

clearing agency under the Exchange Act is warranted.

II. Description of Proposal

A. The System

1. Background

ProTrade reports that it has designed and developed the System as a "stand-along" electronic operation that integrates order-entry, trade-matching, and execution functions with the back office functions of accounting and settlement. ProTrade states that it will interpose itself between the trading parties of each trade and that it will guarantee performance to each contraparty. The System will be made available to a list of qualified customers. As the operator of the System, ProTrade will derive revenues from customer fees on all transactions effected in the System.⁸

2. Options Securities

The System is designed to process over-the-counter options on equities, equity indexes, foreign currencies, and interest rates. ProTrade plans to have two classes, Class A and Class B, of such options. Class A options will be uncertificated, European-style put and call options that will be cash settled and that will expire on the last trading day of the chosen month of expiration.⁹ Class B options will be uncertificated put and call options that will have no standard terms and that will be individually negotiated by the trading parties.

3. Customers

As discussed below under Participation Standards, ProTrade will screen its prospective customers to determine whether they meet certain financial and operational standards.¹⁰ Applicants who fail to meet ProTrade's standards will be denied customer status and therefore will be denied access to the System.¹¹ In general, ProTrade expects to have a sophisticated customer base including professional investors and financial institutions. Each customer will be provided with the System's proprietary

software, which the customer may use on a personal computer for the purpose of entering orders and for performing other tasks within the System. ProTrade expects that customers will be able to connect with the System either by: (1) a dial-up telephone line using a modem or (2) a leased line. ProTrade will provide each customer with a unique identification number and a password that will allow access to the System.

4. Operations

The System will keep a file of its customers' outstanding bids and offers sorted by price and time of receipt. The bids and offers will be displayed in a montage or array, and customers will be able to cancel or modify their orders at any time prior to execution. Bids and offers at the same price will be anonymously matched by the System and will be executed on a first-in, first-out basis. The System will accept market orders, limit orders, stop orders, and market if touched orders.

The System will be designed to calculate balances and to settle accounts immediately (or within a few seconds) after every execution. ProTrade states that each order will be individually processed by the System without netting.¹² Settlement will consist of book-entry debits or credits to the customer's account with the customer's account being part of ProTrade's segregated broker-dealer bank account. As a means of protection, the System is designed to reject any order unless the account of the customer that is entering the order has sufficient equity to satisfy the order's premium payment or has the required collateral.

B. System Safeguards

1. Participation Standards

Customers authorized by ProTrade to use the System will be required to meet initial and continuing financial and operational standards, as may be determined by the ProTrade Board of Directors and administered by ProTrade's management.¹³ Under these standards, customers will be screened for margin purposes to determine their

creditworthiness. Determining factors will be the customers' financial positions and their knowledge and experience in trading options and other derivative products.

ProTrade will require each applicant to disclose, at a minimum, the following information: (1) Trading experience with options and other derivatives, (2) annual income and net worth, (3) history of any account defaults or failures, (4) experience with computers, and (5) existing accounts with other brokers. ProTrade, when it deems it necessary, will obtain credit reports on an applicant. Based on its subjective review of the above criteria, ProTrade may grant or deny customer privileges. Customers also must agree in writing to comply with applicable law and with all of ProTrade's rules. ProTrade will reserve the right to deny access to the System to any person that, among other things, is the subject of a civil injunction or criminal conviction for breach of the laws governing securities or commodities futures.

2. The System's Data Backup

ProTrade reports that it will backup its data daily and that the System itself will have the ability to regenerate electronically all transactions since the previous backup. The System also will be supported by backup hardware that can be put on-line in a matter of seconds.

While customers will be provided with ProTrade's software, the customers will be responsible for their own electronic equipment or hardware. However, if a customer's equipment should break down, the customer could submit orders by telephone to ProTrade where a ProTrade employee will enter the orders.

3. Margin Payment/Collection

Once ProTrade has completed its broker-dealer registration, ProTrade will be subject to Section 7(c) of the Exchange Act, which governs broker-dealer margin requirements.¹⁴ As a consequence of Section 7(c), ProTrade also will be subject to Regulation T of the Board of Governors of the Federal Reserve System ("Federal Reserve System"), which governs credit extended by broker-dealers,¹⁵ and it will be subject to the NASD's rules governing minimum maintenance

⁸ ProTrade has stated that it "will derive most of its revenues from typical 'discount' broker activities, i.e., accepting orders for listed securities on behalf of customers." Letter from Joseph M. Zajac, President, ProTrade, to Eugene Lopez, Assistant Director, Division, Commission, at page 2 (October 15, 1993).

⁹ As European-style options, no positions may be exercised before the expiration date.

¹⁰ ProTrade has chosen the term "customers" for the users of its System, as distinct from participants, subscribers, members, or other similar terms.

¹¹ At this time, ProTrade has no written standards or criteria for acceptance of customers.

¹² Technically, this described form of post-trade processing is known as "trade-for-trade" clearing, the simplest form of clearing, which involves accounting for each trade on a contract by contract basis without netting or at least without the usual types of netting. This form of clearing contrasts with the more sophisticated forms of clearing such as "daily balance order" or "continuous net settlement" where clearing agencies net each of their participant's trades and each participant's money credits and debits in each security on a daily basis.

¹³ At this time, ProTrade has no financial and operational standards for customers authorized to use its System.

¹⁴ 15 U.S.C. 78g (1988).

¹⁵ 12 CFR 220 *et seq.* (1995). See, *esp.*, § 19(f)(2) of Regulation T, 12 CFR 220.19(f)(2), which in general refers a broker-dealer's option margin requirements to the maintenance rules of the broker-dealer's self-regulatory organization ("SRO"). In ProTrade's case, the SRO would be the NASD.