

MEMORANDUM

TO: SEC Market Structure Advisory Committee

FROM: SEC Division of Trading and Markets¹

DATE: October 20, 2015

SUBJECT: Current Regulatory Model for Trading Venues and for Market Data Dissemination

The purpose of this memorandum is to facilitate a discussion of the current regulatory model for trading venues, particularly for the trading of NMS stocks. As discussed more fully below, this memorandum contrasts the regulatory model applicable to national securities exchanges, which are self-regulatory organizations (“SROs”), with that applicable to alternative trading systems (“ATs”), which are registered as broker-dealers. This memorandum also is intended to facilitate a discussion of the SROs’ role in the collection, processing and dissemination of market data and the treatment of associated fees.

The differences in the way the Commission regulates exchanges and ATs, and the role national securities exchanges play in the collection and dissemination of market data, have come under greater scrutiny from market participants in recent years.² This memorandum provides a brief background on the regulation of trading venues and discusses developments that have affected both equity market structure and the current self-regulatory system.

I. Regulatory Framework

A. Background

Exchanges

Exchanges traditionally have exercised regulatory authority over their markets and members.³ The Securities Exchange Act of 1934 (“Exchange Act”) codified the legal status of exchanges as self-regulatory entities under federal law.⁴ The Exchange Act vested exchanges

¹ This is a memorandum by the Division of Trading and Markets of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis or statements herein.

² See, e.g., Letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA, to Chair Mary Jo White, Commission, *Re: Self-Regulatory Structure of the Securities Markets*, dated July 31, 2013 (“SIFMA July 2013 Letter”), available at <http://www.sifma.org/issues/item.aspx?id=8589944673>; letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA, to Commission Chair Mary Jo White, dated October 24, 2014 (“SIFMA October 2014 Letter”), available at <http://www.sec.gov/comments/s7-02-10/s70210-422.pdf>.

³ See, generally, Senate Report No. 792, 73rd Congress, 2d Session, to accompany S. 3420, April 20, 1934, page 4, discussing the self-regulation of exchanges (and the “inadequacy” of such self-regulation) prior to enactment of the Securities Exchange Act of 1934.

⁴ Under the original text of Section 6(d) of the Exchange Act, the Commission was empowered to approve an exchange’s registration if it appeared to the Commission that the exchange was so organized as to be

with the responsibility to oversee trading on their respective markets and to regulate conduct of their members, including the responsibility to enforce compliance by their members with the Exchange Act.⁵ Thus, the Exchange Act reflected Congress' determination to rely upon self-regulation as a fundamental component of the oversight and supervision of U.S. securities markets and their members.⁶

Congress reaffirmed its reliance on self-regulation in the federal securities markets with the enactment of the Maloney Act of 1938, which extended the concept of self-regulation to the over-the-counter ("OTC") market by adding provisions relating to the registration of national securities associations and their statutory responsibilities. FINRA (formerly NASD) is, and has been, the only registered national securities association, although nothing in the Exchange Act precludes other entities from registering as such.

The Securities Acts Amendments of 1975 ("1975 Amendments") further built upon self-regulation as an integral component of the securities markets. The 1975 Amendments, among other things, added to the statutory standards governing exchanges,⁷ established a process for exchanges to file changes to their rules with the Commission, and required that certain proposed rule changes be approved by the Commission as consistent with the statutory standards.⁸ The 1975 Amendments also provided a role for the exchanges in creating the national market system,⁹ including through the provision of a consolidated market data stream.¹⁰ Through the 1975 Amendments, Congress sought to clarify the scope of the self-regulatory responsibilities of national securities exchanges and the manner in which they exercise those responsibilities, as

able to comply with the Exchange Act and rules and regulations thereunder and that the rules of the exchange were "just and adequate to insure fair dealing and the protection of investors." At the same time, the original text of Section 6(c) of the Exchange Act provided that exchanges were permitted to adopt any rules not inconsistent with the Exchange Act or the rules and regulations thereunder. As noted below, Section 6 was amended in 1975 to require that the rules adopted by exchanges meet certain enumerated standards. *See also* current Section 6(b)(1) of the Exchange Act, which requires as a condition of registration that an exchange be so organized and have the capacity to comply, and to enforce compliance by its members, with the Exchange Act, the rules and regulations thereunder, and its own rules.

⁵ In addition to the "just" and "fair-dealing" requirements of Section 6(d) noted at *supra* note 4, Section 6(b) originally provided that no exchange registration could be granted or remain in force unless the rules of the exchange included provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declared that the willful violation of any provision of the Exchange Act or any rule or regulation thereunder would be considered conduct or proceeding inconsistent with just and equitable principles of trade. *See also* the current text of Section 6(b)(6) of the Exchange Act.

⁶ *See also* Report of the Committee on Banking, Housing and Urban Affairs, United States Senate, to accompany S. 249, April 14, 1975 ("Senate 1975 Report"), at page 22, "Self-Regulation and SEC Oversight", including a retrospective on reliance on self-regulation in the enactment and implementation of the original version of the Exchange Act.

⁷ *See* the current text of Section 6(b), which was adopted as part of the 1975 Amendments.

⁸ *See* the current text of Section 19, which was adopted substantially as is as part of the 1975 Amendments, although subsequently revised through minor amendments.

⁹ *See* Section 11A, which was added as part of the 1975 Amendments.

¹⁰ *Id.*

well as strengthen the Commission's oversight of SROs more generally.¹¹

Aside from a few technical revisions, the statutory provisions governing national securities exchanges have remained substantially the same since the 1975 Amendments. Thus, while the Commission retains ultimate responsibility for oversight of the U.S. securities markets and their participants, exchanges as SROs have frontline responsibility for overseeing trading on their markets and their members' compliance with applicable statutory and regulatory provisions. Pursuant to Section 6 of the Exchange Act, exchanges must establish rules that generally: (1) are designed to prevent fraud and manipulation, promote just and equitable principles of trade, and protect investors and the public interest; (2) provide for the equitable allocation of reasonable fees; (3) do not permit unfair discrimination; (4) do not impose any unnecessary or inappropriate burden on competition; and (5) with limited exceptions, allow any broker-dealer to become a member.¹² Exchanges also must set standards of conduct for their members, administer examinations for compliance with these standards, coordinate among themselves with respect to the dissemination of consolidated market data, and generally take responsibility for enforcing their own rules and the provisions of the Exchange Act and the rules and regulations thereunder.

In turn, the Commission oversees the exchanges under the Exchange Act through, among other things, its examination authority under Section 17, its enforcement authority under Sections 19(h)(1) and 21C, its authority to approve and disapprove rules under Section 19(b), and its rulemaking authority under various Exchange Act provisions. This oversight today encompasses the 18 exchanges that are registered as national securities exchanges, 11 of which currently trade "NMS stocks."¹³

Alternative Trading Systems

Regulation ATS, adopted in 1998, was designed to provide an alternative regulatory framework for certain emerging new automated trading systems that offered execution services comparable to those of exchanges.¹⁴ Seeking to encourage market innovation while ensuring basic investor protections, the Commission believed that the new framework would meet the varying needs and structures of market participants and be flexible enough to accommodate the business objectives of, and the benefits provided by, alternative trading venues.¹⁵

Rule 3a1-1 under the Exchange Act, which was adopted as part of the Regulation ATS rulemaking, exempts an ATS from the statutory definition of "exchange," provided that it

¹¹ See Senate 1975 Report, *supra* note 6.

¹² See Section 6(b) of the Exchange Act.

¹³ Regulation NMS defines "NMS stocks" as "any NMS security other than an option," and "NMS security" as "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options."

¹⁴ See generally Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Adopting Release").

¹⁵ *Id.*

complies with the requirements of Regulation ATS, including registering as a broker-dealer.¹⁶ Regulation ATS precludes an ATS from exercising self-regulatory powers.¹⁷ By virtue of the exemption provided by Rule 3a1-1, ATSs are not required to register as national securities exchanges or to comply with the Exchange Act provisions applicable to national securities exchanges.¹⁸

In addition to registering as a broker-dealer under Section 15 of the Exchange Act, an ATS must become a member of an SRO, such as FINRA. An ATS also must file, at least 20 days before commencing operations, an initial operation report with the Commission on Form ATS that provides basic information, among other things, about its operations, subscribers, and order entry and execution procedures. Form ATS is a “notice” filing and is not approved by the Commission or made publicly available. An ATS must amend its Form ATS to report any changes to its operations. Regulation ATS also requires an ATS to maintain records, including an audit trail of transactions.

Further, if an ATS meets a threshold of 5% of the average daily share volume in an exchange-listed stock, and displays prices to more than one person (*e.g.*, it is not a “dark pool” ATS), the ATS must provide its best-priced orders for inclusion in the consolidated quotation data that is widely available to the public and provide broker-dealers the ability to access its best-priced orders.¹⁹ An ATS that meets this 5% threshold also must comply with the specified “fair access” standards with respect to its services more broadly, which require, among other things, that the ATS establish written standards for granting access to trading on its system and not unreasonably prohibit or limit any person in respect to access to services offered by such system by applying these written standards in an unfair or discriminatory manner.²⁰

¹⁶ In recognition that the market significance of an ATS increases as its trading activity increases, Rule 3a-1 establishes thresholds at which the Commission may determine that an exemption from the definition of “exchange” no longer would be necessary or appropriate in the public interest or consistent with the protection of investors.

¹⁷ *Id.* An example of exercising self-regulatory powers, provided in the Regulation ATS Adopting Release, *supra* note 14, was an ATS that regulated its members’ or subscribers’ conduct when engaged in activities outside its trading system.

¹⁸ In 2012, approximately 69% of trading volume in NMS stocks was executed on exchanges, 12% was executed on ATSs and 19% was executed on neither an exchange nor an ATS. *See* <http://www.sec.gov/dera/staff-papers/white-papers/otc-trading-white-paper-03-2014.pdf>. During the first six months of 2015, the combined share volume of the 44 ATSs that traded NMS stocks represented 14.57% of consolidated share volume in NMS stocks (based on data collected from ATSs pursuant to FINRA Rule 4552; Trade and Quote (TAQ) Data provided by the NYSE). As of September 29, 2015, there were 84 alternative trading systems that operate pursuant to Form ATS on file with the Commission, 46 of which have stated that the ATS expects to trade NMS stocks.

¹⁹ An ATS also must report to FINRA transactions that take place on its venue for inclusion in the consolidated stream of transaction information.

²⁰ *See* Rule 301(b)(5) of Regulation ATS. In addition, this rule requires an ATS to make and keep records of all grants, denials, and limitations of access and to report that information to the Commission on Form ATS-R. *Id.*

B. *Regulatory Differences Between Exchanges and ATSS*

As noted above, exchanges and ATSS operate in different regulatory regimes, with varying obligations and benefits.

Although exchanges and ATSS compete to offer trade execution services, ATSS have fewer regulatory obligations, which is a model that offers certain competitive advantages.²¹ In particular, ATSS are not required to fulfill the regulatory obligations of SROs, such as surveilling their markets and disciplining their members. In addition, ATSS have more flexibility in the operation of their business than exchanges insofar as ATSS are not subject to Section 6 of the Exchange Act and are not required to comply with the statutory standards with respect to unfair discrimination, burdens on competition, and the equitable allocation of reasonable fees. Furthermore, ATSS can modify their business practices more quickly than exchanges because ATSS are not required to file their rules with the Commission pursuant to Section 19 of the Exchange Act.

At the same time, ATSS do not receive some of the regulatory benefits that flow from being an exchange. For example, exchanges have the ability to maintain “protected quotes” under Rule 611 of Regulation NMS.²² By contrast, quotations displayed on ATSS gain such protection only when they are submitted to the ADF operated by FINRA.²³ In addition, exchanges have limited immunity from private actions when fulfilling their SRO responsibilities.²⁴ Furthermore, the exchanges (and FINRA), as SROs, help shape market

²¹ See, e.g., Jonathan Macey, Caroline Novogrod, *Enforcing Self-Regulatory Organization’s Penalties and the Nature of Self-Regulation*, 40 Hofstra L. Rev. 963, 988 (2012) (“The regulatory costs that the exchanges face have not encumbered these alternatives”); Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 J. Corp. L. 865, 927 (2008) (“The amazing growth of the ECNs and their displacement of the traditional exchanges have raised regulatory concerns The SEC’s burdensome regulations are driving capital away from public markets such as the NYSE and Nasdaq and into ECNs, which are more lightly regulated”); Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. Cal. L. Rev. 1239, 1260 (2007) (“At the same time, continuing to demand existing exchanges to invest in their regulatory efforts puts them at a grave disadvantage against newcomers While enlisting exchanges as front-line regulators relieves the government budget from regulatory costs, exchanges themselves need to devote significant resources to fulfill their respective obligations. These expenses place stock exchanges at a disadvantage vis-à-vis competitors that are not subject to the same regulatory responsibilities.”).

²² Rule 611 generally requires that a trading center implement policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of “protected quotations.” In order to be a “protected quotation” as defined in Regulation NMS, a quotation must be the best bid or best offer of a national securities exchange or a national securities association (currently FINRA through its Alternative Display Facility (“ADF”). Thus, Rule 611’s trade-through protection only applies to the best prices on a national securities exchange or the ADF.

²³ The ADF is a facility for posting quotes and reporting and comparing trades that is operated by FINRA. ADF is a display only facility and does not provide automated order routing functionality, execution facilities, or linkages between ADF trading centers. See <http://www.finra.org/industry/adf#sthash.FxCz8NfJ.dpuf>.

²⁴ See, e.g., *DL Capital Group, LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 97 (2d Cir. 2005); *Sparta Surgical Corp. v. National Ass’n of Securities Dealers, Inc.*, 159 F.3d 1209 (9th Cir. 1998).

structure policy through their participation in joint national market system plans (“NMS Plans”) and coordinated SRO rule filings. For example, in recent years, the Commission has approved NMS Plans filed by the SROs that establish a Limit Up-Limit Down mechanism to address extraordinary market volatility and a Tick Size Pilot program that would widen the quoting and trading increments for smaller-capitalization stocks.²⁵ In addition, pursuant to Commission Rule 613, the SROs have filed an NMS Plan that would establish a Consolidated Audit Trail (“CAT”) to capture customer and order event information for orders in NMS securities, across all markets, from the time of order inception through routing, cancellation, modification or execution.²⁶

Further, exchanges receive a benefit from their right to directly participate in market data revenues. ATSS do not share directly in these revenues.²⁷ The 1975 Amendments, and more recently Regulation NMS, created a role for SROs in jointly collecting and distributing information about the best quotes and all trades in NMS stocks. Regulation NMS established uniform standards for the distribution of both quotations and trade reports with the aim of creating an equivalent regulatory regime for all types of markets.²⁸ Regulation NMS also confirmed and built upon the requirement that both existing and any new exchanges and associations must act jointly to disseminate consolidated quotation information that reflects the national best bid and offer (“NBBO”) in NMS stocks as well as consolidated reports of transactions in those securities. Today, the exchanges and FINRA collect and distribute the consolidated quote and trade reports through several NMS Plans.²⁹ Consolidated market data is

²⁵ See Securities Exchange Act Release No. 67091, 77 FR 33498 (June 6, 2012) (File No. 4-631) (Order Approving, on a Pilot Basis, the National Market System Plan To Address Extraordinary Market Volatility) and Securities Exchange Act Release No. 74892 (May 6, 2015), 80 FR 27513 (May, 13, 2015) (File No. 4-657) (Order Approving the National Market System Plan To Implement a Tick Size Pilot Program). See also Securities Exchange Act Release No. 74323 (February 19, 2015), 80 FR 10169 (February 25, 2015) (Order Approving the Eighth Amendment to the National Market System Plan to Address Extraordinary Market Volatility); Securities Exchange Act Release No. 72460 (June 24, 2014), 79 FR 36840 (June 30, 2014) (Order Directing the Exchanges and the Financial Industry Regulatory Authority To Submit a Tick Size Pilot Plan).

²⁶ See Securities Exchange Act Release No. 71596 (February 21, 2014), 79 FR 11152 (February 27, 2014) (File No. 4-668) (Order Approving National Market System Plan Governing the Process of Selecting a Plan Processor and Developing a Plan for the Consolidated Audit Trail (“Selection Plan”). See also Securities Exchange Act Release No. 75192 (June 17, 2015), 80 FR 36028 (June 23, 2015) (Order Approving Amendment No. 1 to the Selection Plan) and Securities Exchange Act Release No. 67457 (July 18, 2012), 77 FR 45722 (August 1, 2012) (Consolidated Audit Trail Adopting Release).

²⁷ ATSS and other trading venues, which are members of FINRA, do not share directly in such revenues. However, FINRA, as the SRO with regulatory responsibility for the trade reporting facilities (“TRFs”) through which these entities may report their transactions, currently distributes a portion of the revenues it receives to each such member pursuant to a tiered schedule that takes into account the member’s market share. See the FINRA Rule 7600 Series, relating to the FINRA/NYSE and FINRA/Nasdaq TRFs, which include a definition of “market share” for these purposes. See also Securities Exchange Act Release No. 67385 (July 10, 2012), 77 FR 41832 (July 16, 2012). The tiers and percentages of revenue shared are not identical with respect to the two TRFs.

²⁸ See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (“Regulation NMS Adopting Release”) at 37566.

²⁹ The CTA/CQ Plans govern the collection, processing and distribution of quotation and transaction information for securities listed on all exchanges other than Nasdaq. For more information on these plans,

widely used by market participants as a benchmark for best execution, valuation and other purposes, and is required to be provided to customers under certain circumstances.

The level of fees charged for consolidated market data, and the manner in which the resulting revenues are distributed among market participants, are governed by the CTA/CQ and Nasdaq UTP Plans. Fees charged by the exchanges and FINRA for consolidated market data must be filed with the Commission, and must be both “fair and reasonable” and “not unreasonably discriminatory.”³⁰ Representatives of the securities industry and other constituencies participate in the fee-setting and other governance processes of the consolidated market data plans through “advisory committees.” Consolidated market data revenues are a substantial source of income for the SROs.³¹

The exchanges in recent years also have begun offering proprietary market data products that include quote and trade information. This market data often includes “depth of book” data, with quotations at multiple price levels, and other data elements that are not distributed in the consolidated market data feeds. Exchanges also offer “co-location” services at the exchange facilities to those seeking to minimize the latency of the proprietary market data products offered by the exchanges. In addition, they charge a variety of “port” and other fees to proprietary market data subscribers. As with consolidated market data fees, fees for proprietary market data products, co-location and other fees must be filed with the Commission and, among other things, be “reasonable,” “equitably allocated,” and not permit “unfair discrimination.”³²

II. Prior Commission Reviews of the Self-Regulatory System

The Commission periodically has examined the performance of the self-regulatory model³³ in the securities markets, including the extent to which SROs have successfully fulfilled

see <https://www.ctaplan.com/index>. The Nasdaq UTP Plan governs the collection, processing and distribution of quotation and transaction information for securities listed on Nasdaq. For more information on this plan, *see* http://www.utpplan.com/DOC/UTP_Plan.pdf.

³⁰ *See* Section 6(b)(4) and (5) of the Exchange Act.

³¹ *See* Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010) (“2010 Concept Release”).

³² *See* Section 6(b)(4) and (5) of the Exchange Act.

³³ Prior reviews of self-regulation have often cited several benefits to the SRO model. First, given the complexity of the securities markets, it is more efficient and effective for SRO regulatory staff, more intimately familiar with the nuances of market and broker-dealer operations, to develop and enforce the rules relating to market operations and conduct. *See* Market 2000: An Examination of Current Equity Market Developments (1994) (available at <https://www.sec.gov/divisions/marketreg/market2000.pdf>) (“Market 2000 Report”) at VI-6. Second, direct regulation of the securities industry at the federal level could be costly and could require a substantial increase in the expenditure of public funds, while self-regulation allows the government to leverage its resources through its oversight of SROs. *See* 2004 SRO Concept Release, *infra* note 37, at 71257. Consistent with the self-regulatory model established by Congress in the Exchange Act, the Commission has relied on the proximity of the exchanges to the securities markets and their expertise to be the “front-line” regulators of their own markets. Third, SROs were seen as the appropriate vehicle by which to establish and enforce standards of ethical conduct for market participants, such as requirements to engage in high standards of commercial honor and just and

their statutory obligations. For example, after problems surfaced regarding the floor operations of American Stock Exchange (“Amex”) specialists, the Commission sponsored the 1961-1963 Special Study of Securities Markets.³⁴ The Special Study concluded that SROs have a natural tendency to protect member firms and that SRO regulatory operations appear to falter without the “pointed stimuli” of vigilant Commission oversight. In the period following the Special Study, the Commission and the SROs took various actions intended to address some of the concerns raised by the study and to implement various recommendations of the Special Study. For example, after the study was completed both NYSE and NASD adopted more rigorous examination and licensing procedures for broker-dealers and exchange floor traders, and the Commission augmented its staff and created new divisions to enhance oversight.³⁵

In 1994, Commission staff conducted a review of the structure and costs of the SRO system and published its findings in the “Market 2000 Report.”³⁶ The Market 2000 Report noted the impact that increasing intermarket competition and duplicative SRO rules were having on the self-regulatory system and discussed the extent to which costs to support the SRO system were being fairly allocated across the markets. The Market 2000 Report also examined the desirability of reallocating the regulatory and market functions of SROs and the possibility of the Commission assuming a greater role with respect to the functions carried out by the SROs. The Market 2000 Report concluded that such changes were unlikely to improve the existing SRO system; however, it did not foreclose reconsidering this possibility in the future in light of changed circumstances.

In 2004, the Commission published a concept release on a range of issues relating to the self-regulatory system (“2004 SRO Concept Release”).³⁷ The 2004 SRO Concept Release identified several attributes of, and new challenges facing, the SRO system, such as conflicts among and between members, market operations, issuers, and shareholders; inefficiencies of multiple SROs; cross-market surveillance; and funding of regulation. The 2004 SRO Concept

equitable principles of trade. *See, e.g.*, Report of the Committee on Banking, Housing and Urban Affairs, United States Senate to accompany S. 249, April 14, 1975 (relating to the 1975 Amendments), at p. 23, stating (from unidentified Congressional citation relating to the 1934 legislation) that exchanges “are delegated governmental power in order to enforce, at their own initiative, compliance by members of the industry with both the legal requirements laid down in the Exchange Act and ethical standards going beyond those requirements.” In general, the flexibility afforded by self-regulation was seen as important in regulating an industry as complex and varied as the securities industry. *See id.*, at p. 29, stating, “One of the advantages of self-regulation is the flexibility and informality of its decision-making procedures It would be difficult to prescribe a single “proper” decision-making procedure appropriate to the circumstances of every self-regulatory organization, and it is doubtful that any such formal procedure would better serve the goal of effective securities regulation than the present practice of encouraging each organization to develop procedures which best serve its needs and those of public investors.”

³⁴ *See* 1961–1963 Special Study of Securities Markets. Securities and Exchange Commission, Report of Special Study of Securities Markets, (“Special Study”), H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

³⁵ *See* Sean H. Vanatta (2013). Conflicts of Interest: Regulated Self-Regulation and the 1963 Special Study. Working Paper RR#7 August. *Rethinking Regulation Working Paper Series Organized by The Kenan Institute for Ethics at Duke University*.

³⁶ *See* Market 2000 Report, *supra* note 33.

³⁷ *See* Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004).

Release requested comment on several alternative approaches to the current structure, including: (1) enhancing the current SRO model; (2) requiring SROs to create independent subsidiaries for regulatory and market operations; (3) implementing a hybrid or competing hybrid model, in which a market-neutral single SRO, or market neutral competing SROs, would be solely responsible for promulgating membership rules and taking actions against those members that fail to comply; (4) implementing a universal self-regulator model, in which one industry or non-industry regulator would be responsible for promulgating market and member rules, inspecting for compliance, and taking enforcement action with respect to these rules; and (5) establishing direct Commission regulation of the securities industry.³⁸

At the same time that the Commission issued its 2004 SRO Concept Release, the Commission also proposed rules relating to the governance, administration, transparency, and ownership of national securities exchanges and national securities associations (“2004 SRO Governance and Transparency Proposal”).³⁹ The 2004 SRO Governance and Transparency Proposal addressed the manner in which SROs manage the conflicts of interest inherent in any self-regulatory structure and the effectiveness of the SROs’ regulatory programs. The Commission received 42 comment letters on the 2004 SRO Governance and Transparency Proposal,⁴⁰ but did not act on the proposal.⁴¹ Subsequent to the issuance of the 2004 SRO Governance and Transparency Proposal, a number of regulatory and market developments occurred. For example, in 2005 the Commission adopted Regulation NMS⁴² and in 2007 the Commission approved the creation of FINRA.⁴³

The Commission on several occasions also has addressed issues with respect to the role that SROs play in the collection and dissemination of consolidated market data. In 1999, the Commission published a concept release on market data fees and revenues, and the role they play in funding the operation and regulation of the markets (“1999 Market Data Concept Release”).⁴⁴ In response to the comments received on the 1999 Market Data Concept Release, the Commission in 2000 formed a federal advisory committee – the Advisory Committee on Market Information – to assist it in evaluating issues relating to the public availability of market

³⁸ The Commission received 39 comment letters on the 2004 SRO Concept Release that reflected a wide range of views. The comment file for the 2004 SRO Concept Release is available at: <http://www.sec.gov/rules/concept/s74004.shtml>.

³⁹ See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004).

⁴⁰ The comment file is available at: <http://sec.gov/rules/proposed/s73904.shtml>.

⁴¹ Prior to the 2004 SRO Governance and Transparency Proposal, the New York Stock Exchange received approval from the Commission to implement a series of governance changes. See Securities Exchange Act Release No. 48946 (December 17, 2003), 68 FR 74678 (December 24, 2003) (Order Approving Proposed Rule Change Relating to the Amendment and Restatement of the Constitution of the Exchange to Reform the Governance and Management Architecture of the Exchange).

⁴² See Regulation NMS Adopting Release, *supra* note 28.

⁴³ See *infra* note 60.

⁴⁴ See Concept Release on Regulation of Market Information Fees and Revenues, Securities Exchange Act Release No. 42208 (Dec. 9, 1999), 64 FR 70613 (Dec. 17, 1999).

information. A number of the Advisory Committee's recommendations ultimately were incorporated into Rule 603(c) of Regulation NMS.

In 2010, the Commission issued a Concept Release on Equity Market Structure, which invited public comment on a wide range of market structure issues, including several issues relating to the dissemination of market information by SROs.⁴⁵

III. Recent Developments Affecting the Self-Regulatory System

In addition to the benefits of the SRO model noted above,⁴⁶ the Commission has recognized that self-regulation produces inherent conflicts between an SRO's commercial interests and its regulatory responsibilities.⁴⁷ Given an exchange's dual roles as both a business and a regulator, a potential conflict can exist if an exchange funds its business operations at the expense of regulation.⁴⁸ This conflict is heightened when an exchange demutualizes and becomes a for-profit business in a highly-competitive environment with shareholders to whom it must answer.⁴⁹ In a similar vein, a demutualized exchange may face conflicts in regulating parties that are key business partners (*e.g.*, that provide significant order flow to their business), or conversely, competitors (*e.g.*, that operate ATs).⁵⁰ Similarly, a conflict may exist with respect to exchange listings, as SROs are responsible for monitoring issuers for compliance with listing standards and delisting the securities of those issuers that fail to meet the SROs' minimum requirements, but they also compete vigorously to attract and retain listings.⁵¹

Recent developments in our securities markets, including changes in the ownership and structure of many exchanges and the proliferation of various other types of trading centers, have led some to question the continued efficacy of the SRO structure and the current regulatory model for trading venues. We discuss these developments below.

A. Ownership Structure – Demutualized For-Profit Exchanges and Exchange Affiliations

Recent years have seen a significant change in the structure of U.S. securities exchanges. The exchanges historically were member owned and operated entities. However, all U.S. securities exchanges gradually converted to demutualized, shareholder-owned structures.

⁴⁵ See 2010 Concept Release, *supra* 31. The comment file for the 2010 Concept Release is available at <http://www.sec.gov/comments/S7-02-10/S70210.shtml>.

⁴⁶ See *supra* note 33.

⁴⁷ See 2004 SRO Concept Release, *supra* note 37, at 71259 (stating “Unchecked conflicts in the dual role of regulating and serving can result in poorly targeted SRO rulemaking, less extensive SRO rulemaking, and under zealous enforcement of SRO rules against members.”)

⁴⁸ *Id.* at 71262.

⁴⁹ *Id.* at 71263.

⁵⁰ *Id.* at 71261-2.

⁵¹ *Id.* at 71263.

Consequently, another exchange constituency was created – non-member shareholders, who may seek to emphasize the exchange’s business interests over its regulatory obligations.⁵²

B. Increased Competition

In recent years, the market for execution services traditionally dominated by exchanges has become increasingly competitive both among exchanges, and between ATs and exchanges. The number of trading platforms operating as ATs has increased significantly, with more than 40 trading NMS stocks today.⁵³ Many of these are “dark pool” ATs, that do not display orders, and are operated by large broker-dealers.⁵⁴ The number of registered exchanges trading NMS stocks also has grown, with 11 exchanges currently trading NMS stocks. Exchanges continue to face competition in the trading of NMS stocks by dealers trading in the OTC market, as well. This heightened competitive business pressure on exchanges has raised concerns that it could exacerbate the tension between the exchanges’ regulatory duties as SROs and their commercial interests.⁵⁵

In addition, many of these exchange competitors operating their own electronic trading platforms are dealers or ATs operated by dealers that are members of an exchange, and their interests and the exchange’s interests may conflict.⁵⁶ Thus, an exchange, as an SRO, can be placed in the position of overseeing a competitor or a member that operates a competitor.⁵⁷

The vigorous competition in the businesses of ATs and exchanges also has raised the broader policy concern that regulatory distinctions between exchanges, with their SRO status, and non-SRO trading venues, such as ATs, may no longer be warranted.⁵⁸ Some have

⁵² See *id.* at 71263. In addition, the parent companies of many demutualized exchanges (including the New York Stock Exchange and the Nasdaq Stock Market) are publicly-traded companies, which could create another potential conflict of interest if the publicly-traded exchange chooses to list its securities on its own or an affiliate’s market.

⁵³ In 1998, Commission staff estimated that 45 ATs would register either as exchanges or as broker-dealers and comply with Regulation ATS, and estimated that, over time, that number would remain stable. As of September 29, 2015, there were 84 ATs that operate pursuant to Form ATS on file with the Commission, 46 of which have stated that the ATs expects to trade NMS stocks. See *supra* note 18. A regularly updated list of ATs is available at <http://www.sec.gov/foia/docs/atlist.htm>.

⁵⁴ See FINRA’s ATS Transparency Data Quarterly Statistics, 1st Quarter of 2015, [available at http://www.finra.org/industry/ats/ats-transparency-data-quarterly-statistics](http://www.finra.org/industry/ats/ats-transparency-data-quarterly-statistics). See also Tuttle, Laura, 2013, Alternative Trading Systems: Description of ATS Trading in National Market System Stocks, at 2, available at: <http://www.sec.gov/marketstructure/research/alternative-trading-systems-march-2014.pdf>.

⁵⁵ See, e.g., SIFMA July 2013 Letter, *supra* note 2.

⁵⁶ *Id.* at 71262.

⁵⁷ See 2004 SRO Concept Release, *supra* note 37, at 71262 (“users argued ... that the situation would be rife for abuse because of Nasdaq functioning both as a regulator and competitor”).

⁵⁸ See SIFMA July 2013 Letter, *supra* note 2, at 3 (“the distinction between the activities performed by an exchange compared to an ATs lacks functional difference”).

questioned whether the exchanges' status as SROs provides them with commercial and competitive advantages that remain appropriate in the current market environment.⁵⁹

C. *Reliance on FINRA to Perform Regulatory Functions*

Many exchanges in recent years have turned to FINRA⁶⁰ to perform regulatory functions with respect to their members and, to some extent, their markets, using a combination of Rule 17d-2 plans⁶¹ and Regulatory Services Agreements (“RSAs”).⁶² Rule 17d-2 plans, which are subject to Commission approval, allocate responsibility for regulation of common rules for common members to a designated SRO, often FINRA. A Rule 17d-2 plan relieves the delegating parties of their SRO responsibilities.⁶³ An RSA, by contrast, is a private contract between parties under which one SRO performs regulatory functions as an agent. RSAs are not approved directly by the Commission and, because they are not limited to common members and

⁵⁹ See *supra* notes 22-27 and accompanying text. See also SIFMA July 2013 Letter, *supra* note 2, at 3 (“These benefits can be significant and, in an environment where exchanges fiercely compete with broker-dealers, provide unfair advantages that can no longer be justified.”).

⁶⁰ In 2007, the Commission approved the consolidation of the NASD with the regulatory unit of the NYSE (NYSE Regulation, Inc.) to form FINRA. In its approval order, the Commission stated that “the consolidation of NASD and NYSE member firm regulation should help reduce unnecessary regulatory costs while, at the same time, increase regulatory effectiveness and further investor protection.” See Securities Exchange Act Release No. 56145 (July 26, 2007), 72 FR 42169 (August 1, 2007) (SR-NASD-2007-023). Subsequently, the Commission approved a single set of FINRA rules for joint NYSE-FINRA members, with enforcement of various member rules assumed by FINRA pursuant to a Rule 17d-2 plan. At the same time, NYSE, along with its affiliated exchanges NYSE Arca and NYSE MKT, entered into an RSA with FINRA providing that FINRA would undertake regulatory responsibility for certain market-related rules. *But see infra* note 62.

⁶¹ Under Rule 17d-2 under the Exchange Act, two or more SROs can enter into a plan whereby they allocate among themselves certain specified regulatory responsibilities for members that are members of each SRO. A compilation of Rule 17d-2 plans is located at: <http://www.sec.gov/rules/sro/17d-2.shtml>.

⁶² An RSA is a contract used by exchanges to outsource at least some of their regulatory functions to another SRO. With respect to RSAs, the Nasdaq-affiliated exchanges decided to conduct in-house certain market-related surveillances that previously were performed by FINRA pursuant to an RSA. See, e.g., Securities Exchange Act Release No. 70569 (September 30, 2013), 78 FR 62814 (October 22, 2013) (SR-NASDAQ-2013-102) (approving proposal to assume operational responsibility for certain surveillance activity currently performed by FINRA under Nasdaq’s authority and supervision). Similarly, Intercontinental Exchange, on behalf of NYSE, NYSE Arca, and NYSE MKT, announced that these exchanges would not renew the market surveillance, investigation and enforcement features of their RSA with FINRA when the contract expires at the end of 2015, and instead will hand over these duties to their NYSE Regulation affiliate. See Press Release issued by Intercontinental Exchange, “NYSE Regulation to Perform Market Surveillance, Investigation and Enforcement Program for NYSE Group Exchanges,” dated Oct. 6, 2014, at http://otp.investis.com/clients/us/intercontinental_exchange_group/usn/usnews-story.aspx?cid=953&newsid=18367. As of January 1, 2015, FINRA performs the majority of the regulatory services for CBOE and C2 Options Exchange. See Press Release issued by CBOE Holdings, Inc., “CBOE and C2 enter into Agreements with FINRA Involving Regulatory Services,” dated Dec. 22, 2014, at <http://ir.cboe.com/press-releases/2014/dec-22-2014.aspx>.

⁶³ See Rule 17d-2, 17 CFR 240.17d-2.

common rules, they can cover a wider range of regulatory responsibilities.⁶⁴ Moreover, an RSA does not relieve the contracting SRO from ultimate responsibility for carrying out its regulatory obligations and the contracting SRO must exercise due oversight of its agent's activities.⁶⁵

To the extent an exchange contracts a portion of its regulatory activities to FINRA, concerns have been raised that a key justification supporting self-regulation – namely, that the proximity of the exchanges to the securities markets and their expertise makes it more efficient and effective for exchanges to be the “front-line” regulators of their own markets⁶⁶ – may be less compelling.⁶⁷ On the other hand, it could be argued that having regulation performed by an SRO less directly influenced by the business of the exchange could mitigate some of the conflicts noted above, although the commercial aspect of an RSA may simply transfer those conflicts indirectly to the exchange's agent.

IV. Conclusion

Historically, it has been the prevailing view that the current regulatory structure for trading venues has functioned reasonably well and has adequately served the interests of investors, government, and industry. However, given the recent developments relating to the securities markets, as discussed above, it may be appropriate to reevaluate the current regulatory approach to exchanges, ATSS, and other trading venues. To that end, consideration could be given to the present system of self-regulation, including its advantages and drawbacks. Consideration also could be given to possible ways to improve the current system, taking into account the protection of investors and the public interest. In addition, consideration could be given to the regulatory models for trading venues and whether they continue to be appropriate today.

⁶⁴ See, e.g., Securities Exchange Act Release No. 68341 (December 3, 2012), 77 FR 73065 (December 7, 2012) (File No. 10-207) (finding it to be consistent with the Exchange Act for the applicant to contract with another SRO to perform certain regulatory functions, but noting that the RSA was not before the Commission and, therefore, the Commission was not acting on it).

⁶⁵ See, e.g., *id.* (“Notwithstanding the RSA, MIAX Exchange will retain ultimate legal responsibility for the regulation of its members and its market.”)

⁶⁶ See *supra* note 33.

⁶⁷ See, e.g., SIFMA July 2013 Letter, *supra* note 2, at 4.