange on its own initiative admits the company's securities to "unlisted" trading. Since 1934, the granting of such "unlisted trading privileges" has been subject to the approval of the SEC, which has broad discretion as to whether or not to grant applications. [*See* § 12(f)(2) of the 1934 Act, 15 U.S.C. § 78*l*(f)(2) (1988).] For many years, the Commission's policy has

floor, acting either as a principal and trading for their own accounts or acting as an agent and executing their customers' orders.

The general premise underlying the organization of the exchange markets is referred to as the auction market principle: The floor of the exchange provides a central location for buy and sell orders to meet and to be executed at the best available price.[35] Since access to the exchange floor is restricted to members only, an investor who wants to buy or sell an exchange-listed security generally will give her "order to an exchange member who, acting as a broker (*i.e.*, agent), executes the order on the floor of the exchange and receives a commission as compensation."[36] The public agency orders delivered over to exchange members for execution on the exchange floor generally are either market orders, which require the brokers to execute the orders promptly at the best available price,[37] or limit orders, which require the brokers to buy at or below the stated (limit) price in the case of a buy limit order, or alternatively, to sell at or above the stated (limit) price in the case of a sell limit order.[38]

Within the exchange membership, specialist firms (or "specialists") play a unique role in the auction trading of securities. When a security is listed

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> been to grant applications by stock exchanges for unlisted trading privileges freely if the class of securities is already listed on another exchange. This SEC policy has made it possible for many securities to be traded on more than one stock exchange (*i.e.*, to be "dually traded").

Poser, *supra* note 6, at 888-89.

34. "Since each stock exchange has a limited number of members, [*see* § 6(c)(4) of the 1934 Act, 15 U.S.C. § 78f(c)(4) (1988)] a stock exchange membership or 'seat,' has a value, and there is a market for exchange seats." *See* Poser, *supra* note 6, at 888. The cost of a seat on the NYSE is often viewed as an indicator of the health of Wall Street. After a three-year slump in prices, a membership seat on the NYSE recently sold for $600,000, a significant increase over the $475,000 sale price in December, 1991 and the $301,000 sale price in August, 1990, although far short of the record $1.15 million price paid during the peak of the mid-1987 bull market. *See* Daniel Kadlec, *Market for Cheap Seats*, USA TODAY, Sept. 4, 1990, at A1; Craig Torres, *Why is the Price of a Big Board Seat So Low?*, WALL ST. J., Dec. 4, 1991, at C2; Michael Siconolfi & William Power, *Big Stock Exchanges' Seats Fetch Higher Prices as Trading Expands*, WALL ST. J., Feb. 6, 1992, at C1.

35. *See* Poser, *supra* note 6, at 889 (stating that "[t]he markets maintained by the stock exchanges are known as 'auction' markets because buy and sell orders are executed at a central location at the best available price").

36. *See id.*

37. This obligation is often referred to as the broker's duty to obtain "best execution." *See* Lipton, *supra* note 24, at 450 n.2 (stating that "[t]he term 'best execution' refers to a broker's fiduciary duty to seek the most favorable terms when executing his client's order. In determining which execution is most favorable to his client, a broker may consider many factors. Price is the primary factor, however, . . ."). Congress' enactment of the NMS legislation does not undermine this understanding of the broker's obligation to her customer; if anything, the NMS legislation was intended to improve the standards required for a broker-dealer to satisfy this duty. *Id.* at 449-53. See *infra* notes 146-50 and accompanying text for further discussion of the impact of NMS legislation on a broker's best execution responsibility.

38. *See* Poser, *supra* note 6, at 889; Nicholas Wolfson et al., *The Securities Markets: An Overview*, 16 HOWARD L.J. 791, 814 n.98 (1971).

for trading, the exchange allocates it to a particular specialist. During trading hours, the specialist remains at a fixed location on the trading floor (post). Exchange members who wish to trade in that security will go to the post of the specialist and all trading in that security takes place at the specialist's post. Thus, brokers who meet in the trading crowd at the specialist's post may execute their customers' market orders without the intervention of a specialist.[39] In this fashion, the centralization of trading activity at the specialist's post on the exchange floor facilitates the auction process of the exchange market. At times, however, there may be an imbalance between supply and demand in that a customer cannot be found for the other side of a transaction. In such situations involving temporary imbalances, the specialist is required under the rules of the exchange to take up the other side of the trade.[40] When the specialist takes up the other side of the trade, the specialist firm acts in a dealer[41] capacity, using its own capital to make bids to buy stock (the published "bid" price) and to make offers to sell stock (the published "ask" price).[42]

The specialist on the exchange floor is also obligated to act at various times in a broker[43] capacity. A broker who takes a customer's limit order will deposit it with the specialist in that stock, who will hold it for future

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39. *See* Poser, *supra* note 6, at 889-90. Stated differently, in the case of market orders in listed securities that are routed to the exchange floor for execution, it has always been possible for the agency orders of a buying customer and a selling customer, each represented by an exchange member, to meet on the floor of the exchange and a trade to be executed without the intervention of the specialist acting as a professional dealer. *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2508-09 (3d ed. 1989) [hereinafter LOSS & SELIGMAN].

40. *See, e.g.*, 2 N.Y.S.E. Guide (CCH) ¶ 2104 (rule 104.10(2)-(3)) [hereinafter N.Y.S.E. Guide]; *see generally* 17 C.F.R. § 240.11b-1 (1991); LOSS & SELIGMAN, *supra* note 39, at 2513-30; Nicholas Wolfson & Thomas A. Russo, *The Stock Exchange Specialist: An Economic and Legal Analysis*, 1970 DUKE L.J. 707.

41. *See* 15 U.S.C. § 78c(a)(5) (1988). The statutory definition of dealer is:

> any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

Id.; *see infra* notes 280-87 and accompanying text (explaining why dealer's activities do not create exchange).

42. The bid and ask quotes published by the specialist must bear some reasonable relationship to the price of the last completed sale in that security. *See* N.Y.S.E. Guide, *supra* note 40; Poser, *supra* note 6, at 890.

43. *See* § 3(a)(24) of the 1934 Act. The statutory definition of broker is:

> any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

15 U.S.C. § 78c(a)(4) (1988). Thus, when the trades are facilitated by the specialist, generally matching orders off the limit book against incoming market orders or processing offsetting incoming market orders, the specialist acts as an agent for the public customer, *i.e.*, as a "broker" executing orders for the account of others. *See* Poser, *supra* note 6, at 890. However, when customers' orders are executed against the specialist's quoted bids and offers at times of order imbalance, the specialist acts as a principal, *i.e.*, as a "dealer" trading for his own account.

execution. Because the customer's limit order is "away from the market," it cannot be executed at the current market price. For example, the customer has left with her broker a buy order at twenty-five, when the market in that stock is at twenty-seven. The limit order becomes a market order when the market price moves down to twenty-five. When the market moves down to the customer's limit, the specialist who holds the limit order must execute[44] the order for the customer.[45] The specialist will receive a portion of the commission paid by the customer.

The aggregate of limit orders held by a specialist in any given security is commonly known as the "limit book."[46] As part of her valuable monopolistic position, the specialist is obligated to protect the customers' limit orders against inferior execution.[47] Among other things, this public limit order protection provides assurance to the customer who leaves a buy order at a price of twenty-five on the specialist's book that no transaction will be completed by the specialist at a price lower than twenty-five before her order is executed. In sum, the development of the specialist function, which was an established part of the exchange markets at the time Congress adopted the 1934 Act, permits for a continuous market and provides depth to the market.[48] As a result, there should be no wild price fluctuations attributable to the imbalance of supply and demand.[49]

All trades completed on the exchange floor must be reported immediately to exchange employees.[50] The exchange compiles this data for transmission

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44. The rules of the exchange constitution obligate the specialist to yield to the limit book and execute the limit orders when the market price moves and the limit orders become market orders. *See, e.g.*, N.Y.S.E. Guide, *supra* note 40; *see also* Loss & Seligman, *supra* note 39, at 2509; Poser, *supra* note 6, at 927-28.

45. The case of a customer's sell limit order works in similar fashion. If a broker receives his customer's order to sell at twenty-five when the market price is at twenty-three, the broker will transmit this sell order to the specialist in that stock. When the market price moves up to twenty-five, the customer's limit price, the specialist will execute the customer's order and receive a portion of the commission paid by the customer to the originating broker. *See* Rule 104.10(2) & (3), *supra* note 40.

46. Loss & Seligman, *supra* note 39, at 2508; Poser, *supra* note 6, at 890.

47. *See* Poser, *supra* note 6, at 927.

48. The specialist acts to provide a continuous auction market when there is an imbalance in order activity. *See* Loss & Seligman, *supra* note 39, at 2508-09. Where there is an active market in a particular security, this aspect of the specialist's role is often dormant for long stretches of time, if, in fact, not rendered obsolete. *Id.* at 2514 (stating that "[i]n 1987 specialist dealer activity accounted for 11.6 billion shares, or 12.1 percent of all reported NYSE trades"). Centralized trading maximizes opportunity for orders to meet without intervention of the specialist, *see* Poser, *supra* note 6, at 904, although the specialist continues to maintain the limit book. Where a stock is more thinly traded, the dealer aspect of the specialist's role becomes more critical. *Id.* Report of the Presidential Task Force on Market Mechanisms (Jan. 12, 1988) [hereinafter Brady Report]. The delivery of this service, however, could be performed in different ways not based on the specialist model of the NYSE. *See* Poser, *supra* note 6, at 956-57; *see generally* Macey & Kanda, *supra* note 21; Anders & Torres, *supra* note 2, at A4.

49. *See* Loss & Seligman, *supra* note 39, at 2513-17.

50. *See* Macey & Kanda, *supra* note 21, at 1018.

to the reporting services, which in turn, electronically disseminate this information to their subscribers.[51] Historically, this data was transmitted through the ticker tape; now, it is reported on subscribers' screens or other computer linked electronic read-outs.

There are nine exchanges, of which the NYSE is dominant.[52] The NYSE serves as the primary market for the stocks listed there.[53] On a much smaller scale, the AMEX has historically served as the primary market for the smaller, newer companies whose securities are admitted to trading on the AMEX exchange floor.[54] The other exchanges, generally referred to as the

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51. *See* Poser, *supra* note 6, at 916-18. Prior to the 1975 Amendments, the consolidated tape reported last sale information for trading activity in NYSE listed securities, but only for trades that occurred on the floor of the NYSE. Shortly before the 1975 Amendments, the SEC mandated that data from all market centers, with respect to trades in NYSE listed securities be included in this electronic gathering and transmission service. *See* Rule 17a-15, adopted in 1972 and later redesignated rule 11Aa3-1 in 1980. Exchange Act Release No. 34-9850, 37 Fed. Reg. 24,172 (1972) (adopting rule 17a-15); later redesignated rule 11Aa3-1 in Exchange Act Release No. 34-16,589, 45 Fed. Reg. 12,377 (1980). For a history of the adoption of the consolidated tape rule, see Poser, *supra* note 6, at 916-18; Seligman, *supra* note 6, at 86-90.

As part of the 1975 legislation, Congress also created a new class of regulated entity, securities information processors, which are now registered with, and regulated by, the SEC. *See* § 3(a)(22)(A) of the 1934 Act (defining securities information processor); § 11A(b)(1) of the 1934 Act (authorizing SEC to register securities information processors). In general, regulation of such entities is intended to prevent publication of fictitious information and to assure reasonable and nondiscriminatory access to such information by all interested persons. *See* Loss & Seligman, *supra* note 39, at 2666-70.

52. Today, in addition to the NYSE and the Amex, there are five regional exchanges registered with the SEC: the Midwest (MSE), the Pacific (PSE), the Philadelphia (PHLX), the Boston (BSE), and the Cincinnati Stock Exchange (CSE). *See* 1990 SEC Ann. Rep. 39 [hereinafter SEC Ann. Rep.]. The other exchange registered with the SEC is the Chicago Board Options Exchange (CBOE), which unlike the other registered exchanges, trades options instruments only and does not trade the underlying equities or other types of securities. Until quite recently, the Spokane Stock Exchange (SSE) was registered with the SEC; however, in 1991, its members voted to close down the SSE citing competitive pressures. *Spokane Stock Exchange Closed Permanently*, Wall St. J., May 28, 1991, at C16; *Spokane Shuts Its Exchange*, N.Y. Times, May 27, 1991, at § 1, at 36.

53. Both the AMEX and the NYSE are referred to as "primary" markets since each is the principal market for the securities that are admitted to trading on the floor of that exchange. *See* Poser, *supra* note 6, at 892. The other stock exchanges are referred to as regional exchanges. "Although the regional exchanges began their existence as primary markets for the securities of companies of local geographic interest, most trading on the regional exchanges since the 1930's has been in securities whose primary market is the NYSE or, to a lesser extent, the Amex." *Id.* at 892-93. Regional exchanges are considered derivative markets because "the prices at which transactions were executed on the regional exchanges normally were based on prices in the primary markets." *Id.* at 893. Because the price of most stock transactions executed on the regionals was pegged to the price the security was trading at on the primary market, the trading activity on the regionals did not tend to affect the price of trades in that stock that were executed on the primary exchanges. *Id.*

54. *See id.* The listing requirements of the NYSE and the AMEX have been described as follows:

> Listing requirements for the Amex are easier to satisfy than those of the NYSE. The NYSE usually requires a company to have 2,000 holders of 100 shares or more,

regional exchanges, are considered derivative markets.[55] The regional markets depend heavily on dual trading of securities listed on other exchanges, primarily the NYSE.[56] However, it is widely recognized that "the secondary markets that were made on the regional exchanges did not tend to affect the primary market prices of dually traded securities."[57]

In 1934 and continuing until today,[58] the centralized floor of the NYSE and the floors of other registered exchanges provided a readily available means of centralizing order flow activity.[59] The technology of the telecommunications industry was still rather primitive and did not match the efficiency of the centralized trading provided by the floor of the organized exchanges, particularly the NYSE.[60]

2. The Over-the-Counter Market

In 1934, the alternative market structure for secondary securities trading was the dealer market reflected in the OTC trading market. As it then

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> 1.1 million publicly held shares, and a minimum market value of $18 million depending on market conditions, and to demonstrate earnings powers of $2.5 million before taxes during the latest year. The Amex requires 800 shareholders, 500,000 publicly held shares, $4 million in market value, and a minimum price per share of $3. The Amex traditionally served as a kind of "minor league" to the NYSE's "major league." Frequently securities would remain listed on the Amex until the number of shareholders and shares and the size of the firm satisfied the NYSE's listing requirement. At that point securities would typically delist from the Amex and list with the NYSE.

Loss & SELIGMAN, *supra* note 39, at 2511-12.

55. *See supra* note 53 (discussing concepts of primary and derivative markets); *see also* Board of Trade v. SEC, 923 F.2d 1270, 1275 (7th Cir. 1991) (Flaum, J., dissenting).

56. The regionals may seek unlisted trading privileges (UTP) in securities listed on the primary exchanges. The SEC has been delegated the authority to grant UTPs, and generally, any request by a regional exchange for UTPs in a NYSE listed stock will be routinely granted by the SEC. *See* § 12(f) of 1934 Act; *supra* note 33 (discussing UTPs in general); SEC ANN. REP., *supra* note 52, at 39 (reporting that during 1990 fiscal year SEC granted 843 exchange applications for UTP's).

57. *Board of Trade*, 923 F.2d at 1275 (Flaum, J., dissenting); Poser, *supra* note 6, at 893.

58. Based on the continuing dominance of its auction market process, the NYSE continues to claim preeminence in providing best execution of customers' agency orders, *see* Power & Block, *supra* note 2, at C20, although this claim increasingly has become the subject of debate and skepticism, even among NYSE officials. *See* Jason Forsythe, *The Big Board: Boxed in by Automation*, INFORMATIONWEEK, May 20, 1991, at 46; Richard L. Stern, *A Dwindling Monopoly*, FORBES, May 13, 1991, at 64-66; Craig Torres, *Big Board Facing Serious Erosion As Market for Stocks, Chief Warns*, WALL ST. J., Mar. 13, 1991, at C1; Torres & Power, *supra* note 7, at A1; Zonana, *supra* note 1, at D1.

59. *See* Milton H. Cohen, *The National Market System—A Modest Proposal*, 46 GEO. WASH. L. REV. 743, 746-47 (1978); Poser, *supra* note 6, at 895; *see generally* Macey & Kanda, *supra* note 21, at 1019-20.

60. The SEC has never claimed jurisdiction to regulate the technology underlying the markets, *e.g.*, the telecommunications, telephones, wires, etc., that linked or have linked market participants to the market centers or otherwise allowed secondary market centers to perform their functions. *See, e.g.*, Proposal to Adopt Rule 15c2-10 Under the Securities Exchange Act, Exchange Act Release No. 34-8661, 1969 SEC LEXIS 135, at *5-7 (Aug. 4, 1969).

existed, the OTC market consisted of a loosely connected system of professional dealers. Unlike the exchange markets, the OTC market did not depend on centralizing order flow activity in one physical location. Rather, the dealer market was characterized by the publication of two-way quotes, generally for those securities that were not eligible for listing on the organized exchanges. Dealers, commonly known as market makers,[61] published quotes intended to attract customers' orders to their respective offices for execution.[62] By providing multiple-dealer interest in OTC securities, these dealers offered liquidity for these investments, thereby making the initial distribution of such securities more attractive to the investing public.[63]

In the OTC market, transactions customarily have been executed "over-the-telephone" by broker-dealers who remain in their offices.[64] As in the exchange markets, a trade originates when a customer places a buy or sell order in an OTC traded security with her broker, who then has several options. The broker-dealer may act as a principal and fill the order out of his inventory, charging a fee to his customer.[65] If the broker does not maintain an inventory of the security, he will purchase the security from a market maker in that security and sell the security to his customer, acting either (i) as an agent and charging a commission, or (ii) as a principal and charging a mark up to the customer.[66] Market makers publish "quotes," the prices at which they are willing to buy and sell the stocks that they maintain in inventory. The publication of quotes is one of the principal

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61. A market maker is "any dealer who with respect to securities, holds himself out (by entering quotations in an inter-dealer communication system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis." Section 3(a)(38) of the 1934 Act. Historically, market makers communicated their quotations through publication in the "pink sheets"; today the publication and dissemination of their quotes has been automated through the facilities of the NASDAQ System. *See infra* notes 164-90 and accompanying text (discussing pink sheets and subsequent development of NASDAQ System).

62. *See* Loss & Seligman, *supra* note 39, at 2578 (stating that "OTC dealers may become market makers in a security primarily by signifying an intent to deal in that security .... [and] need not purchase a seat on an exchange").

63. Conventional wisdom in 1934—and even until quite recently—called for trading in the OTC market until such time as the issuer had matured and satisfied the listing criteria of the organized exchanges. At such time, the issuer customarily would seek listing on one of the organized exchanges. Listing on the exchanges, principally the AMEX or the NYSE, was generally seen as enhancing the attractiveness of the issuer's securities to investors, in part because of the increased liquidity of the exchanges' auction market as compared to the dealer market of the OTC. *See* Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 Geo. Wash. L. Rev. 17, 21 (1986).

64. *See* Louis Loss, Fundamentals of Securities Regulation 600 n.h (2d ed. 1988) (stating that "Dealers' counters have gone the way of the grocers'. 'Over-the-telephone' would be a more accurate description") [hereinafter Loss]; Poser, *supra* note 6, at 894

65. This fee is generally referred to as a "mark-up" in the case of a buy order and a "mark-down" in the case of a sell order. For further background regarding the NASD's regulation of broker-dealer compensation, including its 5% mark up policy, see generally Merritt, Vickers, Inc. v. SEC, 353 F.2d 293 (2d Cir. 1965); Richard W. Jennings & Harold Marsh, Jr., Securities Regulation: Cases & Materials 583-86 (6th ed. 1987).

66. Poser, *supra* note 6, at 894.

ways that market-makers attract business in the form of a stream of orders for execution out of their inventory.[67]

The market makers' two-way quotes originally were published by the NASD[68] in the "pink sheets."[69] In the early 1970s, the NASD seized upon the emerging technology of the telecommunications industry to develop the National Association of Securities Dealers Automatic Quotations System (NASDAQ System).[70] The NASDAQ System allowed for rapid transmission of price information that previously had been quoted in the pink sheets, as well as providing for the continuous monitoring and updating of such information by market makers.[71] The NASDAQ System represents one of the earliest efforts of the entrepreneurial NASD to seize new technology and use it to provide improved service to OTC market participants.[72] This early NASD effort has set the tone for future NASD measures to enhance its competitiveness.[73]

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67. *See id.* at 900, 907-10, 920-21 (describing various ways OTC market makers attract order flow).

68. The National Association of Securities Dealers (NASD) is the only organizaton registered under Section 15A of the 1934 Act, which was added by Congress in 1938 to authorize SEC registration and regulation of a new kind of self-regulatory organization: "national securities association." Registration of such an entity is conditioned on its having the rules designed to promote just and equitable principles of trade. *See* § 15A(b)(6), 15 U.S.C. § 78o-1(b)(6) (1988). The largest of the self-regulatory organizations subject to SEC oversight, the NASD as a practical matter has been delegated the day-to-day regulation of securities broker-dealers, who must register both with the SEC and the NASD. *See* 1 THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 495-99 (2d ed. 1990) [hereinafter HAZEN]. "The NASD has extensive rules governing its members and employees which relate both to organizational structure and standards of conduct," *id.* at 499, much in the same way that the exchanges regulate the trading practices of their members. *See generally* Loss, *supra* note 64, at 620-24.

69. *See generally* LOSS & SELIGMAN, *supra* note 39, at 2579.

70. The current eligibility requirements for inclusion of an issuer's securities in NASDAQ, the automated quotation system sponsored by the NASD, have been summarized as follows:

> Quotations for most over-the-counter equity trading are handled today through the NASDAQ quotation system. To be traded in NASDAQ, a security must be registered with the SEC under § 12(g) of the Securities Exchange Act. That Section requires the registration of any equity security held of record by 500 or more persons if the issuer's total assets exceed $5 million. In addition there must be at least two NASDAQ market makers actively dealing in the security. For initial NASDAQ inclusion, there are two alternative standards. Under alternative one, an issuer, among other requirements, must have $4 million in net tangible assets, 500,000 public shares worth a minimum of $3 million, and minimum net income in the latest fiscal year (or two of the last three fiscal years) of $400,000. Under alternative two, an issuer, among other requirements, must have $12 million in net tangible assets and 1 million public shares worth a minimum of $15 million, but need not satisfy a net income requirement.

LOSS & SELIGMAN, *supra* note 39, at 2580.

71. *See* JENNINGS & MARSH, *supra* note 65, at 7-9 (further describing three levels of service available on NASDAQ); LOSS & SELIGMAN, *supra* note 39, at 2581-82.

72. *See* Simon & Colby, *supra* note 63, at 73-74.

73. NASD measures intended to enhance competitiveness generally take the form of

3. Important Differences Between Exchange Markets and OTC Market

There are several important, fundamental differences between the auction process of the exchange markets and the dealer market of the OTC. These differences existed in 1934 and were reflected in Congress' treatment of the two types of trading markets in the 1934 Act.[74]

First and most significantly, the exchange market provides a central trading place for buy and sell orders to meet and matches the highest buy order with the lowest sell order in an orderly auction process. The OTC, however, is not and has not been characterized by this auction process. Instead, the OTC market is a decentralized market in which transactions were negotiated originally over the dealer's desk (or "counter"), later over the telephone, and today, through sophisticated computer technology and screen-displayed messages. The decentralized nature of the OTC, dictated in large part by the technology available, originally did not allow for buying and selling interest to meet directly.[75] Thus, an OTC market transaction historically has been characterized by the participation of a professional

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increased automation of many of the steps involved in the OTC trading process described in the text. *See* Simon & Colby, *supra* note 63, at 73-76. Recently, however, the NASD has been mounting a more frontal attack in its effort to compete with the exchange markets; see, *e.g.*, Newman, *supra* note 2 (describing NASD's electronic trading market that commenced operation on Jan. 20, 1992, trading from 3:30 a.m. to 9:00 a.m. EST, to coincide with opening of London market and to close one half-hour before NYSE opens at 9:30 a.m. EST). This new trading format represents the NASD's effort to take the lead in creating a 24-hour securities trading market. The NASD is heralding its NASDAQ System as the trading system for the future. *See* Business Development Office of the NASDAQ Stock Market, *NASDAQ: The Stock Market for the Next 100 Years* (1991); Patrice Apodaca, *Beleaguered AMEX Hopes to Boost Profits by Challenging NASDAQ*, L.A. Times, Nov. 12, 1991, at D11; *Some OTC Stocks to Trade on Exchanges*, L.A. Times, Sept. 18, 1991, at D4.

74. *See* Simon & Colby, *supra* note 63, at 20-21. For the most part, these differences between the exchange markets and the OTC market remain true. *See* Poser, *supra* note 6, at 895-96. As described further in the next section, the NMS legislation, which was enacted by Congress in 1975, has made several changes to the trading markets in an effort to link the exchanges and the OTC market into one centralized market for qualified securities. This effort to create a central, or national, market system may have led to some changes that dilute the stated differences between the two types of trading markets as set forth above in the text. Thus, the impact of the NMS legislation has contributed to a further blurring of the traditional distinctions between the two types of trading markets—distinctions which arguably burned more brightly in 1934 when Congress adopted its section 3(a)(1) definition of "exchange" and provided for the regulation thereof. See Wolfson et al., *supra* note 38, at 823.

75. Even today, much of the trading in the OTC market requires brokers to access the available quotes through NASDAQ, the computerized quote system, and "then to telephone the dealer with the preferred quotation," to execute a trade on behalf of a broker's customer. *See* Seligman, *supra* note 6, at 104. However, in 1981, "the NASD began operation of an enhanced NASDAQ system called the Computer Assisted Execution System (CAES), to permit direct execution of orders through NASDAQ computer terminals." *Id.* For a more detailed discussion of the technological improvements and other developments that have enabled the OTC market to match orders, and otherwise develop execution capability, see Loss & Seligman, *supra* note 39, at 2578-91; Simon & Colby, *supra* note 63.

dealer who generally takes up the other side of the trade by buying or selling for his own account.[76]

Second, the exchange markets are notable in their allocation of one specialist to every security listed for trading on an exchange. The one specialist is responsible for maintaining an orderly market for that security on the floor of that exchange *only*.[77] In the OTC market, on the other hand, the specialists' dealer function is performed by market makers and there is more than one market maker for every security quoted in the NASDAQ System. Indeed, some of the more actively traded stocks in the NASDAQ system may have upwards of thirty or more market makers.[78] However, NASDAQ market makers do not maintain a limit book[79] and therefore do not have the access to important and sensitive information available to the specialists on the primary markets.

Finally, the remote location of the OTC market maker further deprives him of the ready opportunity to participate in trading in that security, unlike the position of the specialist's post on the primary market. The OTC market-maker realistically can participate in trading only by issuing competitive two-way quotes that hopefully will attract order flow to his office.[80] The primary market specialist, on the other hand, has the advantage of maintaining a vigil at his post—observing and participating where required in all floor trading in that security. This strategic positioning of the primary market specialist, coupled with his exclusive access to the limit order book,

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76. Most OTC transactions are negotiated among professional broker-dealers and between broker-dealers and their customers. Hence, the OTC market is generally known as a "dealer market." Poser, *supra* note 6, at 895.

77. See *supra* notes 39-49 and accompanying text (discussing specialists responsibilities, which include maintenance of the limit book, although this is of most importance to specialists on primary markets, since vast bulk of all limit orders are directed to primary market). *See* Poser, *supra* note 6, at 930. This may be changing, however, in light of the SEC's efforts to implement the NMS legislation, in particular, its proposal for a "consolidated limit order book" (CLOB). *Id.* at 927-31.

78. *See id.* at 895. In 1979, the average security traded in the NASDAQ system had 8.2 market makers. *Id.* at n.48. By 1986, more than 430 NASDAQ securities had at least 15 market makers. *See* BRADY REPORT, *supra* note 48, at VI-12 (1988).

79. Market makers therefore generally do not perform a "broker" function, unlike specialists who are required to yield to the agency orders on the limit book when the market moves to the limit price of a customer's order. *See supra* notes 45-51 and accompanying text.

80. Until the 1975 NMS legislation, there was one additional important difference between OTC and exchange markets. The primary exchanges maintained a ticker tape showing the price and volume of completed transactions as they occurred (on a real time basis), but there was no similar reporting of transactions completed in the third market, *i.e.*, OTC trading of exchange listed securities. Shortly after the 1975 legislation, the SEC adopted the consolidated tape rule and now last sale information of securities covered by the NMS legislation is reported on a real time basis, regardless of the market in which the transaction was executed. *See* 17 C.F.R. § 240.11Aa3-2 (1992). For a detailed description of the consolidated tape and the events that led to its creation, see Seligman, *supra* note 6, at 86-90. NMS securities generally include all securities listed on the registered exchanges and certain others that are traded exclusively in the OTC market but which meet certain eligibility criteria. *See* 17 C.F.R. § 11Aa2-1 (1992) (codifying SEC's rule describing "qualified securities" for purposes of NMS).

is often given as one of the SEC's primary reasons for proposing the NMS legislation to Congress.[81]

Because of these critical differences, which were recognized by Congress, the definition of an exchange under section 3(a)(1) has always excluded the OTC market. No suggestion has ever been made that the dealer market, which historically has characterized OTC trading, falls within the statute's definition of an "exchange."

B. *Statutory Definition of "Exchange"*

1. The Language of the Section 3(a)(1) Definition

Section 3(a)(1) of the 1934 Act defines "exchange" as:

> any organization, association . . . which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and market facilities maintained by such exchange.[82]

As is readily apparent from the face of the statute, Congress intended the definition to include *meeting places* for buyers and sellers. Any trading forum that "provides a market place or facilities[83] for bringing together purchasers and sellers of securities" *is* an exchange. Yet in its definition, Congress did not fix the meaning of exchange to refer to any of the characteristics of the then-existing physical trading floors of the exchanges, such as the NYSE or the AMEX. As it had done in other contexts,[84]

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81. *See* Poser, *supra* note 6, at 951-57. This concern over the role of the specialist has long been the subject of debate; *see generally* Loss & Seligman, *supra* note 39, at 2516-25; Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. Ill. L. Rev. 315; Walter Werner, *The SEC as a Market Regulator*, 70 Va. L. Rev. 755, 774 (1984); *see infra* notes 111-25 and accompanying text (discussing concerns that led to enactment of NMS legislation).

82. Section 3(a)(1) of the 1934 Act; 15 U.S.C. § 78c(a)(1) (1988).

83. The term "facility," as used in the definition of exchange, is separately defined in section 3(a)(2) of the 1934 Act:

> The term "facility" when used with respect to an exchange includes its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticket or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.

15 U.S.C. § 78c(a)(2) (1988).

84. As an example, similarly flexible language contained in the statutory definition of "security" under section 3(a)(10) of the 1934 Act, has been interpreted as embodying "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others . . . ." SEC v. W.J. Howey & Co., 328 U.S. 293 (1946).

Congress fashioned a definition with sufficient elasticity to embrace a variety of trading formats other than just the existing facilities and mechanics of the established exchanges.[85] Congress had sufficient foresight to recognize that the dynamic forces underlying the capital markets were likely to produce change; although Congress, acting in 1934, could not foresee the nature and extent of changes that would occur in our capital markets over the next half century, it deliberately crafted a definition that was intended to be flexible enough to embrace the changing face of our nation's trading markets.

In fashioning this statutory definition, Congress described the heart of what makes a particular securities trading market constitute an "exchange": The auction trading principle. The guiding fundamental of our capital markets has been the notion that an exchange "provides a centralized forum in which stock trades are undertaken. Such a forum provides the means by which the market prices of stocks can be openly established and through which price information can be produced and disseminated to users of the market."[86]

The trading floor has historically provided the "meeting place" for buyers and sellers, albeit not directly but through their intermediaries.[87] The members of the NYSE act as the parties' agents and execute buy and sell orders deposited with the exchange member firms by their customers, the investing public. Where there is sufficient buying and selling interest, customers' orders meet without the intervention of a professional dealer, the specialist. In this fashion, it is intended that the orders shall receive best execution, *i.e.*, customers' orders shall be executed at the best available prevailing price without the added transaction costs of compensating the financial intermediary.[88]

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85. See S. REP. No. 792, 73d Cong., 2d Sess. 5 (1934), wherein the Senate draftsmen observed that:

> From the outset, the committee has proceeded on the theory that so delicate a mechanism as the modern stock exchange cannot be regulated efficiently under a rigid statutory program. Unless considerable latitude is allowed for the exercise of adminstrative discretion, it is impossible to avoid, on the one hand, unworkable "strait-jacket" regulation and, on the other, loopholes which may be penetrated by slight variations in the method of doing business. Accordingly, it is essential to entrust the administration of the act to an agency vested with power to eliminate undue hardship and to prevent and punish evasion. Of course, well defined limits must be indicated within which the authority of such administrative authority may be exercised.

Id.

86. Macey & Kanda, *supra* note 21, at 1008 n.5; *see also* Board of Trade v. SEC, 923 F.2d 1270, 1274 (7th Cir. 1990) (Flaum, J., dissenting) (stating that "[e]xchanges exist to *eliminate* the need for market makers by bringing buyers and sellers together directly." *citing* LTV Federal Credit Union v. UMIC Gov't. Sec, 523 F. Supp. 819, 834-5 (N.D. Tex. 1981), *aff'd*, 704 F.2d 199 (5th Cir.), *cert. denied*, 464 U.S. 852 (1983)).

87. *See supra* notes 35-38 and accompanying text; *Board of Trade*, 923 F.2d at 1274 (Flaum, J., dissenting).

88. Indeed, the opportunity for a customer's order to be executed *with*out the partici-

Because the specialist system was an entrenched part of the structure of the exchange market, and its continued viability was hotly debated prior to and during the congressional hearings on the 1934 Act,[89] it is significant that Congress chose *not* to define "exchange" by reference to this structural component. Rather, the focus of the definition was and continues to be on the auction market provided by exchange floor trading.[90]

To accommodate the ever increasing volume of trading activity, the exchanges have attempted to reduce transaction costs through automation, thereby facilitating the best execution of customers' agency orders.[91] Although modern technological developments have permitted automation of many functions traditionally performed by exchange members or exchange facilities, automation does not replace floor trading. Instead, technology merely allows the computer to perform both faster and cheaper those functions previously done by securities professionals.[92] This new technology, therefore, does *not* undermine the auction market principle of the exchanges.

The auction market principle is the "determinative characteristic, sufficient unto itself to confer exchange status."[93] Some elasticity, however, was built into the definition of "exchange" since the section 3(a)(1) definition also embraces entities that "otherwise perform . . . the functions commonly performed by an exchange."[94] This additional language, while giving flexibility, is not in derogation of the thrust of the statutory definition. Some elasticity, even at the risk of creating ambiguity in the definition, was necessary to prevent unscrupulous individuals from devising a securities

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pation of a dealer was described by Congress as a goal of the NMS. *See infra* notes 142-45 and accompanying text. This is further evidence that Congress was not wedded to the concept of a specialist as a determining characteristic of whether a trading system is an exchange; indeed, as the dissent in *Delta II* points out, the "emphasis on the market making [dealer] function [of the specialist] seems misplaced, however, because exchanges exist to *eliminate* the need for market makers by bringing buyers and sellers together directly." *Board of Trade*, 923 F.2d at 1274 (emphasis in original).

89. *See generally* Loss & Seligman, *supra* note 39, at 2517-18, n.107 (quoting from Securities Exchange Commission, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker 41 (1936), H.R. Rep. No. 1383, 73d Cong., 2d Sess. 14-15 (1934) (accompanying H.R. 9323)).

90. See *infra* notes 126-54 and accompanying text discussing the 1975 NMS legislation, in which Congress, at the SEC's suggestion, adopted a proposal for a central market system which seeks, in part, to reduce the reliance placed on the specialist position to provide liquidity by linking the markets and thereby maximizing the likelihood that customers' buy and sell orders will be executed without the intervention of a professional dealer. Congress' omission of any specific reference to the specialist system in its statutory definition of "exchange" takes on further significance since both the SEC and the Seventh Circuit emphasized Delta's *lack* of a specialist system in concluding that the Delta Trading System was not an "exchange." See *infra* notes 289-303 and accompanying text, discussing this aspect of the *Delta* litigation.

91. For example, the NYSE has implemented the Designated Order Turnaround System (DOT), and the Pacific Stock Exchange sponsors SCOREX, both of which are order routing and execution systems for small orders. *See generally* Seligman, *supra* note 6, at 105-13.

92. *See* Poser, *supra* note 6, at 907; Torres, *supra* note 58.

93. *See* Board of Trade v. SEC, 923 F.2d 1270, 1273 (7th Cir. 1991) (Flaum, J., dissenting).

94. 15 U.S.C. § 78c(a)(1) (1988).

trading system that avoided the literal requirements of the statute, thus escaping regulation by the statute adopted to protect the public interest.[95] Congress presumably sought to avoid this result by giving the statutory definition the flexibility necessary to address future developments; accordingly, the definition of "exchange" was linked to the auction principle underlying floor trading on the stock exchanges then in existence, and was then extended to include entities that otherwise perform the functions of an exchange.[96]

The definition may be considered ambiguous because it fails to describe "the functions commonly performed by an exchange as that term is generally understood."[97] However, the interpretation of this broad language must focus primarily on whether a PTS provides a *meeting place* for buyers' and sellers' orders. In formulating the first prong of the definition of an exchange—indeed, in formulating a definition at all—Congress intended to limit the scope of the SEC's regulation to those entities that provide a meeting place for buyers and sellers of securities. It seems absurd to suggest that Congress in the very next clause of the definition, which extends the definition to include entities that otherwise perform the functions of an exchange, intended to confer broad authority on the SEC to disregard the auction market principle and strike out on its own to define the "functions" of an exchange. Abandoning the auction market principle as the primary guiding principle in deciding whether a particular entity is performing the functions commonly associated with an "exchange" leaves the courts (and the SEC) with no clear statutory criteria to apply to curb agency discretion in this area. Such a construction of this definition robs the definition of all its force—a nonsensical result.

At the time of the adoption of the 1934 Act, the House and Senate Reports both indicated that the definition of "exchange" was self-explanatory.[98] The Committee Reports are likewise clear that the exchanges were to be regulated in a manner distinct from that of the OTC market.[99] The

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95. *See, e.g.*, S. REP. No. 792, 73d Cong., 2d Sess. 6 (1934) (accompanying S. 3420); H.R. REP. No. 1383, 73d Cong., 2d Sess. 15-16 (1934) (accompanying H.R. 9323).

96. *See Board of Trade*, 923 F.2d at 1273 (Flaum, J., dissenting).

97. This ambiguity, inherent in Congress' broad and, of necessity, flexible definition of exchange, formed in substantial measure the basis of the disagreement between the majority and the dissent in *Delta II*. But, as the dissent in *Delta II* correctly points out, this broad language does not undermine the primary thrust of the definition: an exchange is *any* marketplace that brings buyers and sellers of securities together. *Board of Trade*, 923 F.2d at 1273 (Flaum, J., dissenting). Since the Delta Trading System clearly provides such a meeting place, the system is an "exchange" under the 1934 Act.

98. *See* S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934); H.R. REP. No. 1383, 73d Cong., 2d Sess. 17 (1934).

99. As one leading commentator has authoritatively observed, the failure to extend the provisions of the 1934 Act to the OTC market

> [w]as not due to any conviction on the part of Congress that similar safeguards were not equally essential with respect to securities traded in the over-the-counter market. The several exchanges were concrete organized institutions that one could

existence, and, indeed, Congressional recognition, of these two different types of markets does not undermine the importance of the auction market principle as the main conceptual underpinning of the statutory definition of an "exchange," especially in light of how fundamentally different the dealer market of the OTC was from the auction process of the exchange markets. The differences between the two types of markets remained relatively static until 1975, when Congress adopted the NMS legislation in response to a number of changes in the structure of the trading markets that had become a source of concern.[100] The developments that led to the enactment of the NMS, and the relevant portions of this important amendment to the 1934 Act, are discussed in the next part of this section of the article. As this discussion demonstrates, Congress did not amend the statutory definition of exchange; furthermore, nothing in this substantial and far reaching statutory package enacting a NMS dilutes the auction principle that is embodied in that definition.

2. The Registration Obligation Imposed by Sections 5 and 6

To impose some form of government oversight and regulation on the securities industry's pre-existing scheme of self-regulation, Congress decided to register those securities trading systems that constituted "exchanges" within the meaning of section 3(a)(1).[101] Therefore, Congress required all securities exchanges to register with the SEC unless they were exempted. This requirement is set forth in section 5 as follows:

> It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national

> see and touch, and it was a relatively simple matter to condition the use of those markets upon compliance with the registration and other provisions. By contrast, the over-the-counter market was an amorphous thing that did not present a ready platform on which to base similar provisions.

Loss, *supra* note 64, at 409.

100. It must be noted that, in 1964, Congress enacted a set of landmark amendments to the 1934 Act, responding, in part, to the enormous growth of the OTC market, which was reflected in a number of ways including a substantial increase in the trading volume of the OTC market. Congress amended the 1934 Act to extend its regulatory framework to constituencies not previously subject to its requirements. *See* JENNINGS & MARSH, *supra* note 65, at 544; Loss, *supra* note 64, at 408-12. This legislation, however, did not amend the section 3(a)(1) definition of exchange.

101. *See* H.R. REP. No. 1383, 73d Cong., 2d Sess. 15-16 (1934) (accompanying H.R. 9323).

> securities exchange under section 6 of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.[102]

In addition to setting forth the registration requirement, section 5 delegates to the SEC the authority to exempt any exchange where the volume of securities trading is sufficiently low that the protection of investor interests does not merit registration. Thus, on its face, section 5 recognizes that a trading system may satisfy the statutory definition of an exchange, yet may attract such a low volume of activity that it does not justify regulatory intervention.[103]

While section 5 sets forth the registration obligation, the requirements that must be satisfied for registration as an exchange are set forth in section 6. An exchange must file an application with the SEC, setting forth various categories of information necessary for the SEC to make the findings required by section 6 as a prerequisite to exchange registration.[104] The

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102. *See* § 5 of 1934 Act, 15 U.S.C. § 78e (1988).

103. The language of the statute creates the further dilemma of whether the SEC's exemptive authority is limited *only* to situations where "it is not practicable and not necessary or appropriate in the public interest" to require an exchange to register *because* of the low volume of trading activity. Alternatively, could the language of section 5 be interpreted to permit the SEC to consider other criteria—apart from the low volume of trading activity on a particular exchange—such as the potential for innovation presented by a particular exchange, or the sophisticated nature of the investors and other participants trading on that exchange? The language of section 5 appears to limit the SEC's consideration of these other criteria to *only* those situations involving low volume trading as well. As the SEC itself has acknowledged:

> The legislative history of the Act does not discuss the factors the Commission should consider in determining whether registration is not practicable and not necessary or appropriate by reason of "limited volume." Further, in the seven instances in which the Commission has granted Section 5 exemptions to stock exchanges on other than a temporary basis, the Commission's exemptive orders have not delineated the factors considered in reaching the determination that the "limited volume" criterion has been satisfied. Rather, tracking the language of Section 5, those orders recite the Commission's conclusion that registration was "not practicable and not necessary or appropriate in the public interest or for the protection of investors" in light of the limited volume of transactions effected on the exempted exchanges.

Exchange Act Release No. 34-26708, 1989 SEC LEXIS 580, at *44 (Apr. 11, 1989). There are no exempt exchanges today, although presumably the party claiming the exemption would have the burden to establish the exemption.

104. The application is filed with the SEC on Form 1. *See* § 6(a), 15 U.S.C. § 78e(a); 17 C.F.R. § 240.6a-1. Annual amendments, which are required unless the exchange is exempted from this periodic filing obligation, are likewise filed on Form 1-A. *See* 17 C.F.R. § 240.6a-2(a), (c). A complete set of exhibits described in Rule 6a-2(b) must be filed with the SEC every three years unless the exchange is exempted. *See generally* Exchange Act Release No. 34-19814, 1983 SEC LEXIS 1617, 27 SEC Docket 1264 (1983). Finally, Rule 6a-3 describes the obligation of a registered exchange to file supplemental material with the SEC in accordance with a detailed time table. *See* 17 C.F.R. § 240.6a-3.

application on Form 1 must provide nine categories of information concerning the organization of an exchange.[105] Based on the information provided by the exchange in its application, the SEC must make certain findings required by the provisions of section 6 before registration will be granted. Specifically, the SEC must make the following determinations:

(1) the exchange is organized and has the capacity "to enforce compliance by its members and persons associated with its members with the provisions of the title, the rules and regulations thereunder, and the rules of the exchange" [section 6(b)(1)];
(2) subject to § 6(c), the rules of the exchange provide that any registered broker or dealer or associated natural person may become a member of the exchange [section 6(b)(2)];
(3) the rules of the exchange ensure a fair representation of its members in the selection of directors and administration of its affairs, and provide that one or more directors is a representative of issuers and investors who is not associated with a member of the exchange [section 6(b)(3)];
(4) the rules provide for an equitable allocation of reasonable dues, fees, and other charges among its members, issuers, and other persons using its facilities [section 6(b)(4)];
(5) the rules "are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaging in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange [section 6(b)(5)];
(6) the rules provide that the exchange's members and associated persons will be appropriately disciplined for violations of the 1934 Act or the rules of the exchange [section 6(b)(6)];
(7) in accordance with § 6(d) and in general, the rules provide a fair procedure for disciplining of members and the denial of membership [section 6(b)(7)]; and

105. As an example, item 8 of Form 1, the application form, requires the exchange to "[s]tate the classes of membership (e.g., full membership, associate membership, physical access membership, electronic access membership, etc.) and indicate the number of members in each category")." Form 1 also requires considerable additional disclosures in the form of the filing of exhibits, "including a complete set of all forms of financial statements, reports or questionnaires required of members relating to such members as members' financial responsibility or minimum capital requirements." Loss & SELIGMAN, *supra* note 39, at 2654-55 n.3 (Form 1 is reprinted in 4 Fed. Sec. L. Rep. (CCH) ¶¶ 27,151-27, 154).

(8) the rules do not impose any burden on competition not necessary or appropriate in the furtherance of the purposes of the Exchange Act [section 6(b)(8)].[106]

Once registered, the exchange is then required to demonstrate, through periodic filings with the SEC and other oversight activities carried out by the SEC, its continued compliance with these prerequisites to exchange status.[107] The process of gaining exchange status thus presents a complex and challenging task and maintenance of such status requires considerable ongoing effort to comply with the relevant SEC rules and regulations.

In light of the requirements of section 6, what benefits did Congress believe would flow from registration of securities exchanges? These benefits are probably three-fold: (i) protection of the interests of the professionals who participate in the organized trading of securities; (ii) protection of the interests of investing customers; and (iii) protection of the integrity of and confidence in the capital markets. These concerns are reflected in the express findings required to be made by the SEC under section 6.[108] Moreover, the Seventh Circuit recognized these concerns as among the main policy objectives underlying the section 6 registration requirement.[109]

C. *1975 NMS Legislation*

In the early 1970s, the SEC proposed the NMS legislation which was adopted by Congress as part of the landmark 1975 amendments to the 1934 Act. The NMS legislation grew out of a major study conducted by the SEC, under congressional mandate, of all aspects of the structure of the securities trading markets in the United States. Prior to this study, the SEC had become concerned about the monopolistic position of the specialist post on the NYSE, particularly the specialist's almost exclusive access to the order flow activity in its allocated securities and its exclusive control over and knowledge of the limit book for those securities. The SEC reasoned that this monopolistic position insulated the specialist from significant price competition; and that this may have allowed the price spreads to remain artificially high. In its study the SEC concluded that a linkage of the exchanges and the OTC would maximize order exposure, thereby increasing

106. *Id.* at 2655-57.

107. *See, e.g.*, § 19(b) of the 1934 Act, 15 U.S.C. § 78s(b) (1988), which requires, among other things, prior SEC approval of any proposed changes in the rules of the exchanges.

108. For example, section 6(b)(5)-(6) of the 1934 Act makes clear that the exchange must have in place rules that are designed to prevent fraudulent practices that might injure investors or their brokers who execute trades on their behalf on the exchange. *See* 15 U.S.C. § 78f(b)(5)-(6) (1988). These criteria are to be used by the SEC in its evaluation of an application for exchange registration. *See* Exchange Act Release No. 34-24090, 1987 SEC LEXIS 2600, at *9-14 (Feb. 12, 1987).

109. "Section 6 protects investors and broker-dealers that want to influence the operation of the exchanges through which they trade." Board of Trade v. SEC, 883 F.2d 525, 532 (7th Cir. 1989).

the likelihood that buying and selling interest could meet without the intervention of a professional dealer.[110]

At the heart of the SEC's proposal for a NMS is the notion that auction markets work effectively. The SEC proposal was intended to enhance the functioning of the securities trading market by extending the auction market process of the exchanges to include OTC market participation. This section first describes the developments that led to the SEC's recommendation of a central market system and then discusses the statutory criteria Congress used to describe the NMS to be implemented by the SEC. This discussion will demonstrate that nothing in the SEC's proposal for a NMS undermines Congress' original definition of an "exchange"; indeed, the NMS was intended to enhance the ability of buying and selling interest to meet, entirely consistent with the thrust of the section 3(a)(1) definition of an exchange.

1. Developments Leading to the SEC's NMS Proposal

Until the early 1970s, the structure of the securities trading markets remained substantially as described in the preceding section. Moreover, the SEC's regulation of the trading markets respected and maintained the historical distinction between the exchange markets and the OTC market. However, the rapid technological developments of the 1960s were beginning to exert pressure on the securities industry. The back office crisis of the late 1960s[111] led to the introduction of automation to simplify and make more efficient the back-office operations of broker-dealer firms. This evolving technology also was being tested for its application to the trading of securities itself, creating the possibility for a blurring of the distinction between the OTC market and the exchange market.[112]

In the early 1970s, the SEC and other administrative agencies, as well as Congress, began to investigate the trading practices of institutional

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110. However, the SEC has steadfastly refused to repeal the exchanges' off board trading rules. *See, e.g.*, NYSE Rule 390. Its decision is, in large part, attributable to the SEC's concern that repeal of the off board trading rules would lead to "internalization," which is the term used to describe the likelihood that the major brokerage houses would bring order flow in house, and, in effect, create mini-stock markets within their brokerage offices. *See* JENNINGS & MARSH, *supra* note 65, at 569. The concern is that internalization of order flow will produce market fragmentation, diminish the over-all ability of the securities trading markets to centralize order flow activity, and thus produce greater likelihood of increased price spread, thereby diminishing the possibility of receiving best execution of customers' orders.

111. *See generally* JOEL SELIGMAN, TRANSFORMATION OF WALL STREET 450-57 (1982); Douglas M. Branson, *Securities Regulation After Entering the Competitive Era: The Securities Industry, SEC Policy, and the Individual Investor*, 75 NW. U. L. REV. 857, 863-66 (1980).

112. *See infra* note 154 and accompanying text. This blurring of the distinction between the dealer market of the OTC and the auction market of the exchanges market also is described in Section III.A. of this article, discussing the SEC's application of the definition of an "exchange" to the original NASDAQ proposal and later to Instinet and other proposals for new PTSs.

investors.[113] The growth of institutional investors had led to many practices that were perceived as anticompetitive. Many of these "soft dollar" practices, as they have come to be known,[114] were an attempt by large institutional investors to recapture a portion of the commission paid to broker-dealers who executed trading transactions on their behalf. As a result of the fixed commission rates adhered to by the exchanges, the amount of commission paid on behalf of an institutional block trade often far exceeded the actual costs incurred by the broker-dealer. "Managers of institutional portfolios found ways of using the fat [*i.e.*, the excess over the broker-dealer's cost of executing the trade plus a reasonable profit] in the commissions on large transactions for the benefit of the institution or for their own benefit."[115] Recovery of the "fat" led to certain rebate practices, the most significant of which was the customer directed "give-up."[116]

As a result of the fixed rate commission structure rigidly adhered to and enforced by the primary markets, the regional exchanges were able to attract a significant amount of order flow away from the primary exchanges, particularly the NYSE.[117] The regional exchanges developed practices which allowed their members to share a portion of the fixed commission with others, including nonmember broker-dealer firms, thereby expanding institutional investors' opportunities for customer directed "give-ups." The enhanced opportunity for institutional investors to recapture the excess commission by directing their trades to the regional exchanges or the third market[118] for execution has been described as "fragmentation of the mar-

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113. *See* Branson, *supra* note 111, at 866-70; Walter Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233, 1266-69 (1975).

114. Roger D. Blanc, *Soft Dollars*, 18 REV. SEC. & COMM. REG. 51 (1985); Donald J. Myers, *Directed Brokerage and "Soft Dollars" Under ERISA: New Concerns For Plan Fiduciaries*, 42 BUS. LAW. 553, 554 (1987).

115. *See* Poser, *supra* note 6, at 898-99; Branson, *supra* note 111, at 866.

116. As one commentator has observed:

> For example, the manager of a mutual fund would direct the broker executing a portfolio transaction to share the commissions with other broker-dealers who had sold mutual fund shares or provided research or other services to the fund or its manager. If the transaction was executed on the NYSE, the rules of that exchange required such share (or "give-up") of commissions to be limited to NYSE members; if, on the other hand, it was executed on a regional exchange, give-ups could be made to members of that exchange. To attract institutional business, several regional exchanges also amended their rules to permit give-ups to any broker-dealer registered with the SEC, whether or not he was an exchange member.

Poser, *supra* note 6, at 899. Other noninstitutional shareholders, however, *were* obligated to pay commissions according to the fixed rate commission structure of both the primary exchange markets and the regional exchantges' derivative markets. *See infra* note 120 and accompanying text.

117. *See* Branson, *supra* note 111, at 868; Thomas A. Russo & William K.S. Wang, *Structure of the Securities Markets—Past and Future*, 41 FORDHAM L. REV. 1, 13-16 (1971).

118. The OTC market likewise flourished, giving rise to the "third market," the term used to describe transactions in exchange listed securities that were executed in the OTC market. *See* SIDNEY ROBBINS, THE SECURITIES MARKETS 252-257 (1966). "To avoid paying the

kets."[119] The inability of noninstitutional traders to claim a rebate of any of the amount of the commission paid by such investors in accordance with the exchanges' fixed rate commission structure is frequently pointed out as a resulting inefficiency.[120] This diversion of order flow activity away from the primary market to various other market centers, including the regional exchanges and the third market, and the accompanying inefficiencies created thereby, is often given as one of the primary reasons for establishing a NMS.[121]

In March 1971, the SEC forwarded to Congress the results of its comprehensive study of institutional investors and the impact of their securities trading practices on the secondary markets.[122] In its letter of transmittal, the SEC announced its intention to propose a central market system "in which all buying and selling interest in [qualified] securities could participate and be represented under a competitive regime."[123] The

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fixed rate, managers of institutional portfolios would deal directly with non-member market makers in the over-the-counter market." Poser, *supra* note 6, at 900.

119. The diversion of order flow away from the primary markets is largely attributable to the combination of fixed commission rates and the growth of institutional investor activity, causing the phenomenon of "market fragmentation." *See* Branson, *supra* note 111, at 868. These practices have been described as follows:

> The opportunity for making give-ups provided by the fixed commission rate caused a certain amount of institutional business in NYSE-listed stocks to be executed on regional exchanges. In most instances, this business did not go to the regionals because the regionals were offering a better price than that available on the NYSE. In many instances, in fact, the price of a transaction often was fixed even before it was taken to the regional exchange. Brokerage firms that were members of both the NYSE and of the major regional exchanges negotiated transactions on behalf of their institutional customers over the telephone, as in the over-the-counter market. However, the off-board trading rule of the NYSE required these prearranged transactions to be brought to the floor of an exchange and executed there. In some cases, these large transactions were executed on a regional exchange rather than on the NYSE to provide greater opportunity for making give-ups.

Poser, *supra* note 6, at 899. These same concerns arising out of market fragmmentation have been expressed recently in connection with the recent explosive growth of PTSs. *See* Anders & Torres, *supra* note 2, at A4 (stating that "[p]ublicly [exchange specialists] warn of the dangers of a fragmented market. They say small investors unable to use the new networks could suffer from inferior pricing and fewer trading opportunities if big investors route orders through off-exchange systems").

120. Noninstitutional investors paid commissions according to the lock step structure of the established exchange commission fee schedules and thus often paid a proportionally higher price for the same securities than institutional investors. *See* Gordon v. NYSE, 422 U.S. 659 (1975) (noninstitutional investor attacked without success NYSE fixed commission rate structure as anticompetitive under § 1 of Sherman Anti-Trust Act).

121. *See* Poser, *supra* note 6, at 900.

122. SECURITIES EXCHANGE COMMISSION, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 64, 92nd Cong., 1st Sess. 1529-828 (1971) [hereinafter INSTITUTIONAL INVESTOR STUDY REPORT].

123. *Id.* at xxii. In fact, the SEC never contemplated creating a central market for *all* securities. Rather, securities to be eligible for trading in the NMS were to

> be limited to those equity securities whose characteristics of size, earnings history,

report submitted to Congress observed that "the combination of fixed minimum commission rates and barriers to access" had been the principal cause of "the accelerating growth of institutional trading on the regional stock exchanges and in the third market."[124] In June 1975, after giving the SEC's proposal for a NMS considerable study, Congress enacted a set of wide-ranging amendments to the 1934 Act, including new section 11A creating the NMS. In adopting the SEC's proposal, Congress gave the SEC broad powers to implement the proposal.[125]

2. New Section 11A: Congress' Description of NMS

In its 1975 amendments, Congress did not define a central market system.[126] Rather Congress' mandate to the SEC, which would then act as a guide in the SEC's subsequent implementation of the NMS, is reflected in the five qualities that Congress prescribed for our securities trading markets:

> (i) economically efficient execution of . . . [securities] transactions; (ii) fair competition among [brokers, dealers and securities trading markets]; (iii) the availability to brokers, dealers and investors of information with respect to quotations [and transactions]; (iv) the practicability of brokers executing investors orders in the best market; and (v) an opportunity, consistent with [efficiency and principles of best execution], for investors orders to be executed without the participation of a dealer.[127]

Congress was persuaded that these five criteria could be attained if the existing market centers were linked through telecommunication and data processing facilities. As Congress recognized, the establishment of a central market system was made possible as a direct result of the technological strides that occurred during the prior decade. As originally envisioned, Congress did not ordain, nor presumably even anticipate, the demise of any of the regional exchanges or the OTC market. Instead, Congress presumably expected that the SEC, in its implementation of the NMS legislation, would harness modern technology to link the markets, thereby enhancing price competition between regional and primary exchange specialists in dually

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> breadth of ownership, and investor interest make them 'suitable' for auction-market trading. Presumably, any stock having the requisite characteristics is traded by public investors in sufficient volume so that buy and sell orders may be executed against each other without the constant participation of a dealer.

Poser, *supra* note 6, at 942. These securities are generally referred to as "qualified securities." *Id.* at 941; § 11A(a)(1)(D), 15 U.S.C. § 78k-1(a)(1)(D) (1988).

124. INSTITUTIONAL INVESTOR STUDY REPORT, *supra* note 122, at xxii.

125. See § 11A(a)(2), directing the SEC "to use its authority to facilitate the establishment of a NMS for securities." 15 U.S.C. § 78k-1(a)(2) (1988).

126. *See* Werner, *supra* note 113, at 1275-76.

127. Poser, *supra* note 6, at 906.

traded securities and market makers in the third market for these securities.[128] Congress hoped that this competition would lead to narrower price spreads, ultimately redounding to the benefit of investors by assuring best execution of their transactions.[129]

These five criteria prescribed by Congress for the NMS do nothing to amend the statutory definition of exchange as reflected in section 3(a)(1); indeed, the 1975 amendments, if anything, strengthen the notion that the definition of an exchange refers to any organization that provides "a meeting place for buying and selling interest in [qualified] securities."[130] Technological improvements that lead to a linkage of the OTC and the exchange markets, however, may also lead to a blurring of the traditional distinction between these two types of trading markets. Indeed, the implementation of the NMS eventually may lead to the development of an electronic meeting place for buyers and sellers of securities, a reality not contemplated by Congress under the technology existing in 1934.[131]

a. Economically Efficient Execution of Transactions.

Congress presumably intended that creation of a NMS would make transactions in our securities markets more economically efficient by reducing the costs of executing customers' orders. The lower the transaction costs, so the thinking goes, the greater the trading volume and the easier it should be for securities to reach the hands of those investors who value them the most.[132]

Automation provides the ability to significantly reduce transaction costs. Indeed, without automation and the enhanced technology it has spawned, the SEC's NMS proposal would not be feasible.[133] Automation can be used to reduce transaction costs by providing many services more cheaply and quickly, such as through the electronic dissemination of quotations, the electronic routing of orders from broker-dealers to market centers, the automatic execution of customers' orders, and the computerization of many clerical functions including clearance and settlement of transactions, and other recordkeeping obligations. Thus, much of the process of auction

128. *See* Branson, *supra* note 111, at 871.

129. *See* Poser, *supra* note 6, at 903.

130. 15 U.S.C. § 78c(a)(1) (1988).

131. The SEC's implementation measures will be discussed where relevant to explaining Congress' intent with respect to any one of the five statutorily prescribed criteria. This discussion does not provide an exhaustive treatment of the various aspects of the National Market System legislation or the implementation thereof. This legislation has proved to be quite controversial, particularly with respect to the scope of authority delegated to the SEC, and the SEC's actual exercise thereof. For a thorough discussion of this legislation, see generally Branson, *supra* note 111, at 857; Donald L. Calvin, *The National Market System: A Successful Adventure in Industry Self-Improvement*, 70 VA. L. REV. 785 (1984); Cohen, *supra* note 59, at 743; Lipton, *supra* note 24; Macey & Haddock, *supra* note 81, at 315; Poser, *supra* note 6; Seligman, *supra* note 6; Simon & Colby, *supra* note 63; Werner, *supra* note 113, at 1233; Werner, *supra* note 81, at 755.

132. *See* Poser, *supra* note 6, at 906-07; Werner, *supra* note 113, at 1274.

133. *See* Poser, *supra* note 6, at 907.

trading on the traditional exchange floor has been automated and is now done by computer. Automation, however, does not *change* the markets in that the components of an auction trading transaction remain essentially the same, although they may be accomplished electronically rather than in the traditional and more labor intensive manner of exchange floor trading to which investors have grown accustomed.

b. Fair Competition Among Broker-Dealers and Among Markets.

In proposing the NMS, the SEC reasoned that market fragmentation was largely the result of institutional investor efforts to reduce transaction costs by effecting a savings in the commission paid on the institution's large block transactions. Based on the limited competitive role that the regional specialist and OTC market makers were able to maintain in light of the restrictive practices of the dominant NYSE, the SEC posited that meaningful competition among *all* exchange specialists and OTC market makers would result *if* effective access to the flow of orders customarily routed to the floor of the NYSE was made available to *all* market participants.[134] Congress apparently accepted the SEC's position that linkage of the market makers of the OTC and the specialists of the regional markets with the primary market specialists would produce vigorous and open price competition that would lead to best execution on behalf of the public customer. The SEC has summarized its position as follows:

> If market makers in a particular market center have reasonable expectations that they will receive a greater amount of order flow if they make markets which are consistently better in terms of price, depth, or ease of execution, the Commission believes they will be more likely to compete aggressively—thereby providing a better and more efficient market.[135]

The SEC reasoned that its NMS proposal would establish mechanisms to allow brokerage firms to route their customers' orders to the market displaying the best quotes, regardless of whether the destination market was an exchange or the OTC market. The SEC believed that once regional specialists and third market makers had the opportunity to execute public orders against their own bids and offers, their prior unwillingness to disseminate competitive price quotations should melt away.[136] The SEC's

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134. *See* Seligman, *supra* note 6, at 81; Werner, *supra* note 113, at 1272-73.

135. *See* Development of a National Market System, Exchange Act Release No. 34-15671, 1979 SEC LEXIS 1926, at *34-35 (Mar. 22, 1979).

136. Thus, in the SEC's view, existing markets for trading securities should be linked so that a broker-dealer could readily ascertain and route orders to the market displaying the best price. The SEC's proposal assumes that it is technologically feasible to create an electronic marketplace for the meeting of buying and selling interest. The implementation of market linkage mechanisms, however, has been beset with problems, both in the technology required to create such electronic linkages and the unwillingness of existing market centers to cooperate in the development of such linkages. *See* Poser, *supra* note 6, at 927; Seligman, *supra* note 6, at 165.

order flow theory, which is at the heart of its NMS proposal, is not inconsistent with the section 3(a)(1) definition of an exchange; under the SEC's NMS proposal, however, this "meeting" of buying and selling interest generally will take place electronically, rather than on the physical floor of an exchange.

What would have happened, however, had Congress not adopted the SEC's NMS proposal? At least one commentator has suggested that the repeal of the fixed rate commission structure[137] would have led to the strengthening of the competitive posture of the floor of the NYSE and its specialists. In other words, the auction market of the NYSE would have flourished by reclaiming order flow activity that previously had been diverted to the regional exchanges or the OTC market in an effort to take advantage of the soft dollar practices and thereby effect a rebate of the fixed rate commission through customer directed give-ups. Increased concentration of order flow activity to a central market, presumably the floor of the NYSE, would have maximized the efficient functioning of the auction market principle by maximizing the opportunity for buying and selling interest to meet without the intervention of a professional dealer. At the same time, however, the concentration of order flow activity to the floor of the NYSE would have strengthened the monopolistic position of the NYSE specialist.[138] Given the longstanding ambivalence about the specialist system[139] (generally, because of the inherent conflict in the dual roles delegated to the exchange specialist), some have suggested that the SEC proposed the NMS idea in an effort to dilute the monopolistic position of the NYSE specialist.[140] Whatever may be the relative merits of the role of the specialist in the modern trading of securities, such a debate does not impact the statutory definition of exchange. The statute focuses on whether there is a meeting place for buyers and sellers of securities. This definition is not tied to the function of specialist.[141]

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137. The 1975 legislation confirmed by statute the repeal of the fixed rate structure for commissions; such repeal had already been ordered by SEC rule. *See* § 6(e) of 1934 Act, 15 U.S.C. § 78e (1988); Rule 19b-3, 17 C.F.R. § 240.19b-3 (1991).

138. *See* Poser, *supra* note 6, at 904.

139. *See, e.g.*, SECURITIES EXCHANGE COMMISSION, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF BROKER AND DEALER 25-42 (1936) [hereinafter REPORT ON FEASIBILITY]; RAYMOND VERNON, THE REGULATION OF STOCK EXCHANGE MEMBERS ch. 3 (1972); Ralph James & Estelle James, *Disputed Role of the Stock Exchange Specialist*, HARV. BUS. REV., May-June 1962, at 133. SELIGMAN, *supra* note 6, at 335-344; BRADY REPORT, *supra* note 48, at App. VI (1988); SPECIAL STUDY, *supra* note 22, at 57-71.

140. *See* Poser, *supra* note 6, at 904.

141. One might quite logically raise the question of what function is performed by the specialist on the exchange floor and ask whether that function is one that is "commonly performed by an exchange as that term is generally understood." Section 3(a)(1) of the 1934 Act. This leads to an examination of the specialist's function on the exchange floor, which is generally understood to provide liquidity when there is an imbalance between supply and demand. *See supra* notes 39-49 and accompanying text. However, since Congress was aware

c. An Opportunity for Investor's Order to be Executed Without the Participation of a Dealer.

One of the goals of the NMS is to provide for the execution of an investor's order without the participation of a professional dealer.[142] As one commentator has observed, however, "this is implicit in the very notion of a centralized NMS."[143] An auction market, by its very definition, is designed to maximize the opportunity for buying and selling interest to meet without the intervention of a professional intermediary. Automation, by allowing the matching of buying and selling interest without intervention by a professional broker-dealer and by minimizing the transaction costs of executing customers' trades, not only accomplishes such matching, but does so much more cheaply and quickly. By taking the order flow activity previously diverted to regional exchange markets and to the OTC and concentrating this flow of orders into one big (electronic) marketplace,[144] the SEC hoped to facilitate best execution and to minimize the reliance on the dealer function of the specialist to provide countervailing interest for customers' orders.

This aspect of the underlying premise of the NMS also is entirely consistent with the statutory definition of an "exchange." Indeed, the very definition of exchange as reflective of the auction trading principle contemplates the execution of customers' orders without relying on the services of a professional dealer.[145] Thus, nothing in the policy framework established by Congress for the NMS contradicts the section 3(a)(1) definition of exchange. Although technology and the face of the markets have both changed dramatically in the years between the enactment of section 3(a)(1) and the NMS amendments, Congress did not feel compelled to amend the

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in 1934 of this contribution of the specialist, its decision *not* to incorporate the specialist function directly into its definition is important, particularly in light of Congress' charge in 1934 to the SEC to investigate whether the specialist system should be abolished or otherwise modified. *See generally* REPORT ON FEASIBILITY, *supra* note 139. Congress thus was aware of the specialist's contribution to the auction tradiing process of the exchange markets, but nonetheless considered it something that might be the subject of change based on the results of further investigation. This suggests that Congress must have realized that there may be other ways of providing liquidity to the system; at a minimum, this certainly suggests that the absence of a specialist is not fatal to the treatment of a PTS as an "exchange." *See* H.R. REP. No. 1383, 73d Cong., 2d Sess. 14-15 (1934).

142. *See* § 11A(a)(1)(ii) of the 1934 Act, 15 U.S.C. § 78k-1(a)(1)(ii) (1988).

143. *See* Poser, *supra* note 6, at 912.

144. The SEC originally proposed linking existing market centers through a universal message switch. *See* Poser, *supra* note 6, at 922-27; Seligman, *supra* note 6, at 94. The prospect of such linkage has created the fear (or reality, depending on your perspective) of "black box trading." See Poser, *supra* note 6, and Seligman, *supra* note 6, for a further description of the exchanges' fear of "extinction" as one of the primary sources of their reluctance to cooperate in the development of a universal message switch.

145. This point was made by the dissent in *Delta II*. *See* 923 F.2d 1270, 1274 (7th Cir. 1991).

statutory definition at the time of its enactment of the NMS legislation. Congress' silence in the face of such comprehensive legislation affecting the very structure of the markets is powerful evidence of Congress' approval of this definition of exchange and the auction market principle reflected therein.

d. Practicability of Brokers Executing Investors Orders in the Best Market.

Best execution is a reference to the broker-dealer's obligations, under the common law of agency, to exercise reasonable care to obtain the best price available, acting in accordance with the customs and practices of the securities industry in general.[146] Prior to the 1975 NMS legislation, industry convention was to route public customers' retail orders in duly traded stocks to the primary market, even though at any given time it was theoretically possible that a better price would be displayed on the regional exchange or in the third market.[147] Several justifications were offered for this practice, including the broker-dealers' contention that the additional costs involved in ascertaining the best market often may exceed any savings to be obtained if a better price should be discovered.[148] In its implementation of the NMS, the SEC maintained that if facilities were established for the routing of customers' orders to the market displaying the best price, then price competition would develop among the different market centers, making it feasible to hold broker-dealers to a stricter "best execution" requirement.[149]

Once again, this view of the best execution requirement is entirely consistent with the section 3(a)(1) definition of an "exchange." Modern technology now permits market makers in the third market and exchange specialists to enter and monitor screen displays of their two-way quotes in qualified securities,[150] and automation allows brokers to route their customers orders for execution to the market displaying the best price. In this fashion then, the linkage of existing market centers creates the potential for centralization of customers' orders into one big electronic automated marketplace for trading in qualified securities. This aspect of the NMS proposal, as envisioned by Congress and as implemented by the SEC pursuant to Congress' section 11A mandate, is further evidence of the auction market principle as reflected in the statutory definition of an "exchange."

e. Availability of Information with Respect to Quotations and Transactions.

Congress intended that modern computer technology be harnessed to provide the investing public with prompt dissemination of market infor-

146. *See* Lipton, *supra* note 24, at 449.

147. *See generally* Branson, *supra* note 111, at 872-73 & 878; Lipton, *supra* note 24; Seligman, *supra* note 6.

148. *See* Poser, *supra* note 6, at 911.

149. *See id.* at 907-10.

150. *See* Quote Rule, rule 11Ac-1; Seligman, *supra* note 6, at 90.

mation, most specifically, information about prices and completed transactions in qualified securities.[151] One commentator has observed, "the establishment of facilities to provide dissemination of such market information has been the least controversial and consequently the most readily implemented of the goals of the National Market System."[152]

3. Summary

The NMS legislation contemplates linking existing market centers thereby enabling broker-dealers to receive the best price in the execution of their customers' orders, as a result of the price competition that would ensue among exchange specialists and market-makers in the OTC market. Automation and other modern technological developments made this idea of a NMS feasible. Nonetheless, in setting forth the five criteria of a NMS, Congress reinforced the central thrust of its 1934 Act definition of an "exchange": The NMS legislation relies heavily on the principle of auction trading that is reflected in the section 3(a)(1) definition of an "exchange." Since Congress did not give the SEC a blueprint, the actual contours and characteristics of the NMS have been established piecemeal over the past fifteen years, largely through SEC regulatory measures. But the SEC's implementation of these five criteria of its section 11A mandate has relied heavily on using modern technology to link existing market centers, thereby extending auction trading in qualified securities beyond the primary markets, and leading to the best execution of customers' orders.[153]

This section has shown that automation has allowed for the definition of an exchange to evolve beyond the model of an auction market that was before Congress at the time it adopted section 3(a)(1), in particular, the floor of the NYSE. The language of the statutory definition suggested that Congress embraced the auction market principle which relies heavily on the centralization of order flow activity to maximize the possibility of best execution through the matching of buying and selling interest with the minimum of transaction costs. The 1975 NMS legislation does nothing to diminish the significance of this core idea reflected in the original definition of exchange. Rather, the enactment of the SEC's national market proposal suggests that Congress intended to extend this principle to embrace the technology that had emerged since 1934, which now allowed for centralization of order flow activity beyond the model of concentrating trading on a physical floor.

Increased reliance on automation for the trading of securities has led to a blurring of the traditional floor trading of the exchange markets, on

151. *See* § 11A(a)(1)(C)(iii), 15 U.S.C. § 78k-1(a)(1)(C)(iii) (1988). The importance of this information was recently emphasized by the NYSE proposal to require member firms to disclose to the NYSE information about trading activity in NYSE-listed securitiies—wherever they take place. *See* Robert Steiner & Kevin Salwen, *NYSE Seeks Off-Exchange Trading Data*, WALL ST. J., Dec. 27, 1991, at C1.

152. *See* Poser, *supra* note 6, at 910.

153. *See* Branson, *supra* note 111, at 872-73.

the one hand, and trading in the OTC dealer market on the other.[154] Although implementation of the NMS may have unintentionally contributed to this blurring by mandating linkage of existing trading markets, any such blurring does not involve dilution of the auction trading principle. In fact, such blurring is more likely attributable to the *extension* of the auction trading principle to various preexisting market centers. This blurring of traditional distinctions among different types of securities trading markets may make it more difficult to characterize trading systems based on traditional notions of what is auction trading on the floor of an "exchange" as opposed to trading in the OTC dealer market. The growing difficulty in making the traditional distinction between exchange markets and the OTC market is explored further in the next section, which examines the SEC's application of the section 3(a)(1) definition.

III. SEC'S APPLICATION OF STATUTORY DEFINITION OF "EXCHANGE"

The dearth of judicial interpretation[155] of the statutory definition of exchange is probably attributable to the noncontroversial nature of this definition, so long as technology left the trading mechanisms of the exchanges and the OTC market relatively static.[156] Moreover, prior to the 1980s, the SEC was called upon to interpret and apply the statutory definition of "exchange" on only a few, discrete occasions.[157] But, by the start of the 1980s, almost fifty years after Congress adopted the section 3(a)(1) definition of exchange, the pace of technological developments had increased at an overwhelming rate. Each new technological improvement was seized by the participants in the securities trading markets to enhance their competitive posture within the market, both domestically and internationally. This emerging technology unleashed waves of computerized trading formats and thrust the SEC into the center of a growing controversy over what

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154. Indeed, some market centers, particularly the regionals, may be faced with extinction if all of the SEC's NMS proposals are rigorously implemented. *See* Poser, *supra* note 6, at 923 (stating that "it is understandable that the stock exchanges would oppose [the SEC's proposal to link the markets through] the common message switch, since such a facility would, in effect, bypass the stock exchanges by placing the switching mechanism that would form the heart of the NMS in a 'neutral' central computer").

155. *See* Board of Trade v. SEC, 883 F.2d 525, 535 (7th Cir. 1989) (stating that the court "could not find a single case under § 3(a)(1) discussing which attributes (if any) are necessary, and which are sufficient, for sorting a trading apparatus into the 'exchange' bin"); LTV v. UMIC Gov't Sec., 523 F. Supp. 819 (N.D. Tex. 1981), *aff'd*, 704 F.2d 199 (5th Cir.), *cert. denied*, 464 U.S. 852 (1983).

156. After enactment of the 1934 Act and until quite recently, technology, although changing, had not developed any mechanism that would allow order flow (buying and selling interest in a particular security) to meet electronically. However, the development of automated execution capabilities by the exchanges, *see supra* note 91, and further enhancement of NASDAQ's order execution capability, *see infra* note 179, blur the longstanding distinction between the exchange markets and the OTC market.

157. *See infra* notes 159-90 and accompanying text (discussing SEC's early application of § 3(a)(1) definition).

constitutes an "exchange."[158] During the late 1970s and early 1980s, the SEC received many requests for no action letters soliciting staff acquiescence in treating these new computerized trading forums as nonexchanges and therefore not subject to registration under section 6 of the 1934 Act.

This section first examines the approach taken by the SEC in the early years to decide if a particular trading system is an "exchange" under section 3(a)(1). After establishing this foundation, the remainder of this section will examine the SEC's recent application of the statutory definition to the modern situation posed by the recent development of PTSs. Throughout this discussion of the SEC's no action letter responses, the article will emphasize how the SEC's analysis of modern day PTSs lost sight of the focus of the section 3(a)(1) definition of "exchange": The auction trading provided by establishing a meeting place for buyers and sellers of securities.

A. *SEC's Early Interpretation of Section 3(a)(1)*

By December 1934 there were forty-three exchanges, of which twenty-four were registered under section 6 of the 1934 Act and the remaining nineteen had received temporary exemptions from such registration.[159] This contrasts sharply with today, when there are only eight registered exchanges, and the continued survival of many of these is open to debate.[160] The proliferation of floor trading on a multiplicity of exchanges in 1934 presumably reflected the inefficiencies associated with trading in the OTC market as it then existed, since much of the technology required for an efficient OTC dealer market was still in its infancy.[161]

Congress created an exemption to section 6 for exchanges with a low volume of trading, recognizing that it may be inefficient to regulate them as registered "exchanges" in light of the costs and benefits involved.[162] The exemption for low volume exchanges nonetheless acknowledges that these exchanges, albeit small, are still "meeting places for buyers and sellers of securities" within the meaning of the definition of section 3(a)(1). The small number of no action letters granted in the 1970s reflects this understanding and continued acceptance of the traditional distinction between exchange markets and the dealer market of the OTC.[163]

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158. *See infra* notes 191-212 and accompanying text (discussing SEC's application of statutory definition of exchange in series of no action letters handed down during 1980s).

159. *See* Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 34-27611, 1990 SEC LEXIS 100, at *27 n.58 (Jan. 12, 1990).

160. *See* SEC ANN. REP., *supra* note 52, at 25, 39; Power, *supra* note 2, at C1; Michael T. Malloy & Larry M. Greenberg, *Toronto May Shut Down Trading Floor*, WALL ST. J., Jan. 9, 1992, at C1.

161. As the OTC market grew, the number of exchanges fell off. *See* ROBBINS, *supra* note 118, at 249.

162. § 5 of 1934 Act, 15 U.S.C. § 78(e).

163. Prior to 1970, no action letters issued by the SEC staff were not generally available. *See* Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1021-22 (1987); Lewis D. Lowenfels, *SEC "No-Action" Letters: Some Problems and Suggested Ap-*

It is generally acknowledged that the first system to pose squarely the issue of whether an electronic trading system could, or should, be treated as an "exchange" is the NASD's development of an automated trading information system: the NASDAQ System.

1. The NASDAQ System

The mid-1960s brought the computer age to the door of the broker-dealer industry. At first, the broker-dealer industry used this new data processing technology to respond to the life-threatening back office crisis of the late 1960s.[164]

While the broker-dealer industry in general used this emerging technology to automate the clerical aspects of its back office operations,[165] the entrepreneurial NASD seized the latest electronic data processing developments to automate the delivery of price information for securities traded in the OTC market. This new system, called the NASDAQ System, would allow OTC market maker subscribers to insert bid and ask quotations for securities in which they make markets and further would allow for the dissemination of such quotes to other subscribers.[166] The first real occasion that the SEC had to address the question of whether automated trading systems constitute an "exchange" presented itself in the NASD's request to the SEC for a no action letter ruling that its new NASDAQ System was not an exchange subject to registration under the 1934 Act.[167]

While the NASD's original request to sponsor the NASDAQ System was still under consideration, the SEC announced proposed Rule 15Aj-2.[168]

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proaches, 71 COLUM. L. REV. 1256 n.3 (1971). During the 1970s, a few no action letters were issued in connection with the question of whether a particular nontraditional trading format was an exchange for purposes of the registration requirements under Section 6. In general, however, the SEC's no action letter rulings during this period are consistent with the view that the Section 3(a)(1) definition is reflective of the auction trading principle. For example, in *USF Mortgage Exchange*, the SEC emphasized that the proposal to operate a trading information system for interests in the secondary mortgage market, which system also contemplated providing a service to link up matching offers, raised the issue of whether such a system would be an "exchange" under Section 3(a)(1). Other no action letters issued during this same time period generally emphasized the applicant's ability to satisfy the requirements for registration as an exchange under Section 6 of the 1934 Act. *See In re* Ned Steele, 1971 SEC No-Act. LEXIS 2609 (Mar. 20, 1971); *In re* United States Merger Exchange, 1971 SEC No-Act. LEXIS 4708 (Jan. 21, 1971); *In re* Jake Russell, 1971 SEC No-Act. LEXIS 248 (Mar. 1, 1971).

164. *See supra* note 112 and accompanying text.

165. *See* Simon & Colby, *supra* note 63, at 34-38.

166. *See* Proposal to Adopt Rule 15c2-10 Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-8661, 1969 SEC LEXIS 135 (Aug. 4, 1969) [hereinafter Exchange Act Release No. 34-8661]. For a more complete description of the specialized technology of the NASDAQ System, see Poser, *supra* note 6, at 895 n.47; Simon & Colby, *supra* note 63, at 38-40.

167. *See* Exchange Act Release No. 34-8661, *supra* note 166.

168. *See* Proposal to Adopt Rule 15Aj-2 Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-8440, 1968 SEC LEXIS 179 (Nov. 5, 1968). The SEC adopted rule 15Aj-2 while the NASD's application remained pending and used its criteria to evaluate

The provisions of this proposed rule were addressed to any entity promulgating a scheme for the dissemination of price information.[169] This proposed rule addressed the SEC's concerns about the possibility that broker-dealers or their public customers would be denied access to the facilities of the new NASDAQ System or any similar price information delivery system. Therefore, the SEC wanted assurance that there "would be a fair and orderly procedure for consideration of specific access requests and grievances."[170] To address this concern, the SEC pursuant to the requirements of new Rule 15Aj-2[171] insisted that the NASDAQ System include procedures for processing complaints regarding utilization of, and access to, this new automated price information delivery system.[172]

The primary philosophical justification given by the SEC for permitting the NASD to operate its NASDAQ System without registration as an

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the NASDAQ proposal. *Id.* Rule 15Aj-2 was rather short-lived, however. The SEC rescinded the rule in 1975, following congressional enactment of the NMS legislation. *See* Rescission of Securities Exchange Act Rules 9b-1, 15Aj-3 and 17a-8, Exchange Act Release No. 11604, 1975 SEC LEXIS 988 (Aug. 19, 1975).

169. The systems subject to proposed rule 15Aj-2 did not include any capacity for order execution or order routing; instead, these new systems that would be subject to proposed rule 15Aj-2 were disseminators of price information only. Systems that were designed with order routing and/or execution capability were to be considered under proposed rule 15c2-10. See *infra* notes 178-90 and accompanying text discussing the SEC's initial proposal of rule 15c2-10 also coming on the heels of its consideration of the NASDAQ System.

170. *See* Adoption of Rule 15Aj-2 Under the Securities Exchange Act of 1934, Exchange Act Release No. 8470, 1968 SEC LEXIS 197, at *4 (Dec. 16, 1968) [hereinafter Exchange Act Release No. 8470]. The SEC also worried that this new technology employed by the NASD to create the NASDAQ System could be used in a fraudulent, deceptive, or manipulative manner or to promulgate fictitious quotes. *Id.* at *2. In its proposed Rule 15Aj-2, the SEC addressed this separate concern about fraudulent quotation practices by requiring the NASDAQ System to provide grievance procedures that would address any claims of this nature.

171. The SEC adopted this rule pursuant to its authority to regulate to protect against such practices for the benefit of the investing public. See § 23(a) of the 1934 Act, dealing with the SEC's general rulemaking authority to adopt such rules and regulations as may be necessary for the execution of the functions vested in SEC; and § 15A and § 15(c)(2) delegating rule-making authority to the SEC with respect to prevention of fraudulent and manipulative practices, specifically, the dissemination of fictitious quotes.

172. In the release adopting rule 15Aj-2, the SEC maintained that one of the principal objectives of the new rule was to insure that the new NASDAQ System, as well as any other system for the quotation of securities prices, "be operated so as to remove impediments to and perfect the mechanism of a free and open market." *See* Exchange Act Release No. 8470, *supra* note 170, at *3. This observation is reflective of the SEC's general view of its regulatory role over the trading markets. The SEC regulates to insure the fairness of the markets, as to both dealers and other industry professionals as well as their public customers, by regulating to prevent fraudulent and manipulate practices; yet, simultaneously the SEC exercises its regulatory authority to preserve a "free and open market." This same view underlies the SEC's subsequent proposal for a NMS. *See generally* Lipton, *supra* note 24, at 453-62. Indeed, this emphasis on a free and open market is reflected in the SEC's NMS proposal to link existing market centers and thereby promote price competition. *See supra* notes 134-41 and acccompanying text (discussing development of universal message switch). The notion of maintaining a free and open market is consistent with the statutory definition of an exchange as a meeting place for buying and selling interest.

"exchange" under section 6 was the belief that "[s]ince NASDAQ is sponsored by a national securities association that is already registered with the [SEC] under section 15A of the [1934] Act, the [SEC] decided that it would not be appropriate to assign any separate statutory classification to the system itself."[173]

Thus, the SEC ducked this hard question on the earliest occasion forcing it to confront the issue of what constitutes an "exchange." This posture is quite understandable, however, given the limited nature of the automated service to be provided by the NASDAQ System.[174] Moreover, this new system was to operate directly under the auspices of a self-regulatory organization[175] which, in turn, was subject to broad oversight by the SEC.[176] From this perspective, the technology deployed by the NASDAQ system can be viewed as the next evolutionary stage in the decentralized OTC market, which originally had been linked by the telecommunications system and now would be by the emerging technology of computer automation. Essentially no *new* service was being provided; it was simply the first step in automating the traditional functions employed in the operation of the OTC market. The incentive to automate was to produce its services more quickly and cheaply, making the OTC market a more attractive trading forum, and thereby increasing trading volume, with all of its attendant benefits such as the increased profitability of the system and its participants.

The SEC's consideration of the NASDAQ System did force it to confront the separate possibility of the development of electronic, proprie-

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173. *See* Exchange Act Release No. 34-8661, *supra* note 166, at *1.

174. The NASDAQ System represents the use of automation to speed the delivery of quotes (previously distributed in pink sheets) to market participants. As such, it does not represent any radical alteration of the existing structure of the OTC's dealer market, unlike the NMS proposal and later refinements of the NASDAQ System, which contemplate order routing and automatic order execution capabilities. *See* Seligman, *supra* note 6, at 133-37 (discussing development of automatic execution system that would automatically route orders to market displaying best quotation); *see also id.* at 104-05 (discussing Computer Assisted Execution System (CAES) to permit routing and execution of orders through NASDAQ System). Thus, unlike recent PTS proposals, the original NASDAQ proposal does not lead directly to any blurring of the distinction between the exchanges and the OTC market based on the extension of the auction trading principle to the OTC market.

175. Regarding self-regulatory organizations and the decision to rely on some measure of self-regulation rather than exclusively on direct government regulation of the securities industry, see generally Loss & Seligman, *supra* note 39, at 2787-2830; Loss, *supra* note 64, at 615-19; Donald C. Calvin, *Self-Regulation of the Securities Markets: Executive Summary*, 20 Int'l Bus. Law. 240 (May 1992); Roberta S. Karmel, *Securities Industry Self-Regulation—Tested by the Crash*, 45 Wash. & Lee L. Rev. 1297, 1299 (1988); Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. Rev. 475, 476 (1984).

176. *See* § 15A of the 1934 Act, 15 U.S.C. § 78o-1 (1988) (establishing broad supervisory authority in SEC to regulate NASD, and any facilities established by NASD). Based on essentially the same reasoning, the SEC decided that BAS (Block Automation System), an early form of automated information trading system operated under the auspices of the NYSE, would not be required to register as an "exchange." *See* Exchange Act Release No. 34-8661, *supra* note 166, at *4, *9.

tary trading systems.[177] The SEC's early effort to regulate PTSs took the form of proposed Rule 15c2-10.[178] In its proposing release, the SEC acknowledged the limited scope and nature of the service provided by the new NASDAQ System, involving only the electronic publication and dissemination of bid and ask quotations for OTC-traded securities. However, the SEC realized that the same technology that spawned the development of the NASDAQ System also was being examined for other possible uses, including the ability to program a system that would "facilitate various steps in the process of trading securities, up to and including the actual execution of transactions."[179] Thus, the SEC recognized very early that automation presented numerous possibilities, ranging from the rather mechanical computerization of traditional OTC functions, thereby displacing NASD personnel and other securities professionals, to a fully automated trading system capable of completely displacing the traditional operation of both the exchange markets and the OTC market. Such a system, the SEC observed, would allow its participants "[t]o communicate anonymously among each other indications of interest [to purchase and sell securities,] . . . make formal offers to each other, engage in negotiations and execute actual purchases and sales."[180]

The SEC clearly and readily distinguished between an automated system for disseminating price information such as the NASDAQ System and the possibility of a fully automated marketplace that would bring together and execute orders entered into the system on behalf of buyers and sellers of securities. The NASDAQ System therefore did not constitute an exchange because of the limited scope of services it provided to the OTC market. This approach is consistent with the 1934 Act definition of "exchange" and with the view that this definition was intended to preserve the distinction between the OTC market and the exchange markets. The SEC did realize, however, that the development of a fully automated marketplace raised the issue of whether registration of such trading systems as an "exchange" would be required.[181] Since the SEC was aware of some tentative developments in this direction, it issued for comment proposed Rule 15c2-10, its earliest attempt to fashion an appropriate regulatory framework for proprietary trading systems.

In its release proposing Rule 15c2-10, the SEC identified a number of concerns, many of which are sounded again in its no action consideration of the more sophisticated and complex trading systems sponsored during the 1980s.[182] First, the SEC indicated that its proposed rule was not intended

177. *See* Exchange Act Release No. 34-8661, *supra* note 166.

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. *See infra* notes 191-212 and accompanying text. At the time the SEC put forth its original rule 15c2-10 proposal in 1969, it had before it three other proposals to operate automated trading information systems. The most advanced of these was Instinet, a free-

to regulate the technology underlying these new trading systems.[183] Neither the statute nor the SEC had ever purported to exercise regulatory jurisdiction over "traditional forms of communication," *i.e.*, the telecommunications system that formed the basis for the OTC market (in the form of the mails, telephones and teletype wires) back in 1934. But, as the SEC correctly postulates, these new forms of proposed automated trading systems were not just another form of communication devices;[184] rather they have characteristics that justify a different treatment:

> (1) they can be used solely in securities transactions and not for general purposes, (2) there are varying limitations as to the users of the system facilities, (3) their internal programming imposes a high degree of restriction on the content of the messages that may be sent over them, (4) the identity of persons sending messages over the systems is always known to those systems but, depending on the system, may never be known to the recipients of the messages, and (5) the systems themselves can be programmed to determine when a transaction has been executed.[185]

Having decided *not* to leave these new systems unregulated as simply a new method of communication not subject to regulation, the SEC then

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standing system that clearly went beyond an attempt to furnish price information. As originally proposed, Instinet would "provide facilities for its subscribers to communicate anonymously among each other indications of interest to purchase and sell large blocks of securities, make formal offers to each other, engage in negotiations and execute actual purchases and sales." Exchange Act Release No. 34-8661, *supra* note 166, at *2. Institutional investors, such as banks, insurance companies, and mutual funds, were expected to be the principal subscribers. *Id.* at *2-3. The other proposals involved trading systems that were less comprehensive. Autex Service Corp. sponsored the Autex System, to "allow the anonymous communication of indications of interest to buy or sell blocks of 1000 or more shares, which could be entered [into the system] only by broker-dealer subscribers and received only by institutional subscribers." *Id.* at *3. The Autex System was more rudimentary than Instinet because it was not structured to allow actual negotiation or execution of subscribers' orders. Instead, brokers would negotiate the transactions, which would then be executed over the counter or on the exchange floor. *Id.* A third automated trading information system, sponsored by the NYSE and called the Block Automation System (BAS), was more comparable to Autex than Instinet. BAS was not designed to allow for negotiation or execution of transactions; rather, it was to be programmed to allow for communication of indications of interest by institutional subscribers through their broker-dealers.

183. *See* Exchange Act Release No. 34-8661, *supra* note 166.

184. Arguably, this is the main distinction between NASDAQ and the later development of PTSs, which are the evolutionary product of essentially the same technology that gave birth to NASDAQ. In other words, NASDAQ is the product of automation that sought to replace the traditional form of communication for the delivery of price information in the OTC market. As such, NASDAQ does not present as difficult a classification problem as do these other forms of trading systems, such as Instinet with its enhanced capabilities. *See* Instinet Corp., No-Action Letter, 1986 SEC No-Act. LEXIS 1 (Sept. 8, 1986) (wherein Instinet sought SEC confirmation that it would not be required to register as exchange under § 6 in face of its plans to enhance its automated execution services).

185. *See* Exchange Act Release No. 34-8661, *supra* note 166, at *5-6.

turned its attention to the *manner* in which these new automated trading information systems should be regulated. It is here that the SEC set the tone for future regulatory efforts in this area by concluding that Congress intended all professionals participating in the securities industry "be classified as brokers, dealers, securities exchanges or national securities associations and (unless exempted) [all such securities professionals] shall register with the [SEC] and be subject to the pertinent regulatory provisions."[186]

The SEC reasoned that classification of the automated trading information systems involved in the pending proposals was difficult because "the technology that led to the development of the automated trading systems was not envisioned when Congress passed the [1934] Act. Consequently, the applicability or adaptability of the existing statutory classifications is not entirely clear."[187] However, rather than looking to the conceptual framework underlying the language of the section 3(a)(1) definition, the SEC instead relied on a list of historical indicia of an "exchange." Nowhere in this release does the SEC discuss or apply the language of the statutory definition. Thus, the SEC did not examine nor even raise the possibility that automated trading systems simply represent an attempt to automate the auction process of an exchange by applying this new technology to create an electronic market place for buying and selling interest.

Instead, the SEC relied on a four-pronged set of criteria that "have been historically associated with securities exchanges," including the existence of a trading floor, ownership and control of the system by its members, and the absence of specialists (*i.e.*, dealers who risk their capital in securities transactions).[188] The SEC did not explain the source of these criteria as the appropriate indication of whether a particular trading system is an exchange, and made no attempt to tie these criteria to the section 3(a)(1) definition of an "exchange." Yet, the SEC also casually observes that some of these proposed trading systems could be considered "exchanges" within the meaning of section 3(a)(1), without explaining the basis for this conclusion or specifying what additional factors must be present before these new automated trading systems would be regulated as "exchanges" under the 1934 Act.

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186. *See id.*

187. *See id.*

188. These four criteria are: (i) the presence of members who have a proprietary interest in, and control over, the exchange; (ii) a system of self-regulation of members; (iii) the exercise of control over the selection of securities traded within their markets; and (iv) the furnishing of facilities for the auction trading of securities—typically a "floor" on which members can communicate face-to-face and conduct securities business. *See* Exchange Act Release No. 34-8661, *supra* note 166. These four criteria also formed the core of the original analysis of whether the Delta Trading System is an "exchange" under section 3(a)(1). *See infra* notes 233-65 and accompanying discussion of how these criteria were applied to the Delta Trading System and of the further question of whether *all* four of these criteria are relevant to the question of whether a particular trading system *is* an exchange. Arguably, only the fourth factor goes directly to whether a PTS is an exchange whereas the first three focus on whether *registration* as an exchange would be appropriate under the 1934 Act.

In the face of this uncertainty, the SEC proposed Rule 15c2-10 to provide a regulatory framework for those PTSs not operated under the auspices of an exchange or the NASD. Under this new rule, a PTS would be required to register its new system with the SEC by submitting a plan that describes the new system and, more importantly, "details specific rules of operation designed to prevent abuse of the system and providing for adequate recordkeeping."[189] This scheme of regulation is strikingly similar in principle to the framework for regulating the exchanges and the OTC but the SEC does not provide any further support for its proposal, in effect, to create a new classification, while simultaneously purporting to regulate this new classification for ostensibly many of the same purposes as the SEC regulates the exchanges.

Proposed Rule 15c2-10 never became effective. In 1975, the SEC withdrew the proposed rule accompanied by the brief announcement that "[i]n view of the regulatory scheme provided by the 1975 amendments [enacting the SEC's NMS proposal], . . . further consideration, or adoption, of such a rule [regarding PTS's] is deemed no longer necessary."[190]

B. The SEC's No Action Letter Process of the 1980s

After its consideration of the NASDAQ System, the SEC had no meaningful occasion to visit the question of whether a particular PTS was an exchange until early 1985.[191] At about that time, the SEC had pending before it at least four no action letter requests, each seeking review of several proposed over-the-counter automated execution systems.[192] All four

189. Exchange Act Release No. 34-8661, *supra* note 166.

190. *See* Notice of Withdrawal of Proposed Rule 15c2-10, Exchange Act Release No. 11673, 1975 SEC LEXIS 765, at *23 (Sept. 23, 1975). The 1975 NMS legislation added two new categories of securities professionals to the classification of securities professionals subject to SEC registration and regulation: securities information processors (§ 11A(b)) and clearing agencies (§ 17A). *See* Branson, *supra* note 111, at 874-76. The statute previously had relied on registration and regulation of brokers, dealers, exchanges, and the national securities associations. The SEC apparently concluded that the 1975 expansion of the classes of securities professionals to be regulated relieved it of any pressure to treat these new trading systems as "exchanges." But again, as before, the SEC did not address the fundamental question of whether these new PTS's are "exchanges" and if not, why not.

191. In the interim, the SEC had issued in 1979, a no action letter to Schwartz, Kobb, Scheinert, Hamerman & Johnson, [1979 Transfer Binder] Fed. Sec. L. Rep. [CCH] ¶ 82,037 [hereinafter Schwartz et al.], regarding its automated trading system for mortgages; unlike most of the systems described in this section, however, this new system had no automatic execution or clearing capacities. This no action letter was relied on by the Delta Trading System in its original request for no action relief. *See infra* notes 254-55 and accompanying text discussing the Schwartz Kobb no action letter in the context of the SEC's original response to Delta's no action letter request.

192. B & K Securities, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2085 (Apr. 6, 1985) (sponsoring COPS System); Troster Singer Corp., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2407 (June 23, 1985) (sponsoring Inside System); Exchange Services, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2405 (June 22, 1985) (sponsoring Exchange Services System); Transaction Services, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2406

systems essentially involved a computerized system for executing orders in securities that were then traded on the NASDAQ System. In each case, the SEC, in rather conclusory fashion, issued the requested no action relief in what seemed to be a stylized response. The reasoning offered to support this result was essentially the same for each of the four SEC no action responses, and started off with the following observation:

> When a structured system is offered to a number of broker-dealers for the execution of transactions in a specific group of securities, that system has many of the characteristics of an exchange. Section 3(a)(1) of the [1934] Act provides the statutory definition of "exchange," which encompasses, among other things, "any organization . . . which constitutes . . . a marketplace or facilities for bringing together purchasers and sellers of securities."[193]

After quoting from the statute, each letter then provided a brief description of the automated system, ending with the terse conclusion that the SEC would not recommend any enforcement for failure to register the over-the-counter automatic execution system as an exchange under section 6 of the 1934 Act.

In each no action letter, the SEC does *not* conclude that the automated system is *not* an exchange. Instead, the SEC's letter merely relieves the new system from any registration obligation *as an exchange* under section 6 without squarely deciding the core issue of whether such a system *is* an exchange. The decision to issue no action relief seems to assume that the system is not an exchange; on the other hand, it could be that the SEC had not resolved this central question and deliberately decided to be vague, pending future analysis.

Although this approach affords the SEC administrative flexibility, it does raise several concerns. The most immediate is the lack of predictive value for deciding future cases: Affected persons (or potentially affected persons) sponsoring new types of PTSs do not know whether such automated trading systems are *exchanges*, nor can they identify what characteristics led the SEC to decide that these four trading systems were not required to register. Deciding future cases, therefore, is hazardous at best. Furthermore, at the outset of each of these four no action letters, the SEC carefully observes, without any explanation, that the automated system *may* be an "exchange" since such a structured system may constitute an organization that provides a marketplace for buyers and sellers of securities within the

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(June 15, 1985) (sponsoring TRAN System). All four are proprietary trading systems for securities to be operated on a for-profit basis by their sponsors; B & K Securities, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2085 (Apr. 16, 1985).

193. Exchange Services, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2405, at *1-2 (June 22, 1985) [hereinafter 1985 SEC No-Act. LEXIS 2405]. The identical language, which constitutes the core of the SEC's legal reasoning, appears in all four no action letters cited *supra* note 192.

meaning of the section 3(a)(1) definition.[194] The SEC thus has tied these new PTSs into the first part of the statutory definition which is reflective of the auction trading principle. Significantly, the SEC did not focus on the second, more elastic, aspect of the statutory definition, for example, that this new trading system performs the functions otherwise associated with an exchange.

By late 1985 there was a perceptible and noticeable shift in the reasoning used by the SEC in connection with its no action decisions regarding PTSs. The National Partnership Exchange, Inc. (NAPEX) proposed a new electronic trading system that would allow eligible participants[195] to buy and sell units of publicly registered limited partnerships. NAPEX sought SEC permission to avoid registration as an exchange.[196] After describing in a fair amount of detail NAPEX's computerized system for matching buying and selling interest in public limited partnership interests, the SEC turned to the issue of whether this new trading system constituted an "exchange" under the 1934 Act. First, the staff of the SEC recognized that "NAPEX's proposed activities could very well deem it to come within the registration requirements" applicable to exchanges.[197] The staff decided, however, to issue the requested no action relief based on its belief that "those registration requirements, if applied strictly, could impede the development of *innovative* systems for trading and settling limited partnership interests."[198]

In this no action ruling, the SEC enunciated a clear policy interest in support of its no action position excusing a PTS from registration as an exchange. However, the policy interest articulated by the SEC—to encourage innovation in the securities trading markets—finds no support in the statutory definition; indeed, the SEC had already acknowledged, in the same no-action letter ruling, that this new trading system may very well be an exchange under the express language of section 3(a)(1) of the 1934 Act.[199]

The more appropriate way to handle this dilemma is to acknowledge that the new PTS is an "exchange" under the section 3(a)(1) definition, but is exempt from the exchange registration requirements of section 6. The SEC has some discretion under section 5 to exempt exchanges from section

194. 1985 SEC No-Act. LEXIS 2405, *supra* note 193, at *1-2.

195. All subscribers to the NAPEX System will be broker-dealers or their registered representatives. *See* National Partnership Exchange, Inc., NAPEX No-Action Letter, [1985 Transfer Binder] Fed. Sec. L. Rep. [CCH] ¶ 78,161 at 76,700-76,702 (Aug. 2, 1985).

196. *Id.* NAPEX also sought relief from registration as a securities information processor, broker-dealer, clearing agency, or transfer agent.

197. *Id.*

198. *Id.* at 76,701 (emphasis added). The SEC went on to conclude that:

> [T]he staff believes that, where careful protections are included to ensure the integrity of customer funds and securities, and all customer contacts occur through a registered broker-dealer or its personnel, in limited circumstances, it maybe [sic] appropriate to permit the initial development of such *innovative* systems without registration [as an exchange under section 6 of the 1934 Act] . . . .

Id. (emphasis added).

199. *Id.*

6 registration.[200] The SEC, however, did not separate out the consequences associated with finding a PTS to be an "exchange" from the threshold question of whether the PTS *is* an "exchange."[201] By separating out the two issues, the thrust of the statutory definition could be respected by treating the PTS as an exchange, while exempting it from the exchange registration requirements.

The SEC's belief that innovation must be encouraged is consistent with the recurring theme resonating throughout this 200th anniversary year of the NYSE: The need to maintain the competitive posture of United States capital markets in the face of growing international pressure from foreign market centers, particularly Tokyo and London.[202] Nevertheless, the SEC is not authorized to regulate outside the scope of the statutory language.[203] Moreover, now that we have abandoned the clear language of section 3(a)(1), what will limit the SEC's discretion in this area? Under what circumstances will the policy of innovation prevail over the statutory definition of "exchange"? How will marketplace entrepreneurs, seeking new, "innovative" ways to trade securities, predict whether their proposed system will be subject to registration as an exchange or will fall outside this

200. Section 5 specifically authorizes a low volume exemption. 15 U.S.C. § 78e (1988). Arguably this exemption could form the basis of an exemption from the burdens of section 6 registration for a new PTS that would permit it to operate on an experimental basis; presumably the new PTS would maintain a low volume at the time it is launched and for some reasonable amount of time thereafter. Under the terms of the exemption, or as a condition to the issuance of the exemption, the SEC could revisit the question of "exchange" registration as volume grew and the benefits of such registration outweigh the costs associated therewith. It is puzzling that the SEC did not choose this approach, which at least has the singular virtue of acknowledging the boundaries and congressional mandate established under the section 3(a)(1) definition.

201. Arguably, promoting innovation could be subsumed within the open-ended phrase "or otherwise performs . . . the functions commonly performed by an exchange." The difficulty with this argument is that its proves too much: if promoting innovation is one of the criterion to be used to interpret this statutory language, or even if it is the only criterion, it has no outer parameters. With every new technological improvement comes the concern that innovation will be trampled if the SEC insists on regulating the newest wave of technology as an "exchange." Under this line of reasoning it is hard to see when, if ever, a new PTS would be considered an "exchange." Moreover, to the extent the SEC did decide to regulate a new PTS, the SEC presumably must be able to articulate some premise for subjecting this particular PTS to registration as an "exchange." The ability to predict, or to challenge, any specific determination by the SEC, however, has been eliminated once we have abandoned the clear statutory language by reading an open-ended policy of "encouraging innovation" into the elastic phrase "otherwise performs the functions of an exchange." Moreover, the NMS legislation, although it did encourage the SEC to harness technology to improve the markets, cannot be read so broadly as to embrace this approach to interpreting the admittedly elastic language of section 3(a)(1)'s definition. If anything, this language must be read to encourage innovation to *foster* an auction market. *See* Business Roundtable v. SEC, 905 F.2d 406, 413-17 (D.C. Cir. 1990).

202. *See* William Power & Kevin G. Salwen, *Big Board's Donaldson Says SEC Rules Could Cost Exchange Its Global Standing*, WALL ST. J., Dec. 12, 1991, at C1; Torres, *supra* note 58, at C1.

203. *See supra* notes 19-20 and accompanying text.

requirement as part of the SEC's ad hoc flexible approach intended to encourage innovation?[204]

This approach, which emphasizes innovation over the clear language of the statute, leaves the SEC making important allocations of economic franchises with no statutory guidance or framework.[205] This uncertainty may in fact discourage some future entrepreneurs seeking to develop and operate new trading systems. Moreover, the SEC's decision impacts existing players trying to remain competitive in the face of these new pressures, since their efforts to innovate may be subject to continued compliance with the section 6 exchange registration requirements.[206] The additional costs associated with such compliance generally will disadvantage these players, as compared to those new PTSs that obtain SEC no action letters excusing them from section 6 exchange registration.[207]

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204. *See supra* note 15. As one commentator observed almost twenty years ago:

> The result is that the staff, and sometimes junior staff members, are creating substantive law having great precedential force in critical areas under the securities laws without any of the checks and balances which are inherent in our system of government. And most disturbing, a certain amount of this substantive, staff-created law is inconsistent with substantive law duly created in accordance with our normal legislative, judicial, and administrative processes.

Lowenfels, *supra* note 15, at 321.

205. This shift in course announced by the SEC in its NAPEX no action letter set the theme for its subsequent no action letters dealing with PTSs, up to and including the Delta Trading System. *See, e.g.*, Jeffries & Company, Inc., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2292 (July 25, 1987) (sponsoring POSIT); CapitaLink Securities Corp., SEC No-Action Letter, 1986 SEC No-Act. LEXIS 3 (Aug. 9, 1986) (sponsoring CapitaLink System).

206. Several commentators have argued that the SEC's no action letter approach did not create a level playing field since it effectively discouraged innovation by exchanges and NASDAQ because any new developments sponsored by entities currently registered as exchanges or a § 15A association would continue to be regulated as such, putting their efforts at a competitive disadvantage. *See* Exchange Act Release No. 34-26708, 1989 SEC LEXIS 680 (Apr. 11, 1989) [hereinafter Exchange Act Release No. 34-26708]; "SEC Proposes Rule to Govern Proprietary Trading Systems," Daily Report for Executives [BNA] (Apr. 18, 1989) (stating that SEC "is reviving proposed Rule 15c2-10 in response to criticism that its policy of regulating [PTSs] through no-action letters placed registered exchanges at commmpetitive disadvantage"). The proponents of new PTSs argued that to regulate otherwise would be to regulate the PTS out of existence since it would be unable to compete by virtue of the entrenched position held by these other registered entities. This very controversy shows the weakness of the no action approach and illustrates the need for a wide ranging study of the issue of what is an "exchange," resulting in a deliberate statement of the policy priorities and objectives to be relied on in regulating our securities markets in the face of enormous and rapid technological change.

207. Indeed, this competitive disadvantage prompted the futures exchanges to bring suit against the Delta Trading System. *See* Board of Trade v. SEC, 883 F.2d 525, 532-33 (7th Cir. 1989). Whatever we may think of the nobility of their motivations to sue to protect the public interest, by seeking, *inter alia*, an order compelling the Delta Trading System to register as an exchange under the statutory definition, it is nonetheless true that the SEC has impacted the competitiveness of existing markets in its allocative decision as to whether a particular PTS must register. The Seventh Circuit in *Delta I* recognized the validity of this concern and concluded that the options exchanges had standing to bring suit to enforce the statutory definition of "exchange." *Id.*

The SEC's apparent decision to foster innovation, even if it means abandoning the statute's definition of "exchange," leads one to ask: Why does registration as an "exchange" discourage "innovation"?[208] Presumably, the SEC has determined that, as to these new trading systems, the burdens associated with complying with these requirements do not produce sufficient benefits to support imposing registration.

However, the SEC has never explained why the *benefits* associated with exchange registration under section 6 do not manifest themselves when imposed on these new PTSs. All this suggests the question: Why continue to require registration of any "exchange"? Perhaps, in reconsidering the whole issue of the proper regulatory framework for securities trading markets, the focus should *not* be placed on defining what is an "exchange," but rather on the objectives to be served and the public benefits to be obtained by registering and regulating entities as "exchanges."[209] Identification of these objectives should make it easier to articulate the relevant characteristics of those trading markets to be regulated as exchanges and those where the benefits of such regulation are nonexistent, or marginal at best, and therefore, registration is not in the public's best interest.

This approach to the definition of an "exchange" is very different from the one underlying the original 1934 Act. However, recent technological developments suggest that different policies are implicated today than those dominant in the Depression Era that gave rise to this important piece of New Deal legislation. It may well be that encouraging innovation is a laudable goal, but that objective should be established by Congress, not by the SEC.

In summary, this section has demonstrated the historical and practical significance of the auction principle to the proper interpretation of the statutory definition of an "exchange." Having first examined the statutory language, this section then chronicled the manner in which this definition has been interpreted and applied by the SEC. The NASDAQ no action

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208. The SEC has never clearly identified the burdens imposed by registration under section 6 that in turn stifle efforts to innovate. Indeed, the dissent in *Delta II* questioned whether in fact exchange registration would lead to the demise of this new PTS, the Delta Trading System. Board of Trade v. SEC, 923 F.2d 1270, 1276 (7th Cir. 1991) (Flaum, J., dissenting). Often these new PTSs are required to register as other types of securities professionals, such as a broker-dealer or a clearing agency, although often they seek relief from these registration burdens as well. To the extent that the burden associated with exchange registration is created by overlapping and duplicative requirements of registration under the 1934 Act as a different class of securities professional, then such duplication of efforts can be dealt with through appropriate review, and revision if necessary, of these regulatory requirements. The nature of the burdens cannot be determined, however, since there has been no clear articulation of these burdens and how they stifle innovation. Even more importantly, there has been no systematic effort to describe the benefits to be derived from registration as an "exchange." If nothing else, the experience of the Delta Trading System has caused us to recognize the need to reexamine the objectives of our regulatory scheme for exchange registration.

209. *See* Macey & Kanda, *supra* note 21, at 1007.

letter represented one of the earliest opportunities for the SEC to consider the issue of whether an electronic trading system constitutes an exchange. The SEC's no action position, viewed in a historical context, is entirely reasonable. The SEC believed that the operation of the NASDAQ System, under the umbrella of the NASD and thus subject to broad and direct SEC oversight, was satisfactory. By the end of the 1980s, the SEC had moved away from the approach of essentially relying on regulating a PTS through an extension of its supervisory authority over a self-regulatory organization[210] since many, if not most, of these new PTSs were developed by independent entrepreneurs seeking to compete with the established trading markets.[211] Instead, the SEC introduced a new policy concern—that of encouraging innovation. However, this criteria is *not* part of the statutory definition of "exchange," which focuses on whether an organization provides a "market place or facilities for bringing together buyers and sellers of securities."[212] Moreover, this emphasis on promoting innovation overlooks Congress' *and* the SEC's adherence to, and extension of, the auction market principle as reflected in the 1975 NMS legislation. Before casting aside this core of the statutory definition of exchange, which has served so well since its enactment to describe what is an exchange, Congress, at a minimum, should conduct a meaningful debate about the theoretical underpinnings of an exchange.

IV. The *Delta* Decision

The *Delta* case visited the Seventh Circuit twice.[213] The first occasion was in 1989, upon the appeal by the future markets of the SEC's response to Delta's initial request for a no action letter requesting relief from the section 6 exchange registration requirements, among other things. In disposing of this appeal, the Seventh Circuit remanded the case to the SEC with instructions for the SEC to take up and decide the issue of whether the Delta Trading System in fact constituted an "exchange" as that term is defined in the 1934 Act. Following remand, the SEC concluded that the Delta Trading System was not an exchange and therefore adhered to its original no action letter position. Petition for review of this SEC decision was again made to the Seventh Circuit, resulting in its 1991 decision upholding the SEC's determination that the Delta Trading System was *not* an exchange.

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210. *See supra* notes 68 and 190 and authorities cited therein (describing self-organizations subject to SEC oversight).

211. *See* Exchange Act Release No. 34-8661, *supra* note 166. Later PTSs are all free-standing trading systems, developed free from any participation or sponsorship by an established exchange or the NASD. Hence, the SEC's earlier rationale has no continued application to these new developments.

212. 15 U.S.C. § 78c(a)(1) (1988).

213. *See supra* notes 16-18 and accompanying text (describing *Delta* decisions).

This section will demonstrate that the statutory definition of "exchange" acts as an important constraint on the SEC's discretion. By effectively abandoning this constraint in the Delta Trading System no action letter, which is then acquiesced in by the courts as reflected in the Seventh Circuit's decision in *Delta II*, no meaningful criteria are left to define the outer scope of the SEC's delegated authority other than whatever *implied* limitations may or may not be enforced by the courts in the future. Reliance on implied limitations is nonsensical in the face of a clear statutory mandate. Moreover, such reliance is inherently risky since no one can predict or prescribe, with any degree of certainty, what limitations will be imposed on SEC discretion. To understand how the statutory definition of exchange effectively has been abandoned, along with an appreciation for the core of this definition—the auction market trading principle—this section analyzes the Delta Trading System, focusing on the Seventh Circuit's 1991 ruling.[214]

A. *Description of the Delta System and the SEC's No Action Response*

This section gives a brief description of the Delta Trading System for trading *options* on government securities.[215] It highlights those aspects of this new PTS that are most critical to the issue of whether the Delta Trading System constitutes an exchange for purposes of the 1934 Act.

1. Overview of the Delta Trading System

The primary players involved in this new electronic trading system are: (1) RMJ Options Trading Corporation, a registered government securities broker (RMJ), (2) Delta Government Options Corporation, a registered clearing agency (Delta Corp.),[216] and (3) Security Pacific National Trust Company, a bank (SPNTCO).[217] Together these parties proposed a trading

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214. Accordingly, the focus of this discussion of the earlier SEC and Seventh Circuit determinations in the *Delta* matter emphasizes the court's and the SEC's rulings on those issues most directly related to the central inquiry of *Delta II* and the focus of this article: whether the Delta system was an "exchange" within the meaning of the statutory definition. Other issues raised by this litigation that do not directly bear on this question are not fully explored.

215. As used in this article, the term "government securities" includes United States Treasury bills, bonds and notes. *See* § 3(a)(42) of the 1934 Act, 15 U.S.C. § 78c(a)(42) (1988).

216. *See* § 17A of the 1934 Act, 15 U.S.C. § 78q-1 (1988 & Supp. I 1989). For a general description of clearing agencies and the scope of SEC regulation of such agencies, see generally HAZEN, *supra* note 68, at 582-87.

217. The Delta Trading System was originally operated by Security Pacific National Bank (SPNB). In 1985 and 1986, at the request of SPNB, the SEC issued no action letters wherein it concluded that the Delta Trading System as operated by its predecessor owner, SPNB, was not required to register as an exchange under Section 6 of the 1934 Act. *See* Security Pacific National Bank, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2434 (Aug. 18, 1985) [hereinafter 1985 SEC No-Act. LEXIS 2434]; Security Pacific National Bank, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2676 (Aug. 19, 1986) [hereinafter 1986 SEC No-Act. LEXIS 2676]. In 1987, SPNB sold the Delta Trading System to RMJ Securities Corp., in which

system for options on government securities designed to meet the needs of primary dealers in government securities, as well as other brokers and dealers, and certain classes of institutional investors trading in government securities. Until the development of the Delta Trading System, there was very little organized trading in *options* on government securities and anonymity in such trading was not available in the marketplace.[218]

The original incentive to create a secondary trading system in *options* on government securities derives from the hedging relationship that naturally occurs between the options markets and the markets for the underlying securities, here government securities. Prior to the development of the Delta Trading System, participants in the government securities market only had available to them rather crude, imperfect techniques of hedging their exposure to interest rate risk because the then existing markets provided only a limited number of futures and options contracts on government securities.[219] As a result of the immaturity and inadequacy of the then existing market, a primary dealer who had bid on (or otherwise had taken a position in) government securities of varying maturities and yields was often unable "to match completely his cash position with offsetting futures or options positions."[220]

The proponents of the Delta Trading System, capitalizing on this newly recognized market niche, developed an ingenious electronic trading mechanism to permit the purchase and sale of *options* on government securities and to facilitate over-the-counter trading of such options.[221] The purchase

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transaction RMJ acquired the right to act as the exclusive operator of this new PTS. Following this transfer of ownership, SPNTCO was to act as the clearing bank for the Delta Trading System:

> Under a contract with Delta [Corporation], SPNTCO acts as clearing bank (facilities manager) for the [Delta Trading] System. All trades effected between participants are submitted to SPNTCO for acceptance. Under the contract and System Procedures, SPNTCO accepts a trade if both sides of the trade match, the trade does not result in a participant exceeding its trading or position limits, and neither participant has been suspended from the [Delta Trading] System. Upon acceptance of a transaction for clearance by SPNTCO under Delta's procedures, Delta [Corporation] issues the option underlying the transaction and undertakes the performance of obligations arising under that option. . . . With respect to issued options, SPNTCO performs recordkeeping and safeguarding functions.

Delta Government Options Corporation, Exchange Act Release No. 34-27611, 1990 SEC LEXIS 100, at *9-10 (Jan. 12, 1990) [hereinafter Exchange Act Release No. 34-27611].

218. *See* Board of Trade v. SEC, 883 F.2d 525, 528 (7th Cir. 1989); Stanley W. Angrist, *Options Wizardry: Bond System Gets a Name Offering Anonymity*, WALL ST. J., Sept. 19, 1991, at C1. Historically, government securities have been traded exclusively in the OTC market by broker-dealers acting as principals, many of whom specialize in such securities. These dealers are often referred to as primary dealers. *See generally* HAZEN, *supra* note 68, at 545-55; UNITED STATES TREASURY DEPARTMENT, SECURITIES EXCHANGE COMMISSION, & BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, JOINT REPORT ON THE GOVERNMENT SECURITIES MARKET (Jan. 1992).

219. *See* 1985 SEC No-Act. LEXIS 2434, at *9-10.

220. *Id.* at *10.

221. The instruments to be traded in the Delta System are known as "calls" and "puts."

of put and call options instruments on the Delta Trading System was intended to permit participants in the government securities market to "allocate the risk of price movements and [further, to] allow each side of the transaction to hedge its position in the underlying security."[222] The Delta Trading System was organized as a proprietary, profit-making entity, with RMJ acting as its sole broker. Trading on the System was to be limited only to qualified persons.[223]

The main difficulty in designing this new trading system was to provide a mechanism to overcome a well-known, built-in risk of options trading: The risk of nonperformance. This risk is inherent in the "short" positions assumed by sellers of call options and buyers of put options.[224] For example, the seller of a call option typically does not own the underlying security. The seller will be required to go out into the market and purchase the government security specified in the call option for delivery to the other side if the purchaser exercises the call option. Similarly, the buyer of a put option, who also typically does not own the underlying government security at the time of his purchase of the put, will purchase the underlying government security if the buyer decides to exercise the put option. Buyers of call options and put options face a two-fold risk: First, the risk that the price will not change enough to make exercise worthwhile; second, if the price does move sufficiently and the option therefore is exercised, the party on the other side of the option instrument may not deliver (in the case of

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See Exchange Act Release No. 34-27611, *supra* note 217, at *26-29. Simply stated, a "call" option is a promise to sell a specified government security at some specified future date at a price fixed today. *See Board of Trade*, 883 F.2d at 527. The seller of a "call" option thus promises to deliver the government security at the stated price (the strike price) during the time period fixed by the terms of the call option and the buyer of the "call" option pays a sum (the premium) for the privilege of enforcing the option. *Id.* The strike price fixed in the call option exceeds the current market price of the underlying security, here, the underlying government security. Sellers of call options are betting that the price will not exceed the strike price during the option period; conversely, buyers are betting that the market price of the underlying government security *will* exceed the strike price. A "put" option operates in similar fashion, but from the opposite perspective. The seller of the put option promises to pay a fixed price (the "strike price") if the underlying government security is tendered to the seller by the buyer of the "put" during the specified option period. *See generally* JOSEPH M. BURNS, A TREATISE ON MARKETS 57 (1979); Norman S. Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571, 585-92 (1984); Seligman, *supra* note 6, at 141.

222. *Board of Trade*, 883 F.2d at 527. The Seventh Circuit went on to observe that "[a]lthough the mechanics of *futures* transactions differ from those of options transactions, futures may serve the same economic functions, and both have the important byproduct of improving the liquidity of markets." *Id.* (emphasis added). Further discussion of the hedging relationship between the futures, options and underlying primary markets for government securities and the mechanics of hedging transactions lies outside the scope of this article.

223. The Delta Trading System was designed to meet the needs of banks, primary dealers and institutional investors. *See* Security Pacific National Bank, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2524 (July 12, 1985) [hereinafter SEC No-Act. LEXIS 2524].

224. These positions are called "shorts" because these parties generally do not *own* the underlying securities; *Board of Trade*, 883 F.2d at 527. Both the buyer of a call option and the seller of a put option are called "longs" because the holder of such a position will own the underlying government security if such a holder exercises the call or must honor the put.

a call option) or pay (in the case of a put option).[225] The first risk is the risk to be absorbed through the hedging strategy afforded by the development of the Delta Trading System, namely, take a position in the underlying government securities market and purchase an offsetting position in the options market.[226]

As to the second risk, that of nonperformance, the Delta Trading System interposes a clearing house between the parties, guaranteeing the performance of both sides to an option contract.[227] In lieu of the standardized options contracts widely used in trading options on other types of securities, the clearing house used in the Delta Trading System allows the parties to negotiate the terms of the option:

> Once [the] parties agree on the terms of an option, the clearing house "issues" the option and acquires the delivery or payment obligation on the other side. Each party [to the option contract] deals exclusively with the clearing house, which matches transactions and requires margin and guarantees to minimize its own risk.[228]

Once the terms of the parties' transaction are finalized, the trade is executed on the Delta Trading System. Because of the inherent risk of nonperformance in an executory contract such as an option, the clearinghouse provides assurance to the buyer of a call option that the seller will deliver the underlying security upon exercise of the call option, and further, provides assurance to the buyer of a put option that the seller will pay the strike price if the put option is exercised. Since the clearinghouse assumes the risk of nonperformance by guaranteeing the contract, the clearinghouse obviously must take measures to protect itself against a participant's nonperformance on exercise of an option:

> Delta [Corporation, the System's registered clearing agency] protects its own position against participants' defaults by ensuring that each subscriber is creditworthy. No one may join the [Delta Trading] System without satisfying Delta's standards. Delta [Corporation] also sets margin requirements, as well as trading and position limits, to protect itself against the risk that participants will hold unbalanced portfolios taxing their resources (increasing the likelihood of default). SPNTCO acts as clearing bank for the [Delta Trading] System, and Delta [Corporation] does not issue or purchase options until SPNTCO has "accepted" the trade, verifying that the long and short have complied with Delta's rules on margin and position limits. SPNTCO holds the customers' (and Delta's) money and

225. *Id.*

226. *See id.*

227. *See* Poser, *supra* note 221, at 585-92 (describing Options Clearing Corp. (OCC) which performs similar function in options market on equities securities, OCC issues, and guarantees standardized options contracts on certain underlying securities).

228. *Board of Trade*, 883 F.2d at 527.

> securities, paying traders and delivering securities according to the terms of the [negotiated] options.[229]

Finally, interposition of the clearinghouse offers the parties to an option contract at least one other important benefit: Anonymity.[230] Neither party to the option contract knows who is on the other side of the transaction.[231] Such anonymity may be desirable where the parties believe that their identities (coupled with information about the size of their positions) may enable others to infer information that the parties would prefer to keep confidential.[232] Therefore, in the modern world of options, the use of clearinghouses permits the sale of options *without* identifying the parties to the contract, even though one side of the contract is wholly executory. The clearinghouse knows the identity of the parties to the option contract while the traders are in the dark.

2. The SEC's Original No Action Response

In its original no action determination in 1989, the SEC permitted the Delta Trading System to operate without registering as an exchange under the 1934 Act,[233] while permitting the System's proponents, RMJ and Delta Corp., to register as a broker and clearinghouse, respectively.[234] The SEC

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229. *Id.* at 528.

230. *Id.* at 527; *see also* Angrist, *supra* note 218, at C1.

231. The mechanics of a trade executed on the Delta Trading System have been described as follows:

> [The Delta System] itself, as the parties describe it, is a combination of computer hardware and software that matches offers and keeps track of the obligations of the longs and shorts until the options expire or the positions are closed by offsetting transactions. Subscribers can consult terminals linked to the [Delta] System's computer to discover bid and asked prices on options. They may call RMJ Options, the [Delta] System's sole broker, to make bids (which RMJ will post on the System) or accept offers they have seen posted. RMJ enters the information into the System. Delta [Corporation], the clearinghouse, reads the information from the System and formally "issues" the option to the buyer while "purchasing" an offsetting option from the seller. Such a trade is thus anonymous and fully guaranteed, while Delta's books are in balance at all times. Trades need not be anonymous, however. Any participant in the [Delta] System may trade directly with another and notify RMJ, which enters the transaction into the System. [In such a situation,] Delta then acts as administrator and guarantor.

Board of Trade, 883 F.2d at 528.

232. Indeed, the development of "blind brokers" was in large part attributable to the desire for anonymity: such brokers specialize in matching buyers and sellers of government securities without identifying the parties to each other. *Id.* at 527; HAZEN, *supra* note 68, at 548.

233. *See* RMJ Securities, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 21 (Jan. 12 1989) [hereinafter 1989 SEC No-Act. LEXIS 21] (requesting no-action letter).

234. *See* Application for Registration as Clearing Agency, Exchange Act Release No. 34-25956, 1988 SEC LEXIS 1585 (Aug. 1, 1985) [hereinafter 1988 SEC LEXIS 1585]; 1989 SEC No-Act. LEXIS 21, *supra* note 233, at *13, n.15, *16 (May 6, 1988) (citing to Order granting RMJ registration as government securities dealer pursuant to section 15(c) of 1934 Act).

concluded that the Delta Trading System was not required to register as an exchange within the meaning of the 1934 Act because the statutory definition does not include a PTS such as the Delta Trading System, "which utilizes computers and other technological advancements to enhance the furnishing of securities brokerage services."[235]

RMJ and Delta Corporation made a two prong argument to persuade the SEC to reach this conclusion: First, they argued that the new trading system lacked the traditional attributes of an "exchange"; and second, no public policy would be fostered by imposing exchange registration requirements on this fledgling system which could ill-afford the costs of compliance with these requirements.[236]

With regard to their first argument, proponents of the Delta Trading System[237] pointed to four basic attributes that have been the historical indicia of an "exchange":

> (1) the presence of members who have a proprietary interest in, and control over, the exchange; (2) a system of self-regulation of members; (3) the exercise of control over the selection of securities traded within their markets; and (4) the furnishing of facilities for the [auction] trading of securities . . . typically a "floor" on which members can communicate face-to-face and conduct a securities business.[238]

Initially, it should be recognized that the first three of these four criteria are not properly focused on the issue of whether a particular trading system *is* an exchange under the section 3(a)(1) definition. Rather, the first three criteria more appropriately go to the question of whether the application for registration of this trading system satisfies the prerequisites for registration under section 6 of the 1934 Act. From this perspective, only the last factor is relevant to the determination of whether the Delta Trading System is an "exchange." This is critical because the proponents of the Delta Trading System contend that, of the four criteria, only the last one arguably applies to the Delta Trading System. By separating out the two issues

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235. *See* 1989 No-Act. LEXIS 21, *supra* note 233, at *35.

236. *See id.* at *40 (stating "any further delays . . . may sound its death knell"); *see also* 1985 SEC No-Act. LEXIS 2434, *supra* note 217. In its 1989 request for no action relief, the proponents of the Delta Trading System indicated that the legal rationale that supported the SEC's decision to issue no action relief to the predecessor owner of the Delta Trading System remained "equally applicable." *See* 1989 SEC No-Act. LEXIS 21, *supra* note 233, at *36.

237. As for the SEC's part, following a detailed factual description of the Delta Trading System, the SEC concluded, without any extended analysis, that the Delta Trading System was not required to register as an exchange. *See* 1989 SEC No-Act. LEXIS 21, *supra* note 233, at *16. However, in its prior 1985 no action ruling regarding the Delta Trading System, wherein it reached the same conclusion, the SEC staff was careful to point out that in issuing the requested no-action relief, "the staff should not be viewed as taking a position on this legal analysis" [of the four traditional attributes of an exchange]. 1985 SEC No-Act. LEXIS 2434, *supra* note 217, at *4.

238. *See* 1989 SEC No-Act. LEXIS 21, *supra* note 233, at *36.

subsumed in this four pronged inquiry, it becomes clear that, even assuming the validity of the claim that the Delta Trading System does not satisfy the first three criteria, any such failure does not preclude the conclusion that the Delta Trading System is an exchange. Moreover, it is not entirely clear that the Delta Trading System fails to satisfy the first three of the four "historical indicia of an exchange." Further analysis of all four of these traditional attributes of an exchange demonstrates that the Delta Trading System *is* an exchange.

a. Members' Proprietary Interest in the Exchange and a System for Self-Regulation of its Members.

As to the first criteria, namely, the presence of members who have a proprietary interest in, and control over, the exchange, the proponents of the Delta Trading System contended that the participants in the System do not own seats and otherwise hold no indicia of economic ownership, unlike a traditional exchange such as the NYSE.[239] It is not clear, however, whether the "participants" referred to under this criteria are the proponents of the Delta Trading System, who obviously hold an economic stake in the success of the new trading system, or whether they refer to the "participants" who trade on the system, for instance, the government securities dealers and institutions depositing orders for execution on the new trading system.

This confusion over the nature of the participants referred to is aggravated further upon examining the second attribute: Whether there is a system of self-regulation of members. In the Delta Trading System, all participants who deposit orders into the System must satisfy creditworthiness standards and must conduct their trading in accordance with the requirements imposed by the procedures of the Delta Trading System. On its face, therefore, some type of self-regulatory system for the trading of participants or "members" is apparently in place. But the Delta sponsors point out that participants have no role in the development or administration of procedures that govern trading in the Delta Trading System. Rather than acting as co-owners and self-regulators, Delta Trading System participants are subscribers to a service—essentially, a brokerage service—offered by the Delta Trading System. What this position fails to appreciate, however, is that there is indirect, if not direct, participation in the development of procedures for the regulation of "members" (or "participants," as the case may be), in the form of their willingness to utilize the Delta Trading System. If the procedures that must be complied with do not provide sufficient protection for the interests of the participants, then they will decline to "participate." Presumably natural (market) forces will respond to this pressure to solicit, formally or informally, their concerns and modify the regulations and procedures for the System to accommodate them. Thus, the lack of a formal organization and structure in the traditional mode should not defeat con-

239. *Id.*

sideration of Delta Trading System as an exchange under 1934 Act, at least not in and of itself.[240]

Moreover, a system for self-regulation of participants seems to be a variable peculiarly within the control of the proponents of the new trading system. Factors that are subject to inclusion (or exclusion) at the prerogative of the proponent of the PTS, as seems to be the case with this particular factor dealing with the adequacy of the Delta Trading System's proposed scheme for membership self-regulation, should hardly form the basis for deciding whether a new securities trading system is an "exchange."[241] This factor seems to be directed more to the question of whether registration of this new trading system as an "exchange" under section 6 is appropriate. In 1934 there were upwards of forty "exchanges" operating in the United States, and obviously, the organized exchanges were the dominant form of secondary market.[242] Quite properly, before conferring "exchange" status on these entities, thereby sanctioning public trading on these exchange floors by registered broker-dealers, these trading floors were required to demonstrate an adequate system of internal controls to regulate, and maintain records of, members' trading activity on the floor, among other things. Viewed from this perspective, the adequacy of the system of membership self-regulation does not bear directly on whether the trading system *is* an exchange, but does bear directly on the separate question of whether an exchange is eligible for registration under section 6.

Moreover, the existence of a scheme of self-regulation historically has served interests other than those of the participants (or SRO members). Indeed, the rules and regulations of SROs are often described not only to police the conduct of members and their transactions for the protection of

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240. *See* 1985 SEC No-Act. LEXIS 2434, *supra* note 217, at *15 n.2 (citing to REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS OF THE SEC, H. Doc. No. 95, 88th Cong., 1st Sess. 9-11; 20TH CENTURY FUND, THE SECURITY MARKETS: FINDINGS AND RECOMMENDATIONS OF THE SPECIAL STAFF OF THE 20TH CENTURY FUND 263 (1934) (comparing exchange and OTC markets)).

241. This factor, which seems to be peculiarly within the control of the proponent of the System, is easily susceptible of manipulation by the entrepreneurial sponsor of the new PTS. It seems that "exchange" registration should not depend on the willingness of the sponsors of a new PTS to structure the system so as to provide for this scheme of membership self-regulation. Indeed perhaps that is why Congress separated out the definition of an "exchange" from the registration requirements. As a condition to obtaining the status of "registered exchange," (thereby allowing public customers to trade their securities through their registered broker-dealers on this newly registered exchange), these regulatory prerequisites must be demonstrated to the satisfaction of the SEC. But these criteria do not drive the analysis of the more fundamental question of whether the new system is an exchange under section 3(a)(1)'s definition.

242. Moreover, it must be pointed out that both of the sources relied on by the proponents of the Delta Trading System to support use of this set of four criteria to describe what is an exchange predate the development of PTSs, and were relied on when the dominant form of an auction market remained the traditional form of NYSE-styled floor trading that largely existed at the time Congress enacted the original "exchange" definition. *See* 1989 SEC No-Act. LEXIS 21, *supra* note 233, at *15 n.2 and authorities cited therein.

the members, but also to protect the general public's interest in the fairness and integrity of the trading markets.[243] From this perspective, the existence of a "system of membership self-regulation" does not describe an attribute of an exchange, but rather the conditions to qualify for registration as an "exchange" under the 1934 Act.[244] This perspective makes sense because it removes this variable from the control of the participant in deciding whether it must be satisfied in the first place. Designing the trading system to exclude a system of self-regulation thus does not preclude a determination that the Delta Trading System is an exchange under the definition of section 3(a)(1), but may preclude its registration under the requirements of section 6.[245]

b. Listing of Securities for Trading on the New System.

Even the third characteristic, that of "listing" or exercising control over which securities are eligible for trading in the new Delta System, does not preclude a positive finding that an "exchange" exists. The proponents of the Delta Trading System claim that the System does not possess this third attribute because it is designed solely to facilitate options trading on United States Treasury securities in denominations of one million dollars where the terms of these options (such as premium, expiration date, strike price and size) are negotiated by the seller and purchaser of the option. These formalistic arguments fail for many of the same reasons as with the first two traditional attributes.

This characteristic, too, is largely left to the control of the sponsor of the new PTS, and the sponsors of the Delta Trading System have indeed limited the nature of the securities to be traded on this new PTS. The instruments to be traded on the Delta Trading System—options on Treasury securities—are clearly defined and well known to traders in the secondary markets; participants will not come to this new trading market expecting to trade options on corporate equities. The specifics as to size of the order and price to be paid are not specified by the trading forum; rather they are to be established in the context of execution of a specific trade on the Delta Trading System, much as these aspects are fixed in the context of any trade

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243. *See* Loss, *supra* note 64, at 684-94; Karmel, *supra* note 175, at 1299.

244. If the proponents of the Delta Trading System feel that this second criteria is not satisfied because there are no members (similar to seatholders on the NYSE) then this second criteria really cannot be analyzed apart from the first, whether members have an economic stake in the Delta Trading System. If it relates to the existence of a scheme of self-regulation, then the argument above (regarding direct and indirect participation by the users of the System in the design of the System's procedures) shows that rules are in place for the regulation of the new Delta Trading System and such rules are imposed on all "participants."

245. The idea is that the existence and adequacy of the scheme of self-regulation to be imposed by the new PTS on its "members" may properly come before the SEC in deciding whether to grant "exchange" registration status under the criteria of § 6. The SEC should evaluate the PTSs proposed scheme of regulation to be sure that it adequately protects the interests of the members of the exchange and of the general public, as well as insuring that it serves to protect the integrity of the secondary trading markets.

executed on other registered exchanges. The expiration date and strike price are treated somewhat differently but not unlike the treatment of standardized options on equities that are traded on registered exchanges.[246] The manner for establishing these terms on the Delta Trading System differs from that in which options are traded on the registered exchanges, but fundamentally the nature of the instrument does not vary. These differences and the lack of specifics do not necessarily defeat the concept of "listing" and the differences are of degree not of kind.

Moreover, these differences really go to the question of what is the concept of "listing."[247] One of the functions served by this concept, the exercise of control over which securities are eligible for trading, is reduction of trading transaction costs and facilitation of efficient functioning of markets. Classification as an exchange does not require all options instruments traded on that market to be completely fungible in all respects. An analogy to the market for options on equities may illustrate this distinction. For example, the options instruments issued by the clearinghouse in the options market are standardized as to expiration date, strike price and size.[248] However, these options trading markets respond to changing market conditions by creating new instruments to reflect changes in the pricing of the underlying equity.[249] This same economic function is performed on the Delta System through parties' negotiation rather than in the form of the trading system itself creating and offering a new instrument with terms tailored to reflect the changes in market conditions as they occur. Again, this difference is one of degree not of kind. The Delta Trading System still provides a meeting place for buying and selling interest in options on government securities, although the manner of establishing certain specifics of each trade may differ between the Delta Trading System and traditional options exchanges. But this difference more appropriately goes to the secondary policy question of whether it is in the public's best interest to register the Delta Trading System as an exchange under section 6; it does not bear directly on the threshold analysis of whether the Delta Trading System is an exchange under the statute's definition of this term.

c. System Provides Facilities for Auction Trading of Listed Securities.

Finally and most importantly, the proponents of the Delta Trading System concede that this new trading system may possess the fourth attribute historically ascribed to an "exchange": It furnishes facilities for the auction trading of securities.[250] This concession is significant because this is the only one of the four attributes to bear directly on the question of whether the Delta System is an "exchange" under the section 3(a)(1) definition.

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246. *See* Poser, *supra* note 221, at 571; Seligman, *supra* note 6, at 141.
247. *See* Macey & Kanda, *supra* note 21, at 1007-10.
248. *See* Poser, *supra* note 6; Seligman, *supra* note 6, at 247.
249. *See* Poser, *supra* note 221, at 586-88.
250. 1985 SEC No-Act. LEXIS 2524, *supra* note 223, at *7.

The reason that the proponents must concede that the new trading forum is an exchange under this criteria is that *in fact* the Delta System represents an electronic meeting place for buyers and sellers of options on government securities. The screen replaces the physical floor of the traditional exchange. Technological advances now afford buyers and sellers the opportunity to communicate electronically rather than requiring centralization of trading activity on a physical floor to provide them with this opportunity. Technology has allowed the functions served by a physical trading floor to be done or replicated in a cheaper, faster, and therefore more efficient fashion. But in the process, as discussed earlier,[251] these technological developments have caused a blurring between the traditional dealer market model of the OTC and the traditional floor trading, auction market model of the exchanges; the SEC, acting outside the glare of public scrutiny, had previously grappled with the legal and policy questions raised by these technological developments through a series of no action letter requests that culminated in the challenge to the Delta Trading System.[252]

Within the context of the Delta Trading System no action letter request, the proponents of this new System contended that despite these technological developments, there continued to be two kinds of securities trading markets: the auction market of the exchanges and the dealer market of the OTC. Although the proponents contended that this new trading system was an OTC market, and as such not subject to the section 6 registration requirements for exchanges, even they had to recognize that:

> [T]he securities markets are not static and the introduction of automated communications technology over the last ten years in the exchange and OTC markets have blurred the line which once clearly distinguished the two markets. Even with the considerable progress toward development of a NMS, and the increased automation of the OTC market, however, the Commission and its staff have continued to recognize the distinction between exchange and OTC markets.[253]

In urging that the SEC continue to maintain a distinction between the OTC and exchange markets, based primarily on the four criteria that form the historical indicia of "exchanges," the Delta Trading System proponents cited to one of the SEC's earlier no action letter responses to a request to establish a PTS to facilitate secondary trading of certain 1933 Act exempt mortgage securities among qualified institutional traders.[254] In that case, the

251. *See supra* notes 179-80 and accompanying text.

252. *See supra* notes 191-212 and accompanying text (describing prior SEC no-action rulings); *see also* 1989 SEC No-Act. LEXIS 21, *supra* note 233, with regard to the Delta Trading System.

253. *See* 1985 SEC No-Act. LEXIS 2434, *supra* note 217, at *16.

254. *See* Schwartz et al., *supra* note 191, at 81,647. This letter is part of the earlier series of no-action letters in which the SEC considered the issue of whether certain PTS were "exchanges" within the meaning of section 3(a)(1). *See supra* notes 191-212 and accompanying text.

SEC was urged to conclude that the PTS at issue there (which was similar to, but not as advanced as, the Delta System) was not an "exchange." In granting the requested no action relief in 1979, the SEC refused to take a position on this issue,[255] while carefully pointing out that nothing in the 1934 Act, or subsequent amendments thereto suggested that the SEC lacks the authority to regulate as "exchanges" any entity satisfying the section 3(a)(1) of the definition of "exchange." This no action letter relied on by the proponents of the Delta Trading System reflects the early ambivalence of the SEC on this issue. On the one hand, the SEC maintains that the door is open for it to regulate this mortgage trading system should the SEC decide that this PTS is in fact an exchange; on the other hand, the SEC, in an apparent effort to support innovation and competitiveness in United States capital markets, issued the requested no action relief without any extended explanation of whether this PTS is an exchange, and if not, why not.

This same ambivalence in attitude and approach is reflected almost ten years later in connection with the SEC's no action ruling on whether the Delta Trading System is an "exchange." The SEC once again refused to express any opinion as to whether the Delta System for trading options on government securities is an "exchange."[256] Nonetheless, the SEC issued no action relief to the Delta Trading System, releasing it from any obligation to comply with the section 6 registration requirements for "exchanges."[257] Proponents of the Delta Trading System had urged the SEC to take this position on the policy grounds that no clear regulatory purpose would be served if this new System was subject to exchange registration.[258] Although the SEC did not express clear agreement with this public policy rationale, its decision to grant no action relief is consistent with the policy arguments put forward by the Delta Trading System proponents.[259] Indeed, the SEC had previously expressed its concern about stifling innovation prematurely through imposition of the burdens of section 6 registration requirements on new PTSs.[260]

Again, as with earlier SEC no action letters regarding registration of PTS's as exchanges, the overarching problem with this approach is that it overlooks the fundamental irrelevance of these concerns to the basic question facing the SEC: whether a particular PTS, here the Delta Trading System,

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255. Reminiscent of the SEC's language in other no action letters that are part of this series, the SEC concluded:

> Without agreeing or disagreeing with your conclusion that the company and the system are not an exchange, we would not recommend any enforcement action under section 5 of the [1934] Act if the company operated the system in the manner described above without registering under section 6(a) of the [1934] Act.

Schwartz et al., *supra* note 191, at ¶ 81,646.

256. *See* Board of Trade v. SEC, 883 F.2d 525, 535-36 (7th Cir. 1989).

257. *See* 1989 SEC No-Act. LEXIS 21, *supra* note 233.

258. *See id.* at *41; 1985 SEC No-Act. LEXIS 2434, *supra* note 217, at *19.

259. *See* 1985 SEC No-Act. LEXIS 2434, *supra* note 217, at *22-23.

260. *See supra* notes 159-212 and accompanying text.

constitutes an "exchange" within the meaning of section 3(a)(1)'s definition. This *statutorily* crafted definition refers *only* to a meeting place for buying and selling interest. The statute's definition does not speak in terms of a balancing of the benefits and burdens in assessing whether a particular trading forum is an exchange. The omission of any such policy considerations is entirely consistent with the contention that Congress intended the statute's definition to reflect the auction market principle. The balancing of the benefits and burdens was to be left to the subsequent determination of whether registration of this trading market as an exchange is in the public interest. In connection with the analysis of whether registration should be required, it makes sense from a public policy perspective to assess the relative costs and benefits to be derived from section 6 registration in any given trading market situation and to exempt from registration any system where the costs exceed any benefits to be derived therefrom. Indeed, section 5 on its face contemplates such an assessment. Section 5 contains a low volume exemption, which presumably is based on the notion that the costs incurred in complying with section 6 in these situations do not produce sufficient benefits,[261] in terms of either protecting the constituencies participating in the new trading system, or promoting the larger public interest in maintaining the confidence and integrity of our securities markets.[262]

This approach has the advantage of preserving the section 3(a)(1) definition as a meaningful constraint on the SEC's delegated authority, and relies on the rulemaking authority delegated to the SEC to promulgate exemptions from registration where there is no public benefit to be obtained from imposing SEC registration and regulation. Moreover, the SEC's no action ruling on the Delta Trading System similarly (albeit unconsciously) reflects this view. In granting this no action relief, the SEC attached certain conditions to its ruling,[263] many of which reflect the public benefits that would be derived if registration as an exchange were required.[264] By attaching these conditions to its no action ruling, the SEC obtains many of the benefits to be derived from exchange registration of a new PTS without

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261. However, this analysis is not relevant unless the particular trading system at issue constitutes an "exchange" under the section 3(a)(1) definition. *See* Board of Trade v. SEC, 923 F.2d 1270, 1275-76 (7th Cir. 1991) (Flaum, J., dissenting).

262. The SEC recently granted a request by a PTS for a section 5 exemption from the section 6 registration requirements. *See* Wunsch Auction Systems, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 426 (Feb. 28, 1991). This request was granted on condition that the PTS provide certain trading information to the SEC, among other things. This PTS "differs from most others in that it brings buyers and sellers together, similar to a traditional stock exchange. . . . Since [this PTS] is similar to a stock exchange, it needed an exemption from section 5, [SEC] Market Regulation Division Director Richard Ketchum said." 23 Sec. Reg. & L. Rep. [BNA] 272, 273 (Feb. 22, 1991).

263. *See* 1989 SEC No-Act. LEXIS 21, *supra* note 233.

264. The primary benefit is disclosure (of transaction related information such as details regarding trading volume, prices, size or orders, etc.). Section 6, as well as the SEC's rules and the rules of the SROs, require registered exchanges to provide similar categories of information.

imposing any of the other costs associated with section 6 registration on this fledgling trading system.[265] This approach, however, is analytically flawed because it fails to appreciate the statute's definition of exchange, and practically flawed because it accords advantages to this new trading system over other competitors required to register as exchanges.

3. *Delta I*

The development of this new options trading system faced stringent opposition from the futures markets. Two futures markets, the Chicago Board of Trade and the Chicago Mercantile Exchange, trade *futures* on the same government securities and also trade options on futures on these securities. As a prospective competitor, the futures markets insisted to the SEC that this new system was an "exchange" within the meaning of section 3(a)(1) of the 1934 Act and therefore must register as an exchange pursuant to the requirements of section 6 of the 1934 Act. Following the SEC's initial no action determination that the Delta Trading System was not required to register as an exchange, suit was brought by the futures markets requesting the Seventh Circuit to set aside the no action letter and the SEC's decision that Delta Corporation need only register as a clearing agency under section 17A of the 1934 Act.

As might be expected, the sponsors of the Delta Trading System resisted primarily on the grounds that any such registration would be fatal to its competitive posture. Registration as an "exchange" would require the Delta Trading System to conform to the traditional model of the NYSE, when it was trying to break away from this model and create a new and innovative type of trading system.

After reviewing the no action letter proceedings in this matter, the Seventh Circuit concluded in *Delta I* that the SEC's decision did not squarely address the threshold question of whether the Delta Trading System was an "exchange." The Seventh Circuit rejected the SEC's position that it did not have to decide whether this new PTS was an exchange in order to rule on the no action letter request submitted by the sponsors of this new PTS.[266]

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265. *See supra* notes 101-09 and accompanying text.

266. The vast bulk of the Seventh Circuit's decision in *Delta I* discussed procedural issues such as whether the futures exchanges had standing to seek review of the agency determination in this matter; and whether the SEC's no-action letter ruling constituted a reviewable order. In sum, in 1989, the Seventh Circuit in *Delta I* ruled that:

> i. The SEC's no action letter ruling that the Delta Trading System was not required to register as an exchange was a nonreviewable order;
>
> ii. The futures markets did have standing to seek review of the SEC's decision to register Delta Corp. as a clearing agency under § 17A of the 1934 Act;
>
> iii. The SEC had to determine, as a threshold matter, whether the Delta Trading System was an exchange, since, by the terms of the statute, a clearing agency involved in an *unregistered* exchange is not entitled to be registered as a clearing agency under § 17A; and
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> iv. The case therefore was remanded to the SEC for its determination in the first

Accordingly, the Seventh Circuit returned the matter to the SEC, ordering

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> instance as to whether the Delta Corp., seeking registration as a clearing agency, would be participating in trading on an unregistered "exchange."

Board of Trade v. SEC, 883 F.2d 525 (7th Cir. 1989).

The reviewability of a no action letter ruling, however, is not the focus of this article, although this question does raise interesting issues. Likewise, the question of whether the futures markets have standing to seek review of the SEC's order granting Delta Corp's application for registration as a clearing agency under § 17A of the 1934 Act is outside the scope of this article. These issues are important for purposes of this article only to the extent that they bear on the motivations of the futures markets in pursuing this litigation against the SEC (as opposed to a suit against their competitors). Secondarily, the economic incentives that are the core of the futures markets' motivation to institute this litigation may have direct bearing on the policy issues inherent in any effort to fashion a modern definition of an "exchange."

Relying on the Supreme Court's decision in Clarke v. Securities Indus. Ass'n, 479 U.S. 388 (1987), the Seventh Circuit readily concluded that the futures markets are entitled to bring suit, although they were an unlikely champion of investors in futures markets. The court observed in passing that one must view this litigation with a jaundiced eye.

> Futures markets benefit from exclusivity; options trading reduces the volume of futures trading, and competition doubtless reduces the commissions, too. Investors, on the other hand, gain from the competition the futures markets dislike. Futures markets will lay claims under § 6 only if prevailing will break their rivals' kneecaps—which also could injure investors. Indeed, unless the creation of a new means of trading benefits investors (by introducing new financial instruments or driving down the price of trading), the futures markets won't file suit.

Board of Trade, 883 F.2d at 532. Which brings us to the heart of why the motivations of the futures markets are germaine to the topic of this article, which is whether the SEC properly construed the statutory definition of an exchange in its analysis of the Delta System: "Litigants pursuing private advantage may seek to mislead the court about the scope of the statute they invoke, arguing that it bars more competition than it does, or they may litigate to raise their rival's cost of doing business, not caring whether they prevail."*Id.*

The vagaries of private litigation, however, should not be relied on to define the parameters of a modern day definition of an "exchange." Even if one concedes that the 1934 Act definition is antiquated in light of modern trading practices, including automation and other computer-assisted technological developments, the scope of any state of the art definition should not be left to the realm of ad hoc administrative and judicial review of private parties' requests for relief from agency determinations, at least not without more guidance from Congress as to the factors to be considered and the appropriate balancing of such factors. As the Seventh Circuit recognized, "Some bodies of law are designed for the protection of competitors, making competitors the logical plaintiffs. Securities law, though, was not designed to protect futures markets from securities exchanges . . . ." *Board of Trade*, 883 F.2d at 532. Rather the exchange registration requirements were enacted to protect "investors and broker-dealers that want to influence the operation of the exchanges" on which they trade. *Id.* Moreover, "[w]hen Congress establishes the rules, an agency must carry them out. A desire to keep the law 'up to date' does not justify a departure from its rules." *Id.* Consistent with this view, this article maintains that the § 3(a)(1) definition is reflective of the auction trading principle, which must animate any agency interpretation of the statute's language. The SEC's "desire, however keen, to innovate" does not justify departure from the statute's language without prior congressional approval. *Id.* at 535.

Any modern definition of an exchange must recognize society's enormous investment in the efficient and fair functioning of our nation's capital markets, one of our most important national assets. Obviously, the determination of certain fundamental, core issues, such as the factors to be balanced in deciding whether a proposed trading format constitutes an exchange, it to consider and rule on the fundamental question of whether the Delta Trading System is an "exchange."

B. Delta II: *Analysis and Implications*

On January 12, 1990, the SEC handed down its order, wherein it concluded that the Delta Trading System did not constitute an "exchange" within the meaning of section 3(a)(1).[267] Following the decision on remand, the futures exchanges took an immediate appeal to the Seventh Circuit of the SEC's conclusion that the Delta Trading System was *not* an exchange. By this appeal, the appellate court was now required to squarely confront the issue of what constitutes an "exchange" for purposes of the statutory definition of the 1934 Act.

In its 1991 *Delta II* decision, the Seventh Circuit accepted the SEC's conclusion on remand that the Delta Trading System was not required to register as an exchange under the 1934 Act.[268] However, as was persuasively argued by the cogent dissent in that case, the Seventh Circuit's interpretation exceeded the language of the statute and the court's extreme deference to the SEC's interpretation of the "exchange" definition therefore was unwarranted. The compelling analysis of the dissent is entirely consistent with the view that the auction market principle animates the statutory definition of exchange, a point which was overlooked in the majority's often ambivalent analysis of the issue.

The Seventh Circuit's analysis is ambivalent in that it acknowledges, at several different points in its opinion, that the Delta Trading System may well constitute an "exchange" within the meaning of section 3(a)(1):

> There is no doubt that the Delta System creates an electronic marketplace for securities traders, and [the futures markets] say that no more is required to establish that the system must register as an exchange. The Commission's reply emphasizes the words "generally understood" [of the section 3(a)(1) definition of "exchange"]. The Delta System is not—not quite anyway—what is understood by the term "exchange." It lacks a trading floor. It

should be set forth by Congress and not left to the pitfalls and vagaries of private litigation or the nonreviewable orders of the SEC's no action letter process. *See supra* note 15. In this manner, society as a whole, including investors, other market participants and issuers, will receive the benefit of a full and open policy debate by Congress. Moreover, deliberate congressional review and consideration of all relevant criteria should produce the optimal *modern* definition of an "exchange."

267. Exchange Act Release No. 34-27611, *supra* note 217. The reasoning relied on by the SEC in reaching this determination is discussed in the context of examining the Seventh Circuit's decision in *Delta II*, which upheld the SEC's conclusion that the Delta Trading System was not an exchange.

268. The extreme deference accorded to the SEC's decision on remand stands in stark contrast to the foreceful decisiveness of the Seventh Circuit's *Delta I* decision, wherein the court applied the language of the statute and remanded the case with instructions that the SEC undertake a reasoned analysis of whether this PTS is an exchange.

> lacks specialists, who enhance the liquidity of an exchange by using their own capital to trade against the market when the trading is light, in order to buffer price swings due to the fewness of offers rather than to changes in underlying market values. Not all conventional exchanges have specialists, but those that do not have brokers who trade for their own account as well as for their customers' accounts, and the additional trading enhances the market's liquidity. It is fitting that such brokers are called "market makers."[269]

The Seventh Circuit relied on the phrase "generally understood" as used in the section 3(a)(1) definition to allow consideration of the absence of a traditional trading "floor and specialists" who contribute to the liquidity of a traditional exchange market.[270] After focusing on the absence of these characteristics in what is admittedly "an electronic marketplace for securities traders," the majority went on to observe that if the Delta Trading System were required to register as an "exchange":

> The system would be *kaput*. One must question an interpretation of the definitional provision that would automatically prevent competition for the exchanges from an entity that the exchanges are unable to show poses a threat to safety of investors by virtue of not being forced to register and assume the prescribed exchange format. . . . [The SEC] can better determine than we generalist judges whether the protection of investor and other interests within the range of the statute is advanced, or retarded, by placing the Delta System in a classification that will destroy a promising competitive innovation in the trading of securities.[271]

Thus, the Seventh Circuit accepts that there must be some balancing of competing interests in determining whether the section 3(a)(1) definition applies to these new PTSs on the grounds that the SEC should be able to balance the benefits offered by "innovative" new PTS against the fatal burdens imposed by requiring registration as an "exchange." The dissent argued in compelling fashion against each of these arguments proffered by the majority. Their disagreement can be separated into three aspects: (i) proper interpretation of statutory language of section 3(a)(1); (ii) concerns over liquidity and the contribution of specialists to the liquidity of an exchange market; and (iii) the appropriateness of balancing the benefits of innovation provided by these new PTSs such as the Delta Trading System against the burdens that would be imposed if "exchange" registration of these new trading systems were required.

This section addresses each of these concerns in turn. A full discussion of the dissent's arguments will demonstrate that the reasoning of the

269. Board of Trade v. SEC, 923 F.2d 1270, 1272 (7th Cir. 1991).
270. *Id.* at 1272.
271. *Id.* at 1273.

majority in *Delta II* is fundamentally flawed, producing a decision that increases the administrative discretion of the SEC well beyond the scope contemplated by Congress. This discussion also includes an examination of the policy implications of the Seventh Circuit's decision to abandon the auction trading principle as the core of the statutory definition of exchange.

1. Interpreting the Language of the Section 3(a)(1) Definition

The Seventh Circuit engaged in a tortured characterization of the statutory language of section 3(a)(1). The statute on its face suggests that an "exchange" exists where either: (i) an organization provides "a market place or facilities for bringing together purchasers and sellers of securities"; or (ii) an organization performs "with respect to securities the functions commonly performed by a stock exchange as that term is generally understood."[272] This definitional structure suggests that the first line of inquiry is whether the new trading system "provides a market place or facilities for bringing together purchasers and sellers of securities";[273] if not, then the court must proceed to examine whether the new trading system performs with respect to the securities to be traded the "functions commonly performed by a stock exchange as that term is generally understood."[274]

Applying this definition to decide whether the Delta Trading System is an exchange, the initial focus logically would be on whether the Delta Trading System provides a market place or facilities for bringing together purchasers and sellers of securities. As even the majority concedes, the Delta Trading System provides "an ingenious"[275] computerized facility that creates an electronic market place for bringing together purchasers and sellers of options on government securities. The dissent maintains that no further analysis of the question is required because, on this point, the statute is not ambiguous:

> An organization that "constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities" is an exchange. The statute makes it unnecessary to speculate whether bringing together buyers and sellers is one of the "generally understood" functions of an exchange; it makes *that* function a determinative characteristic, sufficient unto itself to confer exchange status.[276]

According to the dissent, there is no need to further analyze the section 3(a)(1) definition because "the statute leaves no doubt that bringing together

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272. Section 3(a)(1) of 1934 Act, 15 U.S.C. § 78c(a)(1) (1988).
273. *Id.*
274. *Id.*
275. Board of Trade v. SEC, 923 F.2d 1270, 1271 (7th Cir. 1991) (Flaum, J., dissenting).
276. *Id.* at 1273 (Flaum, J., dissenting).

buyers and sellers is the principal function of an exchange."[277] This interpretation of section 3(a)(1) is entirely consistent with this article's position that the exchange definition under the 1934 act is reflective of the auction market principle.

The majority took a different approach to interpreting this definition, however. The majority believed that the *entire* definition of section 3(a)(1) was qualified by the phrase "generally understood." The court rejected the position "that the words 'generally understood' apply only to functions other than the central one of 'provid[ing] a market place or facilities for bringing together purchasers and sellers of securities.'"[278] The Seventh Circuit felt that to interpret the statute otherwise would be to advance *too* literal a reading of the statute that would produce anomalous results. For example, such a narrow approach would require a literal reading of the words "bring together." But, as the majority quickly points out: "even an admitted exchange does not literally "bring together" purchasers and sellers of securities, . . . It does not bring them into physical propinquity. And a broker's waiting room, which does bring purchasers and sellers of securities into physical propinquity, is not an exchange."[279]

The nonsensical result of reading the definition literally to require brokers to register as exchanges was ably refuted by the dissent, which pointed out that Congress, in its adoption of the 1934 Act provided for separate treatment of brokers, dealers and exchanges. Brokers[280] and dealers[281] are separately defined, and both are required to register with the SEC under section 8 of the 1934 Act.[282] The exchanges do not act as brokers because they do not act as agents on behalf of the buyers or sellers who come to the exchange to effect their transactions. Similarly, exchanges do not act as dealers since an exchange does not trade securities as a principal, for its own account. Rather, exchanges exist to facilitate securities transactions by providing a central place for buying and selling interest to meet. Thus, by providing separate treatment for brokers, dealers and exchanges, Congress foreclosed the possibility that the definition of exchange would be interpreted to require a broker to register as an exchange.[283]

277. *Id.* The dissent recognizes that "[e]ntities that *otherwise* perform the functions of a stock exchange—whatever those may be—may also constitute exchanges. . . ." *Id.* But the dissent does not reach this aspect of the definition because the Delta Trading System constitutes a marketplace for buyers and sellers of securities.

278. *Id.* at 1272.

279. *Id.*

280. *See supra* note 43 and accompanying text.

281. *See supra* note 41 and accompanying text.

282. Section 8 of 1934 Act requires all brokers and dealers who effect securities trades on a registered exchange or in interstate commerce to register with the SEC. *See* 15 U.S.C. § 78h (1988 & Supp. II 1990). The vast bulk of this regulatory responsibility has been delegated to NASD subject to oversight by the SEC.

283. *See* Board of Trade v. SEC, 923 F.2d 1270, 1274 (7th Cir. 1991) (Flaum, J., dissenting) (observing that one can assume, pursuant to general rules of statutory interpretation, that "when Congress adopted specific definitions for brokers and dealers, it did not intend the definition of exchange to apply to them as well").

In 1934, Congress recognized the differences between the exchange markets and the OTC dealer market,[284] and, by enacting the definition of section 3(a)(1), did not intend to require registration of the OTC market. Congress was well aware that exchange markets limited trading to their members only and specifically sanctioned the ability of the exchanges to continue to limit the number of exchange memberships.[285] Congress, aware that buyers and sellers do not themselves interact on the floor of the exchange, must not have intended its definition of "exchange" to require an exchange to "bring buyers and sellers of securities into physical propinquity." Rather, as the dissent points out, "the 'bringing together' of buyers and sellers refers not to their actual presence but to their offers to trade."[286] Thus, buying and selling interests meet on the exchange floor, in contrast to the OTC market where buy and sell offers "come together only through dealers who interpose themselves between the parties, buying from sellers and selling to buyers; parties rarely negotiate directly."[287]

For these reasons, the majority's attempt to use the words "generally understood" to qualify the entire section 3(a)(1) definition of "exchange" is misplaced. None of the nonsensical results it posits to support its interpretation of the statute's definition are contemplated by the statutory framework for registering brokers, dealers and exchanges.

With respect to the trading proposed under the Delta Trading System, it is clear that this new trading system does blur the traditional distinction between exchange markets and the OTC market. However, as was forcefully observed by the dissent in *Delta II*, the Delta Trading System constitutes a computerized facility that provides a centralized market place for bringing together buying and selling interests in options on government securities. As such, the Delta System is an "exchange" within the meaning of section 3(a)(1)'s definition.[288]

The statutory language mandates the conclusion that the Delta Trading System is an exchange. If, as a policy matter, the SEC is concerned that the current definition may stifle innovation and may lead to the loss of trading activity to offshore markets, the solution is to seek a legislative amendment to the definition of an exchange. The majority in *Delta II*, by virtue of its decision to defer to agency discretion, has allowed the SEC to determine the relevant policy criteria that should guide the modern day definition of an exchange. These policy considerations may be important, but as the dissent recognizes, the SEC does not have the authority to graft

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284. *See supra* notes 74-81 and accompanying text (discussing these differences).

285. *See supra* note 34 and accompanying text (discussing membership on "exchange").

286. *See Board of Trade*, 923 F.2d at 1274 (Flaum, J., dissenting).

287. *Id.*; *see also supra* notes 64-67 and accompanying text (discussing mechanics of OTC market transaction).

288. This article maintains that the section 3(a)(1) definition of exchange is a separate inquiry from the determination of whether an exchange is or should be required to register as an exchange under section 6 of the 1934 Act. *See infra* notes 319-20 and accompanying text.

them onto the existing statutory definition of an "exchange." More importantly, Congress should undertake a comprehensive study of the structure of the markets and the current trading strategies of new PTSs, which in fact seem to favor an auction process, before we cast aside the core aspect of the statutory definition of exchange: The auction market trading principle.

2. Liquidity and the Role of Specialists

The majority in *Delta II* concluded that the Delta System was not an "exchange" as that term is "generally understood" because "[i]t lacks specialists, who enhance the liquidity of an exchange by using their own capital to trade against the market when the trading is light, in order to buffer price swings due to the fewness of offers rather than to changes in underlying market values."[289] However, as the majority implicitly recognizes, the presence of a specialist is not a precondition to a finding that a proposed trading system is an exchange within the meaning of section 3(a)(1). The majority points out that "[n]ot all conventional exchanges have specialists, but those that do not have brokers who trade for their own account"[290] and who also execute customers' trades; these "brokers" are called "market makers."[291] The majority does not provide an example of such an "unconventional exchange."[292] It is unclear whether it is the absence of the specialist, or the presumed illiquidity that flows from such absence, that causes the majority to doubt whether the Delta Trading System is an exchange. Since the majority seems to acknowledge that exchanges qua exchanges do not always have a "specialist," it appears that the majority's concern lies with the liquidity that a specialist system provides to the traditional operation of an exchange.

Historically, the specialist system facilitates the continuous auction market provided by the traditional exchange floor. However, as the dissent observed, in a well-functioning centralized auction market, there often is little or no need for the dealer aspect of the specialist's function.[293] Where a particular security is actively traded, the continuous flow of buy and sell

289. *Board of Trade*, 923 F.2d at 1272.

290. *Id.*

291. *Id.*

292. The majority's discussion of this point is somewhat confusing in its use of terminology. Most conventional exchanges allocate the dealer function to a specialist. The equivalent position in the OTC dealer market is held by "market makers." Moreover, the marketmaker in the OTC transaction generally *is* the other side of the trade because the OTC *is* a dealer's market; whereas, as the majority points out, the exchange specialist trades in a dealer capacity only in periods of temporary imbalance in order flow activity. This contributes to a lack of clarity about what type of "conventional exchange" market the majority seeks to describe.

293. *See Board of Trade*, 923 F.2d at 1274 (Flaum, J., dissenting). This is generally expressed as the specialist's obligation to trade only when necessary to maintain a fair and orderly market. *See supra* notes 39-49 and accompanying text.

activity allows customers' orders to be executed without the intervention of a professional dealer. Indeed, this is one of the goals of the NMS—to create a centralized market for qualified securities that will minimize the need to rely on the professional dealer to provide opposing interest in any given trade.[294] "The SEC's emphasis on the market making function [reflected in the dealer role of the traditional exchange specialist] seems misplaced, however, because exchanges exist to *eliminate* the need for market-makers by bringing buyers and sellers together directly."[295]

As the dissent recognized, the Delta Trading System is designed to promote liquidity in the trading of a particular kind of security, by providing a centralized system for trading options on United States government securities. The absence of a specialist system does not defeat its consideration as an exchange. Unlike the market maker who participates as a dealer in virtually every trade executed on the OTC market, the Delta Trading System provides a facility that *centralizes* trading in options on government securities. The Delta Trading System centralizes order activity on its computer screens and facilitates trading activity, but does *not* act in a dealer capacity by buying and selling such options for its own account—the essential difference between the usual activity of the OTC dealer market and the exchange markets.[296]

Without a dealer function represented in the Delta Trading System, a concern about the liquidity of this market surfaces. Trades will be executed

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294. *See supra* notes 142-45 and accompanying text (discussing this aspect of NMS legislation and SEC's efforts to establish market linkages that will maximize market exposure of order flow as strong indication that it subscribes to this view of liquidity function of specialist's role). Indeed, in a rather sudden change of heart, the SEC ultimately retreated from its reliance on the absence of a specialist as an indication that the Delta System was not an exchange. *See* Exchange Act Release No. 34-27611, *supra* note 217.

295. *Board of Trade*, 923 F.2d at 1274 (Flaum, J., dissenting), citing to LTV Federal Credit Union v. UMIC Gov't Sec., 523 F. Supp. 819, 834-5 (N.D. Tex. 1981), *aff'd*, 704 F.2d. 1991 (5th Cir.), *cert. denied*, 464 U.S. 852 (1983). Indeed, the SEC's efforts to implement the NMS legislation seem to recognize this. The SEC's attempts to establish market linkage through the development of a universal message switch has been met with considerable resistance. The apparent reason for such resistance is the general belief that such a fully automated system would lead to extinction for traditional exchange floor trading even though such a trading system is fully reflective of the auction trading principle that is the heart of the analysis under the section 3(a)(1) definition of exchange. *See* Poser, *supra* note 6.

296. The SEC ultimately recognized this point and in its decision on remand, announced, as a policy matter: "no sponsor of a [new securities trading system] can avoid exchange registration simply by avoiding particular characteristics of traditional exchange markets such as affirmative market making obligations or a limit order book."

Exchange Act Release No. 34-27611, *supra* note 217, at *50. This position implicitly recognizes the distinction between the definition of exchange under section 3(a)(1) and the separate determination of whether a particular system is appropriate for registration under section 6. *See supra* notes 101-09 and accompanying text (discussing this distinction and its significance). It seems illogical to craft a definition where the critical determinants of exchange status are left to the discretion of the sponsor of the new trading system and therefore are easily manipulated to avoid being treated as an exchange.

on the Delta Trading System, which has no market maker, where there is countervailing interest. In the absence of such interest, an order will remain pending in the system until such interest appears and the order is executed or the order is voluntarily withdrawn or otherwise expires.[297] Thus, the absence of a specialist or market maker affects the ability of the Delta Trading System to provide liquidity to the participants who trade on this system.

Liquidity is generally defined as "the ability of an exchange to give traders a reasonable expectation that they will be able to execute their orders at the [prevailing] prices being quoted when the order is placed."[298] Thus, as even the SEC recognized, "[i]t is certainly possible that even a system such as the [Delta Trading] System might attract a level of buying and selling interest to develop into a continuous or regular auction market."[299] Thus, the SEC recognized that with larger volume, liquidity increases and the absence of market makers is less troubling. But this concern over liquidity is misplaced because the Delta Trading System, like the NYSE, is *designed* as an exchange. Its low volume may affect its ability to provide liquidity, but its system is designed so as to provide liquidity as volume increases, without relying on a market maker or specialist. And as the experience of the October 1987 market break dramatically illustrates, "no market, whether or not an exchange, can assure liquidity in all circumstances."[300]

In any case, this entire discussion of liquidity is a red herring because Congress specifically addressed concerns over low volume trading on an "exchange." Section 5 provides for a low volume exemption from the statute's registration requirements.[301] For trading systems that constitute an "exchange" under the statutory definition but whose volume does not exceed specified levels, Congress authorized an exemption from registration.[302] However, the statute's low volume exemption makes clear that volume plays no role in deciding whether the definition of exchange is satisfied; otherwise such an exemption is meaningless.[303]

297. *See supra* notes 216-32 and accompanying text (discussing trading on Delta Trading System).

298. *Board of Trade*, 923 F.2d at 1275 (Flaum, J., dissenting).

299. Exchange Act Release No. 34-27611, *supra* note 217, at 50 n.100.

300. *Board of Trade*, 923 F.2d at 1276 (Flaum, J., dissenting).

301. *See* 15 U.S.C. § 78e (1988).

302. *See* § 5(e) of the 1934 Act, 15 U.S.C. § 78e (1988). Presumably, Congress recognized that the benefits of registration (in terms of investor protection and integrity of the markets as well as the protection of the traders on that exchange) may not outweigh the costs to be imposed on a low volume exchange.

303. See *Board of Trade*, 923 F.2d at 1275-76. Thus, the SEC's apparent indication that the Delta System might develop into an exchange market if its volume of trading activity increases sufficiently is not supported by the language of the statute which treats volume as the basis for an *exemption*.

3. Benefits of Innovation vs. Costs of Registration as an Exchange

In its struggle to reach the conclusion that the Delta Trading System is not an exchange, the Seventh Circuit majority seemed preoccupied with concern over whether sufficient benefits flow from subjecting this new, innovative trading system to the burdensome requirements of registration as an exchange. The majority seems unduly preoccupied with the risk of stifling innovation by imposing the costs of exchange registration on a system that will be utilized primarily, if not exclusively, by sophisticated institutional investors (or their designated representatives) or the primary dealers in the government securities markets. However, the court's almost exclusive focus on the presumed absence of any benefits to be provided to the traders themselves on the Delta Trading System if exchange registration were to be required does not give sufficient consideration to the other interests that are to derive protection from the section 6 registration requirements. Although the section 6 requirements were intended to give protection to the traders on the exchange, the 1934 Act also intended to protect the integrity of United States capital markets as a whole.[304]

The decision to treat the Delta Trading System and other screen based trading systems as non exchanges can lead to the consequences of "market fragmentation," thereby producing too great a burden on the effective functioning of our capital markets as a whole. Order flow activity may be diverted to the alternative markets provided by these new PTSs, and any such diversion may create additional transaction costs associated with market fragmentation. These costs include internalization of order flow thereby disrupting the pricing mechanism in the absence of an order exposure rule.[305] A second significant consequence flowing from market fragmentation is the dilution of the broker-dealers' best execution responsibility. The price disruption that results from internalization of order flow activity may dampen the broker-dealer's ability to obtain best price for her customers because of the increased transaction costs associated with ascertaining and routing the order to the best available market. Therefore, the costs to be born by the capital markets as a whole may justify the imposition of the registration obligation on a proposed trading system.

To the extent that the benefits to be derived by registering the new system as an exchange are insufficient, the analysis may turn on the volume of trading occurring on the new system. In such situations, the better

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304. *See* Board of Trade v. SEC, 883 F.2d 525, 532 (7th Cir. 1989).

305. Anders & Torres, *supra* note 2, at A1 (warning of dangers of fragmented market). NYSE specialists say small investors, unable to use the new PTSs, could suffer from inferior pricing and fewer trading opportunities, especially in lightly traded issues, if big investors abandon the exchanges, and route orders through off-exchange systems. *Id.* A similar controversy has long brewed with respect to repeal of the off-board trading rules adhered to by the exchanges, particularly the NYSE. *See, e.g.*, Rule 390 of the NYSE, 2 NYSE Guide (CCH) ¶ 3651 (Rule 390), and Rule 5 of the AMEX, 2 Am. Stock Ex. Guide (CCH) ¶ 2419 (rule 5). For a further discussion of the implications of these off-board trading rules, see generally Poser, *supra* note 6; Seligman, *supra* note 6; Lipton, *supra* note 24.

approach is to treat the system as an "exchange," but to qualify it for the low volume exemption from the section 6 registration obligation. To the extent that the costs exceed the burdens based on an analysis that does not relate to volume, the SEC's recourse is to Congress to expand the exemptions from exchange registration under section 6. It should not be left to agency discretion, as the majority did in *Delta II.*

The majority shares the SEC's concern about stifling innovation by imposing the cost of the section 6 registration obligation on proposed alternative trading systems. However, as the dissent correctly observes, innovation may well survive these costs.[306] If experience indicates that innovation is discouraged by the existing definition and leads to the loss of trading activity to offshore markets, the solution is to seek a legislative amendment to the definition of an exchange. The majority, by virtue of its decision to defer to agency discretion, has allowed the agency to graft this policy factor upon the definition of an exchange.

It is well settled, however, that the authority of the SEC is established by statute. The SEC may not seek, by rulemaking action or otherwise, to enhance the scope of its authority beyond the literal language of the statute. The Seventh Circuit's decision represents an attempt to allow the SEC to expand the scope of the statute to enhance its discretionary authority, while giving lip service to the notion that the SEC is acting within the scope of its statutory mandate.

4. Epilogue: SEC's Reproposed Rule 15c2-10 and Its Impact on "Exchange" Registration of PTSs

Curiously enough, neither the majority nor the dissent in *Delta II* mentioned the SEC's rulemaking initiative undertaken in the context of the litigation over the Delta Trading System. The SEC proposed to legislate its prior no-action posture into a rule format which was conducted in accordance with formal rulemaking procedures allowing for public comment. However, the SEC's rulemaking proposal reflected in reproposed Rule 15c2-10 is inadequate because of its piecemeal consideration of the issue of what is an exchange without benefit of full public study of the important policy issues raised by this proposal.[307]

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306. *See* Board of Trade v. SEC, 923 F.2d 1270, 1276 (7th Cir. 1991) (Flaum, J., dissenting), wherein the dissent expresses some skepticism about whether this system in fact will be "kaput.

307. In commenting on re-proposed rule 15c2-10, one scholar has observed:

> The electronic trading systems [such as the Delta Trading System] are presenting new and interesting questions for industry regulators. Below, two different aspects of problems are reviewed. First, we look at the domestic market where the SEC is contending with the very specific question of how to regulate existing and future proprietary trading systems. Thereafter, we take on the broader policy issues which arise when trading is done on a global scale, where different national regulatory schemes must interact with one another to meet the needs of the new international

a. The SEC's Incentive to Repropose Rule 15c2-10.

The SEC indicated that it was prompted in part to repropose Rule 15c2-10 because of its concern that "as proprietary trading systems become more complex and particularly as they develop the capability of linking with foreign markets," the no action approach may no longer be adequate.[308] The SEC was concerned about whether foreign participants would be financially responsible and comply with United States securities laws.[309] Further, due to differences between United States securities laws and foreign securities law, the SEC saw the need to have a mechanism in place to obtain surveillance information from the foreign country in the event of federal securities law violations occurring on these new trading systems.[310]

The SEC cited other considerations that favored a review of its regulatory approach to proprietary trading systems.[311] The new regulation would ensure that new PTSs have sufficient capacity to function in times of unusually heavy volume. It would also make certain that access to these systems was fair and nondiscriminatory.

In its release re-proposing Rule 15c2-10, the SEC stated its belief that proprietary trading systems are "distinguishable in function from exchange markets."[312] The proprietary trading systems execute trades which are based on derivative pricing, that is, they are based on a quotation provided by another entity. Further, the SEC was not ready to decide that the proprietary trading systems are exchanges because they do not involve transactions in

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securities market.

Lewis D. Solomon & Louise Courso, *The Impact of Technology on the Trading of Securities: The Emerging Global Market and the Implications for Regulation*, 24 J. MARSHALL L. REV. 299, 322 (1991).

308. *Id.* at 323; *see also* Exchange Act Release No. 34-26708, 1989 SEC LEXIS 680 (Apr. 11, 1989). Indeed, in the few years since the SEC issued its initial no-action ruling regarding the Delta Trading System, the SEC has faced a veritable explosion in no-action letter requests asking it to consider whether a new PTS must register as an exchange. *See, e.g.*, LIMITrader, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1112 (Oct. 1, 1991); Franklin Crossing Arrangement, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1299 (Nov. 22, 1991); New York Securities Auction Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 904 (June 15, 1990).

309. *See* Solomon & Courso, *supra* note 307, at 323.

310. *Id.*

311. *See* Exchange Act Release No. 34-26708, *supra* note 206.

312. *Id.* at *17. In its second no-action letter ruling, the SEC affirmed its earlier finding that the Delta Trading System was not required to register as an exchange by observing in passing that the Delta Trading System performed "bulletin board" functions. *See* Exchange Act Release No. 34-27611, *supra* note 217. The SEC did not describe those functions in its no-action letter ruling nor did the Seventh Circuit rely on the bulletin board function to reach its conclusion that the Delta Trading System is not an exchange for purposes of section 3(a)(1). Since its 1990 no-action ruling regarding the Delta Trading System, however, the SEC has increasingly relied on the "bulletin board" function to support its conclusion that a PTS does not qualify as an exchange for purposes of the 1934 Act. *See, e.g.*, Petroleum Information Corp., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 1236 (Nov. 18, 1989); Order Approving Proposed Rule Change and Notice of and Order Granting Accelerated Approval

which participants enter two-sided quotations on a regular or continuous basis.

The SEC went on to observe that if proprietary trading systems were subject to the exchange registration requirements of Section 6, these requirements would present a great burden on the proprietary systems which would in effect act as a barrier to entry. Imposition of these regulatory requirements would deter development of innovative trading systems. Thus, the SEC settled on reproposed Rule 15c2-10 as the most satisfactory regulatory alternative.

These concerns on the part of the SEC may be very well taken and are certainly consistent with the views it expressed in its 1980s no action letter process. Balancing these considerations, however, is not part of the statutory definition, and therefore, is also outside the scope of the SEC's authority. Moreover, the SEC has overlooked the auction trading principle which forms the heart of the analysis under the statutory definition of exchange—a principle which the SEC had vigorously championed in its NMS proposal and subsequent implementation of the 1975 NMS legislation.

b. The Terms of Reproposed Rule 15c2-10.

Reproposed Rule 15c2-10 would require the sponsor of a new PTS to submit an identification statement of the proposed trading and information facilities, including a description of the system and the type of securities to be traded. The proponent of the PTS would then submit a plan describing the method of operation, terms and conditions of access, and emergency procedures in the event of operation failure. The plan also must include a description of the system's requirements for assessing the financial soundness of its subscribers, as well as for monitoring compliance by subscribers with federal securities laws, rules, and regulations.[313] Finally, the proprietary trading system would enter into a series of agreements with the SEC, including agreements regarding record keeping, submission of data on an annual basis to the SEC, and system-wide supervision of the system to ensure compliance with the plan and with federal securities laws. The proposed rule also specifies provisions for other contingencies, such as plan amendments.

c. Comments on Proposed Rule 15c2-10.

Following publication of the notice of proposed rulemaking, interested parties filed comments with the SEC. Most persuasive of the comments filed was the argument that while proprietary trading systems do indeed

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of Amendment to Proposed Rule Change of the National Association of Securities Dealers, Inc. Relating to the OTC Bulletin Board Display Service, Exchange Act Release No. 34-27975, 1990 SEC LEXIS 799 (May 1, 1990) (regarding operation of NASD's OTC Bulletin Board Display Service).

313. *See* Solomon & Courso, *supra* note 307, at 325.

conform to the literal definition of an exchange found in the statute, they should nevertheless be exempted from the burdens of registration as exchanges until they evolve into "mature" market places.[314] The imposition of certain conditions on the exemption, similar to those proposed under rule 15c2-10, would satisfactorily protect investors using the new systems.

Other commentators expressed a preference for the no-action approach currently used by the SEC because it reduces "red tape" and keeps start-up and operating costs for these new systems low. According to these commentators, the costs of complying with regulatory requirements is, for the most part, fixed and disproportionately impacts small proprietary systems. The cost of regulation as a percentage of the cost of each trade therefore will be proportionately higher for the new proprietary systems than for the larger exchanges.[315] Of overriding concern to the SEC was the contention that if the cost of operating such systems becomes too high because of increased regulatory requirements, the system will move offshore to avoid them. However, to refute the argument that exchange status and the notion of innovation are mutually exclusive, one commentator pointed to the automated systems used by both the NYSE and the smaller regional exchanges.

Finally, opponents of the proposed regulation argued that Rule 15c2-10 would impose an unnecessary regulatory burden on proprietary trading systems which can otherwise be adequately regulated as brokers. Instinet, for example, maintained that it merely automated the business of the broker. Instinet also stated that it should not be regulated as an exchange for several reasons: Instinet communicates quotations of other exchanges or markets, and therefore, there is no Instinet "market" because there is no physical floor or central place for market makers and traders meet, nor are there members of Instinet.[316] Instinet also echoed the concern that promulgation of Rule 15c2-10 would stifle innovation and adversely effect its expansion into international markets.

However, at least one commentator has criticized the arguments proffered by Instinet stating that:

> [b]ut, with its capability for executing trades, Instinet goes beyond the functions of a "mere broker." Looking at the statutory language

314. *Id.* at 326.

315. The basis of this argument is unclear. Is this disproportionate impact created because of the low volume of trades expected to be executed on the new PTS? Or is it because of some other characteristic singularly in the possession of the new proprietary systems that are unregistered as opposed to those sponsored by the established, registered exchanges? If this concern is attributable to the low volume of new trading systems, does not the existing volume exemption under section 6 take care of this concern? Once again we are faced, as we were in considering the Delta System, with an inadequate explanation of the burdens imposed by § 6 exchange registration and why these burdens would be fatal to these "innovative" new systems.

316. Solomon & Courso, *supra* note 307, at 326-27; *see* Saul Hansell, *The Wild, Wired World of Electronic Exchanges*, 23 INSTITUTIONAL INVESTOR 91 (Sept. 1989) (reviewing electronic trading and financial markets); *see also* William C. Freund, *Electronic Trading and Linkages in International Equity Markets*, FIN. ANALYSIS J. 10, 13 (May-June 1989).

> which defines an exchange, it is clear that a proprietary trading system is an organization which provides facilities for bringing together purchasers and sellers.[317]

The statutory definition does not require such attributes as a physical trading floor or a continuous two sided quotation system for a central meeting place for buyers and sellers to exist. Even if a new PTS falls within the statutory definition of exchange, however, the 1934 Act includes an exemption for exchanges with limited trading volume. This exemption may be used by the SEC to promote a policy of innovation at a cost lower than established "exchange" competitors, who presumably must continue to comply with "exchange" registration requirements in their development of new PTSs.[318]

V. Conclusion

This article has focused on the question of *who* should decide the important policy question of what constitutes an exchange. This question is of enormous immediate consequence since the path that the Seventh Circuit's *Delta II* decision has taken leaves the decision almost entirely in the hands of the SEC.[319] As the dissent in *Delta II* pointed out, however, the SEC's interpretation improperly exceeds the scope of the statute's "exchange" definition.

The core of the existing section 3(a)(1) definition reflects the auction trading principle that formed the basis for organized trading on the floor of the exchange markets in 1934 when Congress originally enacted the

317. Solomon & Courso, *supra* note 307, at 327; *see also* Board of Trade v. SEC, 923 F.2d 1270, 1274 (7th Cir. 1991) (Flaum, J., dissenting).

318. *See supra* note 103 and accompanying text (discussing scope of low volume exemption from section 6 registration obligation).

319. If we follow this path, our domestic trading markets ultimately may find themselves in the same regulatory quagmire that has bogged down our domestic banking system:

> Commercial banks have aggressively increased the scope and scale of their securities activities in recent years and have signaled their intentions to continue to do so in the future. This expansion of securities operations has occurred despite the apparent prohibitions of the Glass-Steagall Act on bank involvement in investment banking, which have not been modified greatly by Congress since their enactment in 1933. . . . Despite the failure of Congress to act, many commercial banks, particularly larger ones, have been remarkably successfully increasing their involvement in the securities markets. In doing so, they have taken advantage of ambiguities in the language of the Glass-Steagall Act and the willingness of the federal bank regulatory agencies and the courts to reinterpret that language progressively more liberally.

George G. Kaufman & Larry K. Mote, *Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation*, 107 Banking Law Journal 388, 388-89 (1990); *see also* Donald C. Langevoort, *Statutory Obsolescense and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 Mich. L. Rev. 672 (1987). To avoid the possibility of a similar national nightmare stemming from a similar process of regulatory revisionism with respect to the trading markets, the SEC should be required to adhere to the statutory definition of "exchange."

definition. This article has demonstrated that this auction trading principle has now been extended to create new PTSs that do not physically resemble traditional exchange floor trading. Nonetheless, these new PTSs are exchanges within the meaning of section 3(a)(1) since they provide "a market place or facilities for bringing together purchasers or sellers of securities." As such, these new PTSs must be registered as exchanges, contrary to the SEC's decision regarding the Delta Trading System, which was then acquiesced in by the Seventh Circuit in *Delta II.*

Since the auction trading principle is of continued force and effect, it should not be cast aside without vigorous public debate over what concerns should be paramount in deciding whether a particular trading system should be regulated as an exchange. Accordingly, any proposed modification to the statute's definition is deserving of full congressional inquiry and deliberation, particularly as the historical differences between the exchanges and the OTC market continue to blur.

Therefore, Congress should investigate the structure of existing securities trading markets and decide if the current statutory definition of an exchange is indeed antiquated. Concerns that should be debated vigorously by Congress as part of this recommended study include disclosure, market fragmentation, liquidity, capitalization of the trading system and its members or participants, and efficient functioning of the auction market principle. If change is warranted—as well it might be—the SEC should be required to seek congressional action on this issue, allowing for full public review, debate, and balancing of the competing policy considerations inherent in any such undertaking. Our capital markets, indeed our society as a whole, deserve no less.[320]

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320. *See supra* note 22 and accompanying text (describing other commentators urging that Congress hold hearings on this issue). "As technology moves proprietary trading systems away from niche markets, and mainstream markets become more fragmented and competitive, the debate over how off-exchange trading should be regulated will become more heated. When Congress has finished asking itself what is a bank, it will have to start asking itself what is a stock exchange." *The Shrinking of the Big Board*, ECONOMIST, Feb. 16, 1991, at 67.