

Regulation of Securities Markets

The Division of Market Regulation oversees the operations of the nation's securities markets and market participants. In 2000, the SEC supervised approximately 7,900 registered broker-dealers with over 83,200 branch offices and over 652,125 registered representatives. Broker-dealers filing FOCUS reports with the Commission had approximately \$2.9 trillion in total assets and \$186.1 billion in total capital for fiscal year 2000. In addition, the average daily trading volume reached 901 million shares on the New York Stock Exchange and over 1.55 billion shares on the Nasdaq Stock Market in calendar year 2000.

What We Did

- Developed rules to protect individuals' privacy.
- Approved the International Securities Exchange's application to become a national securities exchange.
- Created a committee to advise the Commission on market information fees and revenues.
- Proposed two rules that would require improved disclosure of order execution and routing practices by market centers and broker-dealers.

- Proposed rules requiring broker-dealers to disclose when a customer's order for a listed option was executed at a price inferior to the best-published quote, and generally requiring options markets' quotes to be firm.
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Broker-Dealer Issues

Financial Modernization Legislation—Implementation of Privacy Rules

In accordance with the Gramm-Leach-Bliley Act of 1999, SEC staff worked with the bank regulators and the Federal Trade Commission to develop regulations to protect individuals' privacy. In June 2000, the Commission adopted Regulation S-P, which became effective on November 13, 2000.¹⁵

Regulation S-P applies to investment advisers registered with the Commission, brokers, dealers, and investment companies. Regulation S-P requires covered entities to adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. It also requires these entities to provide customers with a notice of their privacy policies and practices, including annual updates. In addition, covered parties may not disclose nonpublic personal information about a consumer to nonaffiliated third parties unless the consumer has been provided information regarding the proposed disclosure and the consumer has not opted out of the disclosure.

Internet Release

In April 2000, the Commission issued an interpretive release providing guidance on the use of electronic media, such as the Internet, under the federal securities laws.¹⁶ This release builds on earlier electronic media interpretative releases.¹⁷ Together, they are intended to help promote fair and orderly markets and the efficient dissemination of information to investors, security holders, and the securities markets while preserving key investor protection requirements. The 2000 release also addressed several outstanding issues on the use of electronic media to satisfy delivery obligations and issues relating to online private offerings, including the importance of considering whether such activities require broker-dealer registration.

Letters Related to Broker-Dealer Activities

The staff issued a letter revoking a no-action position that had been granted to Dominion Resources, Inc. (Dominion) in 1985.¹⁸ The letter had been issued in response to a plan by Dominion to assist issuers by analyzing financial needs, recommending or designing financing methods, and participating in negotiations. In exchange, Dominion would have received a fee, that generally would not be payable unless the financing closed successfully, but in this case, the fee was not based on the successful issuance of securities to the public. Since issuing the 1985 letter, the staff has frequently considered the question of when a person is a broker that must register as a broker-dealer, and when a person is merely a “finder” that is not subject to registration. The staff now believes that an entity conducting the activities described in the letter would have to register as a broker-dealer.

The staff issued a no-action letter to an employee-leasing company that planned to “co-employ” the employees of registered broker-dealers. The staff concluded that the

company did not have to register as a broker-dealer because, among other factors, the broker-dealers would maintain all supervisory control over its employees, and the fee received by the employee-leasing company would not be based on brokerage commissions.¹⁹

The staff also issued several letters addressing when online activities constitute broker-dealer activity. A no-action letter was issued to a website operator that proposed to administer an on-line customer loyalty program that gave consumers the option of redeeming cash rebates for shares in a mutual fund.²⁰ No-action requests were denied to website operators that proposed to bring the issuers of securities together with investors.²¹ The staff also advised the operator of a website that conducted auctions of municipal securities that it was engaged in broker-dealer activity and should register.²² The staff further advised a transfer agent that operated a facility that brought together buyers and sellers of securities in return for a fee that it was engaged in broker-dealer activity and should register.²³

Foreign Broker-dealers—Exemption for Activities of Canadian Broker-dealers

On June 7, 2000, the Commission issued an exemptive order permitting Canadian broker-dealers to provide services to individuals who established Canadian retirement accounts while resident in Canada, but who are now resident in the United States, without having to register with the Commission or follow other requirements that apply to brokers or dealers who are not registered with the Commission.²⁴ The order included several conditions, including restrictions on advertising, solicitation of new accounts, and a requirement (subject to exception) that the Canadian broker have an existing relationship with the account participant before the participant enters the U.S.

Order Exempting American Express Travel Related Services

The Commission issued an order exempting American Express Travel Related Services, Inc. (TRS), a wholly-owned subsidiary of the American Express Company (American Express), from having to register as a broker-dealer.²⁵ The exemption allows TRS to establish and operate a processing arrangement for American Express cardholders to purchase variable annuity contracts and mutual funds through affiliated broker-dealers as part of their monthly card payment. The exemption was conditioned on TRS's representation that the registered broker-dealers would have exclusive responsibility for the accounts, orders, and transactions, as well as other representations about the activities and responsibilities of TRS, its employees, and affiliates.

Arbitration and Mediation

The Commission approved a pilot program that allows parties to agree to use a single arbitrator for larger dollar amount cases to keep costs down and to expedite their cases.²⁶ The Commission further approved a NASD rule change that allows parties to stay arbitration proceedings to allow for further efforts at mediation.²⁷ In addition, the Commission's approval of an NASD proposal to place its dispute resolution activities into a separate subsidiary, NASD Dispute Resolution, Inc. became effective on July 9, 2000.²⁸

The National Money Laundering Strategy for 2000

The staff worked with the Departments of Treasury and Justice on initiatives called for by *The National Money Laundering Strategy for 2000*.²⁹ This is the second 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 the creation of guidance for scrutiny of high-risk accounts.

Securities Markets, Trading and Significant Regulatory Issues

SEC/CFTC Joint Proposal

In September 2000, Chairman Levitt and Commodity Futures Trading Commission (CFTC) Chairman Rainer reached an historic accord lifting the statutory ban on single stock futures. They submitted a joint proposal to Congress a statutory framework for the joint SEC/CFTC regulation of markets and intermediaries that trade futures on single securities and on narrow-based security indices. The joint proposal followed a December 1999 request from various Congressional committees. The joint SEC/CFTC proposal was largely incorporated into the Commodity Futures Modernization Act of 2000.

Alternative Trading Systems (ATS)

Regulation ATS under the Exchange Act establishes recordkeeping and reporting requirements for ATSs that choose to register as broker-dealers. In 2000, our staff reviewed 27 initial operation reports, 57 amendments, 120 quarterly activity reports, and 2 reports of cessation of operations under Regulation ATS.

Order Handling Rules

The staff renewed, through June 15, 2001, nine no-action letters to electronic communications networks (ECNs) regarding the ECN Display Alternative provisions adopted as part of the Order Handling Rules. In fiscal 2000, letters were issued to Instinet Real-Time Trading Service, the Island ECN, Bloomberg Tradebook, Archipelago, the Routing and Execution DOT Interface ECN, the ATTAIn System, the Strike System, NexTrade, and MarketXT. No-action relief was also issued for the first time to Globenet System. The Division of Market Regulation published a report entitled *Electronic Communication Networks and After-Hours Trading* (June 2000).

Disclosure of Order Execution and Order Routing Practices

In July 2000, the Commission proposed two rules that would require improved disclosure of order execution and routing practices by market centers and broker-dealers.³⁰ Under rule 11Ac1-5, market centers that trade national market system securities would be required to make publicly available monthly electronic reports that include uniform statistical measures of execution quality. Under rule 11Ac1-6, broker-dealers that route customer orders in equity and option securities would be required, among other things, to make publicly available quarterly reports that identify the venues to which customer orders are routed for execution.

Day Trading

In July 2000, the Commission approved a new NASD rule that requires firms promoting a day-trading strategy to: make a determination that day trading is appropriate for the customer when it approves the customer's account for day trading; or (b) obtain from the customer a written agreement stating that the customer does not intend to use the account

for day-trading activities.³¹ The new rule also requires firms promoting a day trading strategy to furnish a risk disclosure statement to non-institutional customers prior to opening an account.

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, portfolio depository receipts issued by a unit investment trust, and index fund shares issued by an open-end management investment company. By approving these “generic” listing standards and trading rules, these exchanges are now able to begin trading new derivative products using an expedited procedure under rule 19b-4(e). 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. By the end of fiscal 2000, exchanges, in the aggregate, commenced trading of over 100 new derivative products under this rule.

International Securities Exchange

On February 24, 2000, the Commission approved the International Securities Exchange’s (ISE) application to become a national securities exchange.³² The ISE began trading three options classes on May 26, 2000, after the SEC approved the proposed rule changes and grants of exemptive relief from the exclusivity provision in the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information.

Options Market Reform

The Commission continued to work closely with the options exchanges on a number of 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 plan³³ proposed by three of the options exchanges.
- *Proposed Trade-Through Disclosure Rule and Amendments to the Quote Rule.* On July 28, 2000, the Commission proposed a new rule that would require a broker-dealer to disclose when a customer's order for a listed option was executed at a price inferior to the best-published quote. Transactions effected on an options market that participates in a linkage plan approved by the Commission would not require disclosure. The Commission also proposed amendments to its Quote Rule that would require options markets' quotes to be firm up to their published quotation size for customer orders.³⁴

Decimal Pricing

After extensive discussions throughout 1999 and early 2000 among participants in the securities industry about coordinating the conversion from fractions to decimals, the Commission, on June 8, 2000, ordered the self-regulatory organizations (SROs) to submit a decimal pricing phase-in plan by July 24, 2000. In the plan, the SROs outlined a schedule for the complete transition to decimal pricing in the securities markets by April 9, 2001.

On August 28, 2000, decimal pricing began in seven NYSE-listed stocks and six Amex-listed stocks, as well as for the options on those stocks. On September 25, 2000, decimal pricing expanded to 57 additional NYSE-listed stocks and 49 Amex-listed stocks, as well as for the options on those stocks. At each stage of the decimal phase-in of listed stocks, no significant problems were reported for systems operations, market capacity, or clearance and settlement.

As exchange-listed stocks and options converted from fractional to decimal pricing, Nasdaq prepared for decimalization with the goal of completing full decimal conversion no later than April 9, 2001. Decimal pricing on Nasdaq securities and the options on those securities will be implemented in three phases. On March 12, 2001, decimal pricing will begin in a pilot of 15 Nasdaq securities (and their options). On March 26, 2001, decimal pricing will begin in 100-200 additional Nasdaq securities (and their options). All remaining Nasdaq securities and their options will begin quoting in decimals on April 9, 2001.

Market Information

On December 8, 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. 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. 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.

Oversight of Self-Regulatory Organizations

National Securities Exchanges

As of September 30, 2000, 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, Cincinnati Stock Exchange, Chicago Stock Exchange, International Stock Exchange, New York Stock Exchange (NYSE), Philadelphia Stock Exchange, and Pacific Exchange Inc. During fiscal 2000, the Commission granted 180 exchange applications to delist equity issues and 46 applications by issuers seeking withdrawal of their issues from registration and listing on exchanges. The exchanges submitted 386 proposed rule changes during 2000. We approved 330 pending and new proposals. Thirty-two were withdrawn.

National Association of Securities Dealers, Inc.

The NASD is the only national securities association registered with the SEC and includes more than 5,500 member firms. The NASD submitted 82 proposed rule changes to the SEC during the year. We approved 70, including some pending from the previous year. Seven were withdrawn. The NASD 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 private placement of approximately 24 million shares of newly issued common stock in Nasdaq, and the sale by the NASD of warrants to purchase Nasdaq stock owned by the NASD would be redeemable over time for more than 25 million additional shares of Nasdaq common stock. Over 2,800 investors other than the NASD now own approximately 40% of Nasdaq.

Municipal Securities Rulemaking Board

The Municipal Securities Rulemaking Board (MSRB) is the primary rulemaking authority for municipal securities dealers. In fiscal 2000, we received 10 new proposed rule changes from the MSRB. A total of 11 new and pending proposed rule changes were approved, including amendments to MSRB rules that accommodate municipal fund securities. These securities are defined to include, among other things, interests in higher education trusts and local government investment pools, and the development of a new transaction report that will include data regarding all municipal securities transactions.

Trading Practices Developments

Regulation M

In August 2000, the Division of Market Regulation published a staff legal bulletin to remind underwriters, broker-dealers, and any other person who is participating in an offering of securities (distribution participants) that they are prohibited from requiring their customers to make aftermarket purchases as a condition for receiving an allocation of shares in the offering. The bulletin also reminds distribution participants that they are prohibited from soliciting aftermarket purchases while they are still in distribution.³⁵

Technology Developments

Year 2000

The Year 2000 conversion effort concluded with no problems identified in the securities markets. To facilitate this effort, the Division of Market Regulation established a Data Collection Center, which provided a website for major securities industry participants to report their progress. The Data Collection Center was a vital link to maintaining contact

with market centers, broker-dealers, and investment companies and relaying that information to the President's Year 2000 Council and other regulators.

Automation Review Policy Program

The Automation Review Policy (ARP) program oversees the automation systems of the securities markets and market participants focusing on systems capacity and availability. The ARP program staff performed seven on-site inspections and issued 32 recommendations for improvement in information technology resources.

Clearance and Settlement Developments

Lost and Stolen Securities

As of December 31, 2000, 25,824 institutions were registered in the lost and stolen securities program, a one percent increase since 1999. The number of securities certificates reported as lost, stolen, missing or counterfeit increased 23 percent to 1,767,496 in 2000. The aggregate dollar value of these reported certificates was \$28,143,441,256, an increase of 20 percent. The total number of lost and stolen recovery reports received increased 7 percent to 214,165. The dollar value of these recovery reports increased to \$6,810,636,419, a 5 percent increase. Institutions participating in the program inquired about 7,267,028 certificates in total, a decrease of 9 percent. In 2000, a 21 percent increase to \$8,337,252,349 was experienced in the dollar value of certificate inquiries that matched previous reports of lost, stolen, missing, or counterfeit securities certificates.

Trade Reporting Rules

One of the undertakings in the settlement of an enforcement action against four of the five options exchanges³⁶ directs the exchanges to file proposed rule changes that would

require options transactions to be reported within 90 seconds of the time of execution. The staff worked with the options exchanges to finalize their trade reporting rules to maintain consistency with the settlement agreement.

Net Capital Developments

In a no-action letter to the Securities Industry Association's Capital Committee, Commission staff provided guidelines to broker-dealers computing net capital on the appropriate treatment of certain debt securities and preferred stock. Securities will be deemed to have a ready market and receive this favorable treatment if the issuer of these securities is not in default, the initial issuance generally was greater than \$20 million and the securities have not been in inventory for more than 90 days because of a failed offering. Further, the securities must either be issued by an issuer with outstanding non-preferred equity securities that are registered with the Commission whose equity securities are included in the FTSE World Index, traded on a national securities exchange or Nasdaq, have current non-investment grade ratings from at least two NRSROs, or have investment grade rating by one NRSRO. If the above-described criteria are met, the no-action letter sets forth guidelines for the "haircut" a broker-dealer should apply to these securities when computing net capital.

The staff also issued a letter to the NYSE and NASD Regulation clarifying the staff's position regarding the net capital treatment of temporary capital contributions. This no-action letter specifies that when an individual investor contributes capital to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the individual investor, the contribution may not be included in the firm's net capital computation and must be re-characterized as a liability. The letter further states that any withdrawal of capital for that investor within one year (other

than required tax payments or reasonable compensation as permitted under 15c3-1(e)(4)(iii)) will be presumed to have been contemplated at the time of contribution.

Municipal Securities Issues

Municipal Market Roundtable

The Commission held its Second Annual Municipal Market Roundtable in October. During the Roundtable, panels composed of issuers, underwriters, lawyers, financial advisers, investors, and SEC staff discussed current issues in the municipal securities market, including disclosure issues, use of electronic media, and MSRB rules. The Roundtable also included individual investors for the first time.

Pay-to-Play Practices

The Commission continued its efforts to end pay-to-play practices in the municipal securities markets, educate and promote compliance with related rules of the MSRB, and encourage voluntary action by national and local bar associations to end the practice. On February 14, 2000, after four years of controversy, the American Bar Association voted to adopt new ethics rule 7.6. This rule prohibits a lawyer or law firm from accepting government legal engagements or judicial appointments if they make or solicit political contributions for the purpose of obtaining the business or position.