

# Regulation of Securities Markets

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*The Division of Market Regulation oversees the operations of the nation's securities markets and market participants. In 2001, the SEC supervised approximately 7,900 registered broker-dealers with over 87,765 branch offices and over 683,240 registered representatives. Broker-dealers filing FOCUS reports with the Commission had approximately \$3 trillion in total assets and \$208 billion in total capital for fiscal year 2001. In addition, the average daily trading volume reached 1.2 billion shares on the New York Stock Exchange and over 1.9 billion shares on the Nasdaq Stock Market as of September 30, 2001.*

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## What We Did

- Adopted two rules that require improved disclosure of order execution and routing practices by market centers and broker-dealers.
  - Issued a concept release to solicit comments on the effects of subpenny trading on the markets and investors.
  - Engaged in rulemaking and provided guidance to implement the provisions of the Commodity Futures Modernization Act of 2000 (CFMA) that allow trading of single stock futures.
  - Amended a Commission rule to require quotations for exchange-listed options to be firm.
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## Securities Markets, Trading, and Significant Regulatory Issues

### Implementation of the Commodity Futures Modernization Act

In establishing a regulatory framework for security futures products, the CFMA requires the Commission to conduct extensive rulemaking, much of it jointly with the Commodity Futures Trading Commission (CFTC).

- On August 13, 2001, the Commission adopted rules establishing a notice registration process for “security futures product exchanges” that are already registered with the CFTC and an expedited rule filing process for these exchanges.<sup>24</sup>
- On August 20, 2001, the Commission and CFTC adopted rules concerning the statutory definition of a narrow-based security index.<sup>25</sup> The Commission also approved a joint order with the CFTC to permit futures on depositary shares.<sup>26</sup>
- On August 21, 2001, the Commission issued an exemptive order under section 36 of the Securities Exchange Act (Exchange Act), to permit principal-to-principal trading of security futures products between eligible contract participants.<sup>27</sup>
- On August 24, 2001, the Commission and CFTC proposed a rulemaking that would require associations and exchanges that trade security futures products to (1) use a settlement price for cash-settled security futures products that fairly reflects the opening price of the underlying securities, and (2) halt trading in any security futures product when a regulatory halt is instituted by the exchange or association listing the underlying securities.<sup>28</sup>

- On September 5, 2001, the Division of Market Regulation issued Staff Legal Bulletin No. 15 offering guidance on how a national securities exchange or national securities association can comply with section 6(h)(3)(C) of the Exchange Act, which specifies the requirements for listing standards for security futures products. In consultation with staff of the CFTC, SEC staff developed sample security futures listing standards that we consider comparable to listing standards for options.<sup>29</sup>
- On September 25, 2001, the Commission and CFTC proposed a rulemaking regarding the collection of customer margin for security futures.<sup>30</sup>

### Alternative Trading Systems (ATS)

Regulation ATS under the Exchange Act establishes recordkeeping and reporting requirements for ATSS that choose to register as broker-dealers.<sup>31</sup> In 2001, the staff reviewed 17 initial operation reports, 48 amendments, 162 quarterly activity reports, and 12 reports of cessation of operations under Regulation ATS.

### Order Handling Rules

The staff renewed, through March 15, 2002, nine no-action letters rolling over the no-action position towards electronic communications networks (ECNs) regarding the ECN Display Alternative provisions adopted as part of the Order Handling Rules. In fiscal 2001, letters were issued to Instinet Real-Time Trading Service, Island, Bloomberg Tradebook, Archipelago, the RediBook, the ATTAIN System, the Strike System, NexTrade, MarketXT, and the Globenet System.

## Disclosure of Order Execution and Order Routing Practices

In November 2000, the Commission adopted two rules that require improved disclosure of order execution and routing practices by market centers and broker-dealers.<sup>32</sup> Under rule 11Ac1-5, market centers that trade national market system securities are required to make publicly available monthly electronic reports that include uniform statistical measures of execution quality.<sup>33</sup> Under rule 11Ac1-6, broker-dealers that route customer orders in equity and option securities are required, among other things, to make publicly available quarterly reports that identify the venues to which customer orders are routed for execution.<sup>34</sup> Rule 11Ac1-5 has been in effect for all National Market System securities since October 1, 2001.

## Day Trading

In February 2001, the Commission approved new New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD) rules restricting the use of credit (margin) in day trading.<sup>35</sup> Both NYSE and NASD rules impose a higher minimum equity requirement for pattern day traders, prohibit the use of customer-to-customer lending to meet day trading margin calls, and establish special account restrictions for pattern day traders who exceed their buying power.<sup>36</sup>

## Derivatives

The Commission continued to approve new derivative products designed to aid investors in risk management while strengthening market stability and integrity. The Commission approved listing standards and trading rules proposed by several exchanges to permit the trading of several new derivative products, including trust issued receipts and index-linked exchangeable notes. The exchanges also continued to use expedited procedures under rule 19b-4(e) to list and trade portfolio depository receipts issued by a unit investment trust and index fund shares issued by an open-end

management investment company.<sup>37</sup> Approving and utilizing these generic listing standards and trading rules allows the exchanges to trade new derivative products using an expedited procedure under rule 19b-4(e).<sup>38</sup> Under this rule, which the Commission approved in 1998, an exchange can start trading a new derivative product without prior Commission approval as long as adequate trading rules, procedures, surveillance programs, and listing standards that pertain to the class of securities covering the new product are in place.<sup>39</sup>

## Options Market Reform

The Commission continued to work closely with the options exchanges on several initiatives designed to encourage the further integration of the options markets into the national market system.

- *Intermarket Linkage Plan.* On July 28, 2000, the Commission approved an intermarket linkage plan to which all five options exchanges have agreed.<sup>40</sup> Pending completion of the linkage contemplated in the plan, the Commission approved rules submitted by the options exchanges establishing a voluntary interim linkage between the exchanges.
- *Trade-Through Disclosure Rule.* On November 17, 2000, the Commission adopted a new rule that requires broker-dealers to disclose when a customer's order for a listed option was executed at a price inferior to the best-published quote.<sup>41</sup> Transactions effected on an options market that participates in a linkage plan approved by the Commission would be exempted from the rule.<sup>42</sup> The compliance date of this rule was extended twice, most recently until April 1, 2002.<sup>43</sup>

## Decimalization and Subpenny Trading

The conversion from fractional to decimal pricing for equities and options was successfully completed in March 2001. Over the next year, the Commission will need to address several critical decimal-related market structure and investor protection issues. In particular, the Commission will consider issues pertaining to the minimum price increments that the markets have set for consolidated quotations in equities and options. For purposes of the decimal conversion, the self-regulatory organizations (SROs) selected a minimum increment of \$0.01 for stock quotations and of \$0.05 or \$0.10 for options. In September 2001, the SROs submitted studies to the Commission that analyzed how these increments have affected trading behavior as well as the transparency, liquidity, and fairness of the markets. By January 14, 2002, the SROs must submit rule proposals to establish their permanent increments for quotations in equities and options. In a related matter, the Commission issued a concept release on July 18 that solicits comment regarding the effects of subpenny trading on the markets and investors.<sup>44</sup>

## Market Information

On December 9, 1999, the Commission issued a concept release on the regulation of market information fees and revenues to solicit public comment on the arrangements currently in place for disseminating market data to the public.<sup>45</sup> In particular, the release focused on a cost-based limit on market information revenues; increasing public disclosure of fees, revenues, and costs; and expanding participation in the fee-setting process.<sup>46</sup> We received approximately 35 comment letters, which revealed widely varying views. In response, the Commission created an Advisory Committee to examine issues relating to the public availability of market information in the options and equities markets and make recommendations for future action. The Advisory Committee's report was delivered to the Commission on September 14, 2001. The report is available on the SEC website.

## Trade Reporting Rules

On January 23, 2001, the Commission approved the NASD's "TRACE" proposal.<sup>47</sup> The TRACE proposal requires NASD members to report transactions in most U.S. corporate bonds to the NASD, and establishes a facility to collect and redistribute that transaction information.<sup>48</sup>

## Oversight of Self-Regulatory Organizations

### National Securities Exchanges

As of September 30, 2001, there were nine active securities exchanges registered with the SEC as national securities exchanges: American Stock Exchange (Amex), Boston Stock Exchange, Chicago Board Options Exchange (CBOE), Cincinnati Stock Exchange, Chicago Stock Exchange, International Securities Exchange, NYSE, Philadelphia Stock Exchange, and Pacific Exchange Inc. During fiscal 2001, the Commission granted 164 exchange applications to delist equity issues and 42 applications by issuers seeking withdrawal of their registration and listing on exchanges. The exchanges submitted 452 proposed rule changes during 2001. The Commission approved 384 pending and new proposals. Sixty-one were withdrawn.

### National Association of Securities Dealers

The NASD is the only national securities association registered with the SEC and includes more than 5,500 member firms. The NASD submitted 86 proposed rule changes to the SEC during the year. The Commission approved 84, including some pending from the previous year. Twelve were withdrawn.

The NASD partially owns and operates The Nasdaq Stock Market (Nasdaq). In June 2000, Nasdaq ceased to be a wholly-owned

subsidiary of the NASD. This was accomplished through a two-phase private placement of Nasdaq stock, wherein Nasdaq sold newly issued shares of stock and the NASD sold warrants to purchase Nasdaq stock it owned which are redeemable over time. The second private placement was completed in January 2001, and more than 2,900 investors other than the NASD now own approximately 40% of Nasdaq. In addition, the NASD has proposed to further reduce its ownership in Nasdaq by selling convertible debentures to a leading private equity firm. If the debentures are converted, the NASD's ownership of Nasdaq would be further reduced to approximately 27%.

Nasdaq filed its exchange application with the Commission in March 2001. The Commission published the application for comment on June 7, 2001 and extended the comment period to August 29, 2001.<sup>49</sup> The Commission received many comment letters on the application from exchanges, market participants, and other interested individuals. The Division of Market Regulation continues to work with both Nasdaq and the NASD to resolve any outstanding issues that result from Nasdaq's desire to operate as a fully independent exchange to ensure that both Nasdaq and the NASD can fulfill their self-regulatory obligations.

## **Emergency Measures Related to the Tragic Events of September 11, 2001**

The following is a sampling of the key actions taken by the Commission in response to the events of September 11, 2001.

- *Hotline.* The Division of Market Regulation established a "live" hotline to respond to inquiries from brokerage firms, markets, legal counsel, and the general public. The hotline provided immediate or rapid responses to public inquiries stemming from the events of September 11, including the Commission's exemptive order concerning rule 10b-18, the effects of the market closing



on short selling, margin rules, the expiration of options contracts, and contact information for firms affected by the tragedy.

- *Market Center Communications.* The Commission staff participated in daily conference calls with the markets and other regulatory agencies to stay apprised of any new market developments or problems.
- *Temporary Relief for Amex.* The Amex incurred physical damage and disruption that required the temporary relocation of its trading facilities and personnel. The Commission approved various emergency proposals that established temporary arrangements to allow various securities listed or traded on the Amex to trade on other markets.<sup>50</sup> These temporary arrangements also allowed members of the Amex to perform various functions on other markets and, in some cases, allowed members of other markets to temporarily act as members of the Amex.
- *Issuer Repurchases.* On September 14 and 21, the Commission issued emergency orders temporarily easing the conditions of rule 10b-18, the safe harbor for issuer repurchases.<sup>51</sup> The orders suspended the timing condition, so that issuers could purchase at the opening of the markets and stay in each day through the close. In addition, the volume limitation was raised from 25% to 100% of average daily trading volume. The orders were effective for each trading day through September 28.

On September 28, the Commission further extended the issuer repurchase exemptive order through October 14.<sup>52</sup> The exemptive order also allowed issuers with average daily trading volumes of \$1,000,000 or more and public float values of \$150 million or more to stay in the markets until 10 minutes before the close of each trading day.

- *Financial Responsibility Relief for Broker-Dealers*. The Commission provided certain relief to broker-dealers from Exchange Act rules 15c3-1 and 15c3-3 concerning their calculation of net capital and the need to take deductions due to failed transactions and imbalances in securities accounting systems, and for the purposes of FOCUS reporting.<sup>53</sup>

## **Municipal Securities Issues**

### **Municipal Market Roundtable**

The Commission held its Second Annual Municipal Market Roundtable on October 2, 2000. During the Roundtable, panels composed of issuers, underwriters, lawyers, financial advisers, and SEC staff discussed current issues in the municipal securities market. These panels discussed disclosure issues, use of electronic media, and Municipal Securities Rulemaking Board (MSRB) rules. This roundtable also included individual investors for the first time. The transcript of the roundtable is available on the SEC website

### **Municipal Securities Rulemaking Board**

The MSRB is the primary rulemaking authority for municipal securities dealers. In fiscal 2001, the Commission received seven new proposed rule changes from the MSRB. A total of eight new or pending proposed rules were approved, including amendments to MSRB rules establishing optional procedures for electronic submissions of required materials under rule G-36. In addition, a rule was approved providing for the development of a new daily transaction report that will include data regarding all municipal securities transactions. This report will improve price transparency in the municipal market.

## **Broker-Dealer Issues**

### Net Capital Developments

The following guidance highlights the Commission's most significant net capital rule developments.

### Special Purpose Vehicle

In a no-action letter to the Securities Industry Association's Capital Committee, the staff provided guidelines on the appropriate capital treatment of certain asset-backed securities issued by a special purpose vehicle (SPV). Generally, broker-dealers are allowed to treat asset-backed securities issued by a SPV as having a ready market for net capital purposes if:

- neither the issuer nor the securities are in default,
- the securities are rated, at a minimum, in one of the four highest categories by at least one nationally recognized statistical rating organization, and
- the securities are part of an initial issuance size of at least \$50 million.

Asset-backed securities deemed to have a ready market under the terms of the letter may be subject to a portfolio concentration charge under certain circumstances. In addition, the staff's no action relief would not include asset-backed securities that are held in a broker-dealer's inventory for more than 90 days because of a failure to complete an underwriting.

### Use of Financial Models to Calculate Net Capital Requirements

The staff granted the requests of two over-the-counter derivative dealers (CDC Derivatives, Inc. and Credit Suisse First Boston Capital LLC.) to use financial models to calculate their net capital

requirements. The staff's approval was based on a review of each entity's internal risk management control systems regarding controls for market, credit, legal, liquidity and funding, and operational risks.

## Books and Records Development

The Commission published an interpretive release on how the electronic storage requirements of rule 17a-4(f) under the Exchange Act meet, and are consistent with, the requirements of the Electronic Signatures in Global and National Commerce Act of 2000.

## Financial Modernization Legislation

### *Implementation of Title II of Gramm-Leach-Bliley Act*

Title II of the Gramm-Leach-Bliley Act (GLBA) redefined the terms broker and dealer. Under the old definitions, banks had a blanket exception from the definitions for all of their securities activities. Under the new definitions, banks have individual exceptions from these terms for specific bank securities activities. On May 11, 2001, the Commission adopted interim final rules clarifying key terms in the amended definitions of broker and dealer and providing guidance to banks in determining when and how to use a functional exception from the definitions of broker and dealer.<sup>54</sup> The interim final rules also provide non-exclusive safe harbors for banks and thrifts from the definitions of broker and dealer.

On July 18, 2001, the Commission extended the broker and dealer definition comment period; extended a temporary exemption for banks, savings associations, and savings banks from the definitions of broker and dealer; and gave notice of our intent to amend the interim final rules and, as appropriate, to extend further the temporary exemption. On August 2, 2001, Acting Chairman Laura Unger testified regarding the interim final rules on behalf of

the Commission in a joint hearing before the Capital Markets, Insurance and Government-Sponsored Enterprises and Financial Institutions and Consumer Credit Subcommittees of the House Committee on Financial Services. The Commission is carefully considering comments from industry members and the public.

### *Amendments of Privacy Rules*

On August 21, 2001, the Commission adopted amendments to its consumer financial privacy regulation, Regulation S-P.<sup>55</sup> The amendments were adopted in light of section 124 of the CFMA that makes the privacy provisions of the GLBA applicable to activity regulated by the CFTC and its regulated entities. These amendments conformed the definitions of federal functional regulator and financial institution in Regulation S-P to the new meaning that the CFMA gave the corresponding terms in the GLBA.<sup>56</sup> To avoid duplicative regulation, the amendments also permit futures commission merchants and introducing brokers that are registered as broker-dealers to comply with Regulation S-P by complying with the CFTC's financial privacy rules. The amendments to Regulation S-P parallel a similar provision in the financial privacy rules of the CFTC.<sup>57</sup>

### *Registration by Notice for the Limited Purpose of Trading Security Futures Products*

Also on August 21, 2001, the Commission implemented section 203 of the CFMA, which provides for expedited notice registration for intermediaries trading security futures products.<sup>58</sup> Specifically, the Commission adopted Form BD-N and related rules to permit futures commission merchants and introducing brokers that are both registered with the CFTC and members of the National Futures Association to register by notice with the Commission as broker-dealers for the limited purpose of trading security futures products. This notice registration becomes effective upon the filing of a completed Form BD-N. Notice registered broker-dealers that wish to expand their securities

business beyond security futures products, however, would still need to apply for full registration by filing Form BD.

## **Arbitration and Mediation**

The Commission approved amendments to the NASD Code of Arbitration Procedure that permit the Director of Arbitration to remove arbitrators for cause after hearings have begun.<sup>59</sup> The Commission also approved amendments to the NASD Code of Arbitration that permit investors to seek expedited court remedies against NASD member firms that are terminated, suspended, or defunct, to prevent such firms from dissipating assets.<sup>60</sup> In addition, the Commission approved amendments to the NYSE mediation and administrative conference program.<sup>61</sup> Finally, the Commission approved CBOE's rule change to permit it to retain jurisdiction over former members who fail to pay arbitration awards beyond the two-year period applicable to other violations of law.<sup>62</sup>

## **National Money Laundering Strategy for 2001**

The staff worked with the Departments of Treasury and Justice on initiatives called for by The *National Money Laundering Strategy for 2001*. This is the third of five strategies called for by the Money Laundering and Financial Crimes Strategy Act of 1998. We worked closely with other government agencies to implement the Strategy and identify ways to assure that anti-money laundering measures aid broker-dealer efforts in blocking laundering through the securities markets. The staff also worked on initiatives relating to the development of a suspicious activity reporting rule for broker-dealers, the identification of ways in which accountants and lawyers may play a role in the fight against money laundering, and anti-money laundering aspects of anti-terrorism legislation introduced after September 11, 2001.

## Letters Related to Broker-Dealer Activities

The Division of Market Regulation issued 48 no-action letters during the year. Several significant letters are highlighted.

American Express Bank, Ltd.

The staff granted no-action relief to a company seeking to engage in certain securities activities without registering as a broker-dealer. In granting this relief, the staff noted in particular that:

- American Express Bank, Ltd. (AEB) is “engaged in banking” as defined in section 211.2(f) of the Federal Reserve Board’s Regulation K;
- AEB has the same powers as a United States commercial bank, although the exercise of those powers is limited to international banking;
- AEB does business under the laws of Connecticut and, through its agencies, the New York and Florida; a substantial portion of AEB’s business consists of receiving deposits and making loans;
- AEB is licensed by the State of New York Banking Department; AEB’s global operations are supervised and examined on a by the State of New York Banking Department as if AEB were a New York state chartered bank; and
- AEB is not operated for the purpose of evading the provisions of the Exchange Act.<sup>63</sup>

### Broker-Dealer Registration for Internet-based Entity

The staff declined to provide no-action relief from broker-dealer registration for an Internet-based entity that proposed to solicit

orders from public customers, accept fees for communicating those orders, and perform brokerage services such as conducting auctions and reverse auctions.<sup>64</sup>

### Exemption from Exchange Act Rule 10b-17(b)(1)

The staff declined to provide a company an exemption from the requirements of Exchange Act rule 10b-17(b)(1), which requires issuers of publicly traded securities to furnish the NASD with timely advance notice of dividends and other distributions, including stock splits. This information allows the NASD to keep its members and the investing public informed in a timely manner of impending distributions. In denying the exemption, the staff noted in particular that the company did not seek an exemption from the rule until after it had already failed to provide the NASD notice within the rule's time frame.<sup>65</sup>

### Employee Leasing Arrangement

The staff issued a no-action letter granting no-action relief from broker-dealer registration under Exchange Act section 15(a) to an employee leasing services (also known as professional employer organization services). Employees subject to a leasing arrangement become co-employed by the leasing company and its client. The client remains the operational employer and continues to conduct its business and supervise employees it co-employs with the leasing company. The leasing company becomes the administrative employer and provides the client and co-employees with payroll processing, employee benefits and related services. Among other things, the no-action relief was based on the company's representations that client broker-dealers would maintain all supervisory control over their employees, that fees received by the company would not be based on brokerage commissions, and that the leasing company would have no authority to hire or fire broker-dealer personnel.<sup>66</sup>



## Internet-Based Execution Facility

The staff issued a letter granting no-action relief from broker-dealer registration under Exchange Act section 15(a) to an unregistered entity that proposed to help operate an Internet-based electronic execution facility for an affiliated broker-dealer. The staff noted, among many other factors, that:

- the unregistered entity would not receive compensation based directly or indirectly on the size or value of transactions in securities, or dependent upon the occurrence of transactions in securities (including per-order fees);
- the broker-dealer would take full responsibility for the portal leading to the platform and those portions of the platform involving securities (including exercising full discretion and authority with respect to content and substantive operations, and being the contracting party for all agreements related to the substantive portion of the facility); and
- the unregistered entity would not exercise any discretion or authority over the portal and those portions of the platform involving securities.<sup>67</sup>

## Compensation of Accountant Registered Representatives

The staff considered four requests for no-action relief involving broker-dealer compensation of registered representatives who also are accountants with certified public accounting firms (CPA firms), without the CPA firms registering as broker-dealers under Exchange Act section 15(b). The staff granted no-action relief under one compensation scenario, but denied relief under three others. Specifically, the staff granted no-action relief if the broker dealer paid commissions to an accountant registered representative so long as the accountant registered representative is not subject to

any formal or informal agreement or arrangement directing him to turn over securities commissions, or other income received as a result of securities activities, to an unregistered CPA firm or other unregistered entity. The staff declined to provide no-action relief if the broker-dealer paid commissions to an accountant registered representative who would turn the commissions over to a CPA firm, either voluntarily or pursuant to an agreement. The staff declined to take a no-action position under those circumstances because unregistered persons would have a financial stake in the revenues generated by the registered representative's securities transactions, while being in a position to influence the registered representative's actions and to direct customers to the registered representative. Finally, the staff did not provide no-action relief if the broker-dealer paid commissions to another broker-dealer, with which the accountant registered representative is dually registered, when the CPA firm or its partners own the other broker-dealer. The staff rejected that aspect of the request because the question of whether an unregistered person who owns a registered broker-dealer is engaged in broker-dealer activity is highly fact-specific.