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COMMENTS

MOVE OVER TICKERTAPE, HERE COMES THE CYBER-EXCHANGE: THE RISE OF INTERNET- BASED SECURITIES TRADING SYSTEMS

Daniel M. Gallagher⁺

With its unparalleled ability to bring people together, the Internet has revolutionized many aspects of daily life in America.¹ Originally conceived by the Department of Defense as a military program in 1969,² the Internet is now a global network of interconnected computers.³ Countless Americans use the Internet to send and receive electronic mail, chat with other Internet users, access vast databases of information, and shop for various types of merchandise.⁴

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1. For a concise description of the history and capabilities of the Internet, see HOWARD M. FRIEDMAN, *SECURITIES REGULATION IN CYBERSPACE* § 1.02 (1997).

2. See *Reno v. ACLU*, 117 S. Ct. 2329, 2334 (1997) (discussing technical and historical aspects of the Internet, as well as some of the various services it offers). Research done by the United States Department of Defense originally gave rise to the Internet. See FRIEDMAN, *supra* note 1, § 1.02 at 1-4. A military program called "ARPANET" provided the example used to develop the Internet. See *Reno*, 117 S. Ct. at 2334. ARPANET is an acronym for the Advanced Research Project Agency. See *id.* at 2334 n.3. ARPANET allowed the military, defense contractors, and universities conducting defense-related research to maintain communication with each other, even if the networks partially were damaged due to war. See *id.* at 2334. Since the days of the now defunct ARPANET, the Internet has experienced extraordinary growth. See *id.* The number of Internet users is expected to increase to 200 million by 1999. See *id.*

3. See *Reno*, 117 S. Ct. at 2334; see also Federal Networking Council, *FNC Resolution: Definition of "Internet"* (last modified Oct. 30, 1995) <http://www.fnc.gov/Internet_res.html>. The Federal Networking Council has defined the Internet as:

the global information system that— (i) is logically linked together by a globally unique address space based on the Internet Protocol (IP) or its subsequent extensions/follow-ons; (ii) is able to support communications using the Transmission Control Protocol/Internet Protocol (TCP/IP) suite or its subsequent extensions/follow-ons, and/or other IP-compatible protocols; and (iii) provides, uses or makes accessible, either publicly or privately, high level services layered on the communications and related infrastructure described herein.

Id.

4. See *Reno*, 117 S. Ct. at 2334-35 (noting that "[i]t is no exaggeration to conclude that the content of the Internet is as diverse as human thought.") (internal quotation omit-

Within the general growth of business activity on the Internet, a specific market for the buying and selling of securities recently has emerged.⁵ Traditionally, buyers and sellers of securities effect transactions through broker-dealers⁶ present on the floor of conventional stock exchanges, such as the New York Stock Exchange (NYSE), or through those broker-dealers who use the Nasdaq Stock Market system (Nasdaq).⁷ With the advance of technology, however, investors and other market participants can now utilize numerous alternatives to the traditional securities trading methods.⁸ Although still in an early stage of

ted); see also Alexander C. Gavis, *The Offering and Distribution of Securities in Cyberspace: A Review of Regulatory and Industry Initiatives*, 52 BUS. LAW. 317, 318 (1996) ("By the end of the decade—if not sooner . . . consumers will be able to purchase everything from toothpaste to municipal bonds from their homes by using computer based-networks."). But see Adrienne Fox, *Was The Internet Overhyped?* INVESTORS BUSINESS DAILY, Oct. 10, 1997, at A1 (noting that very few people make use of the Internet for shopping). Many Internet users are wary of purchasing merchandise over the Internet because of concerns about publicly disseminating credit card information. See *id.*

5. See FRIEDMAN, *supra* note 1, § 6.01 at 6-2 (stating that several corporate issuers plan to trade their securities on the Internet); see also Lourdes Gonzalez & Diane Mage Roberts, *Internet-Based and Other Online Trading Systems*, INSIGHTS, July 1997 at 8, 8 (stating that the Internet is a uniquely suitable forum for issuing companies and third parties to develop a market for securities because of its ability to reach millions of people in a cost-effective manner).

6. The 1934 Act defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4) (1994). The 1934 Act defines "dealer" as "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.* at § 78c(a)(5). Securities firms typically operate as both brokers and dealers, and are, therefore, referred to as "broker-dealers." See NORMAN S. POSER, *BROKER-DEALER LAW AND REGULATION* 1-6 n.12 (2d ed. 1997).

7. See generally Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883, 885-96 (1981) (discussing the structure of the United States securities markets and the forums available to buyers and sellers of securities for trade execution).

8. See Regulation of Exchanges, Exchange Act Release No. 34-38672, 62 Fed. Reg. 30,485, 30,488 (June 4, 1997). In connection with the publication of the Regulation of Exchanges release (Release), the director of the United States Securities and Exchange Commission's (SEC) Division of Market Regulation, Richard R. Lindsey, made a speech discussing the need for the regulation of alternative trading systems and the related promulgation of the Release. See Richard R. Lindsey, *Opening Statement* (visited Sept. 30, 1997) <<http://www.sec.gov/news/speeches/spch162.txt>>. In his speech, Director Lindsey noted that technology has impacted greatly upon the securities markets. See *id.* at 1. Lindsey also stated that the SEC wanted the Release to start a dialogue regarding the best way to regulate alternative trading systems. See *id.* at 2. Lindsey emphasized that the Release was conceptual, and that the SEC designed it only to lay the foundation for future changes to the regulatory process. See *id.* The SEC estimates that alternative trading systems now account for approximately 20% of over-the-counter (OTC) orders, and approximately 4% of orders for NYSE-listed securities. See Regulation of Exchanges, 62

development, Internet-based securities trading systems promise to be one of these alternatives.⁹

Many of the transgressions anticipated with the increase in Internet securities trading are the same as those that originally spawned the enactment of federal securities legislation¹⁰ in the 1930s.¹¹ Although the forms of abuse might remain the same, the Internet, with its ability to reach a wide audience of investors, poses a unique challenge to the United States Securities and Exchange Commission (SEC) with respect to enforcement responsibilities.¹² As Congress noted in the 1930s, the basic abuses in the

Fed. Reg. at 30,486. The term "alternative trading system" incorporates all automated systems that centralize, display, match, cross, or otherwise execute trades, but are not registered with the SEC as national securities exchanges or operated by a registered securities association. *See id.* at 30,486 n.1.

9. *See* U.S. SEC. & EXCH. COMM'N, THE IMPACT OF RECENT TECHNOLOGICAL ADVANCES ON THE SECURITIES MARKETS 124 (1997) [hereinafter TECHNOLOGY REPORT] (discussing the Internet's developing nature and its effect on securities law enforcement activities).

10. The body of law generally referred to as the federal securities law includes: (1) the Securities Act of 1933, (2) the Securities Exchange Act of 1934, (3) the Public Utility Holding Company Act of 1935, (4) the Trust Indenture Act of 1939, (5) the Investment Company Act of 1940, and (6) the Investment Advisers Act of 1940. *See* JAMES D. COX ET AL., SECURITIES REGULATION CASES AND MATERIALS 14-15, 20 (1991).

11. *See* H.R. REP. NO. 73-1383 at 1-2 (1934) (discussing the causes of dangerous stock market speculation and the related need for federal regulation); *see also* Joseph J. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, 52 BUS. LAW. 815, 830 (1997) (discussing the various abuses that may result from Internet-based securities trading). Aware of the potential for such abuses, the SEC has established a page on its Internet Web site devoted to an offensive against Internet-based securities law violations. *See* Office of Investor Education and Assistance, SEC, *Investment Fraud and Abuse Travel to Cyberspace* (last modified Oct. 17, 1996) <<http://www.sec.gov/consumer/cyberfr.htm>>.

12. *See* TECHNOLOGY REPORT, *supra* note 9, at 127, 131 (discussing the uniqueness of the Internet as a medium for securities trading and the traditional forms of abuse that can occur on the Internet). For a more detailed insight into SEC Internet enforcement activity, *see* SEC v. Chelekis, Litigation Release No. 15264, 63 SEC Docket (CCH) 2489 (Feb. 25, 1997) (involving the publication on the Internet of false and misleading statements regarding several public companies); SEC v. Huttoe, Litigation Release No. 15153, 63 SEC Docket (CCH) 427, 428 (Nov. 7, 1996) (detailing a series of fraudulent acts by the chief executive officer of a public company, including the bribery of the operators of an electronically disseminated "tout sheet" in return for favorable recommendations for the company); SEC v. Western Executive Group, Inc., Litigation Release No. 15106, 62 SEC Docket (CCH) 2686, 2687 (Oct. 3, 1996) (describing a scheme involving the solicitation of investors over the Internet to purchase investment contracts for the sale and lease of ATM machines); SEC v. Wye Resources, Inc., Litigation Release No. 15073, 62 SEC Docket (CCH) 2533, 2534 (Sept. 26, 1996) (describing the use of an Internet-based bulletin board by a company to issue false messages regarding its exploitation of certain mining properties in Africa); *In re* Broad Capital Assocs., Inc., Securities Act Release No. 33-7338, 62 SEC Docket (CCH) 2430, 2431 (Sept. 26, 1996) (involving the publication of false press releases about a company on an Internet bulletin board); SEC v. Sellin, Litigation Release No. 15004, 62 SEC Docket (CCH) 1477 (Aug. 7, 1996) (involving a fraudulent offering of

securities markets include fraudulent manipulation of stocks by brokers and dealers, as well as the various deceptive devices employed by issuers¹³ in connection with securities disclosure practices.¹⁴ In response to these violations—abuses that helped give rise to the stock market crash of 1929 and the ensuing Great Depression—Congress passed several laws during the 1930s and 1940s designed to protect the nation's investors and securities markets from future manipulation and fraud.¹⁵ Of these laws, the earliest were the Securities Act of 1933 (1933 Act) and

securities through Internet postings and advertisements); *SEC v. Octagon Tech. Group, Inc.*, Litigation Release No. 14942, 62 SEC Docket (CCH) 380, 381 (June 11, 1996) (describing an elaborate sham offering of offshore debt securities via the Internet); *SEC v. Spencer*, Litigation Release No. 14856, 61 SEC Docket (CCH) 1679 (Mar. 29, 1996) (involving the Internet-based solicitation of investors by a company using false reports of its business activities in the Dominican Republic); *SEC v. Frye*, Litigation Release No. 14720, 60 SEC Docket (CCH) 1787 (Nov. 15, 1995) (describing the solicitation of investors over the Internet by the head of two Costa Rican companies, based upon false representations of the companies' business dealings); *SEC v. Block*, Litigation Release No. 14598, 59 SEC Docket (CCH) 2543 (Aug. 10, 1995) (involving the Internet-based advertisement of a securities offering that gave inflated estimates of investment returns and falsely stated that the investments were guaranteed); *SEC v. Odulo*, Litigation Release No. 14591, 59 SEC Docket (CCH) 2538, 2539 (Aug. 7, 1995) (describing the solicitation of investors via the Internet by a person promising inflated investment returns and investment insurance in connection with the sale of bonds by an eel raising company); *SEC v. Pleasure Time, Inc.*, Litigation Release No. 14440, 58 SEC Docket (CCH) 2659 (Mar. 15, 1995) (involving the recruiting of investors via the Internet into a "worldwide lottery").

13. The term "issuer" generally is defined in the 1934 Act as "any person who issues or proposes to issue any security." 15 U.S.C. § 78c(a)(8) (1994).

14. See H.R. REP. NO. 73-85 at 2 (1933) (discussing the issuance of fraudulent securities worth billions of dollars following World War I); see also COX ET AL., *supra* note 10, at 15-16 (detailing how brokers and dealers sought to inflate stock prices fraudulently). The severity of the economic situation in the United States, as perceived by Congress and the public following the stock market crash of 1929, can best be realized by reading the actual findings of the federal securities laws themselves. See *id.* The 1934 Act established that:

National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

15 U.S.C. § 78b(4) (1994).

15. See COX ET AL., *supra* note 10, at 14 (finding that the October 1929 stock market crash and the Great Depression provided the political momentum needed to produce the federal securities laws). The states originally regulated securities transactions, but President Franklin Delano Roosevelt, in proposing remedial securities legislation to Congress in 1933, utilized the federal power over interstate commerce in order to justify federal oversight of the securities markets. See CHARLES J. JOHNSON, JR. & JOSEPH McLAUGHLIN, *CORPORATE FINANCE AND THE SECURITIES LAWS* 1-3 (2d ed. 1997); see also *supra* note 10 (providing a list of the federal securities laws).

the Securities Exchange Act of 1934 (1934 Act).¹⁶ The 1933 Act aimed to redress the ills of the pre-crash market by mandating a uniform system of disclosure by corporate issuers.¹⁷ Congress subsequently enacted the 1934 Act to regulate secondary market¹⁸ securities trading.¹⁹ In addition, the 1934 Act included a provision for the creation of the SEC.²⁰

A major provision within the 1934 Act deals with the creation and regulation of national securities exchanges.²¹ Of the national exchanges that have satisfied the 1934 Act's framework, the most prominent is the NYSE.²² The NYSE operates a traditional physical trading floor on which securities trades are completed through human interaction.²³ The trades occur between member firms acting either as agents on behalf of

16. See Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1994).

17. See COX ET AL., *supra* note 10, at 14, 16 (distinguishing the 1933 Act from the 1934 Act, and noting that the 1933 Act is tailored to the narrow task of registering public offerings of securities not otherwise exempted from regulation).

18. The secondary market can be defined as "exchanges and over-the-counter markets where securities are bought and sold subsequent to original issuance, which took place in the primary market. Proceeds of secondary market sales accrue to the selling dealers and investors, not to the companies that originally issued the securities." JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 508 (4th ed. 1995).

19. See 1 THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* 513 (3d ed. 1995) (stating that the 1934 Act "imposes registration and reporting requirements upon issuers of certain securities; it also regulates securities dealers and other market professionals, national securities exchanges, self regulatory organizations . . . as well as municipal securities, municipal securities dealers, and government securities dealers") (internal footnotes omitted).

20. See 15 U.S.C. § 78d(a) (1994). The SEC is an independent agency in the executive branch of the federal government. See OFFICE OF PUBLIC AFFAIRS, POLICY EVALUATION AND RESEARCH, U.S. SEC. & EXCH. COMM'N, *THE WORK OF THE SEC* 5 (1994) [hereinafter *THE WORK OF THE SEC*]. The SEC is nonpartisan, and it has quasi-judicial power. See *id.* The purpose of the SEC is to administer the federal securities laws. See *id.* The SEC consists of five members—a chairman and four commissioners—who serve five year terms. See *id.* With the advice and consent of the Senate, the President appoints each member. See *id.*

21. See 15 U.S.C. § 78f (1994) (setting forth the requirements for qualification as, and regulation of, national securities exchanges).

22. See 1 HAZEN, *supra* note 19, at 3-4 (stating that the NYSE is the most prestigious national exchange); see also COX ET AL., *supra* note 10, at 1188 (describing the NYSE as one of the most important exchanges in the United States); NYSE, *FACT BOOK FOR THE YEAR 1996*, at 3 (1997) (describing briefly the prominence of the NYSE). The NYSE considers itself to be the most competitive stock market in the world, and the first truly global stock market. See *id.* The NYSE dominates stock trading on exchanges, and accounts for the highest dollar value of stocks traded on exchanges. See 5 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 2510, 2510-12 (3d ed. 1990).

23. See 5 LOSS & SELIGMAN, *supra* note 22, at 2506-09 (describing trading activities on the floor of traditional exchanges).

buyers and sellers of securities, or, under certain circumstances, trading for their own accounts as dealers.²⁴ In order to satisfy the self-regulatory requirements of the 1934 Act, the NYSE has promulgated rules and regulations for its members in order to ensure a secure, fair marketplace.²⁵

Nasdaq, another securities market, is also subject to various 1934 Act requirements.²⁶ Unlike a traditional stock exchange, such as the NYSE, Nasdaq does not have a physical trading floor; instead, Nasdaq utilizes a computer-based system of trading that allows broker-dealers to execute trades by viewing quotations on a computer terminal, and then telephoning buyers and sellers directly.²⁷ Nasdaq is regulated by the National Association of Securities Dealers (NASD), a self-regulatory organization, and ultimately is subject to SEC oversight.²⁸

Departing from the time-honored trading methods of the NYSE and Nasdaq, a few Internet-based securities trading systems have recently received SEC staff approval allowing them to provide a forum for investor interaction.²⁹ These new systems facilitate securities trading transactions

24. See *id.* at 2508-09; see also DIVISION OF MARKET REGULATION, U.S. SEC. & EXCH. COMM'N, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS II-6, II-7 (1994) [hereinafter MARKET 2000 REPORT] (describing the market alternatives available to securities buyers and sellers).

25. See generally N.Y.S.E. Guide (CCH) (1984) [hereinafter NYSE Guide] (providing the full text of the NYSE constitution, rules, and related materials).

26. Nasdaq is not a national securities exchange for purposes of the Securities Exchange Act of 1934, and thus it is not subject to national securities exchange provisions of that statute. See 15 U.S.C. § 78f 1994 (defining and establishing requirements for national securities exchanges). Instead, Nasdaq is subject to the 1934 Act's requirements governing registered securities associations. See 15 U.S.C. § 78o-3 (detailing the system of registration and regulation for securities associations).

27. See THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., THE NASDAQ HANDBOOK 11-12 (1987) [hereinafter NASDAQ HANDBOOK] (summarizing how securities are traded through the Nasdaq system).

28. See *id.* at 513; see also *infra* notes 57-60 and accompanying text (defining and describing self-regulatory organizations).

29. See, e.g., Internet Capital Corporation, SEC No-Action Letter, 1997 SEC No-Act LEXIS 1096 at *2 (Dec. 24, 1997) [hereinafter Internet Capital No-Action Letter]; Flamemaster Corp., SEC No-Action Letter, 1996 WL 762990 at *5-6 (Oct. 29, 1996) [hereinafter Flamemaster No-Action Letter]; PerfectData Corp., SEC No-Action Letter, 1996 WL 480429 at *5-6 (Aug. 5, 1996) [hereinafter PerfectData No-Action Letter]; Real Goods Trading Corp., SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,226 at 77,131, 77,134 (June 24, 1996) [hereinafter RGTC No-Action Letter]; see also Cella & Stark, *supra* note 11, at 828-29 (discussing some of the SEC no-action letters regarding Internet-based trading systems); *infra* notes 100-44 and accompanying text (describing recent SEC positions regarding Internet-based securities offering systems).

without the intervention of broker-dealers.³⁰ The elimination of broker-dealer fees is an attractive incentive to corporate issuers who experience low trading volume in traditional securities markets,³¹ or cannot afford the transaction costs associated with the offering and listing of their securities in these markets.³² To date, SEC regulation of these systems has occurred in a case-by-case manner. While this has provided significant guidance for future endeavors in this area, it is not binding upon entities contemplating the creation of fully interactive Internet-based securities exchanges.³³

Seeking to regulate alternative securities trading systems more comprehensively, in June 1997 the SEC published a concept release (Release) in the Federal Register requesting comment on the current regulatory and statutory framework for alternative trading systems.³⁴ While the Release did not focus specifically upon the regulation of Internet-based trading systems, the scope of the Release will directly impact the future

30. See FRIEDMAN, *supra* note 1, § 6.04 at 6-12 (stating that new electronic trading systems bypass broker-dealers).

31. See, e.g., RGTC No-Action Letter, *supra* note 29, at 77,131 (involving a corporate issuer that utilized the Internet to sell its stock because the stock experienced light trading on a regional stock exchange). Real Goods Trading Corp. (RGTC) securities were traded on the Pacific Stock Exchange. See *id.* The market for RGTC stock was very illiquid because of light trading of the stock on the Pacific Stock Exchange. See *id.* The average daily trading volume for RGTC stock was 850 shares. See *id.* Presumably due to this liquidity problem, RGTC wanted to establish a "passive bulletin board" Internet-based trading system for its stock. See *id.*

32. See Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 at *1 (Oct. 25, 1996) [hereinafter Angel Capital No-Action Letter] (involving the creation of a third party, Internet-based listing service for small businesses). One of the biggest obstacles to success for small businesses is the high transaction costs of obtaining equity capital needed to expand businesses. See *id.* at *2. The Angel Capital No-Action Letter discussed the possibility of an Internet-based system of trading for small businesses needing access to equity capital, but unable to afford the associated transaction fees. See *id.* A company generally may acquire funding it needs for expansion through loans from banks, or from a public or private offering of stock in the company. See COX ET AL., *supra* note 10, at 216. In order to effectuate a stock offering, a company usually would engage the services of broker-dealers. See *id.* The broker-dealers could agree to purchase the securities from the issuing company for resale to the public, or simply agree to use their "best efforts" to sell the stock to the public. See *id.* at 216-17. In either situation, the broker-dealer gains a commission typically equal to the difference between the price of the stock as sold and the amount that is paid to the issuer. See *id.* at 217-18.

33. See *infra* notes 109-44 and accompanying text (examining the several no-action/interpretive positions of the SEC with respect to Internet-based systems).

34. See Regulation of Exchanges, 62 Fed. Reg. at 30,485. The SEC noted that technological advances have posed significant challenges to the existing regulatory framework. See *id.* at 30,486. In its search for "forward-looking" regulation, the SEC noted that the exponential growth of alternative trading systems is one of the developments that underscores the need for amendment of the current regulatory system. See *id.*

regulation of Internet-based trading.³⁵ The Release suggested two alternative regulatory approaches that the SEC could employ: (1) amending the current 1934 Act definition of "exchange" to incorporate alternative trading systems; or (2) regulating alternative trading systems under a slightly modified version of the current statutory and regulatory framework for broker-dealers.³⁶ In a proposed rule that followed the Release, the SEC proposed combining the two alternatives outlined in the Release, and allowing the operators of alternative trading systems to choose between exchange regulation and continued broker-dealer regulation.³⁷ Although both of these approaches evidence the SEC's desire to accommodate changing regulatory needs, they too closely adhere to current regulation to be truly effective.³⁸ In order to provide efficient regulation and to promote the growth of alternative trading systems, the SEC must partner with the private sector to create a national securities association with a mandate to regulate and foster non-traditional trading systems.³⁹

This Comment studies the unique regulatory issues that arise in the context of Internet-based securities trading and the standing of such trading under the existing federal securities laws. In addition, this Comment examines the regulatory structures that the SEC could employ toward its goal to efficiently and effectively regulate alternative trading systems. Part I examines the background of the current federal securities laws and the rise of both traditional and non-traditional securities markets. Part II provides an overview of the regulatory structures for alternative trading systems that the SEC suggested in the June 1997 Release. Part III of this Comment focuses on the adequacy of the SEC's suggested regulatory approaches in the Release as applied to Internet-based securities trading systems. Part IV of this Comment analyzes the proposals set

35. See generally *id.* at 30,486-88. The Release indirectly encompassed possible Internet-based securities trading systems within its broad definition of "alternative trading systems" and the suggested redefinition of the term "exchange." See *id.* at 30,486 n.1, 30,487. The Release defined alternative trading systems as "automated systems that centralize, display, match, cross, or otherwise execute trading interest, but that are not currently registered with the [SEC] as national securities exchanges or operated by a registered securities association." *Id.* at 30,486 n.1. For information regarding the Release's suggestion to redefine the term "exchange," see *infra* Part II.B.

36. See Regulation of Exchanges, 62 Fed. Reg. at 30,487.

37. See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-39884, 63 Fed. Reg. 23,504, 23,506. (April 29, 1998).

38. See *infra* notes 201-42 and accompanying text (discussing the SEC's suggestions in the Release and their related shortcomings).

39. See *infra* notes 260-76 and accompanying text (advocating the creation of a new national securities association to act as both regulator and guardian for alternative trading systems).

forth in the SEC's April 1998 proposed rule. This Comment concludes by suggesting that the SEC should consider an entirely different regulatory structure for Internet-based and other non-traditional securities exchanges. This new structure would involve the creation of a new national securities association under the 1934 Act—a regulatory system capable of ensuring efficiency while maintaining the statutory mandates of the federal securities laws.

I. THE RISE OF TRADITIONAL AND NON-TRADITIONAL SECURITIES MARKETS

Congress created the SEC as an independent agency of the federal government designed to administer the federal securities legislation.⁴⁰ Congress passed the SEC's enabling statute, the 1934 Act,⁴¹ in the aftermath of the 1929 stock market crash.⁴² The 1934 Act established a statutory framework by which Congress could create a system of securities regulation in the United States.⁴³ The 1934 Act also specifically provided for the registration and regulation of national securities exchanges.⁴⁴

In 1975, Congress amended the 1934 Act in an effort to “ensure fair and orderly markets, to prevent fraud and manipulation, and to promote market coordination and competition for the benefit of all investors.”⁴⁵ In order to achieve these goals, Congress empowered the SEC to adopt rules promoting (1) economically efficient securities transaction execu-

40. See THE WORK OF THE SEC, *supra* note 20, at 5 (describing the SEC and its statutory powers). The SEC staff attempts to ensure compliance with the federal securities laws by various securities market participants, including publicly-held entities, broker-dealers, investment companies, and investment advisers. See *id.*; see also LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 50-51 (3d ed. 1995) (describing the structural organization of the Securities and Exchange Commission).

41. See 15 U.S.C. §§ 78a-78j (1994) (providing the text of the 1934 Act).

42. Cf. JOHNSON & MCLAUGHLIN, *supra* note 15, at 1 (describing the economic condition of the United States and the mood of investors following the great stock market crash of October 1929).

43. See LOSS & SELIGMAN, *supra* note 40, at 34 (analyzing the 1934 Act).

44. See 15 U.S.C. § 78f (1994). The 1934 Act defines “exchange” as:

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

Id. at § 78c(a)(1).

45. Regulation of Exchanges, 62 Fed. Reg. at 30,489; see also Securities Acts Amendments of 1975 § 7, 15 U.S.C. § 78k-1(a)(1) (1994).

tion;⁴⁶ (2) fair competition;⁴⁷ (3) dissemination of current quotations and related information (transparency);⁴⁸ (4) investor access to the best markets;⁴⁹ and (5) the opportunity, consistent with (1) and (4) above, to execute orders without dealer involvement.⁵⁰

In 1996, Congress enacted legislation which authorized the SEC to grant exemptions from 1933 and 1934 Act requirements.⁵¹ Such exemptions could, for example, release market participants from certain aspects of the 1934 Act's reporting and registration requirements.⁵² The Senate Report accompanying the 1996 legislation indicates that Congress considered the rise of novel trading systems when it gave the SEC this broad exemptive authority.⁵³

A. Traditional Securities Trading Forums

Currently, eight securities exchanges are registered with the SEC as national securities exchanges pursuant to the 1934 Act.⁵⁴ Securities ex-

46. See 15 U.S.C. § 78k-1(a)(1)(C)(i).

47. See *id.* § 78k-1(a)(1)(C)(ii).

48. See *id.* § 78k-1(a)(1)(C)(iii); see also MARKET 2000 REPORT, *supra* note 24, at 17 ("Transparency refers to the real-time dissemination of information about prices, volume, and trades.").

49. See 15 U.S.C. § 78k-1(a)(1)(C)(iv).

50. See 15 U.S.C. § 78k-1(a)(1)(C)(v). For a detailed examination of the provisions of 15 U.S.C. § 78k-1(a), see S. REP. NO. 94-75, at 8 (1975); H.R. CONF. REP. NO. 94-229, at 92 (1975); see also MARKET 2000 REPORT, *supra* note 24, at 5 (discussing the regulatory goals of 15 U.S.C. § 78k-1(a)(1)).

51. See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 105(b), 110 Stat. 3424, 15 U.S.C.A. § 78mm (West 1997); see also Regulation of Exchanges, 62 Fed. Reg. at 30,499 & n.83; S. REP. NO. 104-293, at 15 (1996) (describing Congress's rationale for granting new exemptive authority to the SEC).

52. See Regulation of Exchanges, 62 Fed. Reg. at 30,502 (discussing some of the various requirements from which the SEC could provide exemptive relief).

53. See S. REP. NO. 104-293, at 15 ("For example, the SEC could deal with the regulatory concerns raised by the recent proliferation of electronic trading systems, which do not fit neatly into the existing regulatory framework"); see also Regulation of Exchanges, 62 Fed. Reg. at 30,499 n.83 (noting the specific reference to alternative trading systems in S. Rep. No. 104-293).

54. See Regulation of Exchanges, 62 Fed. Reg. at 30,490 n.24. Of the national securities exchanges, the two primary exchanges are the New York Stock Exchange and the American Stock Exchange (Amex). See MARKET 2000 REPORT, *supra* note 24, at II-6. The Amex has lower listing standards than the NYSE, and thus serves as a market for the securities of smaller, younger companies. See LOSS & SELIGMAN, *supra* note 40, at 606. It is common for companies that are listed on the Amex to transfer their listings to the NYSE once they satisfy the more stringent NYSE listing requirements. See *id.* In this sense, the Amex serves as the "minor league" to the NYSE's "major league." See *id.*

In addition to the NYSE and the Amex, five regional exchanges exist: the Boston Stock Exchange, the Chicago Stock Exchange, the Cincinnati Stock Exchange, the Pacific Stock

changes primarily function to provide liquidity in trading, a characteristic which allows investors to buy or sell securities at a reasonable price and within a reasonable amount of time.⁵⁵ Although all eight exchanges and the Nasdaq market share the common goal of efficiently facilitating securities trading, the means used to accomplish this goal vary greatly.

1. *The New York Stock Exchange*

The New York Stock Exchange (NYSE) has the highest share volume and dollar value of trades among the exchanges, and is an important price discovery market.⁵⁶ Although the SEC regulates the NYSE, the NYSE is also a self-regulatory organization (SRO).⁵⁷ An SRO is defined in the 1934 Act as “any national securities exchange, registered securities association, or registered clearing agency.”⁵⁸ By virtue of this definition, all SEC-registered exchanges are by law SROs, having “quasi-governmental authority” over their members.⁵⁹ By creating a two-tier

Exchange, and the Philadelphia Stock Exchange See MARKET 2000 REPORT, *supra* note 24, at II-6 to II-7. The Chicago Board Option Exchange registered to trade stock in 1990, but to date has only traded options. See *id.* at II-20 n.27.

55. See Poser, *supra* note 7, at 886, 889 (describing the composition and functions of the United States securities markets and the important liquidity function served by stock exchanges). The securities markets can be divided into two separate types of markets, the issuing markets and the trading markets. See *id.* at 886. The stock exchanges and the over-the-counter market comprise the trading markets. See *id.* at 886-87.

56. See 5 LOSS & SELIGMAN, *supra* note 22, at 2510 (discussing the dominance of the NYSE in exchange trading); MARKET 2000 REPORT, *supra* note 24, at II-8 (stating that the NYSE provides an important price discovery function); see also Regulation of Exchanges, 62 Fed. Reg. at 30,488 n.7 (comparing the volume and aggregate dollar values of trading activity on the NYSE and in the Nasdaq market). Price discovery refers to the quoting of prices for stock by the primary market (i.e. NYSE), and the use of these quotes by other market participants (i.e. proprietary trading systems) to establish prices for the same stock. See MARKET 2000 REPORT, *supra* note 24, at II-8. Active pricing markets establish the price at which securities trade “through the interaction of priced orders of sellers with priced orders of buyers, or through participant dissemination of quotes.” Regulation of Exchanges, 62 Fed. Reg. at 30,501.

57. See COX ET AL., *supra* note 10, at 29. The 1934 Act encompasses four types of SROs: national securities exchanges, the national securities association, registered clearing agencies, and the Municipal Securities Rulemaking Board. See *id.* Because it is registered as a national securities exchange under § 6 of the 1934 Act, the NYSE is an SRO recognized by the SEC. See *id.*

58. 15 U.S.C. § 78c(a)(26) (1994).

59. See COX ET AL., *supra* note 10, at 1190 (stating that exchanges are given principal responsibility for their own regulation after having registered with the SEC). Although SROs are given “quasi-governmental authority” in an area where regulation is critical, the SROs are comprised of members who have an inherent self-interest which is incongruous to the public interest. See *id.* See generally David A. Lipton, *Governance of Our Securities Markets and the Failure to Allocate Regulatory Responsibility*, 34 CATH. U. L. REV. 397 (1985) (discussing the structure and inherent problems of the regulatory system established in the 1934 Act); David A. Lipton, *The SEC or the Exchanges: Who Should Do*

system of regulation, the relationship between the SEC and SROs aims to ensure safe, fair, and open United States securities markets for all investors.⁶⁰

In order to fulfill the 1934 Act's SRO requirements, the NYSE constitution, along with rules promulgated by the NYSE board of directors, established a complex body of regulation.⁶¹ These regulatory requirements encompass all activities that take place in the course of exchange business, from member conduct to the trading rules.⁶² In addition to ensuring a stable and efficient marketplace, the NYSE rules are designed to instill investors with confidence.⁶³ NYSE oversight activity mirrors, on a smaller scale, the SEC's regulatory role.⁶⁴

What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets, 16 U.C. DAVIS L. REV. 527 (1983) (analyzing the division of regulatory authority between the exchanges and the SEC, and offering suggestions for a more efficient allocation of such authority); Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853 (1985) (detailing and commenting upon the self-regulatory structure within the securities markets); James J. Moylan, *The Place of Self-Regulation in the Securities Industry*, 6 SEC. REG. L.J. 49 (1978) (reviewing the impact of 1975 securities law amendments on the self-regulatory system established in the 1934 Act).

60. See LOSS & SELIGMAN, *supra* note 40, at 643-44 (discussing the philosophy underlying self-regulation in the securities markets).

61. See generally 2 NYSE Guide, *supra* note 25, ¶ 1002 (setting forth the "objects and purposes" of the NYSE constitution).

62. See *id.* at 2601-3000 (providing the NYSE rules for dealings and settlements); *id.* at 3001-500 (governing member admission to the NYSE); *id.* at 4051-200 (setting forth the disciplinary rules for NYSE members).

63. See 15 U.S.C. § 78f(b)(5) (requiring that the rules of national stock exchanges protect investors and facilitate a free and open market). Specifically, the 1934 Act states that:

The rules of the exchange 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 engaged 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.*

Id. (emphasis added).

64. See H.R. REP. NO. 75-2307, at 4-6 (1938) (discussing the theory behind "cooperative regulation"). Congress has found the operation of a well-conducted stock exchange to be the perfect example of how self-regulation can be accomplished by private organizations, rather than by the SEC. See *id.* at 5. With the passage of the 1934 Act, Congress gave the SEC the means to achieve substantial regulation; the Act required virtually every market that met the statutory definition of an "exchange" to register with the SEC. See 15 U.S.C. §§ 78e-78f. Congress provided an exemption for exchanges that, in the SEC's opinion, had such limited volume that the interest in protecting the public and investors was minimal. See *id.* § 78e. In addition, Congress determined that every registered exchange, in connection with the self-regulatory mandates, must assist the SEC in assuring fair and honest markets, and must establish rules for self regulation. See *id.* § 78f(b). The

The SEC's Division of Market Regulation oversees the daily activity of the various exchanges.⁶⁵ Likewise, the NYSE's market surveillance department constantly monitors the trading activity of the NYSE.⁶⁶ The market surveillance department searches for illegal activities, such as stock manipulation⁶⁷ and insider trading,⁶⁸ problems common to the securities industry.⁶⁹ To accomplish its surveillance activity, the NYSE implemented Stock Watch, an electronic monitoring system that flags un-

SEC is required to review and approve the rules for self-regulation prior to their passage. See Regulation of Exchanges, 62 Fed. Reg. at 30,489-90.

65. See THE WORK OF THE SEC, *supra* note 20, at 27 (explaining how the SEC's Division of Market Regulation is responsible for overseeing the secondary markets, including the registration and regulation of broker-dealers, SROs, and other secondary market participants).

66. See NEW YORK STOCK EXCH., INC., 1996 ANN. REP. 16, 17 (1997) [hereinafter NYSE ANNUAL REPORT] (describing briefly the activity of the NYSE market surveillance department); NYSE, *Regulating the Market* (visited Mar. 27, 1998) <<http://www.nyse.com/public/invprot/5a/5aix.htm>> (discussing the NYSE's market surveillance programs); David P. Doherty et al., *The Enforcement Role of the New York Stock Exchange*, 85 NW. U. L. REV. 637 (1991) (providing a comprehensive examination of NYSE enforcement procedures); cf. Regulation of Exchanges, 62 Fed. Reg. at 30,493 (describing the role of market surveillance in monitoring market activity to prevent fraud).

67. See generally 8-9 LOSS & SELIGMAN, *supra* note 22, at 3939-3942 (discussing the "classic portrait of manipulation). Manipulation is defined as:

The act of depressing or raising securities prices artificially so that prices do not represent true value. This is done by creating an appearance of active buying or selling, either alone or in concert with others. Manipulation violates federal securities laws and is subject to criminal and civil penalties.

ALLAN H. PESSIN & JOSEPH A. ROSS, WORDS OF WALL STREET: 2000 INVESTMENT TERMS DEFINED 130 (1983).

68. "Under the 'traditional' or 'classical theory' of insider trading liability . . . a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information." United States v. O'Hagan, 117 S. Ct. 2199, 2207 (1997). In addition to corporate officers, directors, and permanent insiders, the classical theory applies to "attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation." *Id.* (citing *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)). Another theory of insider trading liability, the "misappropriation theory," states that a fraud occurs when a person "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id.* The classical and misappropriation theories complement each other in an effort to stem the misuse of nonpublic information. See *id.* See generally 7-8 LOSS & SELIGMAN, *supra* note 22, at 3404-48 (discussing the presence of fraud in the United States securities markets and the specific problems associated with insider trading).

69. See Arthur Levitt, *A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading, Remarks at the "S.E.C. Speaks" Conference* (visited Apr. 15, 1998) <<http://www.sec.gov/news/speeches/spch202.txt>> (discussing the large number of insider trading cases that the SEC handles each year); see also Doherty et al., *supra* note 66, at 640 (describing the types of cases that the NYSE's Division of Enforcement encounters and investigates); see also New York Stock Exchange, Inc., *Regulating the Market* (visited Mar. 27, 1998) <<http://www.nyse.com/public/invprot/5a/5aix.htm>> (discussing potentially suspicious trading activity).

usual price and volume activity in NYSE-listed securities.⁷⁰ When market surveillance detects suspicious trading, the NYSE's Enforcement Division investigates and, if necessary, takes disciplinary action against the suspected violator or refers the action to the SEC for further investigation.⁷¹

Underlying all NYSE regulatory activity are the statutory mandates of the 1934 Act.⁷² Because the NYSE is a registered national securities exchange, it must comply with section 6 of the 1934 Act.⁷³ Given the NYSE's self-regulatory responsibilities under the 1934 Act, the exchange also must further the general regulatory and oversight purposes of the statute that would otherwise be within the SEC's realm.⁷⁴ To fulfill its regulatory role, the NYSE enforces member compliance with the 1934 Act, the rules and regulations promulgated thereunder, and the NYSE rules.⁷⁵ As such, the NYSE attempts to carry out the 1934 Act's goals of ensuring fair and honest markets and protecting investors, thereby furthering the underlying statutory premise of safeguarding the national public interest.⁷⁶

2. *The Nasdaq Market*

Like the NYSE, the Nasdaq Stock Market (Nasdaq) provides a market in which buyers and sellers of securities can execute trades.⁷⁷ The Na-

70. See NYSE ANNUAL REPORT, *supra* note 66, at 16, 17 (describing the thorough oversight activity that occurs at the NYSE). The Stock Watch system of the NYSE is "one of the world's most highly automated market monitoring systems." *Id.* at 16. Because of its own market surveillance activities, the NYSE made 54 referrals of possible securities law violations to the SEC in 1996. See *id.* at 16. The NYSE also has an Automated Search and Match system that examines customer, member, and company information in order to identify potential wrongdoers. See *id.* at 17.

71. See Doherty et al., *supra* note 66, at 639-40 (detailing the procedure for case investigation by the NYSE Division of Enforcement).

72. See *id.* at 637-38 (stating that the NYSE has a mandate to enforce the 1934 Act).

73. See 15 U.S.C. § 78f (1994) (providing the text of § 6 of the 1934 Act); see also Doherty et al., *supra* note 66, at 637-38 (describing the 1934 Act's regulatory mandates for exchanges, and how the NYSE implements such requirements).

74. See Doherty et al., *supra* note 66, at 637-38 (stating that one of the principal functions of the NYSE is to enforce the 1934 Act); see also Regulation of Exchanges, 62 Fed. Reg. at 30,493 (discussing the responsibility of SROs to complying with the 1934 Act as well as carrying out the purposes of the Act).

75. See Doherty et al., *supra* note 66, at 637; see also Regulation of Exchanges, 62 Fed. Reg. at 30,493.

76. See 15 U.S.C. § 78b (stating the national policy goals with respect to the enactment of the 1934 Act); see also The New York Stock Exch., *Investor Protection* (visited Mar. 27, 1998) <<http://www.nyse.com/public/invprot/05ix.htm>> (describing the objectives of NYSE regulation).

77. See Poser, *supra* note 7, at 895 n.47 (describing the technology and the setup of

tional Association of Securities Dealers developed Nasdaq, and the market began operation in 1971.⁷⁸ Originally, Nasdaq was a part of the residual securities market commonly known as the “over the counter” (OTC) market.⁷⁹ Nasdaq has since developed into a formal marketplace separate from the OTC.⁸⁰ Nasdaq, which lists approximately 6300 stocks for more than 5500 companies, is the second largest stock market in the world.⁸¹

Despite its comparable size, the Nasdaq market differs significantly from the NYSE.⁸² First, the Nasdaq market is an electronic quotation system in which brokers or dealers⁸³ represent buyers and sellers of securities throughout the trading process.⁸⁴ The brokers and dealers receive

the Nasdaq system).

78. *See id.* The NASD is, to date, the only national securities association registered with the SEC. *See id.* at 1191. The NASD is an association of brokers and dealers which is registered with the SEC pursuant to section 15A of the 1934 Act. *See id.* The NASD is comprised of more than 5500 member firms. *See* U.S. SEC. & EXCH. COMM’N, 1996 ANN. REP. 53 (1996). The NASD owns and operates the Nasdaq stock market through an independent subsidiary, The Nasdaq Stock Market, Inc. *See* NASD, THE NASDAQ STOCK MARKET 1997 FACT BOOK & COMPANY DIRECTORY 1 (1997) [hereinafter NASDAQ FACT BOOK].

79. *See* National Ass’n Sec. Dealers, *Ask the Economist* (visited Feb. 12, 1998) <<http://www.nasdaq.com/sitelayout.asp?section=/reference/reference.htm>> (stating that Nasdaq began as a quotation service for OTC securities, but is now a securities market separate from the OTC market). The OTC market is the securities market in which those transactions not taking place on a stock exchange are executed. *See* Poser, *supra* note 7, at 894. The OTC handles trades of government and corporate bonds, as well as trading in shares of industrial and commercial enterprises. *See id.* Brokers and dealers who trade in the OTC market are required to be registered with the SEC, but are not required to be members of a national securities exchange. *See id.* Most of the brokers and dealers who trade on the OTC market are members of the NASD. *See id.*

80. *See* NASDAQ FACT BOOK, *supra* note 78, at 1.

81. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,488 n.7; NASDAQ FACT BOOK, *supra* note 78, at 1. The total dollar volume of all trades made on the Nasdaq is almost equal to that of the NYSE. *See* Regulation of Exchanges, *supra*, at 30,488 n.7. Companies listed on Nasdaq are divided into two categories, the Nasdaq SmallCap Market, and the Nasdaq National Market. *See* NASDAQ FACT BOOK, *supra* note 78, at 1. The SmallCap Market is for small and medium sized companies, while the National Market operates for larger companies. *See id.*

82. *See* 5 LOSS & SELIGMAN, *supra* note 22, at 2578 (describing transactions occurring in the OTC market and noting how they differ from transactions executed on traditional exchanges). Perhaps the most noticeable difference between OTC and exchange trading is the lack of a centralized trading floor in the OTC. *See id.*

83. *See supra* note 6 and accompanying text (providing the definitions of “broker,” “dealer,” and “broker-dealers”).

84. *See* Poser, *supra* note 7, at 895 n.47 (describing the trading that occurs on the Nasdaq market). The parties involved in Nasdaq trading communicate through telephones and computer terminals, and are thus distanced from personal contact throughout the trading process. *See id.*; *see also infra* note 84 (describing generally the trading mechanisms in the Nasdaq market). *Cf.* 5 LOSS & SELIGMAN, *supra* note 22, at 2513-15 (dis-

real-time price quotations on Nasdaq-listed securities via computer terminals.⁸⁵ As a result, the broker-dealers can execute trades by monitoring the quotations listed on the computer screen, and then telephoning⁸⁶ the market maker in that security to execute trades for the client.⁸⁷

cussing the NYSE's use of the "specialist" to effectuate securities trading). A specialist is a member of the exchange that serves three functions: (1) broker; (2) dealer; and (3) auctioneer. *See id.* at 2513-14. Specialists essentially are awarded a monopoly right to make a market in their securities. *See id.* at 2514.

85. *See* 5 LOSS & SELIGMAN, *supra* note 22, at 2580-81. The Nasdaq system utilizes a Central Processing Complex that is connected to individual computer terminals used by brokers and dealers for trading. *See id.* The computers are connected to the central processing unit by high-speed trunk lines, regional concentrator centers, and leased telephone lines. *See id.* at 2581. Nasdaq computer terminals are divided into three groups, depending on the level of the user's activity. *See id.* The first level of Nasdaq trading allows brokers to receive bid and ask quotations for Nasdaq-listed securities. *See id.* On the second level, brokers or dealers receive quotations along with the names of the "market makers" and the size of trades. *See id.* In the third level, used only by market makers and broker-dealers, market makers are able to insert quotes into the Nasdaq system. *See id.* "Market maker" is defined in the 1934 Act as a broker-dealer who "holds himself out (by entering quotations in an inter-dealer communications system or otherwise as being willing to buy and sell [a] security for his own account on a regular or continuous basis." 15 U.S.C. § 78c(a)(38) (1994); *see also* Byrnes v. Faulkner, Dawkins & Sullivan, 550 F.2d 1303, 1307 n.1 (2d Cir. 1977) (quoting *Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668, 671 (S.D.N.Y.), *aff'd*, 367 F.2d 157 (2d Cir. 1966) (per curiam) (defining "market maker" as "a broker-dealer who, with respect to a particular security that is not traded on a national securities exchange (an 'over the counter' security), 'report[s] for quotation 'bid' and 'asked' prices to indicate, respectively, amounts for which it propose[s] to buy or sell stock'"').

As with many of today's computer systems, Nasdaq has experienced some glitches that have affected trading. *See GAO Report Recommends SEC, NASD Improve Oversight of Nasdaq Market*, 27 SEC. REG. & L. REP. (BNA) 15 (Jan. 6, 1995) (detailing the General Accounting Office's recommendations for better oversight of Nasdaq following instances of malfunction in the trading mechanism); *Nasdaq Informs Markey of Plans to Prevent Repeat of Computer Failures*, 26 SEC. REG. & L. REP. (BNA) 1368 (1994) (discussing NASD's reaction to computer failures that shut down Nasdaq trading in 1994).

86. With certain exceptions, trading of Nasdaq-listed securities occurs by telephone. *See* MARKET 2000 REPORT, *supra* note 24, at 10. The exceptions to telephone trading on Nasdaq involve trading on the Small Order Execution System and the SelectNet systems. *See id.* These systems allow Nasdaq market makers to execute and display orders through Nasdaq terminals. *See id.*

87. *See* 5 LOSS & SELIGMAN, *supra* note 22, at 2581 (detailing the tiered structure of the Nasdaq trading system). A broker acts as a salesperson throughout the securities buying/selling transaction. *See* POSER, *supra* note 6, at 2-4. In order to obtain the service of the broker, however, an investor must give the broker the power to act on his behalf. *See id.* While this system of representation provides the broker with the freedom to act for the investor's best interests, it also invites fraudulent activity on the part of the broker. *See id.* Because the broker acts as the investor's agent, a common law fiduciary relationship is created. *See id.* at 2-3. Under this fiduciary relationship, the broker is legally obligated to act in the best interests of the investor. *See id.* at 2-3 to 2-4. The fiduciary duties imposed upon brokers and dealers are based, in part, upon the "shingle theory." *See* DAVID A. LIPTON, 15A BROKER-DEALER REGULATION 5-2 (1997). The shingle theory has been described "as having two components: (1) a duty to deal fairly with the customer,

Along with the fact that it is a computer-based system, Nasdaq can be distinguished from traditional exchanges by its system of competing market makers.⁸⁸

There is a significant difference between the NYSE and the Nasdaq regarding the manner in which trades are concluded. Unlike Nasdaq's system of market makers posting bid and ask quotations on a computer,⁸⁹ the NYSE is a continuous agency auction market.⁹⁰ While NYSE specialists present on the floor of the exchange are physically in a position to participate in all trading, Nasdaq broker-dealers control trading activity from various locations using Nasdaq computer terminals.⁹¹

Like the NYSE's self-monitoring systems, the NASD has created regulatory organs to continuously monitor Nasdaq trading activity.⁹² Although their trading procedures differ significantly, the NYSE and the Nasdaq are subject to similar self-regulatory oversight.⁹³

The NASD is the SRO for the Nasdaq market.⁹⁴ In response to an internal review of its system of governance, the NASD divided its SRO responsibilities and the operation of the Nasdaq market between two sub-

and (2) a duty to deal with the customer in accordance with the standards of the profession." *Id.* at 5-6 to 5-7.

88. See 5 LOSS & SELIGMAN, *supra* note 22, at 2578 (noting the difference between exchanges with respect to Nasdaq's use of competing market makers); see also NASD, *Nasdaq Glossary* (visited Feb. 12, 1998) <<http://www.nasd.com/sitelayout.asp?section=/reference/reference.htm>> (discussing the differences between Nasdaq and the traditional securities markets). Nasdaq market makers "represent a stock and compete with each other to buy and sell the stocks they represent." *Id.*

89. See *supra* note 85 and accompanying text (discussing Nasdaq's system of securities trading).

90. See COX ET AL., *supra* note 10, at 1282. Traditional exchanges, such as the NYSE, trade securities in "a continuous two-sided auction market." *Id.* at 1282. Each traded security has a designated place on the floor of the exchange where specialists in that security execute trades. See *id.*; see also New York Stock Exch., *The Auction Market* (visited Mar. 27, 1998) <<http://www.nyse.com/public/thenyse/1b/1bix.htm>> (describing generally the auction market atmosphere within the exchange). Although many of the NYSE's functions have been automated during the past 23 years, the exchange remains primarily an auction market in which specialists handle the auction process. See MARKET 2000 REPORT, *supra* note 24, at 36 n.21.

91. See *supra* note 85 and accompanying text (discussing the trading operations of Nasdaq).

92. See NASDAQ HANDBOOK, *supra* note 27, at 513-25 (describing Nasdaq's regulatory systems). The NASD has established a Market Surveillance Section to oversee the Nasdaq. See *id.* at 514. In addition, various computer-generated reports help Market Surveillance oversee the exchange. See *id.* at 515-17.

93. Compare NASDAQ HANDBOOK, *supra* note 27, at 515-17 (explaining the operations of the NASD's Market Surveillance Section), with *supra* note 70 and accompanying text (describing the NYSE's Stock Watch System and its regulatory oversight role).

94. See NASDAQ HANDBOOK, *supra* note 27, at 513 (noting that the NASD regulates Nasdaq).

subsidiaries.⁹⁵ The internal review found NASD's governance structure insufficient to maintain the distinction between broker-dealer regulation and the operation of Nasdaq.⁹⁶ Concurrently with NASD's self-examination, the SEC and the Antitrust Division of the Department of Justice were investigating, among other things, the operations of the NASD and the Nasdaq market, and examining allegations of anti-competitive practices and collusion.⁹⁷ The NASD settled the administrative charges brought by the SEC, and the Department of Justice settled its civil antitrust charges with several securities firms.⁹⁸ As part of its

95. See U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET 4-5 (1996) [hereinafter NASD REPORT] (discussing specific remedial measures, including the restructuring of the NASD governance system, implemented by the NASD following an internal review). The NASD reorganized its governance structure by creating a Board of Governors comprised of a majority of non-industry members. See *id.* at 4. In addition, the NASD created two subsidiaries, NASD Regulation, Inc. (NASDR), and The Nasdaq Stock Market, Inc. See *id.* at 4-5. NASDR is responsible for regulatory matters, and The Nasdaq Stock Market, Inc. is responsible for operating Nasdaq. See *id.* Both subsidiaries have a board of directors equally comprised of industry and non-industry members. See *id.* at 5.

96. See *id.* at 10. The committee undertaking the review of the NASD's governance structure was chaired by former United States Senator Warren Rudman. See *id.* at 9. Rudman's committee (Committee) found that the NASD was governed by a large number of internal committees, each with its own agenda and the ability to assert its specific influence. See *id.* at 10. The Committee also found that one specific internal NASD committee, the Trading Committee, had significant influence over the Nasdaq market and was mostly comprised of dealers, not a representative body of Nasdaq constituents. See *id.* at 11.

97. See Suzanne Manning & Rachel Wilmer, *NASD Settles SEC Charges over Alleged Abuses in Nasdaq Market*, 28 Sec. Reg. & L. Rep. (BNA) 967 (Aug. 9, 1996) (discussing the SEC's settlement with NASD, SEC Chairman Arthur Levitt noted that Nasdaq's "culture of collaboration" curtailed competition). The Department of Justice (DOJ) settlement encompassed 24 major securities firms that trade on the Nasdaq market. See *id.* at 968. The DOJ investigation was prompted by lawsuits that alleged collusion among certain Nasdaq market makers. See *id.*

As part of its investigation, the SEC generated a report regarding the NASD and the Nasdaq market. See NASD REPORT, *supra* note 95, at 1. The report found that the NASD market makers used the NASD regulatory process to employ anti-competitive tactics, including an attempt to restrict the use of Nasdaq's Small Order Execution System (SOES). See *id.* at 11. NASD established SOES to execute small orders in Nasdaq stocks. See *id.* at A-56. SOES participants, namely SOES market makers and SOES order entry firms, are required to be registered with the NASD. See *id.* Relations between Nasdaq market makers and SOES firms became very strained. See *id.* at A-57. The SEC found that the NASD responded to market maker complaints about SOES firms by heightening enforcement activity against such firms and by using admissions processes to limit the admission and activities of potential SOES firms. See *id.* at A-67 to A-68, A-72.

98. See Manning & Wilmer, *supra* note 97, at 967-68.

SEC settlement, NASD was required to spend \$100 million dollars on enforcement and surveillance improvements for the Nasdaq market.⁹⁹

B. Internet-Based Securities Trading

In a significant departure from the institutionalized, well-established trading practices of the NYSE and Nasdaq,¹⁰⁰ the SEC granted no-action relief to several companies attempting to provide liquidity for securities via the Internet.¹⁰¹ The SEC no-action process provides requesting parties with the SEC staff's enforcement position regarding certain factual scenarios, or with the staff's interpretation of rules and statutes in the context of a specified transaction.¹⁰² The SEC staff position usually is conveyed in the form of a no-action or an interpretive letter.¹⁰³ Through no-action and interpretive letters, the SEC allowed for securities trading on the Internet.¹⁰⁴ In most instances of the SEC's Internet-based securi-

99. *See id.* at 967.

100. *See supra* Parts I.A.1-I.A.2 (discussing the operations of the NYSE and the Nasdaq market).

101. *See* Cella & Stark, *supra* note 11, at 829 (discussing important no-action letters pertaining to Internet-based securities trading systems); *see also supra* Parts I.B.1-I.B.3 (discussing significant SEC positions regarding Internet-based trading systems).

102. *See* Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1022 (1987) (detailing the procedural requirements of the no-action request process).

103. *See id.* (describing the difference between no-action and interpretive letters). No-action letters analyze specific transactions, while interpretive letters analyze specific rules, statutes, or regulations as they apply to certain fact patterns. *See* 1 LOSS & SELIGMAN, *supra* note 22, at 525 n.29. No-action letters inform the recipient whether the SEC would bring enforcement action if a specified transaction occurred. *See id.* No-action and interpretive letters are not binding on the SEC, however, because they are issued by the SEC staff, not the full Commission. *See id.* *But see* Lemke, *supra* note 102, at 1042 (stating that, although the SEC has cautioned that it is not bound by no-action letters, the recipient of a favorable no-action response can be "fairly certain" that the letter will be binding). The estoppel effect of no-action letters has not been decided upon by the courts. *See id.* Although no-action letters are issued more frequently than interpretive letters, it is often very difficult to distinguish between the two types of letters because no-action letters often include SEC interpretations of the applicable law. *See id.* at 1022. Due to the informal nature of the no-action process, the differentiation between no-action and interpretive letters is not essential. *See id.* (analyzing the difference between no-action and interpretive letters). *See generally* Lewis D. Lowenfels, *SEC No-Action Letters: Conflicts with Existing Statutes, Cases and Commission Releases*, 59 VA. L. REV. 303 (1973) (discussing the impact of no-action letters on other forms of SEC regulation); Lewis D. Lowenfels, *SEC "No-Action" Letters: Some Problems and Suggested Approaches*, 71 COLUM. L. REV. 1256 (1971) (describing generally the no-action letter process).

104. *See generally* Recent Agency Action, *SEC Allows Internet-Based Trading of Securities*, 110 HARV. L. REV. 959 (1996) [hereinafter Recent Agency Action] (discussing specifically the no-action relief granted by the SEC to Real Goods Trading Corporation); *see also* FRIEDMAN, *supra* note 1, § 6.01 (describing some of the no-action letters issued by the SEC in connection with Internet-based trading systems).

ties trading approval, companies requested that the SEC staff not recommend enforcement action by the SEC if the companies created Internet Web sites for securities trading.¹⁰⁵ In one instance, however, the SEC stepped in, without receiving a no-action request, to provide an interpretive letter to a company that was utilizing the Internet to sell its securities.¹⁰⁶

Web sites allowed the issuing companies to provide information regarding the sale of their securities and contained bulletin boards on which investors could post their interest in purchasing or selling such securities.¹⁰⁷ Regulating in a entirely new area, the SEC responded affirmatively in its no-action and interpretive letters. Gradually, through the no-action process, the SEC developed an informal regulatory framework to address the issues raised by Internet-based securities trading.¹⁰⁸ Unfortunately, however, a lack of cohesive and predictable regulation remains.

1. Spring Street Brewing: The Beer Flows, and So Too Does the Stock

The first securities offering on the Internet arose in connection with an initial public offering (IPO)¹⁰⁹ by Spring Street Brewing Company, a New York based microbrewery.¹¹⁰ Spring Street Brewing desired to sell securities on the Internet in order to gain access to investor funding that

105. See *infra* notes 109-44 and accompanying text (describing the plans of several issuers that wanted to create Internet Web sites in order to offer securities to the public). "A Web site is the space on a server occupied by the information maintained by a company or individual." Cella & Stark, *supra* note 11, at 821 n.33 (citing CRICKET LIU ET AL., MANAGING INTERNET INFORMATION SERVICES 309-10 (1994)). The Web site occupies multiple "pages," the first of which is the "home" page. See *id.*

106. See Spring Street Brewing Co., SEC No-Action Letter, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,201, at 77,001 (Apr. 17, 1996) [hereinafter Spring Street No-Action Letter]. Although the Spring Street Brewing letter appears to be a no-action letter, it is actually an interpretive letter. See *id.* at 77,002 (stating that the SEC believes that interpretive advice was most appropriate in this situation). Spring Street Brewing had actually begun trading securities on its Web site without first seeking no-action relief from the SEC and, thus, the SEC offered its interpretive advice following its suspension of Spring Street Brewing's trading activity. See *id.* at 77,001; see also FRIEDMAN, *supra* note 1, at 6-2 n.5 (noting that the issuance of an interpretive letter, as opposed to a no-action letter, by the SEC is highly unusual).

107. See Cella & Stark, *supra* note 11, at 829 (discussing the SEC's position regarding what types of activities are appropriate within Internet Web sites involved in securities offerings); see also *infra* notes 109-44 and accompanying text (explaining the SEC no-action letters regarding Internet-based trading systems).

108. See Cella & Stark, *supra* note 11, at 829 (describing the SEC's requirements, as set forth in no-action letters, regarding Internet-based trading systems).

109. An "initial public offering" is defined as a "corporation's first offering of stock to the public." DOWNES & GOODMAN, *supra* note 18, at 260.

110. See Spring Street No-Action Letter, *supra* note 106, at 77,001.

would otherwise be beyond the company's reach due to its limited revenue.¹¹¹ Without greater access to investor funding, the IPO either would fail or never occur. Spring Street Brewing, therefore, established a Web site allowing investors to access SEC-required disclosure materials and to purchase the company's securities.¹¹² Following the IPO, Spring Street Brewing expanded its Internet-based services, adding another page to its Web site that enabled buyers and sellers of Spring Street Brewing stock to execute trades.¹¹³ Spring Street Brewing, in effect, had created a secondary market for its stock wholly outside the exchanges or the OTC market.¹¹⁴

After several weeks of operation, the SEC asked Spring Street Brewing to suspend the trading system's operations.¹¹⁵ The trading halt gave the SEC staff time to determine if the trading system complied with federal securities laws.¹¹⁶ After reviewing the Spring Street Brewing trading system, the SEC issued its findings in the form of an interpretive letter.¹¹⁷ In this letter, the SEC staff provided suggestions as to how Spring Street Brewing could operate the trading system within the bounds of the federal securities laws.¹¹⁸ First, the SEC staff found that the company should utilize an independent agent for the receipt and processing of investor funds.¹¹⁹ Second, information should have been provided to investors re-

111. *See id.*

112. *See Gavis, supra* note 4, at 337-38 (1996) (describing the Spring Street Brewing trading system and the SEC's response thereto).

113. *See id.* at 337 (discussing the secondary market for trading that Spring Street Brewing established following its successful IPO on the Internet).

114. *See id.* Spring Street Brewing set up a system called Wit-Trade, comprised of two bulletin boards. *See id.* One bulletin board contained a listing of buyers and the amounts that they were willing to pay. *See id.* The other listed sellers and the price that they were requesting. *See id.* Buyers and sellers that found each other on Wit-Trade contacted each other through electronic mail. *See id.* Spring Street Brewing handled the delivery of funds and stock certificates. *See id.*

115. *See id.* (stating that the SEC was concerned with various compliance aspects of Spring Street Brewing's Internet trading system).

116. *See id.* (describing the SEC's concern that the Spring Street Brewing trading system was operating in violation of certain 1934 Act requirements).

117. *See Spring Street No-Action Letter, supra* note 106, at 77,001-02 (stating, in an interpretive letter, the SEC's position regarding the Wit-Trade system); *see also supra* note 105 and accompanying text (describing how the SEC issued an interpretive letter instead of a no-action letter after suspending the trading of the Wit-Trade system).

118. *See Spring Street No-Action Letter, supra* note 106, at 77,001-02 (describing the requirements that the SEC imposed before Spring Street Brewing could continue operation of Wit-Trade).

119. *See id.* at 77,001 (explaining the SEC's position with regard to Wit-Trade's handling of investor/seller funds). The SEC suggested that Spring Street Brewing Company utilize the services of a bank or an escrow agent in order to process investor and seller

garding the inherent dangers of investing in illiquid securities.¹²⁰ Third, investors should have been informed that they were subject to regulation as broker-dealers if they posted listings on both the “buy” and “sell” bulletin boards within the trading system.¹²¹ Lastly, the SEC warned Spring Street Brewing that unless an available exemption existed, the company would likely have to register the trading system under the 1933 Act.¹²² Registration under the 1933 Act entails a burdensome series of registration and reporting requirements for companies, especially for small companies such as Spring Street Brewing.¹²³

funds. *See id.*

In a traditional securities trading scenario, a clearing agency would act as an intermediary for the making of payments and delivery of securities. *See COX ET AL.*, *supra* note 10, at 30. Clearing agencies are one of the four types of self-regulating entities recognized in the 1934 Act. *See id.* at 29. Congress created registered clearing agencies in response to a crisis in the 1960s and 1970s, during which long delays occurred in the stock transfer and payment process. *See id.* at 30. The congressional response was Section 17A of the 1934 Act, which established clearing agencies as SROS, and created minimum standards for their operation and membership. *See id.* The largest registered clearing agency is the National Securities Clearing Corporation, formed through the combination of subsidiaries of the NYSE, Amex, and the NASD. *See id.*

120. “Liquidity” is defined and explained as the

[A]bility to buy or sell an asset quickly and in large volume without substantially affecting the asset’s price. Shares in large blue-chip stocks like General Motors or General Electric are liquid, because they are actively traded and therefore the stock price will not be dramatically moved by a few buy or sell orders. However, shares in small companies with few shares outstanding . . . generally are not considered liquid, because one or two big orders can move the price up or down sharply.

DOWNES & GOODMAN, *supra* note 18, at 305. In its interpretive letter to Spring Street Brewing, the SEC required that the company notify investors that “there is no guarantee that they will be able to sell the Company’s shares at the price they paid for them, or at any particular published indication of interest.” Spring Street No-Action Letter, *supra* note 106, at 77,001. The SEC also required Spring Street Brewing to inform investors that the company’s securities are not traded on a national securities exchange or Nasdaq. *See id.*

121. *See* Spring Street No-Action Letter, *supra* note 106, at 77,001-02 (explaining that users would be required to register as brokers if they acted as both buyers and sellers of Spring Street Brewing stock on the Wit-Trade bulletin boards). The 1934 Act requires brokers and dealers to register with the SEC. *See POSER*, *supra* note 6, at 3-3. Once registered with the SEC, brokers and dealers are subject to SEC authority over certain aspects of their business, including the supervision of personnel, financial responsibility, and the maintenance of corporate books and records. *See id.*

122. *See* Spring Street No-Action Letter, *supra* note 106, at 77,002 (stating that the offering of securities on Wit-Trade resembled an “offer or sale” for purposes of the 1933 Act registration requirements). The SEC provided guidance to Spring Street Brewing, however, in the form of notice regarding available exemptions from the 1933 Act’s registration requirements. *See id.*; *see also* FRIEDMAN, *supra* note 1, at § 6.03 (discussing the 1933 Act’s registration requirements as they apply to Internet-based trading systems).

123. *See* JOHNSON & MCLAUGHLIN, *supra* note 15, at 5-9 (discussing the myriad of requirements imposed upon corporate securities issuers by the 1933 Act). Because the

Although the SEC staff's interpretive guidance to Spring Street Brewing appears restrictive, the SEC reviewed the trading system's activities with an open mind.¹²⁴ In fact, the SEC staff specifically noted that "[i]nnovation and creativity are the hallmark of our nation's securities markets," and that the Spring Street Brewing system was an "innovative mechanism" for providing shareholders with greater liquidity.¹²⁵

2. Real Goods Trading Corporation: Passive Trading in an Aggressive Market

Following the Spring Street Brewing letter, the SEC soon found itself faced with another opportunity to review a proposed Internet based securities trading system.¹²⁶ In June 1996, Real Goods Trading Corporation (RGTC) requested no-action relief from the SEC in connection with its proposal to establish a "passive" Internet bulletin board.¹²⁷ RGTC established this bulletin board to provide information to prospective buyers and sellers of RGTC's stock.¹²⁸ RGTC's sole role in the passive trading system would be to provide information describing the securities.¹²⁹

The SEC staff granted RGTC's request not to register the trading system with the SEC in any capacity.¹³⁰ In doing so, the SEC staff again set

1933 Act is considered to be a "disclosure statute," it requires detailed public reporting of information concerning the business and finances of the issuer. *See id.* at 6. The information that is disclosed by the company is made public by the SEC in order to allow investors to have access to material information regarding the issuer and the issuance. *See id.*

124. *See* Spring Street No-Action Letter, *supra* note 106, at 77,001 (stating that the SEC tries to encourage modernization within the nation's securities markets, but that the agency is primarily concerned with protecting investors).

125. *Id.*

126. *See* RGTC No-Action Letter, *supra* note 29, at 77,134 (providing the SEC staff's reply to a no-action request letter regarding an Internet-based securities trading system).

127. *See id.* at 77,131. A passive Internet trading system uses bulletin boards to list information regarding stock for sale or purchase. *See id.* The term "passive" is used because the system and its operators do not get involved in the actual trading of the securities. *See id.* at 77,132. Instead, the buyers and sellers of stock obtain the information they need from the bulletin boards, and then effectuate the transaction by direct contact with each other outside of the system. *See id.* Even though RGTC would not be involved in the transaction, the company was required to keep records of the stock price quotations for a minimum of three years to be made available to the SEC and to the Pacific Stock Exchange upon request. *See id.*; *see also* Gerard R. Boyce, *Internet Stock Trading and the SEC*, N.Y. L.J., July 11, 1996, at 5 (providing a detailed analysis of the RGTC trading system and the related SEC no-action letter).

128. *See* RGTC No-Action Letter, *supra* note 29, at 77,131 (discussing the parameters of the RGTC bulletin board trading system).

129. *See id.* at 77,132 (stating that RGTC would have no role in the buy/sell transaction beyond providing information to investors about the company's stock).

130. *See id.* at 77,134 (providing the SEC staff's favorable response to RGTC).

forth guidelines for the operation of the system.¹³¹ First, RGTC was not to receive compensation for the use of the Web site.¹³² Second, the SEC staff stated that RGTC could not become directly or indirectly involved in any negotiations taking place on the bulletin board.¹³³ Third, the SEC staff forbid RGTC from providing information regarding the advisability of buying or selling securities.¹³⁴ Lastly, RGTC could not receive, transfer, or hold funds or securities in connection with the bulletin board.¹³⁵ With regard to the last requirement, the SEC staff did not provide any guidance on the settlement procedures to be used by the trading participants.¹³⁶ In the months following the RGTC no-action letter, the SEC provided similar relief to other issuers using systems similar to RGTC's.¹³⁷

3. *Internet Capital Corporation: It's All in the Name*

After the RGTC no-action letter, the SEC staff granted no-action relief to Internet Capital Corporation (ICC), a third party offering Internet-based securities trading services to issuing companies.¹³⁸ In this no-

131. *See id.* (detailing the SEC staff's guidelines for the operation of RGTC's trading system).

132. *See id.* (describing the SEC's position prohibiting RGTC from receiving any compensation for its efforts in establishing and operating the trading system).

133. *See id.* (stating that RGTC would be prohibited from taking an active role in the trading between stock buyers and sellers).

134. *See id.* (finding that RGTC would be prohibited from advising transaction participants in connection with the buying or selling of RGTC stock).

135. *See id.* (describing the SEC's position that RGTC would be prohibited from handling investor/seller funds).

136. *See id.* (requiring that RGTC not handle funds, but remaining silent on how participants should settle their transactions).

137. *See* PerfectData No-Action Letter, *supra* note 29, at *5-7 (involving a computer accessory company that established an Internet-based bulletin board trading system); Flamemaster No-Action Letter, *supra* note 29, at *5-6 (involving an aircraft sealant company that established an Internet-based bulletin to facilitate trading in its stock). The SEC staff stated that it would no longer respond to no-action requests with respect to systems similar to RGTC's because the staff already expressed its opinion on the applicability of 1934 Act requirements to such systems. *See id.* at *6.

138. *See* Internet Capital No-Action Letter, *supra* note 29, at *1 (involving a third party Internet Web site designed to allow numerous corporate issuers facilitate securities trading transactions with investors). In an earlier, similar no-action letter, the SEC staff granted relief to Angel Capital Electronic Network (Ace-Net), a conglomerate of universities and non-profit entities that proposed to establish a Web site listing small corporate offerings. *See* Angel Capital No-Action Letter, *supra* note 32, at *1. The Office of Advocacy of the U.S. Small Business Administration sponsored Ace-Net with the understanding that Ace-Net would become a private, independent, not-for-profit organization once fully operational. *See* Angel Capital Electronic Network, *Ace-Net* (visited Feb. 12, 1998) <<https://ace-net.sr.unh.edu/what/>>.

action letter, the SEC staff allowed ICC to post and deliver prospectuses and offering materials for unaffiliated corporate issuers whose offerings were SEC-registered.¹³⁹ ICC proposed to offer its service to issuing companies in need of investment capital, but lacking sufficient assets to pursue traditional underwriting activities associated with offerings.¹⁴⁰

ICC clearly stated in its SEC no-action request letter that the company would act simply as a "delivery mechanism," not a broker-dealer, agent, or underwriter for the issuing companies, and that ICC would have no involvement in the transactions following the delivery of a prospectus.¹⁴¹ Furthermore, ICC stated that it would only receive a flat fee, not a commission, from its corporate issuer clients, and that it would not offer any

The drafters of Ace-Net's request for no-action relief noted two substantial obstacles that a small company confronts. *See* Angel Capital No-Action Letter, *supra* note 32, at *2. First, the company had "limited exposure to experienced, accredited investors." *See id.* Second, the company faced costly transaction fees associated with obtaining equity capital. *See id.* The SEC staff's no-action relief provided that the trading system could operate as long as Ace-Net did not: (1) provide advice about the merits of particular opportunities; (2) receive compensation other than flat fees to cover administrative costs; (3) participate in negotiations; (4) directly assist investors or listing companies with the closing of any transaction; (5) handle funds or securities; or (6) hold itself out as providing securities-related services other than a listing or matching service. *See id.* at *8.

In a separate no-action letter, the SEC staff granted relief to another company named "Internet Capital Corporation" (ICC-2). *See* Reid & Co., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1104 at *1 (Dec. 22, 1997). ICC-2 requested SEC relief to establish an Internet-based trading system for companies whose stock was already listed in a trading market. *See id.* at *1. ICC-2 would charge its corporate issuer clients a one time flat fee in exchange for its services, which would include: (1) a separate page on ICC-2's Web site for each corporate issuer with direct links to the issuer's SEC filings and detailed information about the issuer and its offering; (2) price quote for each company derived from the exchange on which the issuer's securities trade, or from Nasdaq; and (3) periodic newsletters. *See id.* at *2-4.

The SEC staff approved ICC-2's trading system as long as ICC-2: (1) provided proper disclaimers, as described in the no-action letter; (2) continually verified that each issuer was a member of a national exchange or Nasdaq; (3) maintained proper records for SEC inspection; (4) complied with the advertising restrictions set forth in the requesting letter; and (5) only executed trades on the system when in compliance with the federal securities laws. *See id.* at *9-10. Furthermore, the SEC staff prohibited ICC-2 from: (1) receiving transaction-related compensation for the system; (2) participating in negotiations; (3) offering advice; (4) receiving, transferring, or holding funds or securities incidental to operating the system; and (5) referring participants to a third party for clearing or settling a transaction (other than a bank approved under § 3(a)(6) of the 1934 Act). *See id.* at *10.

139. *See* Internet Capital No-Action Letter, *supra* note 29, at *1, *5. ICC's Internet Web site, the *Internet Capital Financial Forum*, is located at <<http://www.inetcapital.com>>.

140. *See* Internet Capital No-Action Letter, *supra* note 29, at *4 (discussing the types of issuing companies that ICC wanted to enlist for its Internet-based securities trading system).

141. *See id.* at *8, *10.

investment advice.¹⁴² Finally, ICC would require the issuers to covenant that they would comply with all federal and state laws.¹⁴³

Taken together, these recent no-action and interpretive letters represent a system of tenuous SEC regulation in connection with Internet-based trading systems. At a minimum, the decisions reflect the SEC's desire to allow innovative securities trading systems to depart from traditional methods existing within exchanges such as the NYSE and Nasdaq.¹⁴⁴

II. THE SEC RESPONDS: CONCEPTUAL REGULATORY FRAMEWORKS FOR ALTERNATIVE TRADING SYSTEMS

Faced with the continued creation and expansion of alternative securities trading systems, the SEC realized the need for a coherent regulatory framework to ensure fairness and stability in the securities markets.¹⁴⁵ For this reason, and because the SEC operates under a congressional mandate to establish more efficient and effective market operations,¹⁴⁶ the SEC published a concept release (Release) on June 4, 1997.¹⁴⁷ In the

142. *See id.* at *8-10.

143. *See id.* at *10.

144. *See* Spring Street No-Action Letter, *supra* note 106, at 77,001 (stating expressly that the SEC tries to encourage modernization within the nation's securities markets). The SEC stated that "[i]nnovation and creativity" were instrumental in the creation of the United States securities markets, and that such advances created "the most efficient capital formation system in the world." *Id.*; *see also supra* Part I.B.2 and I.B.3 (discussing the SEC staff's positions regarding certain Internet-based securities trading systems); *supra* Parts I.A.1.-I.A.2 (describing the traditional methods of trading on the NYSE and Nasdaq).

145. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,486 (noting that technological changes imposed significant challenges for the federal securities law regulatory framework). The SEC noted that the exponential growth of trading systems offering viable alternatives to traditional stock exchanges has highlighted the need for "forward-looking, flexible" regulation. *See id.*

146. *See* 15 U.S.C. § 78k-1(a)(2) (1994) (directing the SEC to establish a "national market system" for securities). In requiring the SEC to establish a national market system, Congress found that "data processing and communications techniques create the opportunity for more efficient and effective stock market operations." *Id.* § 78k-1(a)(1)(B).

147. Regulation of Exchanges, 62 Fed. Reg. at 30,485. The SEC issued the Release for the express purpose of soliciting comments regarding the regulation of alternative trading systems, national securities exchanges, and foreign market activities in the United States. *See id.* Throughout this Comment, the Release is analyzed only for its suggestions regarding alternative trading systems and national securities exchanges. The SEC has issued an interpretive release regarding the applicability of federal registration requirements upon Internet Web sites that disseminate information on offshore securities sales. *See* Statement of the Commission Regarding Use of Internet Web Sites, International Series Release No. 1125, 63 Fed. Reg. 14,806 (Mar. 27, 1998). For a discussion of the jurisdictional issues presented when mutual funds are marketed on the Internet, see Tim Herring-

Release, the SEC suggested two alternative frameworks designed to modify the regulation of alternative trading systems.¹⁴⁸ As a guiding principle in the Release, the SEC sought to create the most efficient system to promote market-wide transparency, protect investors, and provide fairness in trading.¹⁴⁹

The two alternatives outlined in the Release seek to incorporate alternative trading systems, which under the Release's definition would include Internet-based exchanges, into the existing federal securities law purview.¹⁵⁰ While both alternatives are more efficient than the current no-action letter system, they differ dramatically in concept.¹⁵¹ The first alternative suggests a system of continued broker-dealer regulation combined with regulatory modifications.¹⁵² The second alternative advocates a wholesale restructuring of exchange regulation accomplished by redefining the term "exchange."¹⁵³ Although both alternatives exhibit a desire to adapt to changing technology, a close analysis reveals that the alternatives lack the comprehensive regulatory structure necessary for the effective monitoring of alternative trading systems.¹⁵⁴ Proper regulation and facilitation of alternative trading systems can best be achieved through a different, yet easily ascertainable alternative: the creation of a new national securities association.¹⁵⁵

ton, *Marketing Funds on the Internet*, 25 INT'L BUS. LAW. 340 (1997).

148. Regulation of Exchanges, 62 Fed. Reg. at 30,487 (discussing the two frameworks suggested by the SEC).

149. See *id.* "Market-wide transparency" generally refers to a situation where investors and sellers of stock have access to the best and most accurate price quotations available for an individual stock, no matter where the trade is executed. See *id.* at 30,492-93.

150. See *id.* at 30,487.

151. See *supra* notes 145-50 and accompanying text; see also *infra* notes 156-91 and accompanying text (describing in detail the Release's two suggested regulatory alternatives). Although not expressly mentioned in the Release, another possible method of regulating non-traditional trading systems would be to amend the federal securities statutes dealing with exchanges to expressly provide for alternative trading systems. See Junius W. Peake, *Comments to SEC Concept Release on Regulation of Exchanges* (visited Sept. 10, 1997) <<http://www.sec.gov/rules/concept/s71697/peake1.htm>> (responding to the Release's third question). However, the time involved in amending the provisions, as well as the relative power of competing interests, could mire this approach indefinitely. See *id.* (responding to the Release's 23rd question).

152. See Regulation of Exchanges, 62 Fed. Reg. at 30,487 (describing generally the first alternative suggested by the Release).

153. See *id.* (discussing the second alternative suggested by the Release). For a detailed discussion of the alternatives suggested in the Release, see *infra* notes 156-91 and accompanying text.

154. See *infra* Part III (discussing various shortcomings of the two proposals set forth in the Release).

155. See *infra* Part V (proposing the creation of a new national securities association for alternative trading systems).

A. *Continued Regulation of Alternative Trading Systems as Broker-Dealers*

The Release's first alternative framework calls for the continued regulation of alternative trading systems as broker-dealers.¹⁵⁶ Broker-dealers must comply with various aspects of the 1934 Act, including a system of registration and reporting requirements.¹⁵⁷ Furthermore, broker-dealers are subject to the regulations imposed by their supervising SROs.¹⁵⁸

The first alternative would allow the SEC to devise special rules for alternative trading systems that would operate in conjunction with the existing body of broker-dealer regulation.¹⁵⁹ Specifically, the Release suggested requiring SROs to subject alternative trading systems to the jurisdiction of the SRO's real-time surveillance system.¹⁶⁰ This would allow the SROs to police the new markets for both fraud and manipulation.¹⁶¹ The SEC also would require SROs to create new market surveillance controls that would work specifically with the technology of the new trading systems.¹⁶² The first alternative further demands that alternative trading systems provide a more complete audit trail to their SROs,

156. See Regulation of Exchanges, 62 Fed. Reg. at 30,495 (discussing how the SEC could integrate alternative trading systems into the established regulatory framework through broker-dealer regulation).

157. See *supra* note 121 and accompanying text (referencing generally the federal securities laws requirements imposed upon broker-dealers). See generally 6 LOSS & SELIGMAN, *supra* note 22, at 2965-3103 (describing the federal securities law requirements as they apply to broker-dealers). Violations of federal securities laws are punishable by civil and criminal penalties. See 1 HAZEN, *supra* note 19, at 546. When the SEC uncovers a possible criminal violation of the federal securities laws, it relinquishes jurisdiction to the United States Department of Justice. See *id.* In addition, the SEC is empowered under the 1934 Act to hold administrative hearings in its supervisory role over broker-dealers. See 15 U.S.C. § 78o(b)(4) (1994). See generally Gregory S. Crespi, *The Reach of the Federal Registration Requirements for Broker-Dealers and Investment Advisors*, 17 SEC. REG. L.J. 339 (1990) (summarizing administrative and judicial interpretations of federal statutory registration requirements); David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U. L. REV. 899 (1987) (analyzing the fundamentals of federal broker-dealer registration requirements); Arthur F. Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901 (1971) (detailing the development of SEC criminal cases).

158. See generally 6-7 LOSS & SELIGMAN, *supra* note 22, at 2965-3400 (detailing the system of broker-dealer regulation, including the role of SROs in overseeing broker-dealer activity).

159. See Regulation of Exchanges, 62 Fed. Reg. at 30,487.

160. See *id.* (discussing the surveillance of alternative trading systems); see also *supra* note 70 and accompanying text (describing the NYSE's Stock Watch system).

161. See Regulation of Exchanges, 62 Fed. Reg. at 30,487 (discussing the need for surveillance of alternative trading systems).

162. See *id.*

detailing the flow of transactions through each system.¹⁶³ These measures would enable the SEC to ensure a higher degree of investor protection and market stability as required by the 1934 Act.¹⁶⁴

The Release maintains a strong desire to further the goals of the 1934 Act, while at the same time successfully incorporating alternative trading systems into the domain of the federal securities laws.¹⁶⁵ To this end, the first alternative suggests that new trading systems assist the SROs in market surveillance activities, as well as adopt their own rules and procedures aimed at ensuring system integrity.¹⁶⁶ Furthermore, the Release posits that alternative trading systems be required to make all orders in their systems available to a supervising SRO.¹⁶⁷ Recognizing its congressional mandate to ensure timely and adequate disclosure, the SEC would require the SRO to promulgate the orders¹⁶⁸ on a public quotation system.¹⁶⁹ In addition, the SEC suggested that it could require operators of alternative trading systems to allow the public to access the systems for the purpose of interacting with posted orders.¹⁷⁰ Such requirements would ensure fair trading practices, while simultaneously increasing market competition.¹⁷¹

163. *See id.* at 30,495-96. By providing SROs with more extensive audit information, alternative trading systems would facilitate SRO oversight. *See id.* at 30,496. Furthermore, the audit information would enable the SROs to integrate alternative trading systems into their surveillance programs. *See id.*

164. *See id.* at 30,495-96 (discussing the market surveillance problems inherent in alternative trading systems, and the possible solutions); *supra* note 19 (referencing the 1934 Act's mandate regarding investor protection and market stability).

165. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,486 (discussing the problems with the application of existing law to alternative trading systems, and the need to incorporate those systems more fully into a regulatory scheme).

166. *See id.* at 30,487 (describing the SEC's intention to incorporate market surveillance procedures into alternative trading system regulation).

167. *See id.*

168. "Order" is defined in the Release as "any firm trading interest, including both limit orders and market maker quotations." *Id.* at 30,486 n.2.

169. *See id.* at 30,495-96 (discussing the SEC's suggested inclusion of alternative trading system stock quotation within publicly accessible quotation systems).

170. *See id.* at 30,495 (stating that the SEC could require the operators of alternative trading systems to allow public interaction).

171. *See id.* at 30,496. The SEC has found that existing alternative trading systems operated by broker-dealers do not sufficiently disclose information to the public, thereby excluding the public from material information needed to ensure fairness in the market. *See id.* The SEC posits that better public disclosure mechanisms will increase competition and transparency in the market. *See id.* Therefore, the Release requires that alternative trading systems incorporate disclosure mechanisms so that information regarding trading interest, prices, and volume will be made widely available to market participants. *See id.*

B. The Tiered Approach to Exchange Regulation

The SEC's second alternative framework involved a general expansion of the regulation of securities exchanges.¹⁷² Under this approach, exchanges would be grouped into three tiers, with each tier containing different methods and levels of regulation.¹⁷³ The Release stated that a tiered system of exchange regulation could be implemented through a redefinition of the term "exchange."¹⁷⁴ The first tier of exchanges would incorporate the majority of alternative trading systems already in operation at the time of the Release.¹⁷⁵ The Release suggested limiting participants in the first tier to companies that either (1) had a limited volume, or (2) did not create listing prices.¹⁷⁶ If an alternative trading system satisfied one of these standards, then under the terms set forth in the Release, the system would likely be exempt from formal registration with the SEC as a national securities exchange.¹⁷⁷

The second tier of proposed exchanges would include alternative trading systems that experienced higher trading volume than those in the first tier.¹⁷⁸ The Release called for these systems to be regulated as national securities exchanges, but in a modified manner.¹⁷⁹ In this tier, the

172. *See id.* at 30,499.

173. *See id.* at 30,487.

174. *See id.*

175. *Cf. id.* (discussing the requirements for, and types of, first tier exchanges); *see also supra* Parts I.B.1-I.B.3 (discussing alternative trading systems that already have been presented to the SEC).

176. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,487 (detailing the first tier of exchanges that would be established under the Release's second regulatory alternative).

177. *See id.* at 30,487, 30,500. The 1934 Act provides an exemption from registration for exchanges if, in the SEC's opinion, the limited volume on these exchanges does not warrant registration as national exchanges under § 78f of the 1934 Act. *See* 15 U.S.C. § 78e (1994). Section 78f of the 1934 Act deals with the registration of national securities associations. *Id.* § 78f. In 1997, only one exchange, known as AZX, was exempted by the SEC from registration as a national exchange due to its light volume. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,490 n.24; *see also* Self-Regulatory Organizations; Wunsch Auction Systems, Inc.; Order Granting Limited Volume Exemption from Registration as an Exchange Under Section 5 of the Securities Exchange Act, Release No. 34-28899, 56 Fed. Reg. 8377 (1991) (granting an exemption to Wunsch Auction Systems, Inc., now known as AZX). The 1934 Act authorizes the SEC to "conditionally or unconditionally exempt any person, security, or transaction, or any class [thereof]," from any provision of the 1934 Act or rule thereunder, as long as the exemption is "necessary or appropriate" to protect investors or the public interest. 15 U.S.C.A. § 78mm (West 1997).

178. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,487 (noting that these exchanges more closely resemble traditional exchanges).

179. *Id.* at 30,487 (discussing the proposed regulation of second tier exchanges as national securities exchanges with appropriate exemptions).

SEC would have used its exemptive authority¹⁸⁰ to modify any 1934 Act registration and regulatory requirements that would be unduly burdensome on alternative trading systems.¹⁸¹ To determine what 1934 Act exemptions are necessary for a particular qualified trading system, the SEC would have been required to thoroughly review the characteristics and structure of each system.¹⁸²

The third and final tier of exchanges would have included traditional exchanges.¹⁸³ The SEC would continue to regulate these traditional securities markets as national exchanges pursuant to the 1934 Act.¹⁸⁴ In an attempt to facilitate the competitiveness of traditional exchanges, the Release suggested that the SEC could utilize its exemptive authority to reduce unnecessary regulatory requirements imposed upon the traditional exchanges by the federal securities laws.¹⁸⁵ Other than these ex-

180. *See supra* notes 51-52 and accompanying text (discussing the general exemptive powers that Congress granted to the SEC in the National Securities Markets Improvement Act of 1996). Congress granted the SEC this exemptive authority with respect to the 1933 Act in order to allow the agency to consider more flexible approaches to registration, disclosure, and related issues. *See* JAMES HAMILTON, *SECURITIES REFORM: NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996*, at 19 (1996) (discussing generally the SEC's increased exemptive authority under the 1996 Act). Congress authorized the SEC to act by rule or regulation with respect to 1933 Act exemptions. *See id.* The SEC was authorized to act through orders and rulemaking with respect to 1934 Act exemptions. *See id.* Read literally, the new exemptive powers appear to allow the SEC to exempt persons or transactions from any rule. Congress, however, has noted expressly that the exemptive authority did not apply to the anti-fraud provisions in the 1933 and 1934 Acts. *See id.* Moreover, Congress specifically referred to alternative trading systems in its consideration of the National Securities Markets Improvement Act of 1996. *See* S. REP. NO. 104-293, at 15 (1996); *see also* Regulation of Exchanges, 62 Fed. Reg. at 30,499 (discussing how the SEC could use its exemptive authority to create a tiered approach to exchange definition and regulation).

181. *See* 15 U.S.C.A. § 78mm (creating broad exemptive power for the SEC); *see also* Regulation of Exchanges, 62 Fed. Reg. at 30,499 (discussing how the SEC could utilize its exemptive authority to create a new category of exchanges).

182. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,502 (describing how the SEC could consider exempting alternative markets from certain statutory and regulatory requirements).

183. *See id.* at 30,487.

184. *See id.*

185. *See id.* at 30,516 (discussing how a re-evaluation of market regulation due to the rise in alternative trading systems could benefit traditional exchanges). In the Release, the SEC expressed concern for traditional exchanges due to the increased popularity of alternative trading systems that could provide similar services at lower costs or with superior efficiency. *See id.* For example, the Release noted that burdensome 1934 Act requirements regarding SEC approval of exchange rule changes could be streamlined in order to expedite the review process, thereby making exchange rulemaking more efficient. *See id.* at 30,518. The SEC would not, however, make any exemptions that would sacrifice "investor protection or market integrity." *See id.* at 30,516.

emptions, the third tier exchanges would have continued to operate as traditional national securities exchanges under the 1934 Act.¹⁸⁶

The SEC suggested in the Release that the tiered approach to exchange regulation could best be effectuated by modifying the definition of "exchange."¹⁸⁷ The new definition suggested by the SEC was "any organization that both: (1) consolidates orders of multiple parties; and (2) provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of a trade."¹⁸⁸ Due to the current narrow definition of "exchange,"¹⁸⁹ many non-traditional trading systems are not required to register as exchanges, and instead have been registered as broker-dealers.¹⁹⁰ By redefining the term "exchange," the SEC hoped to incorporate existing alternative trading systems more adequately into its regulatory framework, and to allow for the easy incorporation of future non-traditional trading systems.¹⁹¹

III. THE REACH OF THE RELEASE AND THE CONTINUED SEARCH FOR REASONABLE REGULATION

In this era of daily technological advances, the SEC's Release was a timely reaction to the needs of the securities industry.¹⁹² The SEC's posi-

186. *See id.* at 30,487.

187. *See id.* at 30,487, 30,505-06 (discussing the definitional history of the SEC's term "exchange" and its effect on various alternative trading systems).

188. *Id.* at 30,507 (emphasis omitted) (citation omitted). The SEC asserted that this new definition would more closely resemble the 1934 Act's concept of "bringing together" buyers and sellers. *See id.* More importantly, the SEC felt that the new definition would broaden the SEC's concept of what is typically understood to be an exchange. *See id.* By broadening this concept, the new definition of exchange would reflect global changes in securities markets brought on by automated trading. *See id.*

189. *See supra* note 44 (providing the 1934 Act's definition of "exchange").

190. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,505-06; *see also* Self-Regulatory Organizations; Delta Government Options Corp.; Order Granting Temporary Registration as a Clearing Agency, Release No. 34-27611, 55 Fed. Reg. 1890 (1990) (granting relief from SEC enforcement action to a government securities trading system because the system did not meet the definition of "exchange"). The Seventh Circuit upheld the SEC's authority to utilize a narrow definition of exchange. *See* Board of Trade of Chicago v. SEC, 923 F.2d 1270, 1273 (7th Cir. 1991).

191. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,486 (stating that the SEC is attempting to be forward-looking in its regulatory approach).

192. *See* Securities Industry Association, *krongar1.htm* (visited Oct. 17, 1997) <<http://www.sec.gov/rules/concept/s71697/krongar1.htm>>. The Securities Industry Association (SIA) represents the interests of more than 770 securities firms in North America. *See id.* (describing SIA in footnote one of the SIA's comments in response to the Release). In the summary to its comments regarding the Release, SIA applauded the SEC for its timely effort to provide possible directions for future market regulation. *See id.* In addi-

tions in previous no-action letters regarding Internet-based trading, although ad hoc in nature, evidenced a desire to foster innovative trading procedures.¹⁹³ The Release further bolstered this desire.¹⁹⁴ Despite criticism from various scholars and practitioners,¹⁹⁵ the SEC should be commended for its forward-thinking and accommodating approach towards alternative trading systems.¹⁹⁶ However, a mere desire to foster innovative trading practices does not necessarily mean that the ideas set forth in the Release should be blindly accepted.¹⁹⁷ Indeed, both alternatives presented in the Release are subject to criticism.¹⁹⁸ Moreover, the SEC mentioned, but failed to fully explore, certain creative options available within the 1934 Act framework.¹⁹⁹ These creative statutory and regulatory alternatives would allow for efficient, fair, and safe regulation of the

tion, SIA pointed out in the introduction to its comments that investors will turn to other sources, including cyberspace, if regulators and broker-dealers do not adapt to the accelerating pace of technology. *See id.* SIA also noted in its introduction that the process of adaptation in the securities industry never ends. *See id.* Finally, SIA advocated in the summary of its comments that any new regulatory scheme for alternative trading systems should be narrowly tailored to demonstrated regulatory needs. *See id.*

193. *See supra* Parts I.B.1-I.B.3 (describing the SEC's forward-looking no-action positions regarding certain Internet-based securities trading systems).

194. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,488 (noting that "[r]egulation should not be static"). In the Release, the SEC expressly stated its willingness to work with market participants to provide regulation for alternative trading systems in a manner that does not stifle innovation. *See id.* at 30,500.

195. *See* Sam Scott Miller et al., *Tethering Technology: The SEC's Market Structure Concept*, INSIGHTS, Sept. 1997, at 7, 11 ("While the Concept Release was issued under the auspices of adapting to technological development, the proposed reforms are more likely to retard it.").

196. *See* Securities Industry Association, *supra* note 192 ("We wish to commend the [SEC] for its thoughtful, innovative, and far-reaching effort to provide possible directions for market regulation at the gateway of the 21st century.").

197. *See* American Bar Association, *liftin4.htm* (visited Nov. 19, 1997) <<http://www.sec.gov/rules/concept/s71697/liftin4.htm>> (stating, in the "General approach" section, that the Release did not identify any existing regulatory problems that needed to be remedied); National Association of Securities Dealers, *conley1.htm* (visited Oct. 17, 1997) <<http://www.sec.gov/rules/concept/s71697/conley1.htm>> (favoring the Release's alternative of continued broker-dealer regulation of alternative trading systems); Orrick, Herrington & Sutcliffe LLP, *miller2.htm* (visited Oct. 17, 1997) <<http://www.sec.gov/rules/concept/s71697/miller2.htm>> (stating, in the "General comments" section, that the SEC's suggested alternatives would have "seismic" consequences and promote unpredictable regulation); Peake, *supra* note 151 (providing in-depth criticisms of the Release's suggested alternatives); Securities Industry Association, *supra* note 192 (criticizing the existing SEC suggestions and proposing detailed alternatives).

198. *See supra* Part III (examining and criticizing the two SEC alternatives set forth in the Release); *see also* Miller et al., *supra* note 195, at 7-11 (criticizing the SEC's suggestions for alternative trading system regulation).

199. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,498 (discussing the possibility of a new SRO created by brokers and dealers under Section 15A of the 1934 Act).

nation's securities exchanges, including those that are established on the Internet.²⁰⁰

A. The Insufficiency of Continued Broker-Dealer Regulation for Alternative Trading Systems

The SEC hesitantly suggested in the Release that alternative trading systems could continue to be regulated as broker-dealers.²⁰¹ In addition to existing broker-dealer regulations, operators of the new systems and their related SROs would be subjected to specially promulgated rules.²⁰² With respect to Internet-based trading systems, however, this alternative raises two serious issues.

First, the proposed continuation of broker-dealer regulation assumes the presence of a broker-dealer, or broker-dealer related activity.²⁰³

200. See *infra* notes 260-76 and accompanying text (discussing regulatory alternatives capable of encompassing Internet technology).

201. Regulation of Exchanges, 62 Fed. Reg. at 30,494-95 (detailing the SEC's reluctance to continue the current regulatory scheme for alternative trading systems).

202. See *id.* at 30,495 (discussing the SEC's intention to create new rules specific to alternative trading systems if the current system of broker-dealer regulation continues).

203. See *id.* at 30,495-96. In its discussion of regulation through existing broker-dealer requirements, the Release presupposed that all operators of alternative trading systems were registered broker-dealers. See *id.* at 30,495. Many broker-dealers have active alternative trading systems currently in effect, such as the Instinet, Bloomberg Tradebook, and POSIT systems. See Miller et al., *supra* note 195, at 7; see also MARKET 2000 REPORT, *supra* note 24, at II-12, II-13 (noting the difference between proprietary trading systems, which are privately owned and affiliated with broker-dealers, and trading systems expressly owned and operated by broker-dealers). The SEC granted 11 no-action letters to owners and operators of proprietary trading systems through April 1989. See Proprietary Trading Systems, Exchange Act Release No. 34-26708, 43 SEC Docket (CCH) 979, 979-80 n.3 (1989). These systems were sponsored by broker-dealers (including government securities broker-dealers), affiliated entities, or those entities that were in the process of registering with the SEC. See *id.* at 981 n.13. The SEC specifically noted that "proprietary systems that have developed to-date are distinguishable in function from exchange markets." *Id.* at 984. Most importantly, the SEC stated that "[t]hese systems have not, however, evolved into interdealer quotation or transaction mechanisms in which participants enter two-sided quotations on a regular or continuous basis, thus ensuring a liquid marketplace." *Id.* By January 1994, the SEC's Division of Market Regulation had provided no-action relief to 21 proprietary trading systems. See MARKET 2000 REPORT, *supra* note 24, app. at IV-2. However, many of the systems that received no-action relief never began operation, and only 10 systems were operative by January 1994. See *id.*; see also TECHNOLOGY REPORT, *supra* note 9, at 97 n.292 (discussing alternative trading systems that had been reviewed by the SEC).

The general understanding was that proprietary trading systems did not fall under the 1934 Act's definition of "exchange." See LOSS & SELIGMAN, *supra* note 40, at 631. Although the 1934 Act's definition included "facilities for bringing together purchasers and sellers of securities," it also limited the definition to those systems "performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood." *Id.* (quoting 15 U.S.C. § 78c(a)(1) (1994)) (emphasis added).

Internet trading systems, however, do not necessarily require broker-dealer participation.²⁰⁴ In fact, the Internet-based trading systems that have been reviewed by the SEC have been premised in part upon efficiency gained through trades made without broker-dealers, and the SEC has not required these systems to register as broker-dealers.²⁰⁵ Thus, these Internet-based systems would be subject only to the informal body of regulation established by the SEC through the no-action process.²⁰⁶ At a minimum, if the suggestion for continued broker-dealer regulation of alternative trading systems is implemented, the SEC should consider codifying its no-action positions with respect to Internet trading systems in order to promote uniformity.

Another issue raised by the Release's first alternative regulatory framework concerns the evolving nature of Internet-based securities trading systems. As these systems become less passive and begin to facilitate interactive trading activities, the need for suitable regulation will arise.²⁰⁷ Under the Release's first alternative, however, it appears that

To correct this limitation, in 1988 the SEC proposed Rule 15c2-10 under the 1934 Act to govern proprietary trading systems. See *LOSS & SELIGMAN, supra* note 40, at 632. Rule 15c2-10 offered a definition of "trading system" that included "any system that provides for the dissemination outside the sponsor and its affiliates of indications of interest, quotations, or orders to purchase or sell securities and that provides procedures for executing or settling transactions in such securities." Exchange Act Release No. 34-26708, *supra*, at 986. Instead of promulgating Rule 15c2-10, however, the SEC issued Rule 17a-23 under the 1934 Act. 17 C.F.R. § 240.17a-23 (1997). Rule 17a-23 requires specific recordkeeping and reporting by proprietary trading systems. See *id.*; see also Recordkeeping and Reporting Requirements for Trading Systems Operated by Brokers and Dealers, Exchange Act Release No. 34-33605, 56 SEC Docket (CCH) 35, 35-36 (1994) (discussing the SEC's rationale for establishing reporting and recordkeeping requirements for proprietary trading systems). Under the SEC's April 29, 1998 proposed rules, Rule 17a-23 would be repealed, and alternative trading systems would be required to furnish information to the SEC in accordance with proposed Regulation ATS. See Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. at 23,507.

204. See *FRIEDMAN, supra* note 1, at 6-14 (noting that Internet-based trading systems have not been required to register as broker-dealers); see also *supra* Parts I.B.1-I.B.3. (describing the SEC's grant of no-action letters to Internet trading systems). To date, the SEC has allowed Internet-based trading systems to remain outside the realm of broker-dealer regulations, as long as the specific requirements set forth in each trading system's no-action letters are met. See *supra* Parts I.B.1-I.B.3 (discussing, in part, the SEC's position with respect to broker-dealer regulation of certain Internet-based trading systems).

205. See *supra* Parts I.B.1-I.B.3 (discussing, in part, the rationale for the creation of certain Internet-based trading systems).

206. See *supra* notes 109-44 and accompanying text (detailing the no-action and interpretive positions of the SEC with respect to Internet-based securities trading systems).

207. See *FRIEDMAN, supra* note 1, at 6-4 (noting that the existing differences between Internet-based trading systems and exchanges will become more blurred if certain proposed Internet-based systems are implemented). The future of Internet-based trading does not necessarily rest with the passive trading systems approved by the SEC, as evidenced by at least one organization that plans to create a "cyber stock exchange." See *id.*

the only regulatory framework available to these future systems will be in the form of broker-dealer regulation, and SRO oversight.²⁰⁸ Given the current structure of the securities industry, this regulatory structure would require non-passive Internet-based trading systems to seek SRO regulation from the NASD.²⁰⁹

Regulation of Internet-based trading systems by the NASD presents an inherent conflict of interest.²¹⁰ Because non-passive Internet-based systems foreseeably could compete with the Nasdaq market, regulation by the NASD would trigger competitive concerns and could stifle these systems from inception.²¹¹ Although the tone of the Release indicated

This exchange would consist of a Web site having links that would enable investors to buy stock directly from publicly traded corporations, as well as allowing visitors to trade stock on a bulletin board linked to the Web site. *See id.* at 6-4 to 6-5. There are several other organizations planning to build similar, active Internet-based trading systems. *See infra* note 219 (citing sources that discuss planned Internet-based stock exchanges).

Andrew Klein, president of Wit Capital, has posited one of the most ambitious and timely Internet-based stock exchange proposals. *See* Wit Capital, *Our Services* (visited Oct. 29, 1997) <<http://www.witcapital.com>>. Wit Capital's proposed Internet stock exchange will be called the "Digital Stock Market." *See id.* Wit Capital planned for this exchange to become operational in 1998. *See id.* The Digital Stock Market will provide less expensive trading alternatives because investors will be able to avoid broker or specialist trading fees. *See id.* Wit Capital envisions that this new, Internet-based exchange will allow investors to create their own auctions for stocks, and the company will handle the allocation of shares among investor members. *See id.*

208. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,495-97 (describing the possibility of continued broker-dealer regulation of alternative trading systems); *but cf id.* at 30,497-99 (discussing various regulatory burdens and inadequacies that the continued broker-dealer regulation would create).

209. *See* COX ET AL., *supra* note 10, at 29 (finding that the NASD is the only national securities association under the 1934 Act).

210. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,498 (stating that operators of alternative trading systems have been reluctant to comply with SRO surveillance activities in instances where the SRO operated its own trading system); MARKET 2000 REPORT, *supra* note 24, at 2 ("[F]air competition among markets and market participants should be promoted."). The SEC stated that "the benefits of competition should not be lost in an attempt to capture the advantages of uniformity." *Id.* at 13. In addition, the SEC found that "fair market competition can be promoted by fairly allocating regulatory responsibilities . . . without stifling the ability of alternative markets and services to emerge." *Id.* at 25 (emphasis added); *see also* Peake, *supra* note 151 (discussing conflicts of interest created by Nasdaq). Professor Peake called for neutral regulation of market centers in order to avoid conflicts of interest. *See id.* Professor Peake regards this approach as especially important for the NASD because the NASD owns and operates its own market center, the Nasdaq. *See id.*; *see also* Bill Singer & Vincent P. Liberti, Singer Zamansky LLP, *singer1.htm* (visited Nov. 7, 1997) <<http://www.sec.gov/rules/concept/s71697/singer1.htm>> (discussing, in its "National Self-Regulatory Organization" section, the past abuses that the NASD inflicted upon electronic members, and advocating an SRO presence unique to Internet-based exchanges); *supra* notes 95-97 and accompanying text (discussing the abuses that have taken place within the NASD, including anti-competitive practices).

211. *See supra* notes 95-97 and accompanying text (discussing, in part, the abuses pres-

that the SEC did not want to pursue the continued regulation of alternative trading systems as broker-dealers,²¹² if the first alternative is to remain a viable option, the SEC must pursue SRO alternatives to the NASD.

B. The Redefinition of "Exchange": Wall Street Meets Silicon Valley

The Release's second suggested framework for the incorporation of alternative trading systems into the existing regulatory framework involved the restructuring of the definition of "exchange" as it appears in the 1934 Act.²¹³ The new regulatory system would include three tiers of exchanges.²¹⁴ At a minimum, the modification of the definition of "exchange" and the division of exchanges into three tiers would allow Internet-based trading systems to fit into a proposed classification.²¹⁵ Internet-based trading systems thus would be eligible for more comprehensive, predictable, and effective regulation.²¹⁶ Yet, despite the fact that this alternative would improve upon the existing regulatory structure, it might be unduly burdensome if applied in practice.²¹⁷ The intricate and divisive

ent in the NASD and the effect of NASD activities on SOES). Although the NASD has responded to SEC and Department of Justice investigations by implementing procedures to remedy past abuses, an inherent conflict of interest will remain as long as the NASD is directly affiliated with the operation of the Nasdaq market. See *supra* note 210 (providing Professor Peake's opinion regarding inherent conflicts with SROs that operate trading markets).

212. See Regulation of Exchanges, 62 Fed. Reg. at 30,490 (discussing the potential continuation of broker-dealer regulation with a negative bias, as evidenced by at least two subsection headings: "I.B.1 The Current Regulatory Approach Applies Inappropriate Regulation to Alternative Trading Systems"; and "I.B.2. The Current Regulatory Approach Impedes Effective Regulation").

213. See *id.* at 30,505.

214. See *supra* Part II (describing the new three-tiered approach of exchange regulation suggested by the Release).

215. See Regulation of Exchanges, 62 Fed. Reg. at 30,487. The SEC proposed implementing the three-tiered approach to exchange regulation by redefining the term "exchange." See *id.* The newly proposed definition would incorporate any organization that "(1) consolidates orders of multiple parties; and (2) provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of a trade." *Id.* Given the broad scope of the Release's suggested definition, it appears that active Internet-based securities trading systems would be classified as exchanges if the redefinition is implemented. See FRIEDMAN, *supra* note 1, § 6.01(c) (discussing the level of activity that will occur on active Internet-based securities trading systems); see also *supra* Parts I.B.1-I.B.3 (describing some of the Internet-based securities trading systems that have operated to date, and the SEC response thereto).

216. See Regulation of Exchanges, 62 Fed. Reg. at 30,486-88 (describing the suggested regulatory frameworks that could be imposed upon qualifying alternative trading systems).

217. See Miller et al., *supra* note 195, at 9 (discussing the overly burdensome nature of the Release's suggested redefinition of the term "exchange").

nature of this alternative would complicate the scheme of exchange regulation, contravening the SEC's goal of regulatory simplification.²¹⁸

1. *What is Behind Tier One?*

Within the redefinition suggestion, the SEC has accounted—whether expressly or implicitly—for all types of exchange structures: from traditional exchanges like the NYSE to the proposed Internet stock exchanges of the future.²¹⁹ The first tier definition of exchange would include all alternative trading systems that have limited volume or those that do not establish trading prices.²²⁰ Such trading systems would be exempt from regulation as “exchanges.”²²¹

By definition, this first tier encompasses the Internet-based trading systems that already have begun operation.²²² The first tier does not impose SRO membership on alternative trading systems, even though these systems would not be required to register as national securities exchanges, and thus would not qualify as SROs under the 1934 Act.²²³ The Release

218. *See id.*

219. *See supra* Part II.B (describing the Release's three-tiered framework for exchange regulation). For discussions of proposed Internet-based securities exchanges, see *Brewing Company Takes on the NYSE*, NET GUIDE, June 1996, at 13 (discussing Andrew Klein's vision of an Internet-based stock exchange that could compete with the New York Stock Exchange); Bill Barnhart, *Internet Rewriting Scripts for Stock Market Dramas*, CHI. TRIB., Aug. 26, 1996, at C1 (describing the present and future impact of the Internet upon the securities industry); Matthew Doull, *Bypass the Broker*, THE DAILY TELEGRAPH (LONDON), Apr. 23, 1996, at 12 (discussing American innovation in Internet-based securities trading and its effect on the British securities industry); Leslie Eaton, *Slow Transition for Investing: Stock Market Meets Internet*, N.Y. TIMES, Nov. 11, 1996, at A1 (describing the various uses and unlimited potential for the Internet within the securities industry); Beth Healy, *Trades with a twist, to Wit, a Net Broker*, BOSTON HERALD, Aug. 14, 1997, at 31 (discussing Andrew Klein's interaction with Massachusetts securities regulators over plans to operate an Internet-based stock exchange); Helen Huntley, *Brokers Push Web Exchange*, ST. PETERSBURG TIMES (FLORIDA), Mar. 7, 1997, at 1E (discussing the Globe-Net Stock Exchange, an Internet-based stock market planned by Floridian entrepreneurs); Bruce Rule, *Wit Capital Acquires Rights to Stock Trading Software; Recruits Former NYSE Technology Chief Keith as CIO*, INVESTMENT DEALERS DIG., Sept. 9, 1996, at 14 (discussing business moves of Andrew Klein as he pursues an Internet-based stock exchange).

220. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,487.

221. *See id.* (noting that most such exchanges would be exempt); *see also supra* notes 214-20; *infra* notes 222-42 and accompanying text (describing the SEC's tiered approach to the definition of exchange).

222. *See supra* notes 109-44 and accompanying text (discussing several of the Internet-based trading systems that have been reviewed by the SEC).

223. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,500 (stating that the SEC could exempt small trading systems from all exchange registration requirements under either Section 5 or Section 36 of the 1934 Act).

does, however, list several stringent requirements for first tier exchanges.²²⁴ These requirements, while less burdensome than traditional exchange regulation, could prove to stifle fledgling Internet-based trading systems. Specifically, any requirement that would necessitate substantial interaction between Internet-based systems and an existing SRO, such as reporting requirements,²²⁵ would raise concerns similar to those associated with NASD regulation of these systems.²²⁶

Pursuant to the Release's second alternative, first tier exchanges would be required to assume certain duties traditionally allocated to SROs, and accordingly would bear burdens and costs that could adversely affect their growth.²²⁷ Membership in an SRO, rather than simply assuming SRO responsibility, would appear to be more suitable for first tier exchanges. Unfortunately, within the existing market structure, the NASD remains the only SRO available to first tier exchanges.²²⁸ Therefore, although the first tier exhibits an innovative regulatory approach by the SEC, it could be an overly burdensome environment for Internet-based trading systems.

2. One Step Up to Tier Two

The Release's second tier of exchanges only incorporated those alternative trading systems that have a substantial volume of trading.²²⁹ These

224. See *id.* at 30,501. In addition to completing an initial application with the SEC, the Release proposed that first tier exchanges could be required to:

- (1) Notify the [SEC] in the event of a material change in operations or control;
- (2) maintain a record of trading through the system and make such information available to the [SEC] upon request;
- (3) implement procedures for surveillance of employees' trading . . . ;
- (4) cooperate with registered SRO investigations and examinations of the exempted exchange's participants;
- (5) report trades to one or more designated SROs . . . ; and
- (6) require participants to make adequate clearance and settlement arrangements prior to participation in trading on the exempted exchange.

Id.

225. See *id.* (requiring that alternative trading systems report trades to one or more designated SROs).

226. See *supra* note 210 (discussing Professor Peake's comments on the inherent conflict of interest surrounding NASD's operation of the Nasdaq market); see also *supra* notes 95-97 and accompanying text (discussing the anti-competitive practices and other abuses found within the NASD); *supra* notes 209-11 and accompanying text (discussing the SRO options available within the current market structure).

227. See Miller et al., *supra* note 195, at 9 (discussing the "user unfriendly" nature of the Release's proposed exchange redefinition).

228. See *supra* notes 209-11 and accompanying text (describing the SRO options available to Internet-based trading system under the existing regulatory framework).

229. See Regulation of Exchanges, 62 Fed. Reg. at 30,487 (describing the second tier of exchanges); see also *supra* notes 178-82 and accompanying text (discussing the Release's

trading systems would be required to register as national securities exchanges under existing 1934 Act requirements.²³⁰ Second tier exchanges would be regulated as national exchanges with certain exceptions made to eliminate growth barriers.²³¹ As such, second tier exchanges would be subjected to a regulatory scheme more predictable than the others suggested in the Release.²³²

The volume of trading on the Internet-based trading systems that have already been reviewed by the SEC would not be sufficient to warrant classification in this tier.²³³ The second tier assumes either that a trading system graduates from the first tier when its trading volume increases or that the system has a substantial volume of trading from its inception.²³⁴ The provisions in the Release suggesting the first tier's framework do not provide the environment needed by Internet-based systems for growth, and thus a graduation from the first tier to the second tier would be an impossibility for such systems.²³⁵ Furthermore, given the infant state of Internet-based trading, it would be unreasonable to assume that a newly-created system could meet the definitional requirements of the second tier upon its inception.²³⁶ Thus, Internet-based trading systems will be in limbo because they are inadequately provided for in the first tier, and not

proposed second tier of exchanges).

230. See Regulation of Exchanges, 62 Fed. Reg. at 30,487 (describing the second tier of exchanges); see also *supra* notes 178-82 and accompanying text (describing how trading systems attaining a substantial level of volume would be incorporated within the second tier of exchanges).

231. See Regulation of Exchanges, 62 Fed. Reg. at 30,487 (describing how the SEC could grant exemptions to second tier exchanges to eliminate barriers to growth).

232. See *id.*

233. See *supra* Parts I.B.1-I.B.3 (describing the SEC's current no-action position with regard to Internet-based securities trading systems).

234. See Regulation of Exchanges, 62 Fed. Reg. at 30,500. (discussing the progression of alternative trading systems from the first tier to the second tier of exchanges). Given the Internet-based trading systems that have already begun operation, it would be hard to imagine an Internet-based trading system that would initially draw substantial volume. See *supra* Parts I.B.1-I.B.3 (describing the Internet-based trading systems that have been operated to date). Within the limited history of Internet-based securities trading, one of the motivating factors behind the creation of the systems remains constant, namely the inability to access capital through traditional means. See Angel Capital No-Action Letter, *supra* note 32, at *1-2 (discussing the hardship a small company faces as it tries to access investment capital through traditional means). Therefore, for an Internet-based trading system to be included in the Release's second tier, the system would have to develop its volume to the point where it could graduate from its position in the first tier.

235. See Regulation of Exchanges, 62 Fed. Reg. at 30,500 (describing the SEC's vision of a progression for alternative trading systems from the first to second tier).

236. See *supra* notes 234-35 and accompanying text (discussing the progression of Internet-based trading systems within the Release's proposed system of tiered exchange regulation).

advanced enough at initiation to be eligible for inclusion in the second tier.

3. *The Third Tier's Intrusion Upon the Old Boy Exchange System*

Finally, the third tier of exchanges would consist of the traditional exchanges.²³⁷ At first glance, this tier seems to have little impact on Internet-based exchanges. The third tier, however, is important to Internet-based systems because it would provide traditional exchanges with exemptions from certain SEC regulations in the interest of competitive fairness.²³⁸ Such exemptions would make traditional exchange regulation less burdensome, and also might benefit alternative trading systems.²³⁹ If existing restrictions on traditional exchanges are eased, these exchanges might be dissuaded from employing anti-competitive tactics against smaller competitors, much to the benefit of Internet-based trading systems.²⁴⁰

When viewed as a whole, the SEC's tiered structure of exchange regulation is an innovative approach to an existing regulatory void. This approach, however, does not consider the impending growth of Internet-based securities exchanges.²⁴¹ The tiered approach focuses regulation on existing proprietary systems while ignoring the impending rise of Internet-based exchanges. Without modification, the Release lacks adequate provisions necessary to regulate Internet-based exchanges in a fair and consistent manner.²⁴²

IV. THE SEC LISTENS

After reviewing the comments letters received in connection with the Release, the SEC published proposed rules (Rules) for the regulation of exchanged and alternative trading systems on April 29, 1998.²⁴³ The pro-

237. See Regulation of Exchanges, 62 Fed. Reg. at 30,487 (describing the third tier of exchanges proposed by the SEC); see also *supra* notes 185-86 and accompanying text (discussing how the traditional exchanges would benefit from the Release's suggested tiered structure for exchange regulation).

238. See Regulation of Exchanges, 62 Fed. Reg. at 30,487 (discussing the competitive benefits that traditional exchanges would experience as a result of SEC exemptions from regulatory burdens).

239. See *id.*

240. See *id.* (discussing the competitive advantages that SEC exemptions could provide for third tier exchanges).

241. See *supra* note 219 and accompanying text (discussing the future of Internet-based securities trading).

242. See *supra* notes 220-28 and accompanying text (describing the inadequacy of the first tier as applied to Internet-based trading systems).

243. See Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. at

posed rules essentially combined the two alternatives set forth in the Release.²⁴⁴ Therefore, operators of alternative trading systems would have a choice between exchange regulation and continued broker-dealer regulation.²⁴⁵ Although now combined, the SEC proposals are substantially the same as the suggestions found in the Release. The SEC did, however, adapt specific portions of the Release's regulatory alternatives in light of the views expressed in many of the comment letters.²⁴⁶

A. *The Proposed Regulatory Structure*

The proposed rules evidence the SEC's desire to adopt a flexible regulatory framework for alternative trading systems.²⁴⁷ This flexibility is provided through the availability of regulatory options for alternative trading systems. Specifically, the Rules would allow alternative trading systems to register as either broker-dealers or as national securities exchanges.²⁴⁸

The Rules include a new Regulation ATS, which would impose additional requirements on alternative trading system that choose to register as broker-dealers.²⁴⁹ Under the proposed Regulation ATS, alternative trading systems that opt for broker-dealer regulation would be regulated in accordance with the level of their trading volume.²⁵⁰ Those alternative trading systems with limited volume would have to meet only minimal regulatory requirements, such as providing notice of operation to the SEC and maintaining adequate records.²⁵¹ Alternative trading systems that experience significant trading volume would be subject to a much more rigorous regulatory regimen, including price dissemination re-

23,504.

244. *See id.* at 23,506 (discussing the options for alternative trading system regulation under the proposed rules).

245. *See id.*

246. *See id.* at 23,538 (describing how the SEC responded to comments by not adopting a tiered approach to exchange regulation).

247. *See id.* at 23,506 (discussing how the proposed rules should provide adequate flexibility for alternative trading system regulation).

248. *See id.*

249. *See id.* at 23,507 (describing the broker-dealer registration option).

250. *See id.* (detailing the different requirements for high and low volume alternative trading systems).

251. *See id.* Specifically, the Rules propose that limited volume alternative trading systems would have to: (1) notify the SEC of the system's operation; (2) provide the SEC with quarterly reports; and (3) maintain audit trails of transactions and other records. *See id.*

quirements and participant oversight activities.²⁵²

For alternative trading systems that choose to be regulated as exchanges, the Rules propose the promulgation of new Rule 3b-12.²⁵³ Under this new rule, certain terms used in the SEC's current definition of "exchange" would be defined to encompass most alternative trading systems. As opposed to the three tier approach to exchange regulation suggested in the Release, the Rules propose that alternative trading systems electing to be regulated as exchanges would be subject to the same regulatory requirements as existing registered exchanges with certain modifications.²⁵⁴

B. Internet-Based Exchanges Still in the Dark

Like the Release, the Rules evidence the SEC's timely commitment to provide a comprehensive regulatory framework for alternative trading systems. Also like the Release, the Rules do not specifically address the various issues raised by the advent of Internet-based securities exchanges. Unfortunately, because the Rules leave us without a structured regulatory framework that is specifically mindful of Internet-based trading systems, these systems could be subjected to uneven regulation.

The Rules propose that alternative trading systems could elect to be regulated as broker-dealers.²⁵⁵ As discussed above, the Release initially suggested a system of continued broker-dealer regulation for alternative

252. *See id.* The Rules propose that alternative trading systems with significant volume should be required to satisfy various requirements in addition to the requirements set forth for limited volume trading systems. *Id.* First, systems with significant volume would be required to link to a registered market for the purpose of disseminating prices to the public. *See id.* Second, these systems would be required to comply with the rules regarding execution priorities and obligations which are imposed upon members of the registered markets. *See id.* In addition, trading systems with significant volume would have to: "(1) Grant or deny access based on standards established by the trading system and applied in a non-discriminatory manner; and (2) establish procedures to ensure adequate systems capacity, integrity, and contingency planning." *Id.*

253. *See id.* at 23,506. Rule 3b-12 would incorporate "any organization, association, person, group of persons, or system that: (1) Consolidates orders of multiple parties; and (2) sets non-discretionary material conditions (whether by providing a trading facility or by setting rules) under which subscribers entering such orders agree to the terms of a trade." *Id.* Rule 3b-12 would exclude trading systems that serve limited functions, such as routing orders to a registered exchange. *See id.*

254. *See id.* at 23,524 (discussing the proposed system of exchange registration for alternative trading systems). In the Rules, the SEC solicited comments regarding whether any exemptions from exchange regulation should be made to accommodate alternative trading systems. *See id.* In addition, the SEC proposed amending the registration application forms for alternative trading systems to allow for various types of membership, or non-membership, structures. *See id.* at 23,507.

255. *See id.* at 23,506.

trading systems.²⁵⁶ As with the Release's suggestion, the proposal in the Rules is an inadequate solution to the regulatory void existing for Internet-based trading systems, including Internet-based exchanges.²⁵⁷

Although the Rules have eliminated the confusing, intricate tiered approach to exchange regulation, the remaining regulatory option appears to preclude the participation of Internet-based exchanges. Without the tiered approach, it seems even less likely that Internet-based trading systems could elect to be regulated as an exchange. As discussed above, Internet-based systems would most likely experience little volume as they begin operation.²⁵⁸ Therefore, a system of full exchange regulation, with all of its attendant responsibilities, would be an extreme burden for fledgling Internet-based trading systems.²⁵⁹ As such, exchange regulation under the Rules would not be an alternative for Internet-based securities exchanges.

V. A NEW NATIONAL SECURITIES ASSOCIATION AND THE FOSTERING OF INTERNET-BASED EXCHANGES

An alternative to the suggestions set forth in the Release would be the creation of a new "national securities association" (NSA).²⁶⁰ Internet-

256. See *supra* Part II.A (detailing the Release's suggestion for the continued regulation of alternative trading systems as broker-dealers).

257. See *supra* Part III.A (analyzing the insufficiencies of continued broker-dealer regulation of alternative trading systems in light of Internet-based trading systems).

258. See *supra* Part III.A.2 (arguing that the Release's suggested second tier of exchanges would be unsuitable for Internet-based trading systems due to the limited nature of trading volume that these systems will command).

259. The Rules propose that alternative trading systems electing to be regulated as exchanges would be subject to "exchange obligations [which are] fundamental to the fair and efficient operation of exchanges." Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. at 23,524. As part of these obligations, exchange-registered alternative trading systems would be required to fulfill the self-regulatory obligations of the 1934 Act. See *id.* This obligation, along with the various other requirements that the 1934 Act impose upon registered exchanges, would be a burden to fledgling Internet-based exchanges.

260. In the 1938 Maloney Act, which became § 15A of the 1934 Act, Congress officially sanctioned NSAs. See LOSS & SELIGMAN, *supra* note 40, at 644. Congress created NSAs after finding that the OTC market on which broker-dealers operated was the primary source of major underwritings in the country, and thus was the channel by which American dollars flowed into new financings. See H.R. REP. NO. 75-2307, at 3-5 (1938). Congress looked to the legislative history of the 1934 Act because it wanted:

[T]o authorize the [SEC] to subject [OTC trading] to regulation similar to that prescribed for transactions on organized exchanges. This power is vitally necessary to forestall the widespread evasion of stock-exchange regulation by the withdrawal of securities from listing on exchanges, and by transferring trading therein to 'over-the-counter' markets where manipulative evils could continue to flourish, unchecked by any regulatory authority.

based trading systems, along with other types of alternative trading systems, provide a regulatory challenge to the SEC akin to that which led to the creation of NSAs in the 1934 Act.²⁶¹ A new NSA would operate as the SRO for all alternative trading systems, including Internet-based trading systems.²⁶² Although the 1934 Act provides for the creation of such associations only when all members are broker-dealers, Congress could amend the pertinent statutory section, or create an analogous section relating specifically to alternative, non-traditional trading systems.²⁶³ Amendment of the 1934 Act would entail congressional action similar to that which originally gave rise to NSAs.²⁶⁴

A new NSA would be crucial to the regulation of Internet-based trading systems; the NSA would provide a regulatory presence that would promote compliance with applicable regulations while simultaneously establishing notions of fair dealing.²⁶⁵ In addition, just as the NASD has fostered and overseen the Nasdaq market, so too would the new NSA, comprised of Internet-based and other alternative trading system members, act as a protective shield for fledgling Internet-based trading systems. This protection would extend to Internet securities exchanges,

Id. at 3 (quoting S. REP. NO. 73-792, at 6 (1934)).

In adopting the NSA structure, Congress looked at two alternatives: (1) the enlargement of the SEC, and (2) the creation of a system of "cooperative regulation" akin to that found in well-run stock exchanges. *See id.* at 4; S. REP. NO. 75-1455, at 3-4 (1938) (discussing the two regulatory alternatives available to Congress). The purpose of a national securities association is to supervise the conduct of its members "under the general aegis of the [SEC]." LOSS & SELIGMAN, *supra* note 40, at 644. The National Association of Securities Dealers (NASD) is the only organization ever to apply for registration as a national securities association. *See id.* The NASD regulates through rulemaking and "enforces its rules through a system of inspection comparable to that of the [SEC] and the exchanges." *Id.* at 645.

In an attempt to promote equality between traditional stock exchanges and the OTC market, Congress amended § 15A of the 1934 Act in 1964 to make broker-dealer membership in a self-regulating organization mandatory. *See id.* Those broker-dealers not registered with the NASD were subject to direct regulation by the SEC. *See id.* In 1983, Congress amended the 1934 Act to make it illegal for brokers or dealers to effect any trades unless they were a member of the NASD or the exchange on which they were trading. *See* H.R. REP. NO. 98-106, at 1, 6, 8 (1983) (discussing Congress's decision to require broker-dealers to join a national securities association or an exchange).

261. *See supra* note 260 (detailing the statutory basis for the creation of NSAs).

262. *See* Regulation of Exchanges, 62 Fed. Reg. at 30,498 (suggesting that a new national securities association for alternative trading systems could be created under § 15A of the 1934 Act).

263. *See* 15 U.S.C. § 78o-3 (1994) (providing the statutory framework for the creation of national securities associations).

264. *See supra* note 260 and accompanying text (discussing the creation of NSAs under the 1934 Act).

265. *See supra* notes 156-71 and accompanying text (detailing the Release's proposed regulation of alternative trading systems as broker-dealers).

which, without NSA oversight, might fall prey to over-regulation and the superior market power of existing rivals.²⁶⁶

If a new NSA is established, the current statutory framework should, in the interest of competitive fairness, be altered to prohibit the creation and operation of a securities exchange by any such NSA.²⁶⁷ Under the existing securities market structure, an inherent conflict exists because the NASD owns and operates Nasdaq, yet serves as the overseeing SRO for other broker-dealer trading systems.²⁶⁸ A purely regulatory NSA would be more conducive to efficient and even-handed oversight of alternative trading systems. In addition, such an SRO presence would help fulfill the mission of the 1934 Act by protecting the nation's investors against fraud and manipulation, thereby helping to ensure fair markets.²⁶⁹ At the same time, the new NSA would allow smaller companies to gain access to otherwise unobtainable capital through Internet-based IPOs and subsequent secondary market trading, while investors would save on transaction costs due to increased efficiency and/or the removal of middlemen in their securities trades.²⁷⁰

Ultimately, the goal of a new NSA for alternative trading systems would be to provide a presence similar to that of the Small Business Administration (SBA).²⁷¹ Like the SBA, the new NSA could foster the

266. See Peake, *supra* note 151 (discussing the competitive market pressures that alternative trading systems would face under the Release's tiered regulatory scheme). In an analogous situation, there was a great debate in the late 1960s among market participants regarding the possibility that Nasdaq would provide quotations for stocks listed with the NYSE or AMEX. See 3 *Securities Industry Study, Hearings before the Subcomm. on Sec., Senate Comm. on Banking, Hous. & Urban Affairs*, 92nd Cong., at 4 (1972). In response to the debate, the National Association of Securities Dealers Board of Governors voted that Nasdaq would not provide quotations for NYSE or Amex securities. See *id.* at 10. The NASD most likely reached this decision out of fear that NYSE members would boycott the Nasdaq system if it created competition with NYSE specialists and/or NYSE stocks. See 5 LOSS & SELIGMAN, *supra* note 22, at 2582-83 n.282.

267. See Peake, *supra* note 151 (discussing the advantage of separating self-regulatory duties from the owning and operation of a securities exchange).

268. See Regulation of Exchanges, 62 Fed. Reg. at 30,490 (describing the NASD's regulation of alternative trading systems and the inherent conflict that arises due to NASD's operation of the Nasdaq system); see also *supra* notes 95-97 (discussing the abuses, including anti-competitive practice, that have taken place within the NASD).

269. See *supra* note 260 and accompanying text (discussing the creation of NSAs and the regulatory role that NSAs serve in the securities markets); see also *supra* notes 14-16 and accompanying text (discussing the objectives and purpose of the 1934 Act).

270. See *supra* note 32 and accompanying text (describing the reasons why Internet-based trading can help smaller companies and investors).

271. The SBA's fundamental purpose is to aid, counsel, assist, and protect the interests of small businesses. See 15 U.S.C. § 631(a) (1994). When creating the SBA, Congress specifically noted that the basis of the American economy is free competition. See *id.* Furthermore, Congress stated that promoting full and free competition creates free markets

growth of its members, while simultaneously protecting the public from a member's bad acts.²⁷² Investor protection would be accomplished through close oversight and a requirement of reporting to the SEC.²⁷³ Furthermore, a new NSA that understands and adapts to new technology could maintain regulatory stability more adequately than either the SEC or a more traditional oversight entity.²⁷⁴

The creation of a new NSA would entail statutory revisions, but could be more flexible and effective than the overly burdensome and intricate alternatives set forth in the Release. The basic tenets of the Release, however, need not be abandoned. For example, if a member trading system within the new NSA began to experience sustained, heavy trading volume, it could be subjected to fuller regulation as a traditional exchange.²⁷⁵ If such a situation arose, the SEC could use its new exemptive authority to loosen the restrictions on traditional exchanges, thereby providing an even playing field for the competing exchanges.²⁷⁶

VI. CONCLUSION

The creation of Internet-based and other alternative trading systems has caused the SEC to address the future of securities exchange regulation. Unfortunately, the SEC's response to alternative trading system development is insufficient with respect to Internet-based trading. Within the suggested regulatory alternatives in the Release and the Rules, the SEC fails to expressly provide for fully active, Internet-based securities exchanges. The existing body of regulation for Internet-based trading is in the form of ad hoc, non-binding no-action letters issued by the SEC. The securities industry and the nation's investors need specific guidance regarding Internet-based securities trading. While well-intentioned, the SEC's suggestions in the Release and the Rules fail to

and free entry into business. *See id.* A nurturing presence, such as the SBA, would provide necessary support for alternative trading systems as they begin operation and attempt to compete with the already established more powerful exchanges.

272. *See supra* note 271 (discussing the functions of the SBA).

273. *Cf. supra* note 260 (discussing the role of NSAs). The new NSA for alternative trading systems would operate similarly to the NASD, except that the members of the new NSA would be the owners and operators of alternative trading systems as opposed to brokers and dealers only. *See supra* Part IV (proposing the creation of a new national securities association for alternative trading systems).

274. *See* H.R. REP. NO. 75-2307, at 4-6 (1938) (describing how a NSA would be more efficient than direct SEC oversight). Congress looked to the NSA system of regulation because regulation would be handled by representative organizations of market professionals, with proper SEC oversight. *See id.* at 5.

275. *See supra* note 234 (discussing the progression from the first tier to the second).

276. *See supra* notes 183-186 and accompanying text (discussing the third tier of exchanges proposed in the Release).

provide a suitable framework for Internet-based trading systems. This framework should be provided by a new NSA, and not left to the existing collection of inapplicable rules and conflicting interests. A new NSA would provide the necessary break from tradition, and could be the propelling force behind creative innovation in securities trading for years to come. Regulation of Internet-based securities exchanges is crucial, and a new NSA would be an effective means by which to provide this regulation. Time is of the essence, for the era is rapidly approaching when the Internet's place in the world of securities exchanges will become much more than virtual reality.