INTRODUCTION

In beginning this symposium on the structure and regulation of the securities markets, I'm sure we will all keep in mind George Santayana's caution that: "Those who cannot remember the past are condemned to repeat it."[1]

Although enormous changes have taken place over the past few decades, we keep hearing echoes of the past. When the London Stock Exchange (LSE) switched from floor-based to electronic trading exactly twenty years ago, it decided that the transformation might be too traumatic for its members, so it adopted a hybrid market—an electronic market combined with traditional floor trading. The hybrid market lasted just over four months, at which time the LSE closed its floor for trading in equities. Will the New York Stock Exchange's experience with its new hybrid market be the same or different?

The Consolidated Limited Order Book (CLOB), which I expect will be discussed today, was first proposed to the SEC thirty years ago by Professor Peake, one of today's speakers, in 1976, a year after Congress told the SEC to create a national market system. The CLOB, which would execute investors' orders electronically under a rule of time and price priority, seemed to him the best way to assure best execution of investors' orders throughout the national market system.

In 1978, the SEC told the exchanges to create a CLOB. A year later the Commission had second thoughts: it feared that a CLOB would lead to the elimination of exchange trading floors by inexorably forcing all trading into a fully automated trading system.

In 2000, the SEC again suggested the CLOB as one of several possible alternatives in order to prevent fragmentation of the markets. Like Rasputin, it simply wouldn't die. But last year, when it adopted Regulation NMS, the Commission again rejected the notion of a CLOB, but for a very different reason from the one it had given back in 1979. This time, the SEC said that a CLOB would greatly reduce the opportunity for markets to compete by offering a variety of trading services.

I mention this little piece of history not necessarily to promote the CLOB, but rather to remind you that when we consider the future structure of the markets we are not writing on a clean slate. Also, we should never forget that the overriding goal of securities regulation is to protect investors. As David Walker, a senior adviser at Morgan Stanley, wrote in the *Financial Times* last Wednesday, "there are important public interests at stake that mirror the utility-like services"[2] that stock exchanges provide,

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1. GEORGE SANTAYANA, THE LIFE OF REASON OR THE PHASES OF HUMAN PROGRESS: INTRODUCTION AND REASON IN COMMON SENSE 294 (1906).

2. David Walker, *Exchange Mergers Must Benefit Users*, FIN. TIMES, Nov. 8, 2006, at 19.

and that in the new era of publicly owned stock exchanges, accountability to shareholders must be complemented by explicit accountability to users (i.e., investors).

That reminds me of a story about the humorist Robert Benchley who, while an undergraduate at Harvard, took a course in international law. Having been carousing the entire night before the final exam, he was ill-prepared to answer the only question on the exam, which was "to discuss the North Atlantic fisheries dispute from the point of view of one of the parties." He answered, and I paraphrase, "Wiser heads than mine have discussed this case from every point of view, except for the point of view of the fish. I would like to undertake that task."[3] He flunked.[4]

Norman S. Poser[*]

3. The exact quote that has been attributed to Robert Benchley is: "I know nothing of the point of view of Great Britain in the arbitration of the international fisheries problem and nothing about the point of view of the United States. I shall therefore discuss the question from the point of view of the fish." Robert Benchley: A Profile in Humor, http://www.davidpietrusza.com/benchley.html (last visited Mar. 28, 2007).

4. *See id.*

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ARTICLES

INTERMARKET COMPETITION AND MONOPOLY POWER IN THE U.S. STOCK MARKETS

Roger D. Blanc[*]

I. INTRODUCTION

Stock exchanges in the United States have undergone dramatic change in the last several years. Their conversion from not-for-profit entities controlled by their members into for-profit, publicly owned corporations over which their former members have substantially less influence and control has significantly altered the initial regulatory assumptions that allow stock exchanges to be self-regulatory organizations. The introduction of electronic trading media put substantial pressure on floor-based exchanges and encouraged stock exchanges to embrace electronic technology. The new profit incentives and ease of transferring information in the age of electronic communications led the exchanges to begin marketing the quotation and trading data their members were required by law to give them. The exchanges are now using the data entrusted to them as self-regulatory organizations to further their new profit-seeking objectives.

In response, the Securities and Exchange Commission (SEC) has substantially revised its regulation of the markets in light of several of these changes, yet its revised regulations consistently appear to be one step behind the exchanges, which have used their regulatory revenues to serve private, for-profit ends rather than the ends the Securities Exchange Act of 1934 (Exchange Act) envisions. This article reviews some of the effects of those changes on market structure and on market participants, including the effects on "fragmentation" of the markets. A particular concern is that a result of the exchanges' profit-seeking structure has been to foster the creation of a two-tiered market where large investors are charged market data fees beyond the means of smaller investors and then given faster access to that data, thus granting them substantial trading advantages. The article then reviews the current debate over the revenues the exchanges are

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attempting to collect by selling depth-of-market data, and the recent petition by NetCoalition.com seeking to overturn the SEC staff's approval of certain NYSE Arca market data fees. That petition strikes at the heart of the revenues exchanges collect. It has sparked a vigorous debate and challenges the staff's use of its delegated authority to approve exchange rule changes setting market data fees.

II. THE FRAGMENTATION OF THE U.S. STOCK MARKETS

There was a time not very long ago when fragmentation of the U.S. stock markets was thought to arise from having separate market centers. It was a time when trading resided mostly on physical exchange floors and in the offices of over-the-counter dealers. In fact, the SEC may have helped promote fragmentation in 1941 when, in the *Multiple Trading Case*,[1] it forbade the New York Stock Exchange (NYSE) from preventing its members from trading in NYSE-listed securities on other exchanges. Indeed, the exchanges' "off board trading rules," chiefly the now-rescinded NYSE Rule 390 (formerly Rule 394), severely limited the ability of NYSE members to trade NYSE-listed stocks in the over-the-counter market.[2]

The time when physical exchange floors dominated equity trading in the United States began to draw to a close in the 1970s. In 1975, the Congress directed the SEC to use its authority under the newly amended Exchange Act to foster the establishment of a national market system (NMS). It cast serious doubt, moreover, on whether off-board trading rules, such as NYSE Rule 390, would continue to have a place in the new system.[3] It was not until the late 1990s, however, that the SEC responded to that call and directed the NYSE to abandon its off-board trading rule.[4] But

1. In the Matter of The Rules of the New York Stock Exchange, 10 SEC 270, 297 (Oct. 4, 1941) (holding that the NYSE rule prohibiting dealings on other markets is against public interest and illegal).

2. *See* Order Approving Proposed Change to Rescind Exchange Rule 390, Exchange Act Release No. 42,758, 65 Fed. Reg. 30,175 (May 5, 2000) (approving the NYSE rescission of Rule 390). *See also* Andrew M. Klein & Andre E. Owens, *The Intermarket Trading System: Reassessing the Foundation of the National Market System*, WALLSTREETLAWYER.COM, Mar. 2000, at 1.

3. Exchange Act § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2) (2000). The Congress added this section to the Exchange Act as part of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 113.

4. *See* Arthur Levitt, Chairman, SEC, Remarks at Columbia Law School: Dynamic Markets, Timeless Principles (Sept. 23, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch295.htm [hereinafter Levitt 1999 Speech].

> This rule has long prohibited NYSE members from dealing in listed securities off an exchange. For years, proponents have argued that Rule 390 prevents fragmentation. Others contend that the rule is an anticompetitive use of market power by a dominant market. As I see it, Rule 390 may very well be on its ninth life. Now is the time to ask

what then happened? In fact, trading in the NYSE-listed stocks, if anything, became more concentrated on the NYSE as its market share grew by a small amount to over 80% before later settling back to under 70%.[5]

Did any of that have to do with increasing or decreasing market fragmentation? If market fragmentation is taken, erroneously this writer believes, to mean dispersion of order flow among competing market centers, then concentrating trading on the NYSE would diminish fragmentation, and diversion away from that market center would increase it. That, however, is not fragmentation in today's context.

The SEC correctly views efficient markets as resulting from the exposure of all buying interest to all selling interest, and vice versa, regardless of how that exposure occurs.

> The NMS is premised on promoting fair competition among individual markets, while at the same time assuring that all of these markets are linked together, through facilities and rules, in a unified system that promotes interaction among the orders of buyers and sellers in a particular NMS stock. The NMS thereby incorporates two distinct types of competition—competition among individual markets and competition among individual orders—that together contribute to efficient markets. Vigorous competition among markets promotes more efficient and innovative trading services, while integrated competition among orders promotes more efficient pricing of individual stocks for all types of orders, large and small. Together, they produce markets that offer the greatest benefits for investors and listed companies. Accordingly, the Commission's primary challenge in facilitating the establishment of an NMS has been to maintain an appropriate balance between these two vital forms of competition.[6]

In fact, increasing competition among market centers will no doubt promote innovation while rewarding efficiency and punishing inefficiency. In a system of electronically interconnected markets where order-entry firms can use "smart" order-routing technology to route and, as necessary,

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> ourselves: is there a valid justification for a rule that appears to be more a barrier than a benefit? And how, under any circumstances, could such an anticompetitive rule be sustained should the NYSE become a for-profit corporation? While rulemaking is certainly an option, one way or another, Rule 390 should not be part of our future.

Id. *See also* Order Approving Proposed Change to Rescind Exchange Rule 390, 65 Fed. Reg. at 30,175.

5. *See* Gaston F. Ceron, *NYSE's Market Share In Its Listed Stocks Falls*, WALL ST. J., Jan. 8, 2007, at C5 (finding the NYSE share of the securities market peaked at eighty percent); *see also* Historical NYSE Group Monthly Volume, *available at* http://www.nyse.com/financials/1143717022567.html (last visited Mar. 31, 2007).

6. Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,503 (June 29, 2005).

re-route orders in search of the best sources of liquidity and best prices, it matters far less than it once did how many markets there are or whether any single market center becomes or remains dominant. In place of the traditional assumption that having multiple market centers quoting and trading the same securities meant the market was fragmented is the new reality that, given the relatively low cost of bandwidth, a system of electronically interconnected market centers competing for order flow both permits orders to be shunted back and forth in search of liquidity and price and promotes economic efficiency and investor choice.

SEC Chairman Arthur Levitt recognized this in a speech at Columbia Law School when he extolled the virtues of the then relatively new phenomenon of electronic communications networks (ECNs), which had begun to erode the market share Nasdaq enjoyed in Nasdaq securities. He stated:

> Electronic communication networks have been one of the most important developments in our markets in years—perhaps decades. But exactly what are ECNs, and what are we to make of their impact on our markets? In simplest terms, ECNs bring buyers and sellers together for electronic execution of trades. They have provided investors with greater choices, and have driven execution costs down to a fraction of a penny. As a result, these networks present serious competitive challenges to the established market centers. More fundamentally, they illustrate the breath-taking pace of change that results when technology and competition coalesce.[7]

A number of regulatory changes had promoted an environment in which technology could begin effectively to challenge the control over order flow previously enjoyed by the exchanges. The establishment of Nasdaq itself at the end of the 1960s signaled the beginning of the new era. Originally, Nasdaq was just a quotation medium—a way to shine light in the dark corner of over-the-counter trading where market efficiencies were all but absent and dealers were not easily put in competition with one another. Over time, however, with further prodding from the SEC, Nasdaq grew into an automated system that involved publication to investors and not just dealers of the "inside inside," that is, the best available bids and offers (instead of the earlier "representative bid and asked" that gave a far less accurate indication of what the best prices actually were)[8] and a

7. *See* Levitt 1999 Speech, *supra* note 4.

8. *See, e.g.*, Order Approving Proposed Reporting Plan for NASDAQ/NMS Securities Traded on an Exchange on an Unlisted or Listed Basis, submitted by the National Association of Securities Dealers, Inc., and the American, Boston, Midwest and Philadelphia Stock Exchanges, Exchange Act Release No. 28,146, 55 Fed. Reg. 27,917, 27,917 (July 6, 1990).

quotation montage—called for by Exchange Act Rule 11Ac1-2 (now Rule 603 of Regulation NMS)[9]—that showed investors the available alternatives.

The dealer community, however, found an alternative. Instinet offered a way for dealers to put better quotations on a private system available only to a favored institutional clientele without offering the same pricing to other dealers and the retail public.[10] That of course contributed to a two-tier market, with the institutional investors getting preferred treatment.[11] Whether that made sense from the point of view of public policy was more debatable. On one hand, retail customers tend to think they should get the same pricing as institutional investors regardless of the different costs of servicing them—just as many retail consumers buying automobiles would doubtless be upset if they knew of the better pricing offered to large buyers such as the major automobile rental companies. Getting to the bottom of that issue may depend, it seems, on how to resolve the question of who is the small investor: the retail individual, such as a doctor, lawyer, or corporate executive who buys a few hundred shares at a time, or the large pension fund or mutual fund that buys several hundred thousand shares at a time on behalf of thousands of indirect investors such as schoolteachers, firefighters, and police officers, whose aggregate investments may be quite a bit smaller than those of the individual retail investors who invest directly through their brokers.

In any event, the SEC decided that the Instinet game had to end. In August 1996, it adopted the Order Execution Rules.[12] Chief among their provisions were requirements that: (1) broker-dealers making markets in publicly traded stocks not quote better prices, or publish customer limit orders at better prices, in private networks such as Instinet unless they adjusted their publicly disseminated quotations to match the private ones, and (2) unless—and this was an important unless—the private networks published the best quotations on their books in their own names in Nasdaq or another permissible venue. The dealers could thus continue to quote inferior prices under their own names in Nasdaq, but the better pricing they were offering via Instinet or other similar media would for the first time see the light of day publicly in an anonymous way via the private network's

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9. 17 C.F.R. § 242.603 (2006).

10. *See* SEC, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET (Aug. 8, 1996), *available at* http://www.sec.gov/litigation/investreport/nasdaq21a.htm; *see also* In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 37,538, Administrative Proceeding File No. 3–9056, 1996 SEC LEXIS 2146 (Aug. 8, 1996).

11. In the Matter of National Association of Securities Dealers, Inc., 1996 SEC LEXIS 2146, at *2–4.

12. *See* Order Execution Rules, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48,290 (Sept. 6, 1996).

own name. The SEC's rules required, moreover, that these better quotations be accessible by any registered broker-dealer.[13]

This regulation was an important, indeed watershed, event for two reasons. First, it made it more difficult, although by no means impossible, for dealers to publish better pricing in some media than in others. Second, and quite possibly more important, it led to the rise of a new class of competing electronic communications networks that challenged both the hegemony of Instinet among private networks and Instinet's own market share. At the same time, to goad the order-entry brokers into searching out the best prices, and possibly to reward dealers who took the risk of offering price improvements, the Commission published a release announcing the adoption of its Order Execution Rules, including a long discussion of a broker's duty of "best execution."[14] The Commission thus federalized a duty previously thought to be a creature of state agency law. The SEC made it clear that it would consider it improper, for example, for a dealer to quote a bid and asked and to take two customer market orders, one to buy and one to sell, and to then execute the customer sell order against the dealer's bid and execute the customer buy order against the dealer's asked quotation. Instead, the dealer would need to execute the customer orders against one another, presumably inside the bid-asked spread, giving each a better price than it would have received had its order been executed against the dealer bid or asked.[15]

These steps did much to curtail fragmentation in the Nasdaq market. Previously, market makers in Nasdaq stocks had operated pretty much independently. There was no public disclosure of the actual "inside inside" on Nasdaq and what was published as the National Best Bid and Offer (NBBO) did not really represent true best pricing in many securities. With the implementation of the new rules, for the first time, the true best prices (not including the pricing of block transactions, which were largely excluded from operation of the Order Execution Rules) were being published and were accessible to any registered broker-dealer. The SEC has

13. *See* 17 C.F.R. § 242.602(b)(5)(ii) (2006); *see generally id.* § 242.604(b)(5) (regarding the display of customer limit orders).

14. Order Execution Rules, 61 Fed. Reg. at 48,322–24.

15. *Id.* at 48,322–24. The Commission also suggested that a customer limit order executed against a customer market order had to receive the limit price (even though a limit order was commonly understood to mean "give me a price no worse than my limit price and try to get me a better price"). *See id.* That, of course, made limit orders even more susceptible than otherwise to the risk of adverse selection and gave rise to the "not held" limit order—a stratagem introduced by the institutional dealers to neutralize the Commission's unfairly discriminatory treatment of limit orders. The not-held limit order was a limit order not held to the market price; its terms provided that the broker should try to get the best price possible but in any event a price no worse than the limit price. That, of course, was what many had thought—until the SEC spoke to the contrary—was the implicit or explicit understanding underlying all limit orders.

made it clear, as a matter of federal law, that brokers were expected to live up to a duty of best execution requiring them to use commercially reasonable efforts to get the best available prices for their customers.

The SEC reinforced that duty a few years thereafter by adopting Rules 11Ac1-5 (now Rule 605 of Regulation NMS)[16] and 11Ac1-6 (now Rule 606 of Regulation NMS),[17] which, respectively, required market centers—exchanges, electronic communications centers and market makers—to disclose information concerning orders executed on their markets and required order-entry firms to disclose their order-routing policies and methods. Those rules increased the amount of data available to order-entry firms and required them to publish how they were taking advantage of the data.

During this period, another major development affected pricing in the markets and the risk of fragmentation—the decimalization of securities pricing. Originally quoting prices mostly in eighths of a dollar and then for a short time in sixteenths, the exchange markets and Nasdaq were required to move to pricing in pennies, producing 100 price points to the dollar instead of the previous eight or sixteen. That development had a number of implications and adumbrations. Among them, the regulatory provisions turning on "tick" tests—whether a trade was above or below the previous one—ceased to make any sense and the SEC began to move toward deletion of the price test in the short sale rule.[18] Also, and more importantly, it began to cast doubt on whether getting the best price, down to the last penny, was worth the trouble, particularly if it meant incurring the extra costs and possible delay inherent in going to several different market venues in search of pennies. Finally, it vastly diminished the informational value of the best bid and offer since, with 100 price points to the dollar, the amount of liquidity apparently available at a market's best bid or offer was a small fraction of what it had been when prices were quoted in eighths or even sixteenths.

Notwithstanding these developments, there always has been some ambiguity as to whether a two-tiered market could in fact be eliminated, and whether it was sound public policy to require that institutional investors not be permitted to use their economies of scale and scope to obtain from the markets any special advantages over retail investors. Some, including some in Washington, may have believed that all orders should interact with all other orders and institutional investors should "walk" the market up or down, filling retail orders by the bushel in the process of satisfying their gargantuan appetites, much like a baleen whale devouring untold millions

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16. 17 C.F.R. § 242.605 (2006).

17. *Id.* § 242.606.

18. *See, e.g.*, Amendments to Regulation SHO and Rule 10a-1, Exchange Act Release No. 54,891, 71 Fed. Reg. 75,068 (Dec. 7, 2006) (to be codified at 17 C.F.R. pts. 240, 242).

of plankton. Of course, the institutional investors and their brokers and block positioners have long recognized that best execution of institutional orders hardly would be achieved in such a fashion. One commented:

> At Fidelity, we have no reason or incentive to by-pass readily accessible limit orders in any market where executions are certain and immediate. In seeking best execution of large orders, we seek the best overall execution, that is, best overall price. Walking the market up or down over several minutes or even seconds, if the ability to sweep the limit order book is denied, seriously impairs our ability to obtain the best execution for our funds. Often, liquidity at prices above or below the NBBO will fade away if we have to work our way, over the course of several seconds or minutes, above or below the NBBO. That fading away occurs as market professionals see us taking up liquidity at the prices nearer to the NBBO and then either compete with us for liquidity at the more distant prices or withdraw orders they have placed at those prices only to put them further away from what had been the NBBO. All of this suggests the markets are sufficiently complex that a one-size-fits-all trade-through rule is too limiting unless market participants are permitted to opt out of the rule when their fiduciary duty or economic self-interest tells them they should.[19]

Those facts and comments did not fit an idealized picture of a homogeneous market where all order flow could interact in an orderly fashion and everyone would stand in line and get the same treatment as everyone else. In fact, as institutional investors and major dealers know, an "order" may not necessarily become an order unless the order entrant has some idea of what execution price or prices it might receive. Particularly in the context of large orders, factors affecting the overall price an investor received, such as the degree to which its buying or selling interest would be kept confidential from other players in the market, can exert a profound influence on the overall execution price of a large block. That means the sophisticated trader is not looking solely at quoted prices in selecting a venue to present its orders. Fidelity listed some of the non-price factors it considered important:

- What are the out-of-pocket costs that a market center imposes on investors? These may include not only access or transactional fees, but also market data costs. Market centers differ in their pricing of supplemental market data, that is, market data other than best bid or offer quotes and last sale reports. Some markets charge separate fees to

19. Letter from Eric D. Roiter, Senior Vice President and Gen. Counsel, Fidelity Mgmt. & Research Co., to Jonathan Katz, Sec'y, SEC (June 22, 2004), *available at* http://www.sec.gov/rules/proposed/s71004/sdesano072204.pdf.

investors who seek to view the depth of quoted bids and offers—which, as the Commission is aware, has become much more important upon the introduction of decimalization. Even among markets who charge such market-data costs, pricing may vary significantly. From the investor's standpoint, best execution involves not only the price at which a security is bought or sold, but other costs which investors must pay to enter into and clear their trades.

- What is the liquidity and depth of any particular market center? Again, if a market center charges a fee to an investor for the "privilege" of seeing the depth of quotes away from the best bid and offer, should this market be viewed by investors as offering liquidity comparable to that of another market center that discloses the depth of its quotations for no fee or lower fees?
- What is the quality of a market center's program of self-regulation? How well does a market center monitor the trading activities of its members and how strong or consistent is its record of disciplining members who violate its trading rules?
- How fair are the market center's trading rules? Does a market center confer special privileges on some of its members that give them an advantage over public investors?
- How competitive is a market's own trading venue? For any given security, does it allow for competing market makers or does it confer a monopoly market-making privilege on a single member?
- How efficiently, quickly, and reliably does a market center confirm trades occurring in its trading venue? The advantage to an investor of being able to enter into automated trades on a given market can be undermined if confirmations of those trades are marked by delay or uncertainty.
- How quickly does a market center refresh its quoted prices after a trade occurs? This is crucial to investors seeking to effect large transactions in stages.
- How well does a market center maintain the anonymity of investors placing orders in that market?[20]

For other traders, particularly those operating algorithmic trading programs that spit out thousands of trades a day in search of minute profit opportunities thought to be available only for very short periods of time

20. *Id.*

intra-day, speed is all important. Speed is similarly important in the case of trades that involve simultaneously executing orders in a physical stock and one or more derivative instruments; there, capturing the spread is all important and the actual execution prices is less so.[21]

III. WHERE WE ARE TODAY: THE SEC ADOPTION OF REGULATION NMS

The SEC's response to these various developments, notwithstanding vigorous and well-reasoned objection, came in the form of a massive set of rules known as Regulation NMS.[22] Many of these rules were in fact old wine in new bottles, previous rules somewhat recast and renumbered. Others broke new ground, such as a prohibition on trading in sub-pennies, an access rule, and amendments to joint industry plans. The most significant and controversial of these rules was the Order Protection Rule, also known as the Trade-Through Rule.[23] The SEC apparently was not convinced that its 1996 statements about broker-dealers' duties of best execution[24] would be sufficient to cause investors to fill publicly displayed limited orders. Thus, given the likelihood that sophisticated investors would not be willing to wait in line with everyone else but would instead seek to "jump the queue" to get greater liquidity at prices somewhat inferior to the NBBO (where little liquidity now resides), the SEC pushed over the past objections of several major commenters and imposed its Trade-Through Rule.[25]

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21. *See, e.g.*, Aaron Lucchetti, *Fast Lane: Firms Seek Edge Through Speed as Computer Trading Expands*, WALL ST. J., Dec. 15, 2006, at A1.

22. *See* Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496 (June 29, 2005).

23. *See id.* at 37,501.

24. *See* Order Execution Rules, Exchange Act Release No. 37,619A**,** 61 Fed. Reg. 48,290, 48,291 (Sept. 6, 1996).

25. *See, e.g.*, Letter from Eric D. Roiter, Senior Vice President and Gen. Counsel, Fidelity Mgmt. & Research Co., to Jonathan Katz, Sec'y, SEC (Mar. 28, 2005), *available at* http://www.sec.gov/rules/proposed/s71004/edroiter032805.pdf; Letter from Thomas N. McManus, Managing Dir. and Counsel, Morgan Stanley & Co. Inc., to Jonathan Katz, Sec'y, SEC (Feb. 7, 2005), *available at* http://www.sec.gov/rules/proposed/s71004/s71004-754.pdf; Letter from Richard M. Whiting, Executive Dir. and Gen. Counsel, The Fin. Services Roundtable, to Jonathan Katz, Sec'y, SEC (Feb. 4, 2005), *available at* http://www.sec.gov/rules/proposed/s71004/fsrt020405.pdf; Letter from Jeffrey T. Brown, Senior Vice President, Charles Schwab & Co., Inc., to Jonathan Katz, Sec'y, SEC (Feb. 1, 2005), *available at* http://www.sec.gov/rules/proposed/s71004/charlesschwab020105.pdf; Letter from Stewart P. Greene, Chief Counsel, Securities Law, Teachers Insurance and Annuity Corporation of America/College Retirement Equities Fund, to Jonathan Katz, Sec'y, SEC (Jan. 16, 2005), *available at* http://www.sec.gov/rules/proposed/s71004/spgreene012705.pdf; Letter from C. Thomas Richardson, Managing Dir., U.S. Equities, Citigroup Global Markets Inc., to Jonathan Katz, Sec'y, SEC (Jan. 26, 2005), *available at* http://www.sec.gov/rules/proposed/s71004/ctrichardson012605.pdf; Letter from Kim Bang, Bloomberg L.P., to Jonathan Katz, Sec'y, SEC (Jan. 25, 2005), *available at* http://www.sec.gov/rules/proposed/s71004/kbang012505.pdf.

If it had been adopted in a form that would have protected limit orders below the NBBO—below the national best bid or above the national best offer—the Trade-Through Rule might have actually achieved its objectives. But to do so, the Commission would also have had to mandate that exchanges and other market centers publish quotations above and below the liquidity displayed at the NBBO. In such a case, a more robust Trade-Through Rule would have required the protection of published limit orders above and below the NBBO, so that a competing market center would have to protect not only the best bid or order in a competing market—that is, not trade at quoted prices inferior to it—but also not be able, having matched or filled that order, to trade through the next best prices in line.

Such a rule, had it been adopted, might have done much to invigorate the competitors of the major markets, particularly the NYSE. At the same time, however, unless block trades were exempted,[26] it might well have disrupted institutional trading and, possibly, driven institutions even more toward what are being called "dark pools of liquidity," which would have increased, rather than diminished, fragmentation (in the sense of the failure of orders to interact).[27] As it happened, though, the Commission was lobbied heavily and settled for the current rule, which might be called Trade-Through Rule Light. The current rule protects only the top of the file in a given market center, even though the liquidity represented by the top of the file—that is, the best bid or best offer—may be trivial indeed (especially now that stocks trade *in hundredths of a dollar*).

As a result, a trader—such as a block positioner—can take out a market center's best bid or offer and then trade through all that market's liquidity at inferior prices. This prevents the Trade-Through Rule from offering any substantial limit-order protection. Equally important, the rule does not have any notion of time priority and permits a market center to match rather than ship. That is, a market center does not have to forward an order to a competing market center that was the first to offer price improvement. In concrete terms, if the best bid on the NYSE is $X.05 and a bid is available at $X.07 on another venue, the NYSE can match the best bid, $X.07, and trade at that price even though the same bid had been presented in the other market center, possibly long before, the NYSE trade. Effectively, that disadvantages someone who took the risk of offering "price improvement"

26. The Intermarket Trading System Trade-Through Rule, which (by design) was largely unenforced, had a block exception that prevented it from interfering with block trading. The Regulation NMS Order Protection Rule does not contain such an exception.

27. *See, e.g.*, Aaron Lucchetti, *Shares Bought in the Dark, As Large Institutional Investors Use Anonymous Trading, Regulators and Small Investors Worry About Pricing, Disclosure*, WALL ST. J., Jan. 9, 2007, at C1; Nina Mehta, *SEC New Market Reg Chief Has Dark Pools in Focus*, TRADERS MAGAZINE, Oct. 30, 2006 (quoting Dr. Erik R. Sirri, Director of the Commission's Division of Market Regulation).

by placing a limit-order in a competing market. The party that placed the unexecuted limit-order ran the risk of adverse selection—that it would get executed only if the market was moving away from it—but was denied an execution as a reward for taking that risk.[28]

Regulation NMS did serve an important role as a catalyst. Even if it did not actually address fragmentation in any meaningful way, the limited protections that the Trade-Through Rule afforded were available only to a fast market—a market that responds electronically to incoming order flow. The NYSE floor members were the last vestige of a physical exchange floor in any major securities market in the world—other than the American Stock Exchange and options exchanges—and they would be cut out from the Trade-Through Rule's protection. That realization provided an important impetus for the NYSE to reform and introduce electronic technology.[29]

A. EXCHANGES RESPOND TO REGULATION NMS

The NYSE's response—in the form of a "hybrid" market—did a number of things. First, it provided for an expansion of a previously trivial electronic execution functionality so that it would begin operating alongside

28. Since the Regulation NMS so-called Order Protection Rule protects only the best bid and the best offer in any trading center, it would require a trading center such as the NYSE to match or fill an order at a competing "fast" trading center (e.g., Nasdaq or the Philadelphia Stock Exchange) before trading at an inferior price (lower in the case of a bid, higher in the case of an offer). Accordingly, if the NYSE specialist filled all the orders at the best quoted price shown in each other trading center, it could then trade down to prices that were inferior to the next best price or prices on those other trading centers. For example, if the best bid on the NYSE was $X.03 and the best bids were $X.07 for 200 shares on Nasdaq and $X.08 for 300 shares on Philadelphia, respectively (with there being other bids on those exchanges at prices inferior to the best prices there), the NYSE specialist could: (a) sell as many shares as it wished at $X.08 without filling the Philadelphia order (or of course the $X.07 order on Nasdaq); (b) ship an order to Philadelphia to sell 300 shares at $X.08 and then sell as many shares as it wished at $X.07 without filling Nasdaq's $X.07 order or an $X.07 order (if it then existed) on Philadelphia; or (c) ship an order to Philadelphia to sell 300 shares at $X.08, ship an order to Nasdaq to sell 200 shares at $X.07 and then sell as many shares as it wished on the NYSE at prices below $X.07 even though those sales traded through any then remaining better bids (e.g., at $X.06, $X.05, $X.04 . . .) on Philadelphia and Nasdaq. Nevertheless, in the case of (c), the NYSE specialist's best-execution obligations, if enforced, may require a different result, one that goes beyond what the Order Protection Rule would alone command.

29. Other important catalysts include the prosecutions brought against all seven NYSE specialist units for frauds, chiefly involving specialists trading for their own accounts ahead of customer orders. Some of those prosecutions involved criminal liability and substantial jail time. Those actions underscored what many had been saying for some time, that business as usual on the NYSE floor was run without reference to the requirements of the Exchange Act. *See, e.g.*, David Glovin, *Former Van der Moolen Managers Sentenced for Fraud*, BLOOMBERG.COM, Jan. 19, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arM.tGw8KByI; Edgar Ortega, *NYSE Fines Specialists $2.8 Million for Violations*, BLOOMBERG.COM, Jan. 16, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acHH79QEiMCI (reviewing history in which specialists were fined $247 million in 2004 for similar conduct).

the traditional floor. That expansion, combined with the NYSE's acquisition of a major competitor, the Archipelago Exchange (ArcaEx), provided the foundation for a new NYSE.[30] Second, the NYSE took measures to protect the NYSE floor members—principally the specialists, but also the floor brokers. There were four principal ways in which the NYSE hybrid proposal did this: (i) specialists and floor brokers were able to enter what might be called "stealth orders"—that is, orders not visible to those off the floor—which were to be given equal priority with pre-existing orders from the public; (ii) specialists were given the power to have automated matching engines match superior quotations on other venues, thus having electronic means for taking advantage of the permission in the Commission's Trade-Through Rule to match such quotations rather than provide any reward to external competitors offering price improvement; (iii) incoming market orders to buy (sell) that were matchable against several limit orders at successively higher (lower) prices were to be given a "clean up" price that gave all the limit orders the highest (lowest) price, with the result that the market order was severely disadvantaged; and (iv) specialists were given the power to halt the operation of the electronic market—applying what might be called regulatory air brakes—if certain

30. It also eliminated criticism of the NYSE's conduct by ArcaEx, which had long been skeptical about the NYSE's claim that it actually provided limit order protection. The Archipelago Exchange testified that under the then existing Intermarket Trading System Trade-Through Rule, the NYSE specialists traded through ArcaEx limit-orders hundreds of times a day without any risk of enforcement action by the NYSE:

> Empirical data shows that the NYSE trots out the trade through rule when it suits its competitive purposes, but ignores it when it does not. Here are some facts: ArcaEx runs software (aptly named "whiner") that messages alerts when exchanges trade through an ArcaEx quote in violation of the ITS plan. The whiner database reflects that ArcaEx customers suffered up to 7,500 trade-through violations in a single week by the NYSE. In fact, trade-through violations have actually risen most recently despite the glare of the regulatory spotlight on the NYSE. Since just this last . . . fall (2003), the annualized cost to investors of the NYSE specialists trading through ArcaEx's quotes has increased 3-fold from approximately $1.5 million to $5 million. On any given day, ArcaEx has a billion shares on or near the national best bid or offer. Yet on any given day, the NYSE sends only 2 million shares to ArcaEx over ITS when we have the best price.
>
> We have confronted the NYSE with our voluminous data but to no avail. If, in the NYSE's own words, the trade through rule "serves to protect investors," the NYSE has some "splaining" to do and needs to take corrective action forthwith to enforce and comply with the trade through rule in its own marketplace.

Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace: Hearing before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services, 108th Cong., 2d Sess. 6 (Feb. 20, 2004) (written statement of Gerald Dean Putnam, Chairman & Chief Operating Officer, Archipelago Holdings, L.L.C.), *available at* http://financialservices.house.gov/media/pdf/022004gp.pdf.

price parameters were triggered—the so-called "Liquidity Replenishment Points" (a term possibly suggestive of kegs dotted around the NYSE floor to which thirsty members, beer mugs in hand, could repair).[31]

Notwithstanding these developments and the NYSE's efforts to maintain a grip on the order flow in NYSE-listed securities, the NYSE's share of that order flow began to decline precipitously during the time the SEC was considering Regulation NMS, from a high of about 80% to just under 70%.[32] Member firms, in turn, began to reduce the number of their employees on the NYSE floor.[33] This effect seems to have resulted largely in greater competition from Nasdaq, whose registration as a national securities exchange had finally been approved by the SEC.[34] It certainly did not result from the effectiveness of Regulation NMS, which even today is still unfolding. In any event, the NYSE has thus far been unable to reverse that trend. It may be that the gradual conversion of the market to electronic media from what had been the last vestige of a floor-based system among

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31. These various special advantages, which were soundly criticized to no avail by several commenters, preserved many of the time-and-place advantages the floor had previously enjoyed, at the expense of public investors, and they may have substantially reduced the likelihood that other markets would be able to offer meaningful competition to the NYSE specialists. *See, e.g.*, Letter from Ari Burstein, Assoc. Counsel, Inv. Co. Inst., to Jonathan Katz, Sec'y, SEC (July 20, 2005), *available at* http://www.sec.gov/rules/sro/nyse/nyse200405/aburstein072005.pdf; Letter from Kim Bang, President and CEO, Bloomberg Tradebook LLC, to Jonathan Katz, Sec'y, SEC (Sept. 22, 2004), *available at* http://www.sec.gov/rules/sro/nyse/nyse200405/kbang092204.pdf; Letter from Eric D. Roiter, Senior Vice President and Gen. Counsel, Fidelity Investments, to Jonathan Katz, Sec'y, SEC (Oct. 26, 2004), *available at* http://www.sec.gov/rules/proposed/s71004/fidelity102504.pdf (giving trading examples that demonstrated graphically the unfairness of the NYSE rules).

32. *See* Roger Aitken, *Technology Equity Markets—Big Players Set To Flex Their Muscles*, Sept. 1, 2006; *see also* Historical NYSE Group Monthly Volume, *available at* http://www.nyse.com/financials/1143717022567.html (last visited Mar. 31, 2007).

33. *See, e.g.*, Aaron Lucchetti, *The NYSE: Faster (and Lonelier)*, WALL ST. J., Jan. 24, 2007, at C1.

> For some traders left working on the floor of the New York Stock Exchange, it appears the Big Board has dimmed the lights. The exchange, a unit of NYSE Group Inc., is scheduled to finish today its long push to have its 3,618 securities traded almost exclusively electronically, a move that is translating into speedy service for investors. But for the employees on the NYSE's iconic trading floor it means fewer jobs and the biggest change to the way the Big Board has traded stocks in its 214-year history.
>
> Every day more of the human brokers disappear. Big brokerage firms like Lehman Brothers Holdings Inc. and J.P. Morgan Chase & Co. have let go some floor brokers in recent weeks, between five and 10 people each. Merrill Lynch & Co. has discussed with its brokers the possibility of transferring off the exchange.

Id.

34. *See* David Gaffen & Scott Patterson, *Yours is Mine and Mine Yours*, WALL ST. J., Feb. 20, 2007, at C6; In the Matter of the Application of the Nasdaq Stock Market, Exchange Act Release No. 66,572, 71 Fed. Reg. 3550 (Jan. 23, 2006).

equity exchanges has finally broken the NYSE's ability to use its regulatory powers to defeat competition. Of course, only time will tell whether that is the case.

IV. THE FUTURE: THE MARKET DATA DEBATE

Accompanying the market structure developments reflected in the debate over fragmentation and the Commission's adoption of Regulation NMS has been considerable focus on the increasingly large revenues the exchange markets have extracted from market professionals and from investors by selling their market data in the form of quotations and last-sale data.[35] The exchanges are required under Regulation NMS to make public the best bid and offer, and the last sale trade, on a continuous basis.[36] Regulation NMS does not require them to make depth-of-market quotations available, but several of the exchanges have been developing depth-of-market products for sale to the public, at prices that have begun to stir up vigorous opposition, as discussed below.

A. LEGISLATIVE REQUIREMENTS

In fashioning the Securities Acts Amendments of 1975, which added the national market system provisions in section 11A of the Exchange Act, the Congress was alert to the risk that exchanges, as government-protected monopolies, could exert monopoly power over market data. It warned that the exchanges—if allowed to continue to have monopoly powers—should be regulated as public utilities:

> The [Senate Banking] Committee believes that if economics and sound regulation dictate the establishment of an exclusive central processor for the composite tape or any other element of the national market system, *provision must be made to insure that this central processor is not under the control or domination of any particular market center. Any exclusive processor is, in effect, a public utility, and thus it must function in a manner which is absolutely neutral with respect to all market centers, all market makers, and all private firms*. Although the existence of a monopolistic processing facility does not necessarily raise antitrust problems, serious antitrust questions would be posed if access to this facility and its services were not available on reasonable and nondiscriminatory terms to all in the trade or if its charges were not reasonable. Therefore, in order to foster efficient market development and

35. *See generally* Letter from Michael Atkin, Vice President, Fin. Info. Serv. Div. (FISD), Software & Info. Indus. Ass'n (SIIA), to Joel Seligman, Advisory Comm. on Mkt. Info., SEC (Apr. 2, 2001), *available at* http://www.fisd.net/mdregulation/sec_040201.asp (detailing the issues and considerations in the market data debate).

36. 17 C.F.R. § 242.603(b) (2007).

> operation and to provide a first line of defense against anti-competitive practices, Sections 11A(b) and (c)(1) would grant the SEC broad powers over any exclusive processor and impose on that agency a responsibility to assure the processor's neutrality and the reasonableness of its charges in practice as well as in concept.[37]

B. COMMISSION RESPONSE

The Commission's response to that severe admonition has been instructive. The Commission's oversight of exchange fees, including market data fees, is accomplished through its power to review and either approve or disapprove exchange rules. Exchange Act section 19(b) requires the exchanges to file as proposed rule changes any rules setting fees, as well as any other rules granting or limiting access to exchange facilities.[38] Exchange rules setting dues, fees, and other charges can become effective upon filing with the SEC.[39] However, the Commission traditionally expects the exchanges to file fee rules for ordinary course notice and public comment before taking effect if the fees are payable by anyone other than members of the exchange.[40] The Commission is required, with respect to fee rules, to determine whether the rates are "fair and reasonable" and "not unreasonably discriminatory" and whether the exchanges' rules provide for the "equitable allocation of reasonable . . . fees . . . among its members and issuers and other persons using its facilities.[41]

For many years, the Commission's oversight of exchange market data fees was benign and not vigorous. In a Concept Release issued in 1999, the Commission discussed the legal standards applicable to its review of such fees:

> Terms such as 'fair,' 'reasonable,' and 'equitable' often need standards to guide their application in practice. One standard commonly used to evaluate the fairness and reasonableness of fees, particularly those of a monopolistic provider of a service, is the amount of costs incurred to provide the service. Some type of cost-based standard is necessary in the monopoly context because, on the one hand, it precludes the excessive

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37. S. REP. NO. 94-75, at 11–12 (1975) (emphasis added).

38. *See* Exchange Act Rule 19b-4, 17 C.F.R. § 240.19b-4 (2006). The Commission's power to review exchange rules extends to regulatory provisions having to do with access to exchange facilities regardless of whether the provision is called a rule or is, for example, embedded in a contract the exchange requires those accessing its facilities to sign. *See* In the Matter of Bloomberg L.P., Exchange Act Release No. 49,076, 2004 SEC LEXIS 79 (Jan. 14, 2004).

39. Exchange Act § 19(b)(3)(A)(ii), 15 U.S.C. § 78s(b)(3)(A)(ii) (2000).

40. *See* Annual Filing of Amendments to Registration Statements of National Securities Exchanges, Securities Associations, and Reports and the Municipal Securities Rulemaking Board, Exchange Act Release No. 35,123, 59 Fed. Reg. 66,692, 66,697 (Dec. 28, 1994).

41. *See* Exchange Act § 6(b)(4), 15 U.S.C.§ 78f(4) (2000); Exchange Act § 11A(c)(1)(C)(D), 15 U.S.C. § 78k-1(c)(1)(C)(D) (2000); *see also* 17 C.F.R. § 242.603(a)(2) (3) (2007).

> profits that would result if revenues were allowed to far outstrip costs, and, on the other hand, it precludes underfunding of a service if the revenues were held far below costs (or subsidization of the service by other sources of revenues).[42]

At the same time, the Commission admitted that its approach had been basically limited to seeing whether anyone objected to fees and, if not, allowing them. "In this context, the Commission has relied to a great extent on the ability of the SROs and Plans to negotiate fees that are acceptable to SRO members, information vendors, investors, and other interested parties."[43] The Commission began using this approach of regulating fees shortly after the 1975 Amendments were enacted.[44]

The Commission did not change course or develop new approaches in light of the comment on its Concept Release, much of which was directed at SRO fees. It suggested that the fees should relate to costs, and that the only allowable costs should be the costs of "collecting, consolidating, and distributing the data."[45] The Commission subsequently published a Market Data Advisory Committee Report[46] whose majority recommendations were largely consistent with those of the exchange representatives on the Committee who wrote the report; it resulted in a strong dissent by others who had different views. Then, in a concept release issued in 2004 on the regulation and governance of exchanges and other self-regulatory organizations, the SEC reminded itself that it would be necessary to return to the subject of market data fees.[47]

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42. Regulation of Market Information Fees and Revenues, Exchange Act Release No. 42,208, 64 Fed. Reg. 70, 613, 70,619 (Dec. 17, 1999).

43. *Id.* at 70,622. This might be analogized to a local zoning board that approves applications for variances, finding them to be justified to relieve "undue hardships," on the basis that the neighbors did not object. Today, as noted below, in the Commission's case, even when objections are raised by the neighbors, they do not seem to matter.

44. *Id.*

45. *See, e.g.*, Letter from Eric D. Roiter, Fidelity Invs., to Jonathan Katz, Sec'y, SEC (Apr. 25, 2000), *available at* http://www.sec.gov/rules/concept/s72899/roiter1.htm; Letter from W. Hardy Callcott, Senior Vice President and Gen. Counsel, Charles Schwab & Co., Inc., to Jonathan Katz, Sec'y, SEC (July 10, 2000), *available at* http://www.sec.gov/rules/concept/s72899/callcot1.htm; Letter from Marc E. Lackritz, President, Sec. Indus. Ass'n, to Jonathan Katz, Sec'y, SEC (Apr. 11, 2000), *available at* http://www.sec.gov/rules/concept/s72899/lackrit1.htm. (Following its merger with The Bond Market Association, the Securities Industry Association is known as the Securities Industry and Financial Markets Association.) *See also* Letter from Lou Eccleston, Bloomberg L.P., to SEC (Apr. 11, 2000), *available at* http://www.sec.gov/rules/concept/s72899/ecclest1.htm.

46. *See* Letter from Joel Seligman, Dean and Ethan A.H. Shepley University Professor, Washington University School of Law, to SEC, Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (Sept. 14, 2001), *available at* http://www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm.

47. Concept Release on Self-Regulation, Exchange Act Release No. 50,700 (Nov. 18, 2004).

C. CHANGES IN THE EXCHANGES' COMPOSITION

No discussion of this topic would be complete without a reference to the economic climate affecting the operation of exchange markets and their governance. The economics of exchanges were changing rapidly and dramatically. During Arthur Levitt's tenure as Commission Chairman (1993–2001),[48] the Commission pressured the exchanges to reconstitute their boards of directors to dramatically reduce the representation of exchange members.[49] Soon thereafter, the major exchanges converted from being cooperative not-for-profit organizations into for-profit organizations with publicly traded securities. That gave them the usual private sector incentives to use their powers to maximize their revenues, crush their competitors, and increase their share prices. They swiftly bought up their largest competitors—INET and BRUT, in the case of Nasdaq, and the ARCA Exchange, in the case of the NYSE—and, proposing to use their now public stock as an acquisition currency, set out to acquire exchanges in Europe and elsewhere.[50]

While the change in the constitution of exchanges was accompanied by dramatic increases in their market power, it was not accompanied by any change in the Exchange Act standards applicable to them. By law, they continue to be subject to a statutory regime that never contemplated that they would be publicly owned, for-profit companies. The monopoly powers they continue to enjoy give them increasing incentives to branch out into adjacent markets, such as value-added products, using the market data to which they enjoy monopoly access. In addition they can charge whatever the traffic will bear, effectively monopoly rents, for market data.[51] By

48. *See* SEC Biography: Chairman Arthur Levitt, http://www.sec.gov/about/commissioner/levitt.htm (last visited Mar. 30, 2007).

49. Paula Dwyer, *Arthur Levitt's Hardball at the SEC*, BUS. WK., Sept. 29, 1997, at 50, *available at* http://www.businessweek.com/@@U@zn52YQG27gWQYA/1997/39/b3546087.htm. Notably, the NYSE did not change the structure of its board until 2003, after Chairman Levitt was gone. *See, e.g.*, *NYSE Board Members to Resign From Other Boards*, FORBES.COM, June 5, 2003, http://www.forbes.com/newswire/2003/06/05/rtr992168.html; Stephen Labaton, *Big Board Overhaul Plan Faulted*, N.Y. TIMES, Nov. 21, 2003, at C1.

50. *See* Aaron Lucchetti & Alistair McDonald, *Euronext Holders Approve Deal for Historic Merger with NYSE*, WALL ST. J., Dec. 20, 2006, at C3; Aaron Lucchetti & Eric Bellman, *NYSE Extends Reach to India*, WALL ST. J., Jan. 11, 2007, at C3; Gaston F. Ceron, *NYSE and Tokyo Tie a Knot*, WALL ST. J., Feb. 1, 2007, at C2; Edward Taylor & Alistair McDonald, *Exchanges Step Up Chase for Foreign Mates*, WALL ST. J., Jan. 19, 2007, at C5; Alistair McDonald, *Nasdaq Fails in Hostile Takeover Bid for London Stock Exchange*, WALL ST. J. ONLINE, Feb. 11, 2007.

51. Petition for Commission Review from Markham C. Erickson, Executive Dir. and Gen. Counsel, NetCoalition.com, to SEC, Regarding Exchange Act Release No. 54,597, at 14 (Nov. 14, 2006), *available at* http://www.netcoalition.com/vertical/Sites/%7BF1D948CC-5797-482E-B502-743C873E2848%7D/uploads/%7B2DE79A1C-7CFE-4DD8-BE12-EAEF3CE234C6%7D.PDF [hereinafter NetCoalition.com Petition]; Letter from Sanjiv Gupta, Bloomberg L.P., to Nancy

federalizing a duty of best execution, the Commission deprived exchange members and their fiduciary customers of the ability to control market data prices. They were ill-equipped to decline to buy the market data the exchanges sell at ever increasing prices, along with their value-added products. In particular, when offered data products by the exchanges that regulate them, many broker-dealers decide it is prudent to buy "protection" from their regulators.[52] The Commission's Market Data Study concluded that the Commission should not require exchanges to publish depth-of-book data; the exchanges interpreted this as license to sell the data for whatever they could get.[53]

Morris, Sec'y, SEC (Jan. 17, 2007), *available at* http://www.sec.gov/comments/34-55011/3455011-5.pdf.

52. Securities Industry and Financial Markets Association made this point forcefully in a comment letter in response to a recent petition by NetCoalition, discussed post, concerning staff approval of market data fees:

> [T]he Commission has been placing increasing emphasis on the duty of best execution. Regulation NMS itself was designed, in large part, to support the duty of best execution. The Commission and the SROs have conducted repeated examination sweeps of broker-dealers' execution quality committees, to assure that those committees are adequately considering the execution quality data required by former Rule 11Ac1-5 (now Regulation NMS Rule 605). Similar examination sweeps have sought to assure that broker-dealers' order routing information, required by former Rule 11Ac1-6 (now Regulation NMS Rule 606) also is accurate. Still other widely publicized examination sweeps and enforcement investigations have reviewed very particularized elements of broker-dealers' order-routing practices, for example why some broker-dealers did not make use of a particular market's "opening cross" methodology. . . . As a result of these trends, broker-dealers and other securities market participants have become convinced that it is prudent to buy any number of single-exchange "depth-of-book" market data products that arguably could assist them in meeting their best execution obligations. . . .When the major SROs tell their member firms that a particular market data product facilitates better executions, those member firms understandably feel pressure to buy that market data product, regardless of their own evaluation of the merits of that product. As a result of these trends, many broker-dealers and other market participants have come to the conclusion that it is prudent to purchase and evaluate single-market "depth-of-book" market data, at least from the major markets, so there can be no doubt they have met their duty of best execution.

Letter from Ira Hammerman, Senior Managing Dir. and Gen. Counsel, Sec. Ind. and Fin. Mkts. Ass'n, to Nancy Morris, Sec'y, SEC, Regarding In the Matter of NetCoalition, File No. SR-NYSE Arca-2006-21, at 14 (Jan. 17, 2007), *available at* http://www.sec.gov/comments/34-55011/3455011-6.pdf [hereinafter Hammerman January 17, 2007 Letter].

53. *See, e.g.*, Letter from Exchange Market Data Coalition (The American Stock Exchange, The Boston Stock Exchange, The Chicago Board Options Exchange, The Chicago Stock Exchange, The International Securities Exchange, The NASDAQ Stock Market, The New York Stock Exchange, The NYSE/Arca Exchange, and The Philadelphia Stock Exchange), to Nancy Morris, Sec'y, SEC 5–6 (Jan. 26, 2007), *available at* http://www.sec.gov/comments/34-55011/3455011-9.pdf.

D. NEW BUSINESS MOTIVATIONS OF THE EXCHANGES

The SEC Division of Market Regulation, meanwhile, continued to process exchange market data fee filings and to approve them by delegated authority,[54] regardless of the change in economic circumstances or other considerations bearing on the fairness and reasonableness of rates.[55] The Commission was not wholly unaware of the conflicts between regulatory power and the commercial impulses that the newly for-profit exchanges were beginning to exhibit. For example, the SEC did tell Nasdaq, in the order granting Nasdaq's registration as a national securities exchange, that it could not lawfully use OATS data (regulatory data gathered from Nasdaq members) for commercial (i.e., non-regulatory) purposes. Further, the SEC defined clear and unambiguous boundaries to what it would constitute commercial use of OATS data:

> Nasdaq responded to commenters' concerns [that Nasdaq should not be permitted to use OATS data for non-regulatory purposes] by reaffirming its commitment not to use OATS data for commercial purposes. Nasdaq, however, believes that its use of OATS data by Nasdaq's Department of Economic Research to study public policy issues, such as sub-penny trading and decimalization, does not constitute commercial use of the data. The Commission believes that any non-regulatory use of the data would have a commercial benefit.[56]

Gentle reminders were not enough. Notwithstanding the Commission's admonition, Nasdaq soon thereafter filed for immediate effectiveness a package of rule changes and told the Commission the rules were "non-controversial."[57] However, the rules contravened what the Commission had

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54. The Commission has delegated to its Division of Market Regulation the SEC's authority under Exchange Act section 19(b) to approve SRO rules. *See* 17 C.F.R. § 200.30-3(a)(12) (2007). Exchange Act section 4A delineates the Commission's power to delegate functions to its staff. That power does not extend to adopting SEC rules, but exchange rules are approved by order, not by rule. Nonetheless, NetCoalition has raised questions whether in fact the staff's issuance of "long orders, disputing public comment and reaching policy judgments, such as those at issue here, that have not been blessed by the Commissioners themselves" is consistent with the staff's delegated powers. Letter from Markham C. Erickson, Executive Dir. and Gen. Counsel, NetCoalition.com, to Nancy Morris, Sec'y, SEC 11 (Mar. 6, 2007), *available at* http://www.sec.gov/comments/34-55011/3455011-16.pdf.

55. *See* NetCoalition.com Petition, *supra* note 51.

56. In the Matter of the Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550, 3558 n.133 (Jan. 13, 2006) (noting the approval of Nasdaq exchange registration).

57. Pursuant to paragraph (f)(6) of Rule 19b-4, added in 1994, an exchange may file a rule change for immediate effectiveness if the rule "[d]oes not significantly affect the protection of investors or the public interest" and "[d]oes not impose any significant burden on competition." 17 C.F.R. § 240.19b-4(f)(6)(i), (ii) (2006).

told the Nasdaq that it should not do, thereby effectively flouting the Commission's express directive. The Nasdaq rules include OATS data as well as a proposed analytics package that includes share data not visible in its existing quotation and order data feeds or in its quotation montage.[58]

Public criticism of that filing was swift and fierce,[59] but the 60-day period for summary abrogation[60] was allowed to expire without the Commission acting to curb Nasdaq's rules. The Commission neither effectively prevented Nasdaq from using its regulatory muscle to nourish its commercial ventures nor punished Nasdaq for flouting the Commission's policy.

V. NETCOALITION.COM'S PETITION: CHALLENGING THE OLD ORDER

Not long thereafter push came to shove, but not directly from the Commission. NYSE Arca, following in Nasdaq's footsteps, filed a package of rule changes establishing fees for value-added data to which there was equal, if not more powerful, objection.[61] The Division of Market Regulation approved those rules.[62] The prospect of the NYSE, as the dominant securities exchange, commercializing regulatory data that Arca had previously provided without charge led to a most unusual step by the industry. NetCoalition.com, a trade group whose trustees include CNET Networks, Bloomberg L.P., Google, IAC/Interactive Corp. and Yahoo!, filed a petition under a little-used provision of the Commission's Rules of Practice—Rule

58. *See* Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 To Establish a Package of Real-Time and Near-Real-Time Data Products Called the Market Analytics Data Package, Exchange Act Release No. 54,003, 71 Fed. Reg. 36,141 (June 16, 2006).

59. *See* Letter from Gregory Babyak, Chairman, Mkt. Data Subcomm. of the SIA Tech. and Regulation Comm. & Christopher Gilkerson, Chairman, SIA Tech. and Regulation Comm., to Nancy Morris, Sec'y, SEC (July 14, 2006), *available at* http://www.sec.gov/comments/sr-nasd-2006-056/nasd2006056-2.pdf; Letter from Markham C. Erickson, Executive Dir. and Gen. Counsel, NetCoalition.com, to Christopher Cox, Chairman, SEC (Aug. 9, 2006), *available at* http://www.sec.gov/comments/sr-nasd-2006-056/mcerickson080906.pdf; Letter from Bruce Garland, Bloomberg L.P., to Nancy Morris, Sec'y, SEC (July 14, 2006), *available at* http://www.sec.gov/comments/sr-nasd-2006-056/nasd2006056-1.pdf; Letter from Sanjiv Gupta, Bloomberg L.P., to Nancy Morris, Sec'y, SEC (Aug. 22, 2006), *available at* http://www.sec.gov/comments/sr-nasd-2006-056/nasd2006056-4.pdf.

60. The second sentence of Exchange Act § 19(b)(3)(C), 15 U.S.C. § 78s(b)(3)(C) (2000), allows the Commission sixty days from the date of filing to abrogate summarily any exchange rule that became effective upon filing.

61. Notice of Filing of Proposed Rule Change Relating to Approval of Market Data Fees for NYSE Arca Data, Exchange Act Release No. 53,952, 71 Fed. Reg. 33,496 (June 9, 2006).

62. *See* Order Approving Proposed Rule Change Relating to NYSE Arca Data, Exchange Act Release No. 54,597, 71 Fed. Reg. 62,029 (Oct. 20, 2006) (approving the rule on October 12, 2006).

430[63]—asking the Commission to review and set aside the staff's action in approving NYSE Arca's rules.[64] NetCoalition argued basically five things:

1. NYSE Arca's fees are excessive and put access to NYSE Arca data, which had been free before Arca's merger with the NYSE, well beyond the reasonable economic reach of advertiser-sponsored media such as the Internet websites sponsored by NetCoalition's trustee Internet Service Providers (ISPs).
2. NYSE Arca's fees are not "fair and reasonable" and the Commission cannot so conclude in the absence of any data as to the cost of collecting, consolidating and distributing those data.
3. NYSE Arca failed to comply with the Commission's own Form 19b-4 since it did not discuss or give any justification for burdens on competition its fees would impose.
4. NYSE Arca is making anticompetitive and inappropriate use of its monopoly powers to enter and control downstream markets, such as the market for data analytics and other value-added products and services.
5. NYSE Arca is making inappropriate use of regulatory data to which it has exclusive access to foster the development of commercial products.

The SEC staff recommended to the Commission that the petition to review the staff action be granted—possibly, one might surmise, because a conclusion had been reached that the record on appeal would be rather weak unless the Commission granted the petition and gave further consideration to the issues at hand.[65] In any event, the Commission granted the petition unanimously at the end of 2006 and opened up a 21-day comment period, running, not as usual from the Federal Register publication of the order, but from the date of the order itself, which was issued during the Christmas holiday.[66]

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63. 17 C.F.R. § 201.430 (2004).

64. NetCoalition.com Petition, *supra* note 51. Under SEC Rule of Practice 431(e), 17 C.F.R. § 201.431(e) (2004), the filing of such a petition automatically stays the effectiveness of the challenged staff action. *See* Alan Sipress, *Internet Firms Seek Rollback of Quote Fees: Coalition to Ask SEC to Reconsider Charges for Posting Real-Time Stock Prices*, WASH. POST, Nov. 14, 2006, at D5; Jed Horowitz, *Internet Forms Seek SEC Review of Stock Exchanges' Data Fees*, WALL ST. J., Nov. 14, 2006, at C4.

65. Exchange Act § 25(a)(1), 15 U.S.C. § 78y(a)(1) (2000), provides for a direct appeal to the United States Court of Appeals of SEC final orders.

66. In the Matter of NetCoalition, Exchange Act Release No. 55,011, 2006 SEC LEXIS 3016 (Dec. 27, 2006) (order granting petition and scheduling filing of statements).

The public reaction has been substantial.[67] SIFMA strongly supported the NetCoalition petition and urged the Commission to reverse the staff decision on the grounds urged by NetCoalition and also to impose a moratorium on future exchange market data rule filings:

> The price of market data has a direct impact on its availability and on who can access it. In order for an exchange to justify a market data rule proposal as "fair and reasonable," "not unreasonably discriminatory" and representing "an equitable allocation of costs" as required by the Exchange Act, the Commission should require the exchanges to submit information regarding the exchange's cost to collect, consolidate and distribute that market data. The Commission should make it clear that the exchanges may take into account only their legitimate costs in producing the market data that they control. However, exchanges may not use their control to charge unfair or unreasonable fees for the market data at a level that would enable them to cross-subsidize their competitive operations.[68]

One significant point SIFMA made was that NYSE Arca and other exchanges are beginning to develop, even for the publicly mandated Best Bid and Offer data, streaming technology that operates markedly faster than the public utility data stream offered by Securities Industry Automation Corporation and thus will truly promote a two-tiered market in which "smart" investors—hedge funds and others—will have an inside track that will leave the average investor in the dust, an inside track resulting in part from the Commission's own emphasis on "best execution":

> [T]he process through which the SIPs consolidate quotes from different markets takes a certain amount of time (especially since the exchange administrators of the SIPs have little if any financial incentive to invest money to modernize their operations). As a result, some markets—including (as relevant in this petition) the NYSE and NYSE Arca—now advertise that their unconsolidated market data products are faster than the consolidated market data feeds. These markets (again, including the NYSE) also advertise that their market data products therefore offer better order execution opportunities than the consolidated market data feeds.[69]

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67. *See* SEC, Comments on Order Granting Petition for Review and Scheduling Filing of Statements (Exchange Act Release No. 55,011), *available at* http://www.sec.gov/comments/34-55011/3455011.shtml (last visited Mar. 27, 2007).

68. Hammerman January 17, 2007 Letter, *supra* note 52.

69. *Id.* at 13–14. SIFMA quoted NYSE Arca's promotional materials, which emphasized that the new data feed would be on a fast track 60 times faster than the slow-track data made generally available to the public and would provide six times the liquidity.

> The ArcaBook data feed provides real time, depth of book limit order information for NYSE Arca and ArcaEdge (OTCBB). By receiving the information directly from the source, ArcaBook clients are able to receive order information *approximately 60 times*

SIFMA also advised the Commission that it should address the risk that the exchanges would leverage their positions as government-sponsored monopolies to enter and dominate competition in adjacent markets, namely, the markets for value-added data products:

> The Commission should explore structural alternatives that would introduce competition in value added market data products as a supplement to, or even substitute for, cost-based regulation. The exchanges compete today for listings, investment products, and services they provide to traders and other users of an exchange. The Commission should encourage a structure in which they can compete also in the area of market data products. Today, however, they use exclusive control over basic market data (facts about orders and quotes submitted by broker-dealers) to package simple consolidation as a "product" for which they charge a fee unconstrained by market forces. A structural alternative for a new market data framework could include requiring each exchange to place market data operations in a separate subsidiary, and requiring each exchange to sell raw market data on the same terms to third parties as it does to its own subsidiary.[70]

The advantages enjoyed by exchanges in setting their fees amounted, according to several commenters, to a complete absence of any external control, from the Commission, from market forces or anywhere else. The Financial Services Roundtable observed:

> The most significant deterioration in market data price controls . . . has been the change in ownership structure at the exchanges. Rather than continuing as member-owned, not for-profit enterprises, nearly all U.S. exchanges have migrated to shareholder-owned, for profit corporations. Exchange management owes its fiduciary duties to the shareholders of the corporation and those duties include maximizing the revenue generated by market data fees. Brokers and users of the exchanges, while often owning shares in the exchange corporations, are far less capable of constraining the fee levels. This is particularly true of market data fees because exchanges retain government-sponsored control over the sale of market data. Exchange transaction fees are subject to competitive pressures among the competing markets. However, market data is consolidated

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> *faster than they can through the securities information processor (SIP)* and see 6 times the liquidity within five cents of the inside quote that is offered by the market inside.

NYSE ARCA, ARCABOOK—FEE TRANSITION FACT SHEET, *quoted in id.* at 14 n.24 (emphasis added).

70. Hammerman January 17, 2007 Letter, *supra* note 52, at 8–9.

among the exchanges prior to sale and the exchanges share in the proceeds. No mechanism for competition exists for this product.[71]

VI. SIGNIFICANCE OF MARKET DATA TO EXCHANGES AND TO THE PUBLIC

Why is all of this important? Market data have often been called the "oxygen" of the markets. The Congress emphasized in 1975 that if exchanges were allowed to become or remain the sole source of market data, they should be subject to strict regulatory control to curb burdens on competition and to ensure the fairness and reasonableness of pricing. In the more than thirty years since then, the exchanges have been allowed to justify their fees not on the basis of the costs of collecting, consolidating, and distributing the data, which are probably relatively trivial—SIFMA has calculated on the basis of the Commission's own numbers that the exchanges extract a 1,000 percent mark-up over those costs[72]—but on the basis of comparing their fees against market data fees charged by other exchanges, which some commenters have suggested amounts to comparing one monopoly rent against another.[73] From time to time, the exchanges have adverted the notion that they have property rights in the data originating on their facilities, a proposition NetCoalition disputes vigorously in its petition, citing *Feist v. Rural Service Telephone Company, Inc.*[74] and the NYSE's unsuccessful efforts to get the Congress to adopt legislation overturning the case law.[75]

To the exchanges themselves, revenues from market data are a substantial portion of their overall revenues. In fact, the Commission acknowledged that market data fees were a substantial part of the overall revenues of the exchanges. In its 1999 Concept Release on Regulation of Market Information Fees and Revenues, the Commission reported that for 1998 the NYSE had received $111.5 million from the sale of market information, 15.3% of its total 1998 revenues of $728.7 million, while the NASD in that year had received $152.3 million from the sale of market

71. Letter from Richard M. Whiting, Executive Dir. and Gen. Counsel, The Fin. Services Roundtable, to Nancy Morris, Sec'y, SEC (Jan. 17, 2007), *available at* http://www.sec.gov/comments/34-55011/3455011-7.pdf [hereinafter Whiting January 17, 2007 Letter].

72. Hammerman January 17, 2007 Letter, *supra* note 52, at 3.

73. *See* Letter by Gregory Babyak, Chairman, Market Data Subcomm. of the SIA Tech. and Reg Comm., to Nancy Morris, Sec'y, SEC (Aug. 18, 2006), *available at* http://www.sec.gov/comments/sr-nysearca-2006-21/gbabyak5693.pdf.

74. Feist Publications, Inc. v. Rural Tel. Serv. Co. Inc., 499 U.S. 340, 359–60 (1991).

75. NetCoalition.com Petition, *supra* note 51, at 17.

information, 21.7% of its total 1998 revenues of $699.8 million.[76] The NYSE Group's Annual Report on Form 10-K for 2005 reported that, for that year, the NYSE received $178.2 million from the sale of market information, 15.9% of its total 2005 revenues (net of section 31 fees) of $1,123.1 million. Nasdaq does not disclose the components in its Annual Report on Form 10-K for 2005 the components of a revenue category it calls "market services,"[77] but reported that, for the third quarter of 2006 ended September 30 of that year, Nasdaq received $38.6 million from the sale of "market services subscriptions," 22.5% of its total 2005 net revenues of $171.2 million.[78] These numbers show that market data fees account for a significant portion of these two exchanges' revenues, which affects their market capitalization and thus the value of their stock, including its value as an acquisition currency.

The exchanges certainly need revenues for public purposes such as market regulation, but traditionally there has been no effort to demonstrate how the market data revenues serve that purpose. SIFMA has asserted that market data fees should not go to pay those costs and that SIFMA's members would be willing to be charged separately for the costs of exchange regulation.[79] The absence of any real control on those costs, and the compulsion the Commission itself imposed on broker-dealers and investment managers to seek out "best execution" possibilities have removed, as the commenters suggested, any semblance of market discipline or market forces controlling such costs.[80] The congressional admonition in the 1975 Amendments to impose utility-type regulation on the exchanges to curb their abuses of monopoly powers—at a time when they remained cooperative, not-for-profit entities—seems not to have borne fruit.

The NetCoalition petition to the SEC Commissioners is an effort not only to prevent the creation of the two-tiered market structure, but also to prevent the exchanges from dominating both the securities and adjunct value-added data markets through the use of their privileged, monopoly access to market data. That the Commission granted the NetCoalition

76. Regulation of Market Information Fees and Revenues, Exchange Act Release No. 42,208, 64 Fed. Reg. 70,613, 70,625 (Dec. 17, 1999); *see also* Concept Release Concerning Self Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256, 71,270 (Dec. 8, 2004).

77. *See* Nasdaq, Inc., Annual Report (Form 10-K), at F-4 (Mar. 8, 2006), *available at* http://www.sec.gov/Archives/edgar/data/1120193/000119312506054916/d10k.htm.

78. *See* News Release, Nasdaq Stock Exch., Nasdaq Announces Third Quarter 2006 Results (Oct. 19, 2006), *available at* http://www.nasdaq.com/newsroom/news/pr2006/ne_section06_120.stm; *see also* News Release, Nasdaq Stock Exch., Nasdaq Third Quarter 2006 Financial Statements (Sept. 30, 2006), *available at* http://www.nasdaq.com/newsroom/documents/NDAQ_3Q06_Financial_Statments.pdf.

79. Hammerman January 17, 2007 Letter, *supra* note 52, at 21.

80. *See, e.g.*, *id.* at 12–14, 23–24; Whiting January 17, 2007 Letter, *supra* note 71.

petition was certainly an unusual event. The SEC is not in the habit of granting petitions to review staff action taken by delegated authority. Indeed, there have been no other significant instances in which such a petition has been granted.[81] The issues involved, and the fact that the securities industry—represented by SIFMA—and several of the major Internet web operators—represented by NetCoalition—have lined up against the SEC staff and urged the Commission to reverse its staff, is certainly a first. The Commission has a real opportunity in this instance to deal with these important issues and to provide leadership to the markets, and to its staff.[82]

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81. Letter from Markham C. Erickson, Executive Dir. and Gen. Counsel, NetCoalition.com, to Nancy Morris, Sec'y, SEC 1 (Jan. 17, 2007), *available at* http://www.sec.gov/comments/34-55011/3455011-2.pdf.

> It is our understanding that the Commission has rarely—if ever—approved such a petition for review. We believe this step underscores the Commission's appreciation of the critical importance to the investing public of addressing the issues raised in the NetCoalition petition.

Id.

82. The American Bar Association's Committee on Federal Regulation of Securities, in a comment letter on the NetCoalition petition, emphasized the importance of the issues facing the Commission:

> With this trend away from self governance, exchange members are afforded less of an opportunity to act as a check on SRO rules, including those relating to market data fees, to ensure that they are designed
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> > to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers or dealers.
>
> In recent years, greater pressure has been placed on this analysis as SROs have transformed themselves to compete with their broker-dealer members for market share and trading volume. Thus, although SROs remain largely the exclusive purveyors of market information for their associated exchanges, they are no longer necessarily neutral public utilities for the mutual benefit of their respective members. This necessarily bears on the Commission's view of SRO rulemaking, particularly in the context of rules imposing fees on exchange members and on public investors, as is the case here.
>
> Steps have been taken to allay concerns about potential conflicts-of-interest associated with the role of member firms in the governance of particular SROs. The Committee believes, however, that action is also needed to address other potential conflicts, such as the ability of exchanges to use their position as exclusive purveyors of market data to disadvantage the investing public as well as their members with whom they compete. The Committee urges the Commission to tackle comprehensively the issues of SRO governance and funding, including the associated issue of market data fees.

The policy issues involved are complex, but the fundamental question is whether the Commission will reject the approval of fees on the basis of comparing one monopoly rent to another and call the exchanges to task for using their market power to muscle their way into, and potentially dominate, adjacent markets. The public interest is substantially and inexorably involved in both issues.

Letter from Keith F. Higgins, Chair, Comm. on Fed. Regulation of Sec., ABA, to Nancy Morris, Sec'y, SEC 2–3 (Feb. 12, 2007), *available at* http://www.sec.gov/comments/sr-nysearca-2006-21/nysearca200621-20.pdf (citations omitted).

ENTROPY[1] AND THE NATIONAL MARKET SYSTEM[2]

Junius W. Peake[*]

I was invited to the *Brooklyn Journal of Corporate, Financial & Commercial Law* symposium to discuss my predictions for and thoughts on some of the problems facing and changes occurring in the current national market system. My thoughts are presented from a unique perspective. I have been an executive in the securities industry, and governor and vice-chairman of a self-regulatory organization. I founded the first electronic futures market and have been a consultant to government agencies, markets and market participants. Most recently I was an academic for 14 years. I am now retired.

During almost all that time, I followed the torturous path of the development of the national market system. I have written and spoken about it for more than thirty years. As a result, this essay reflects my thoughts on the past, present, and future state of the national market system.

I. A BIT OF HISTORY

My first exposure to market structure came when, in 1965, I was placed in charge of the operations of the brokerage firm Shields & Company. Although my area of responsibility did not include floor or over-the-counter trading, it encompassed the operational results of those activities. In those days, operational systems were almost entirely manual. Automation consisted of tabulating machines, key punches and Addressograph plates. The mechanics of floor and over-the-counter trading were accomplished by scribbles, shouts and telephone calls.

Needless to say, these archaic technologies contributed to what would be called the "back office crisis," which continued until the mid-1970s. Errors were rampant; correcting them was time-consuming and costly. DKs, or Don't Knows—which stood for transactions on exchange floors that were not confirmed by both parties—were legion and many firms lost bookkeeping control. Securities were not delivered in a timely fashion, and the number of "fails," which were transactions that did not close within normal settlement times, escalated to numbers that placed more than a few firms into financial jeopardy or bankruptcy.

With much time and effort, the operational side of the business was finally addressed with considerable success. Consensus was achieved when

1. Entropy: "In software, it is the disorder and jumble of its logic, which occurs after the program has been modified over and over." Entropy Definition, http://www.pcmag.com/encyclopedia_term/0,2542,t=entropy&i=42666,00.asp (last visited Mar. 31, 2007).

2. Please note that portions of this paper incorporate or have been adapted from my previous writings.

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both the banking and brokerage industries finally realized that the clearance and settlement part of the business was almost entirely on the expense side of the ledger, and that cooperation and consolidation of these functions would result in enormous cost savings and greater efficiency for all participants, including the customers.

Major milestones in resolving these operational problems came about through the establishment of the Committee on Uniform Securities Identification Procedures (CUSIP) number for identifying publicly-traded securities, the implementation of what was known as a continuous net settlement system for clearing houses, and the metamorphosis of those entities into a national clearing, settlement and depository system.

The modernization of these back office functions came about from 1966–1973, starting with CUSIP. During the same time period, lots of discussions about problems with the trading side of the business were held and Congress started to examine the problems of the securities industry with the view toward determining whether legislation was needed.

Congress—and others such as myself—began to explore whether trading systems are just as much cost centers as the clearing and settlement activities. Who does and should pay their costs? The same universe is involved in both: investors and issuers. I attended a conference at New York University in 1979 when the executive vice president of the New York Stock Exchange (NYSE) stated that automating the NYSE would cost as much as $20–$30 million.[3] He rhetorically asked where the industry would ever find that much money. In contrast, twenty-five years later, when the Securities and Exchange Commission (SEC) issued the proposed Regulation NMS[4] in 2004, the Commission stated:

> The Commission staff estimates that there would be an initial one-time burden of 200 burden hours per SRO or 1,800 hours, and 150 burden hours per non-SRO order execution facility or 1,015,200 hours, for a total of 1,017,000 burden hours to establish policies and procedures designed to prevent the execution of a trade-through for an estimated one-time initial cost of $145,469,475. The Commission estimates a capital cost of approximately $101,655,000 for both SROs and non-SROs resulting from outsourced legal work.[5]

Those figures, of course, do not include the enormous costs of hardware and programming the millions of lines of code that will be needed to

3. Morris Mendelson, Junius W. Peake, & R.T. Williams, Jr., *Toward a Modern Exchange: The Peake-Mendelson-Williams Proposal for an Electronically Assisted Auction Market*, *in* IMPENDING CHANGES FOR SECURITIES MARKETS: WHAT ROLE FOR THE EXCHANGES? 53, 67 (Ernest Bloch & Robert A. Schwartz eds., 1979).

4. “NMS” refers to the National Market System.

5. “SRO” refers to self-regulatory organization. *See* Regulation NMS, Exchange Act Release No. 49,325, 69 Fed. Reg. 11,126 (Feb. 26, 2004) (codified at 17 CFR pts. 200, 230, 240, 242, and 249) (citations omitted).

implement Regulation NMS. Nor do they reflect the true price tag being paid by investors and issuers through their brokers and market centers.

In 1971, both the House and Senate held investigative hearings; in 1973, legislative hearings were held that culminated in the May Day enactment of the Securities Acts Amendments of 1975, which were intended to foster competition among the securities markets. I testified at a number of House and Senate hearings leading up to the Amendments.

In 1975, section 11A of the Securities Exchange Act of 1934 became law. Congress ordered the Commission to:

> [U]se its authority under this title to facilitate the establishment of a national market system for securities (which may include subsystems for particular types of securities with unique trading characteristics) in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection.[6]

Many believed that accomplishing the mandate entrusted to the Commission would be straightforward and rapid. Although we are now starting the fourth decade since that fateful May Day legislation, Regulation NMS, the latest iteration of the SEC's instructions to facilitate this task, was not started until March 2007.[7]

A. A Proposed Solution

When Professor Morris Mendelson of the Wharton School, R.T. Williams, Jr., my fellow consultant, and I submitted to the Commission's National Market Advisory Board our National Book System (NBS) proposal for the development of the NMS in 1976, we wrote:

> While it may appear that some of the elements of our proposed National Book System differ substantially from the present mechanism, the fact remains that our system will cost less to design, build, operate and regulate than any interim system. It will also be simpler to construct and will restore a centralized trading facility. Any attempt made to obtain a system such as we present, in stages, must result in a sequence of fully developed systems, each operating only long enough to permit the next stage to be constructed before being discarded.[8]

Specifically, our NBS proposal recommended several important features, including: screen-based electronic auction trading; consolidation of market makers' bids and offers with customers' bids and offers into a "book" of all orders for each security; an instantly accessible display of the aggregate quantities of all bids and offers at each price; anonymity for all

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6. Exchange Act § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2) (2000).

7. Gaston F. Ceron, *New Trading Rules to Launch*, WALL ST. J., Mar. 5, 2007, at C3.

8. Letter from Junius W. Peake, Morris Mendelson & R.T. Williams, Jr., to George A. Fitzsimmons, Sec'y, SEC, Reference: File No. 57-619 (Apr. 24, 2000), *available at* http://www.sec.gov/rules/sro/ny9948/peake1.htm [hereinafter April 24, 2000 Letter].

orders entered; minimum price increments in decimals; price-time priority for execution of all entered bids and offers; multilateral price negotiation; and equal and instant information and global access by all qualified participants, including investors, dealers, market makers and specialists.[9]

The Commission did address these issues. It started out by proposing an automated central limit order book (CLOB). On December 19, 1975, the Commission issued Exchange Act Release No. 11,942, which stated unambiguously the reasons why it was necessary.

> Development of a central electronic repository for limited price orders would be of special significance to ensure integration of the markets and preservation of an opportunity for public orders to meet without the participation of a dealer. Such a step will certainly enhance competitive opportunities in market makings. For all these reasons, the Commission will utilize its new powers under the Act promptly to ensure implementation of a national mechanism for multi-market protection of limit orders. Nevertheless, it must be emphasized that it would be inappropriate to withhold from the markets the benefits to be derived from increased market maker competition indefinitely. Development of a national limit order mechanism is a further step in creating a national market system and must be expedited.[10]

And in 1976, SEC Exchange Act Release No. 12,159 further elaborated on the need for automation.

> The Commission believes that there is a need for further modernization and improvement of our securities markets, not only for the purpose of utilizing new data processing and communication techniques, but also to insure economically efficient execution of securities transactions and fair competition among brokers and dealers and among various securities markets which either directly compete with each other or have the potential for such competition. Existing exchange mechanisms for the storage and execution of limited price orders appear to be in need of modification to meet the requirements of member firms and investors for expeditious handling of order flow in the context of a national market system, as well as to cope with an increasing volume of securities transactions (such as that experienced in recent weeks). Further, existing limit order mechanisms are unable to provide nationwide limit order protection and thus cannot always provide the degree of protection for limit orders which hopefully could be furnished by a composite book. Finally, a composite book appears to be well suited to assuring an opportunity for public orders to meet without the participation of a dealer.[11]

9. Mendelson, Peake, & Williams, *supra* note 3, at 53, 67.
10. Exchange Act Release No. 11,942, 41 Fed. Reg. 4507 (Jan. 30, 1976).
11. Exchange Act Release No. 12,159, 9 SEC Docket 76, at *1 (Mar. 2, 1976).

The Commission further responded in SEC Exchange Act Release No. 14,416, dated January 26, 1978, which explained the goals of the SEC.

> The concept of a national market system was first articulated in the Commission's letter of transmittal accompanying its Institutional Investor Study, submitted to Congress on March 10, 1971. There the Commission stated that:
>
> > [a] major goal and ideal of the securities market and the securities industry has been the creation of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime.[12]

Again, quoting from the 1978 Release:

> In addition to elaborating on the principles set forth in the Future Structure Statement, the Commission's Policy Statement articulated two new proposals to govern trading within a national market system: an auction trading rule, which would provide price priority protection for all public orders entered in a proposed central electronic repository, and a public preference rule, which would accord preferential treatment to public orders entered in the central electronic repository by preventing securities professionals acting as principal from competing for execution with such orders unless such professionals bettered public bids or offers entered in that system.[13]

In reporting the legislative history of the 1975 Amendments, the same Release stated:

> [T]he Senate Committee on Banking, Housing and Urban Affairs (the "Senate Committee") stated that
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> > [t]he rapid attainment of a national market system . . . is important . . . to assure that the country maintains a strong, effective and efficient capital raising and capital allocating system in the years ahead.[14]

And again:

> The Senate Committee noted, however, that auction trading principles could not be perfected under existing circumstances because of fragmentation of the markets, particularly "the lack of a mechanism by which all buying and selling interest in a given security can be centralized and thus assure public investors best execution." Thus, the concept of implementing a nationwide system according price and time priority to all

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12. Exchange Act Release No. 14,416, 43 Fed. Reg. 4354, 4354 (Feb. 1, 1978) (quoting INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 92-64, pt. 1, at xxiv (1971)).

13. *Id*. at 4355.

14. *Id*. (quoting SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, REPORT TO ACCOMPANY S. 249, S. REP. NO. 94-75, at 3 (1975)).

> limit orders of public investors over all professional orders, regardless of where such limit orders originate or in what market center professional orders may be executed, received considerable support from the draftsmen of the 1975 Amendments.[15]

Discussing progress to date, the Release continued:

> The major problems to which the idea of a national market system is addressed are those arising from "market fragmentation," or the existence of multiple, geographically separated forums in which trading in the same security occurs, and from the institutionalization of the markets.[16]

The Release then specifically discussed "THE COMMISSION'S FUTURE PLANS FOR FACILITATING ESTABLISHMENT OF A NATIONAL MARKET SYSTEM."[17] In those plans, these prophetic words appeared:

> The adverse consequences of failing to achieve more rapid progress toward a national market system have become particularly apparent in the context of the Commission's pending proceeding concerning removal of exchange off-board trading restrictions. During the course of that proceeding, many elements of the securities industry, members of Congress and representatives of American business have urged the Commission to assume a leadership role in developing a national market system in order to overcome the impediments to development of that system inherent in the diversity of the securities industry, so that the benefits to the markets, the professional trading community and the public which the Congress and the Commission have long believed would inure from that system might finally be secured. Commentators in that proceeding, for example, were virtually unanimous in the view that the risks which many believe would attend removal of the remaining off-board trading restrictions could be minimized by assuring more effective integration of the markets for securities presently covered by those restrictions by means of national market system mechanisms.[18]

In regard to nationwide limit order protection, the Commission stated:

> The Commission continues to believe that one of the basic principles upon which a national market system must be based is the assurance that all agency orders in qualified securities, regardless of location, receive the benefits of auction-type trading protections. To this end, the Commission believes the several self-regulatory organizations should take joint action promptly to develop and implement a central limit order file (the "Central

15. *Id*. at 4356.
16. *Id*.
17. *Id*. (capitalization in original).
18. Exchange Act Release No. 14,416, 43 Fed. Reg. 4354, 4357–58 (Feb. 1, 1978).

File") for public agency orders to buy and sell qualified securities in specified amounts at specified prices ("public limit orders").[19]

The Commission concluded by saying:

> The Commission urges the self-regulatory organizations to prepare and submit to the Commission, preferably jointly, a plan or plans no later than September 30, 1978, contemplating the design, construction and operation of a Central File. However, *should voluntary cooperation among such organizations to that end prove difficult, or involve undue delay, the Commission intends to commence rulemaking to consider the manner and timing of compulsory development of a Central File (including the question of whether that task should be assigned principally to a single self-regulatory organization).*[20]

But, in 1979, thanks to intensive lobbying efforts by the NYSE and other exchanges and market makers to preserve the status quo, the SEC suddenly reversed course and permitted a trio of unconnected systems to be, as the Commission put it, the "cornerstones" of the national market system. That reversal sealed the unconscionable delay of a national market system, at least for the rest of the 20th Century. In their April 1979 Exchange Act Release No. 15,770, the SEC stated:

> Most other self-regulatory organizations opposed creation of a Central File as described in the January Statement. These commentators argued that the kind of priority proposed to be afforded public limit orders entered into the Central File would have significant and deleterious effects on the exchange trading process. In essence, these commentators asserted that such a preference for public limit orders would provide a major trading advantage to those orders, thereby creating a disincentive to the commitment of market making capital by dealers, and would eventually lead to the elimination of exchange trading floors by inexorably forcing all trading into a fully automated trading system. In addition, several self-regulatory organizations suggested that, in lieu of the immediate implementation of a Central File, the Commission should permit the participants in the Intermarket Trading System ("ITS") sufficient time to attempt to provide limit order protection on an inter-market basis using the ITS. Specifically, the New York Stock Exchange, Inc. ("NYSE") and the MSE submitted proposals which envisioned the electronic dissemination and display of limit order information from each market center and use of the ITS to assure inter-market price protection of displayed limit orders in any market.[21]

The CLOB was to be a straightforward electronic file of all entered bids and offers for each security. All bids and offers would be queued in price-

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19. *Id.* at 4359.
20. *Id.* at 4359 (emphasis added).
21. Exchange Act Release No. 15,770, 44 Fed. Reg. 26,692, 26,694 (Apr. 26, 1979) (emphasis added).

time priority, and executions would occur on a first-come, first-served basis. Designing and building such a computer system would be relatively simple in terms of programming.

Not surprisingly, led by the NYSE, the broker-dealer establishment attacked such a system as being nothing but a "black box" solution. And they asked where a computer would obtain the capital to trade. They said such a system (a) would not work, and (b) would destroy the finest capital market mechanism in the world. Instead, they promoted separate order entry, order displays, and reporting systems that would negate an integrated electronic one. The Intermarket Trading System was one cornerstone of their proposal. Interestingly enough, then President of Merrill Lynch, William Schreyer, testified under oath before two House Subcommittees in 1979 that "[i]t is as far from the concept of an automated, efficient marketplace as a tom-tom is from a communications satellite."[22]

The other elements of the NYSE's version of the national market system included a separate Consolidated Quotations System (CQS), and a separate Consolidated Tape System (CTS).

I have analogized these disparate systems with a comparable Automated Teller System. Under such a system it would be necessary to go to one ATM to enter the transaction amount, another ATM to obtain the results of the transaction, and a third ATM to obtain a report of the transaction. I believe very few—if any—would prefer such a system to the actual automated teller systems available today. The present-day ATM differs from its analogous market system because competition and private enterprise, rather than mandated regulations, fostered the development of the ATM system.

II. PRESENT ISSUES: THE ORIGINAL SOLUTION IS STILL RELEVANT TODAY

Presently, there are four interesting issues in the state of the national market system: (1) balancing the demands for competition and consolidation against the dangers of fragmentation, (2) whether trading markets will be electronic or manual, (3) to what extent (if any) retail and institutional interests will be reconciled, and (4) how to enforce best execution as a legal standard.

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22. *Progress Toward the Development of a National Market System: Joint hearings before the Subcomm. on Oversight and Investigations and the Subcomm. on Consumer Protection and Finance of the Comm. on Interstate and Foreign Commerce,* 96th Cong. 70 (1979), *quoted in* Letter from Junius W. Peake, to Jonathan G. Katz, Sec'y, SEC, Regarding File No. 4-206, Exchange Act Release No. 40,204 (Aug. 21, 1998), *available at* http://www.sec.gov/rules/proposed/4208/peake1.htm.

A. BALANCING THE DEMANDS FOR COMPETITION AND CONSOLIDATION AGAINST THE DANGERS OF FRAGMENTATION

Today, it is important to balance the demands for competition and consolidation against the dangers of fragmentation. I think that all economists know that a securities market is a natural monopoly unless prevented from becoming one by technological limitations, regulation or unfair competition. The best and most open prices are attained when *all* potential buyers and sellers can have the opportunity to have their orders interact.

Competition should focus on price—not place. When securities markets were manual because of the technological inability to centralize them, exchanges and broker-dealers would trade the same securities at the same time in different locations and at different prices forming "pools" of orders. This enabled intermarket arbitrage—the buying or selling of a security at one location and immediately selling or buying it back at a guaranteed profit at another location—and was *prima facie* evidence that the system was inefficient.

Today, the buzzword is "liquidity pools," with the newest one being "dark liquidity pools," primarily comprised of hedge funds. But what is needed is an "ocean" of liquidity formed by integrating all the pools into a format wherein each and every bid in a security has the opportunity to interact with each and every offer in that security.

The main argument against letting the new securities market become a natural monopoly has been—and still is—that competition will be stifled and the market mechanisms will suffer. I disagree. Just as clearing and depository have been centralized, market structure centralization would improve services and reduce costs, provided it is properly structured and governed.

B. ELECTRONIC VS. MANUAL TRADING MARKETS

Going forward, it is important to assess whether the trading markets will be electronic or manual. This is a no-brainer. The recently announced proposed merger of Chicago's derivative exchanges punctuates the answer forcefully. As one of the founders of the world's first electronic futures exchange, I am thrilled—but not surprised—that automation has won the day.

While the NYSE is continuing to push its Hybrid market structure, it is only the Commission's acquiescence to the NYSE's anticompetitive floor trading rule proposals that have allowed it to come this far. So, why does the Commission approve the anticompetitive rule changes proposed by the NYSE? I sent a comment to the Commission on Releases SR-NYSE-2006-65 (November, 2006) and SR-NYSE-2006-36 (October, 2006):

> I would like to make but one point about the NYSE's proposals in their Hybrid Market. There never is—and cannot ever be—any discretion in an order entered electronically. All of the preconditions under which the order will be executed, cancelled or changed ***must*** be determined and entered ***before*** its arrival at the execution engine (the processor). It makes no difference if it is called a floor broker's so-called "discretionary" order or a specialist's algorithmic order. The terms which will decide any action on these orders have been predetermined. Since this is a fact, and since investors and ***all*** other market participants have the theoretical or practical capacity to place complex conditions on orders entered electronically, there is absolutely ***no*** regulatory reason to prevent them from having exactly the same ability to enter so-called "discretionary" orders or algorithmic orders. As a result of the Commission's apparent willingness to permit the NYSE to have such unfair competitive advantages for their floor brokers and specialists, I assume that all broker/dealers and investors will be able to enter so-called discretionary orders and use algorithmic orders on all market centers except the NYSE. . . . I cannot believe the Commission's intent is to approve proposed rules of the NYSE that would create unfair competition among brokers and dealers, among exchange markets and markets other than exchange markets, as well as denying investors' orders to be executed without the participation of a dealer (floor brokers are also registered as broker-dealers).[23]

While the actual execution of all orders will be done electronically, pre-trade strategy will continue by personal judgment (manually) assisted by technology.

23. Junius W. Peake, Comment on Releases SR-NYSE-2006-65 and SR-NYSE-2006-36, http://www.sec.gov/comments/sr-nyse-2006-65/nyse200665-1.pdf (last visited Mar. 28, 2007) (emphasis in original). Section 11A(a)(1)(C) of the 1934 Securities Exchange Act, 15 U.S.C. § 78k-1 (2000), states:

> It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure—
>
> i. economically efficient execution of securities transactions;
>
> ii. fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
>
> iii. the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
>
> iv. the practicability of brokers executing investors' orders in the best market; and
>
> v. an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.

C. Reconciling Retail and Institutional Interests

As markets evolve, it is yet to be determined to what extent (if any), and how, retail and institutional interests should be reconciled. The interests of retail and institutional investors are congruent. Although reconciliation is not required, both groups want to pay the very least net cost for their purchases and to receive the largest net proceeds for their sales. A properly-designed market system should be able to accommodate both interests. Automation has made multiple execution reports a trivial matter. Innovation and competition will get the job done.

D. Enforcing Best Execution as a Legal Standard

It is also necessary to develop a solution for the problem of how to enforce best execution as a legal standard. In order to do that "best execution" must be properly defined. A simple definition is the easiest to enforce. Today's definition is far too complicated and focuses in the wrong direction—on orders, rather than executions. In 2002, I counted 533 references by the SEC to the term "best execution" since the Commission started issuing '34 Act Releases. The first was in 1938; the next was in 1963. Three hundred fifty-five of the references were issued from 1992 to 2002.[24]

Early on, best execution referred to transactions rather than orders. In the 1963 Special Study of the Securities Industry, the Commission wrote:

> The Report concludes that the factors contributing to or detracting from the public's ready access to all markets and its assurance of obtaining the best execution of *any particular transaction* require the continuous attention of the Commission and the Policy and Planning Unit.[25]

In the same report, the Commission further noted:

> [W]hile the NASD has recognized the principle of best execution, it has not prescribed specific guidelines or standards with respect to it. *The Report recommends that rules and standards be adopted by the Commission and/or the NASD requiring broker-dealers executing retail transactions, whether as principal or as agent,* to make a reasonable effort to ascertain the best interdealer quotations and "to provide an execution as favorable as may reasonably be obtained in light of the kind and amount of securities involved and other pertinent circumstances."[26]

More recently, the subject of what should receive best execution has metamorphosed from transactions to orders. There can be a considerable difference between the two: execution always equals transaction, but order

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24. A LexisNexis search in the source SEC Decisions, Orders & Releases for "best execution," until April 21, 2002 returns 355 releases.
25. Special Market Study, Release No. 32 (July 17, 1963) (emphasis added).
26. Special Market Study, Release No. 31 (July 17, 1963) (emphasis added).

may, or may not, equal transaction. In 1968, the Commission addressed the difference: "One of the basic duties of a fiduciary is the duty to execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances . . . ."[27]

As previously noted, in securities markets, investors and other traders each want only one thing. Buyers want to pay the smallest total amount for each execution. Sellers want to receive the greatest proceeds for each execution. When an order is executed in more than a single transaction, the investor would like to receive the highest aggregated proceeds for the entire sale, or the lowest total cost for the entire purchases. The Commission has the ability to define precisely the term "best execution" for each transaction in a national market system, but always uses broad generalities to attempt to define best execution for orders requiring multiple transactions. Orders determined to require more than a single transaction have but one thing in common: They need the professional skill and judgment of the person or persons responsible for fulfilling the order. Experts may execute large orders differently, depending on their differing judgments, just as competent and skilled attorneys will handle the same case differently. Attempts to measure best execution of complicated orders will always be subjective.

Complicated orders—especially large orders for hundreds of thousands or millions of shares entered by institutional investors—may require multiple trade executions, sometimes taking one or more days. This may be required to accrue the lowest overall cost or the highest proceeds. But if each and every trade execution, at the time it is made, is made at the highest bid (for a purchase) or the lowest offer (for a sale), the total cost or proceeds of the entire order will assure best order execution, provided reasonable judgment and care is taken with the order.

The term price improvement is fraudulent. In every market, for a trade to take place, a bid must be hit or an offer taken. The Commission itself defines "best bid" and "best offer" as follows: "Best bid and best offer mean the highest priced bid and the lowest priced offer."[28] At the moment of execution, the spread must be zero. There can be no price improvement, since a bid must be hit or an offer taken.

The issue becomes: Who gets to see and trade with the best bid or offer? Price improvement is only possible if the market system hides either the bid or the offer (or both) from some market participants. If the best bid and offer is neither disclosed nor executable by all market participants, it becomes a "Tantalus system." Tantalus was condemned to hang from the

27. In the Matter of Kidder, Peabody & Co., Inc., Edward B. Goodnow, Investment Advisors Act Release No. 232, Exchange Act Release No. 8426, 43 S.E.C. 911, 915 (Oct. 16, 1968).

28. 17 C.F.R. § 242.600(b)(7) (2007).

bough of a fruit tree over a pool of water. When he bent to drink, the water would recede; when he reached for a fruit, the wind would blow it from his reach. A further account of his punishment tells of a great stone hanging over his head threatening to fall.[29] Like Tantalus, some best bids and/or offers are always kept out of reach of certain market participants.

Designing state-of-the-art trading systems is a task best left to the free market, not Commission lawyers who tend to create Alice in Wonderland solutions. It has been more than three decades since the Congress mandated that the Commission facilitate the development of a national market system for securities.[30]

The following is what the Commission itself said about proposed Rule (11Ac1-5): "While broker-dealers currently may be able to obtain order execution information from some market centers, that information may be of limited use and may not allow broker-dealers to compare execution quality among the different market centers."[31] The problem with the Commission's best execution definition is that the best published quote is seldom made up of ***all*** the bids and offers available at a moment in time. There are often better bids and offers, but there is no practical or economical way for all orders to interact with them.

The only way for the best execution of each transaction to be guaranteed is for all bids and offers in any particular security to be able to interact, preferably on a price-time priority basis. Best execution of a multiple transaction order will still require skill and judgment, as it should. But the cost of such a system would probably be at least one order of magnitude less than the present multiple, cobbled-together systems that have been ordered by the Commission since 1975.

Below, in a brief excerpt from the Commission's staff, is an attempt to explain the complexities of the reporting requirements that make up the raw data to measure best execution:

> **Division of Market Regulation: Staff Legal Bulletin No. 12R** (*Revised*)
> "Frequently Asked Questions About Rule 11Ac1-5"
> **Action**: Publication of Division of Market Regulation Staff Legal Bulletin
> **Date**: June 22, 2001 (revised). . .
>
> The Commission adopted the Rule in November 2000. It generally requires a "market center" (as defined in the Rule) that trades national market system securities to make available to the public monthly electronic reports that include uniform statistical measures of execution quality . . . .

29. Tantalus, Infoplease, http://www.infoplease.com/ce6/ent/A0847814.html (last visited Mar. 28, 2007).

30. *See* Exchange Act §11A(a)(2), 15 U.S.C. §78k-1(a)(2) (2000).

31. Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43,590, 65 Fed. Reg. 75,414, 75,432 (Dec. 1, 2000).

Question 1: Format of Monthly Reports and Procedures for Making Reports Publicly Available
Question 2: Vendor or SRO Assistance in Making Reports Available
Question 3: Definition of Market Center - Multiple Trading Venues
Question 4: Integrated Broker-Dealer Firms - Orders Received as Market Center and Orders Received Solely as Agent for Routing
Question 5: Definition of Covered Order - Special Handling Exclusions
Question 6: Exemption for Manually-Received Orders
Question 7: Locked and Crossed Quotes
Question 8: Trading Halts
Question 9: Activity Within the Intermarket Trading System ("ITS")
Question 10: Activity within SuperSOES and SelectNet (modified)
Question 11: Partial Executions and/or Partial Cancellations
Question 12: Orders Left Unexecuted and Uncancelled at End of Regular Trading Hours
Question 13: Establishing Time of Order Receipt
Question 14: Orders Received in Same Second as a Quote Change
Question 15: Time of Execution for "Stopped" or "Guaranteed" Orders
Question 16: Adjusted or Voided Order Executions
Question 17: Calendar Month Reporting
Question 18: Phase-In of Reporting
Question 19: Exemption for Orders Received Prior to Dissemination of Quotations by Primary Listing SRO (new)
Question 20: Filtering Potential Errors in Consolidated Best Bid and Offer (new)
Question 21: Time of Consolidated Best Bid and Offer (new)
Question 22: Rounding of Statistics (new)
Question 23: Modified Orders (new)
Question 24: Riskless Principal Orders (new)
Question 25: Exemption for Inactively Traded Securities (new)
Question 26: Exemption for Small Market Centers (new)
Question 27: Exemption for Block Orders (new)[32]

In order to determine how accurate the results of analyzing this type of data have been until now, all we have to do is to read the lead story in the October 16, 2006 issue of *Global Investment Technology*, entitled, *Transaction Costs: Buy-Side Firms Want Transaction Cost Analysis Offerings to Incorporate Risk in Real Time*. The article states in part:

> [Transaction Cost Analysis] pioneers who analyzed transaction data and reported on it quarterly are finding periodic reports outmoded. . . . The biggest impediment to effective TCA is always the data itself, according to Ian Domowitz, Chief Executive Officer of ITG Solutions Network, a

32. SEC, Division of Market Regulation: Staff Legal Bulletin No. 12R (Revised): Frequently Asked Questions About Rule 11Ac1-5 (June 22, 2001), *available at* http://www.sec.gov/interps/legal/slbim12a.htm.

> division of ITG Inc., an agency brokerage and trading technologies provider whose offerings include TCA solutions. "The nature of change in the market structure both validates and renews [the] emphasis on best execution within which regulators can actually regulate[.]" . . . Investors still look at individual orders, Domowitz explains. But the orders are being broken down into small trades and spread out over time, so analysis of the order can be quite difficult.[33]

In conclusion, the clean, straightforward electronic trading system that could have been built in the 1976–1979 period (and can still be built) has now become a Rube Goldberg-type Gordian knot created by the Commission.[34] Reading and trying to understand all the complex rule proposals for the NYSE's Hybrid system is an absolute cure for insomnia. In my judgment, it is now time for the Commission to engage a staff that is intimately familiar with both trading and the appropriate use of electronics, and create the national market system the Congress wanted. Using the definition of "entropy" I have selected, the Commission surely has jumbled and disordered its logic, which occurred after the program was modified over and over in three decades. There is still time to do what the Congress ordered.

III. CONCLUDING REMARKS: ONGOING CONCERNS

There are a few additional issues that I would like to address in this commentary. I have long been concerned about the continued approval, albeit with changes, of section 28e. I see no reason mutual fund or other investors should pay excessive execution costs that are charged to the benefit of managers. I am also concerned about the dangers of naked short selling, especially immediately after an original offering. Total trading volumes the day following effective registration can sometimes exceed the total available float of the new issue. I am also worried about the enormous impact of hedge funds on our capital markets. I would hope the Commission would continue to examine their potential to damage the integrity of our markets. Finally, I hope and trust that if the Congress eliminates the one cent coin from circulation, that it continues one cent increments as the minimum price differential in trading equities and options.

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33. *Transaction Costs: Buy-Side Firms Want Transaction Cost Analysis Offerings to Incorporate Risk in Real Time*, GLOBAL INV. TECH., Oct. 16, 2006, at 1.

34. Rube Goldberg is an American cartoonist and sculptor "known for his drawings of ludicrously intricate machinery meant to perform simple operations." Rube Goldberg, Infoplease, http://www.infoplease.com/ce6/people/A0821154.html (last visited Apr. 5, 2007). Gordius was an "ancient king of Phyrgia, who tied a knot (the Gordian knot) that, according to prophecy, was to be undone only by the person who was to rule Asia, and that was cut, rather than untied, by Alexander the Great." Gordian, Infoplease, http://www.infoplease.com/ipd/A0460642.html (last visited Apr. 5, 2007). To "cut the Gordian knot" means "to act quickly and decisively in a difficult situation" or to "solve a problem boldly." *Id.*

SELF AND SELF-REGULATION: RESOLVING THE SRO IDENTITY CRISIS

Onnig H. Dombalagian[*]

Market-based self-regulatory organizations (SROs) are in the throes of an identity crisis. Once the physical hub of trading activity, securities exchanges have become primary nodes in a larger web of electronic securities trading. Their mantel of regulatory authority, a traditional source of reputational integrity, is now characterized as a yoke around their necks, stifling competitive initiatives while embarrassing them in successive marketplace scandals. Once the voice of the securities industry, SROs are now accused of advocating no interest more keenly than their own survival. Faced with these challenges, it is not surprising that many exchanges are looking for ways to shed their self-regulatory responsibilities and join the ranks of their erstwhile members as for-profit competitors.

And yet, the apparent crisis of faith in exchange-based regulation has called into question the broader idea of self regulation. New regulatory models—such as the one employed by Congress in creating the Public Company Accounting Oversight Board (PCAOB)—are being devised to fund and oversee regulation of the securities industry, without being accountable to it. SROs are taking pains to play down the ties of their industry personnel with (or distance them altogether from) the industry they regulate. Industry leaders and associations have even entertained the possibility of dismantling the current self-regulatory system entirely in favor of Securities and Exchange Commission (SEC) regulation.[1]

With all its shortcomings, however, self-regulation is inherently a sound—and perhaps somewhat underutilized—means of regulating securities market conduct. Even if exchange-based regulation has failed, policymakers should think twice before writing self-regulation out of the Exchange Act. Despite the extraordinary public attention devoted to stock

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* Associate Professor of Law, Tulane Law School. I would like to thank my fellow panelists, Professors Roberta Karmel and Eric Pan, for their thoughtful comments on prior drafts of this article, as well as all of the participants in this Symposium for their insights on the topics discussed herein. I would also like to thank Samuel Vigil and Christopher Kyle Johnston for their research assistance. All errors are mine.

1. *See* SEC. INDUS. ASS'N, REINVENTING SELF-REGULATION: WHITE PAPER FOR THE SIA'S AD HOC COMMITTEE ON REGULATORY IMPLICATIONS OF DEMUTUALIZATION (Jan. 5, 2000), *available at* http://www.sia.com/market_structure/html/sia whitepaperfinal.htm [hereinafter SIA White Paper]. Among other goals, the SIA (which has since merged with The Bond Market Association to form the Securities Industry and Financial Markets Association) called for a unitary SRO, with industry representation in regulatory oversight and a transparent fee system, which would serve as the sole source of SRO rulemaking and interpretations, examinations, and investigations. *See* Rachel McTague, *In Push for Single SRO for Brokers, SIA Enunciates Its Goals, Principles*, 38 Sec. Reg. & L. Rep. (BNA) No. 5, at 162 (Jan. 30, 2006).

exchanges and the NASD, there are many SROs that provide the critical infrastructure needed to ensure fair and efficient markets while sparing the SEC and the public the cost of securities oversight. SROs are also best positioned to debate and promulgate the ethical norms that govern the industry, as long as such responsibilities are confined to those spheres of activity where they work best. The presence of multiple SROs with overlapping memberships, if properly coordinated by the SEC to ensure standardization, can further help ensure fair representation of all industry groups in regulatory decisionmaking and promote better rulemaking.

I. SELF-AWARENESS

What does "self-regulation" mean? On a purely etymological level, it suggests a process by which a person, organization, or group of persons establishes and enforces rules to govern its, or their own, conduct without the need for regular outside intervention. This definition, of course, might well pick up any public company, financial institution, or other business entity that is required to establish internal controls for regulatory purposes. In the securities and commodities industries, the term is rooted in the historic private compacts among exchange members. The basic structure of self-regulation assumes (and the Exchange Act now requires)[2] that broker-dealers would be members of at least one SRO, that members would be fairly represented in the governance of SROs, and that SROs would undertake to enforce compliance with their rules by their members.[3]

The Exchange Act nevertheless has some difficulty articulating what should qualify as a self-regulatory organization, since the term itself was defined after the fact to refer to national securities exchanges, registered securities associations such as the NASD, registered clearing agencies, and other specialty bodies.[4] The source of congressional intent lies in the term "member," which includes, in addition to natural persons trading on the floor of an exchange and their associated brokerage firms, any "broker or dealer which agrees to be regulated" by an exchange or registered securities association and with respect to whom the exchange or association "undertakes to enforce compliance with the provisions of [the Act], the rules and regulations thereunder, and its own rules."[5]

Though the two are often analogized, self-regulation must be differentiated from *private ordering* in the sense that self-regulatory

2. *See* 15 U.S.C. § 78*o*(b)(8) (2000).

3. As discussed below, SROs have the additional responsibility of enforcing compliance by their members and controlling persons with the provisions of the Exchange Act and the rules and regulations thereunder. 15 U.S.C. §§ 78f(b)(1), 78*o*-3(b)(2) (2000).

4. *Id.* § 78c(a)(26). The only statutory self-regulatory organization recognized in section 3(a)(26) of the Exchange Act is the Municipal Securities Rulemaking Board (MSRB); however, other bodies with self-regulatory powers and duties, such as the Securities Investor Protection Corporation (SIPC), have been created by the Exchange Act. *See id.* § 78ccc(a)(1).

5. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881.

organizations operate under Commission oversight, receive limited immunity from the antitrust laws,[6] and must observe specific formalities for the adoption of new rules, policies, and procedures.[7] Private ordering remains an important component of the regulatory system for securities markets, particularly in those areas where securities regulators lack the jurisdiction to regulate their members' conduct.[8] Today, numerous securities trade associations promulgate "uniform rules" or best practices for their members, maintain standard agreements for interbroker transactions, collect statistical information about their members for the benefit of the public, and perform other market ordering functions.[9]

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6. *See, e.g.*, Silver v. N.Y. Stock Exch., 373 U.S. 341, 357 (1963); Gordon v. N.Y. Stock Exch., 422 U.S. 659 (1975); United States v. NASD, 422 U.S. 694 (1975); *In re* Stock Exchs. Options Trading Antitrust Litig., 317 F.3d 134 (2d Cir. 2003). *Cf.* A.L.A. Schecter Poultry Corp. v. United States, 295 U.S. 495 (1935) (striking down provisions of the National Industrial Recovery Act establishing a National Recovery Administration to oversee voluntary compliance with industry codes of competition).

The U.S. Supreme Court granted certiorari in Credit Suisse First Boston v. Billing, 426 F.3d 130 (2d Cir. 2005), *cert. granted*, 127 S. Ct. 762 (2006), *cert. vacated and granted*, 2007 U.S. LEXIS 3020 (March 19, 2007), on the question:

> [w]hether, in a private damages action under the antitrust laws . . . , the standard for implying antitrust immunity is the potential for conflict with the securities laws or . . . a specific expression of congressional intent to immunize such conduct and a showing that the SEC has power to compel the specific practices at issue.

Petition for Writ of Certiorari, Credit Suisse First Boston v. Billing, 2006 WL 616006, at *1 (2006) (No. 05-1157). The registration requirements for self-regulatory organizations and the statutory delimitation of the scope of their self-regulatory activity may thus remain a critical prerequisite to antitrust immunity.

7. 15 U.S.C. § 78s(b), (c) (2000) (establishing procedures for the filing of "any proposed rule or any proposed change in, addition to, or deletion from the rules of [each] self-regulatory organization"); *see also* 17 C.F.R. § 240.19b-4(c), (d) (2007) (requiring the filing, as a "proposed rule change," of any "stated policy, practice, or interpretation" of, or "interpretation of an existing rule" by, a self-regulatory organization).

8. *See, e.g.*, Securities Industry and Financial Markets Association (SIFMA), http://www.sifma.org/about (last visited Mar. 21, 2007) ("[SIFMA] represent[s] more than 650 member firms of all sizes, in all financial markets in the U.S. and around the world."); Counterparty Risk Management Policy Group II, http://www.crmpolicygroup.org (last visited Mar. 21, 2007) (describing itself as a group of senior officials from major financial institutions with the "primary purpose of . . . examin[ing] what additional steps should be taken by the private sector to promote the efficiency, effectiveness and stability of the global financial system"); Financial Market Lawyers Group (FMLG), http://www.newyorkfed.org/fmlg/ (last visited Mar. 21, 2007) (describing itself as a group sponsored by the Federal Reserve Bank of New York comprised of lawyers who "advise[ ] on legal issues relevant to over-the-counter foreign exchange and other financial markets" and "support foreign exchange and other financial markets trading in leading worldwide financial institutions").

9. *See, e.g.*, SIFMA Standard Agreements, http://www.bondmarkets.com/stdagrmnts.asp (last visited Mar. 21, 2007) (noting the guidelines, procedures and documentation for, inter alia, offerings of securities by government-sponsored enterprises, trading practices with respect to repurchase agreements, delivery guidelines and buy-in procedures for mortgage-backed securities, and standard documentation and supporting legal opinions for global master repurchase agreements and master securities loan agreements); SIFMA Bond Markets & Prices, http://www.investinginbonds.com/MarketAtAglance.asp (last visited Mar. 21, 2007) (providing

Such organizations have, however, historically lacked the wherewithal to monitor for compliance, as well as the legal ability or economic incentive to discipline non-compliant members: The inability of exchanges and industry associations to police securities markets effectively prior to the Crash of 1929—despite their anti-regulatory lobbying efforts—aptly illustrates how private ordering can break down in securities markets.[10] As such, industry norms are most likely enforced, if at all, through provisions in bilateral agreements between members. A systemic failure of such enforcement mechanisms, however rare, is almost certain to invite Commission intervention absent the buffering effect of self-regulatory compliance and disciplinary mechanisms.

The most basic self-regulatory function might be deemed *mutual* regulation, or the regulation of transactions among members through rules that "foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities."[11] This standardization function sets the rules governing the interaction of public orders, the execution of transactions, the comparison of trading logs by members, the settlement of such transactions, and the delivery of securities.[12] Rules of mutual

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data on municipal, government and corporate bonds; and mortgage and other asset-backed securities transactions); FMLG FXC Master Agreements, http://www.newyorkfed.org/fmlg/documentation/master.html (last visited Mar. 21, 2007) (standard documentation that sets forth common legal terms for foreign exchange and currency option transactions, "including payments and close-out netting provisions"); International Swaps and Derivatives Association (ISDA) Bookstore/Publications, http://www.isdadocs.org (last visited Mar. 21, 2007) (providing documentation for over-the-counter derivative transactions and accompanying protocols and user guides).

10. *See, e.g.*, MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 31–36 (1970) (describing the gap between the "managerial and moral responsibility for the national securities industry" the Investment Bankers Association had undertaken as a result of its anti-regulatory lobbying efforts and its "incommensurate . . . organizational development and . . . fund of economic intelligence," its "serious information lag" with respect to the operation of the larger marketplace, and its reluctance "to coerce either members or clients" to provide full disclosure); *id.* at 36–41 (describing stock exchanges' "reluctan[ce] to enforce standards of disclosure upon listed companies" and their inability and unwillingness to verify the accuracy of statements made in listing applications).

11. Order Granting Approval of a Proposed Rule Change Amending Rule 180 to Require Member Organizations to Use the Automated Liability Notification System of a Registered Clearing Agency, Exchange Act Release No. 55,132, 72 Fed. Reg. 3896 (Jan. 26, 2007).

12. The centrality of this function is evidenced by the fact that it is coordinated by a single SRO, the Depository Trust & Clearing Corporation, pursuant to section 17A of the Exchange Act regarding a national system for clearance and settlement of securities transactions. *See* 15 U.S.C. § 78q-1 (Supp. II 2002); RULES, BY-LAWS AND ORGANIZATION CERTIFICATE OF THE DEPOSITORY TRUST COMPANY, http://www.dtcc.com/CustomerFocus/dtc_rules.pdf. While exchanges and the NASD retain basic rules for the post-trade clearance and settlement of transactions, Congress has expressed a preference for uniformity across all markets in this area. *See* H.R. Rep. No. 94-229, at 102 (1975), *reprinted in* 1975 U.S.C.C.A.N. 321, 333 ("To assure the development of a modern, nationwide system for the safe and efficient handling of securities transactions in a manner which best serves the financial community and the investing public, the Senate bill and the House amendment directed the [Securities and Exchange] Commission to

regulation might also be deemed to include minimum capital requirements for broker-dealers who clear securities transactions, since members who agree to abide by uniform rules of execution and settlement must rely on each other's creditworthiness. The discipline or expulsion of noncompliant members is a clear restraint against trade, but one which is sanctioned as long as it is conducted under the supervision of the Commission.

A second, equally important self-regulatory function might be deemed *reciprocal* regulation, or the development of standards that govern relations between members and their public customers. While members may not be financially interested in the terms of their peers' transactions with the public, such norms of competition not only enhance the protection of investors by prohibiting predatory conduct, but also increase the profitability of being a market intermediary by credibly signaling the higher standard of care to which SRO members adhere.[13] Thus, members will commit to observe collectively-developed standards regarding business conduct and practices on the condition that other members do so as well.[14] Because such rules may also carry an anti-competitive tinge, even when they exist for otherwise valid regulatory reasons, some supervision by regulators or antitrust enforcement authorities is appropriate.

Some aspects of self-regulation may also be characterized as purely *partitive*, in the sense that they are driven by the desire to balance the interests of one class of members (e.g., the managerial class, the specialist class, the "bulge bracket" firms) against the often conflicting interests of

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facilitate the establishment of the system and centralized in the Commission the authority and responsibility to regulate, coordinate and direct the operations of all persons involved in the securities handling process."); S. Rep. No. 94-75, at 5 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 184 ("[The Senate Banking, Housing and Urban Affairs] Committee is persuaded that the present uncoordinated state of affairs with respect to securities processing should not be allowed to continue. When securities firms must deal with a dozen or more different clearing and depository systems in their daily securities operations, the result necessarily is excessive cost and poorer service to investors. A national clearance and settlement system is clearly needed.").

13. *See, e.g.*, Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563, 581–82 (2005). The requirement that all broker-dealers be members of an SRO, of course, correspondingly deters SROs from raising their standards to a level that would make entry into continued participation in the broker-dealer industry unreasonably prohibitive.

14. *Cf.* Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71 (2003) (arguing that the "logic of reciprocity" may provide greater incentives to overcome collective-action problems than conspicuous rewards and punishments). In the context of broker-dealer regulation, such business conduct and practices comprise, among other things, rules regarding customer solicitation (e.g., advertising, sales practices, suitability, and know-your-customer diligence), personnel (e.g., qualifications, examinations, and supervision), fees (e.g., commissions, markup schedules, and terms of credit), and disclosures (e.g., confirmations and periodic statements). *See, e.g.*, NASD Rule 2000 Series (CCH Jan. 2005).

The model of reciprocity is reflected, when considering the international or supranational arenas, in agreements among states or regulatory bodies that require a market's or investment firm's home country regulator to apply and enforce minimum standards of regulation as a condition of permitting such market or firm to provide services in the territory of another member state or regulatory body. *See infra* notes 83–84 and accompanying text.

another. Rules regarding the affirmative and negative obligations of exchange specialists, as well as the obligations of market makers, were adopted for the benefit of public brokers. Because specialists profit from trading against customer order flow even as they facilitate the execution of public orders, a regulatory balance must be struck to ensure that the symbiotic relationship does not become parasitic.[15] Similarly, SRO rules regarding the form and minimum content of clearing arrangements ensure that the relationship between clearing and correspondent brokers is clearly defined with respect to all material terms.[16] One might view recent rules governing the automation of exchange trading systems as serving institutional interests (i.e., earnings from execution fees) at the expense of member firms with competing electronic trading systems or market making operations.

Finally, some aspects of self-regulation are not really "self"-regulatory at all, but merely serve a *gatekeeping* function.[17] For example, SROs adopt minimum quantitative standards for listed issues to create a reasonable expectation that such securities will trade in a liquid secondary market. Qualitative listing standards regarding corporate governance and investor protection also serve an important reputational goal for the SRO and its membership, as does the surveillance of markets for manipulative or deceptive conduct by insiders or other individuals improperly trading on the basis of material nonpublic information in an issuer's securities.[18] Such rulemaking is difficult to describe as "self-regulation" to the extent that issuers are not afforded significant representation in exchange governance structures.[19]

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15. SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 88-95, pt. 2, at 64–67, 142–57, 162–71 (1963); *see generally* George T. Simon & Kathryn M. Trkla, *The Regulation of Specialists and Implications for the Future*, 61 BUS. LAW. 217 (2005) (exploring the role of the specialist and how federal law regulates them).

16. *See, e.g.*, NYSE Rule 382 (requiring that agreements between NYSE members or member organizations that relate to the carrying of customer accounts specifically identify and allocate certain enumerated functions and responsibilities and be submitted to and approved by the Exchange); NASD Rule 3230 (requiring clearing or carrying agreements entered into by members to specify the respective functions and responsibilities of each party with respect to certain enumerated matters).

17. Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53–54 (1986) (defining "gatekeeper liability").

18. Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 329–30 (2001) (describing exchange listing standards developed before the enactment of the Exchange Act); John C. Coffee, Jr., *Racing Towards the Top: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1772 (2002) (noting that non-U.S. firms may choose to cross-list their securities in the United States, in part, based on the reputational value of a U.S. listing and the "higher likelihood of legal enforcement, the signal of profitable investment opportunities, the more credible promise of improved disclosure, contractual protections negotiated on entry into the U.S. market, [and] the enhanced analyst coverage" associated therewith).

19. *See infra* text accompanying notes 46–56.

Conferring regulatory authority on SROs for promulgating and enforcing such standards may, to a degree, be justified on the ground that it builds upon their commercial interests. As the burdens of federal regulation grow and listing fees and trading revenues are placed in jeopardy by over-regulation, the exchanges' commercial interest in acting as gatekeeper for the securities industry becomes far more attenuated. For example, surveillance of manipulative and deceptive conduct by members and their associated persons and other persons trading through the facilities of the exchange—while originally intended to curtail certain trading practices by exchange members and their customers in listed securities[20]—now fairly encompasses any manipulative or deceptive conduct under Rule 10b-5 and requires coordinated enforcement effort by all exchanges and the NASD.[21]

The taxonomy above illustrates the fundamental benefits and disadvantages of self-regulation. When the power of self-interest is harnessed to achieve common benefits, self-regulation (with the Commission's well-oiled shotgun behind the door) can be a very effective and affordable means of regulating the securities markets. Troubles abound, however, when SROs are asked to take on regulatory obligations that are at best tangential, and at worst inimical, to their managers' or members' interests. In these cases, reliance on self-regulation can be more of a hindrance than if promulgation or enforcement of rules were undertaken directly by the SEC or another regulator.

II. SELF-DOUBT

Although the premises of self-regulation have regularly been called into question, the concept has endured because lawmakers have generally regarded self-regulation to be a practical and efficient way to outsource the burdens of regulation to the private sector. Thus, despite the periodic scandals of exchange governance and member misconduct,[22] Congress and the Commission have reacted to public lapses in confidence by expanding the scope of self-regulatory responsibility and the Commission's oversight over SROs. In the present environment, by contrast, there is a growing lack of confidence on the part of SROs themselves and their own members in the axioms of self-regulation. This part discusses four reasons why self-regulation is now under assault: the incremental federalization of self-regulation, the diminishing representation of the securities industry in

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20. 15 U.S.C. § 78f(b)(5) (2000) ("The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices . . . ."); *id.* § 78i(a) (prohibiting certain fraudulent conduct on exchanges).

21. *See, e.g.*, Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256, 71,265–66 (Dec. 8, 2004) (describing the formation of the Intermarket Surveillance Group and its role in coordinating the enforcement efforts of its SRO members).

22. Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347, 1347–49 (2004).

SROs, the new-found self-interest of market-based SROs, and the difficulty in extending the concept of self-regulation internationally.

A. THE FEDERALIZATION OF SELF-REGULATION

One of the principal reasons for the decline of self-regulatory organizations may be the incremental federalization of securities law. While we think of the Exchange Act as creating a pervasive system of federal regulation, many elements of securities regulation were governed by rules of, or heavily influenced by, the eponymous exchanges for a significant part of the Act's history. Incremental federalization may have been inevitable—as it remains the one of the few tools Congress has to address the periodic scandals that shock the securities marketplace—but each successive tick of the one-way ratchet has reduced the autonomy of the securities industry, while increasing the costs and reputational stakes for SROs and their members.

The most celebrated example of incremental federalization at the expense of state or SRO regulation is the development of *disclosure and governance standards* for public companies.[23] For example, the Exchange Act, as originally enacted, largely limited the application of its periodic reporting, proxy solicitation, and insider reporting and trading provisions to exchange-listed firms.[24] Thus, exchanges could play a representative role in negotiating the federal disclosure and governance standards for top-tier companies that sought national credibility. In 1964, following its *Special Study of Securities Markets*,[25] the Commission gained the authority to extend these requirements to all over-the-counter issuers meeting the size

23. *See generally* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1 (1993) (discussing the displacement of state corporate governance norms by federal regulation).

24. Sections 13, 14, and 16 of the Exchange Act extend only to an issuer of a security registered pursuant to section 12 of the Exchange Act (and in the case of section 16, only with respect to registered classes of equity security). *See* 15 U.S.C. §§ 78m(a), 78n, 78p (Supp. II 2002). Certain over-the-counter firms that effected a registered securities offering under the Securities Act of 1933 were required to include an undertaking to file "such supplementary and periodic information, documents, and reports as may be required pursuant to section 13" in respect of securities registered under section 12, but were not required to comply with the corporate governance provisions of sections 14 and 16. *See* 15 U.S.C. §§ 78*o*(b), 78*l*(d) (1958); SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 3, at 2–7 (1963); Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565 (adding subsection (g) to section 12 and amending section 15(d) of the Exchange Act); *see also* H.R. REP. NO. 1418, 88th Cong., 2d Sess. (1964), *reprinted in* 1964 U.S.C.C.A.N. 3013, 3027 (describing the addition of section 12(g) to the Exchange Act "to provide for registration of securities traded in the over-the-counter market and for disclosure by issuers thereof comparable to the registration and disclosures required in connection with listed securities by section 12(b) of that act"); *id.* at. 3037 (describing the extension of the requirement under section 15(d) that each registration statement filed under the Securities Act "must contain an undertaking to comply with the reporting requirements of section 13" to all Securities Act registrants).

25. H.R. DOC. NO. 88-95, pt. 3, at 7–17, 60–64.

and shareholder requirements of section 12(g).[26] Moreover, beginning in the 1970s and continuing to the present day, the Commission transformed the Exchange Act's periodic disclosure requirements into a system of forward-looking disclosure, rather than purely historical data. These developments considerably expanded the range of information required to be disclosed by all listed and unlisted companies, while simultaneously diminishing the scope and prestige of exchange standards.[27]

Exchanges retain the incentives and discretion to promulgate qualitative governance rules and standards that are stricter than Commission requirements as a means of reputationally distinguishing their listed issues.[28] Thus, in addition to the quantitative requirements for listing eligibility, the New York Stock Exchange (NYSE) has historically imposed obligations such as real-time disclosure of certain material information during volatile market conditions, and corporate governance rules respecting the independence of auditors, directors, and audit committees.[29] NYSE listing agreements also continue to provide important protections for investors in exchange-listed securities by restricting the dilution of their voting rights in various corporate finance transactions.[30]

Even in these areas, the Commission and Congress have sought to use exchange rules to further their regulatory goals. Exchange rulemaking and enforcement in the area of corporate governance, for example, often appears to have been prodded by the Commission as a means of circumventing statutory limitations on its own authority.[31] Legislation such as the Sarbanes-Oxley Act, which appears to be the first to mandate specific listing standards through legislation,[32] can only further erode the self-regulatory principle that exchanges autonomously develop standards for corporate governance.

26. *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565; Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17, 29–30 (1986).

27. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 465–66 (rev. ed. 1995).

28. *See* Karmel, *supra* note 18, at 329–30.

29. *See* NYSE, Inc., Listed Company Manual §§ 202.03, 303A.00 (2006) [hereinafter NYSE LCM].

30. *Id.* § 313.00(A).

31. Karmel, *supra* note 18, at 352; Comm. on Fed. Reg. of Sec., ABA, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1490 (2002). Prominent examples are the Commission's efforts to require the NYSE to enforce its rule against dual class recapitalizations after its own Exchange Act Rule 19c-4 was vacated in *Business Roundtable v. SEC*, 905 F.2d 406, 417 (D.C. Cir. 1990), and to require exchanges to adopt rules governing auditor independence in the late 1990s. *See, e.g.*, Ira M. Millstein, *Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1057 (1999).

32. Sarbanes-Oxley Act of 2002 § 301, Pub. L. No. 107-204, 116 Stat. 745, 775 (codified at 15 U.S.C. § 78j-1(m)).

Standardization of *financial responsibility* rules for securities intermediaries, such as net capital, customer protection, and bookkeeping requirements, has also figured prominently in the downsizing of the SRO's special statutory mission.[33] While the unique expertise and mutual interest of exchange members in upholding high standards of financial responsibility might have militated in favor of keeping these rules largely within the purview of SRO regulation, the back office crisis and subsequent insolvencies of several brokerage firms put these rules squarely on the federalization agenda in the 1960s. Initially, the Congressional reaction favored a self-regulatory approach to the problem of customer protection: the Securities Investor Protection Act of 1970 provided a self-regulatory model for customer protection under the auspices of the Securities Investor Protection Corporation.[34] Within five years, however, Congress gave the Commission the authority to promulgate uniform net capital and customer protection rules for all registered broker-dealers.[35]

Today, while exchanges might not impose significant additional net capital requirements by rule, exchanges such as the NYSE and the Chicago Board Options Exchange (CBOE) still play a very important role in the application and interpretation of the Commission's rules and work closely with the Commission and the brokerage industry to adapt to marketplace developments. Two factors, however, threaten the future of this relationship. First, following the Gramm-Leach-Bliley Act of 1999, banking regulation can be expected to play a greater, if indirect, role in the standard setting process for financial responsibility rules.[36] Second, with the

33. Section 7(d) of the Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636, 1653, required the Commission to prescribe "safeguards with respect to the financial responsibility and related practices of brokers and dealers," and in particular, "the maintenance of reserves with respect to customers' deposits or credit balances." *See also* Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. 25,224 (Nov. 29, 1972) (adopting the Commission's customer protection rule, 17 C.F.R. § 240.15c3-3). Five years later, section 11(3) of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, amended section 15(c)(3) of the Exchange Act to require the Commission to promulgate rules and regulations establishing minimum financial responsibility requirements for all brokers and dealers. 15 U.S.C. § 78*o*(c)(3) (2000). *See also* Adoption of Net Capital Rule, 40 Fed. Reg. 29,795, 29,795–96 (July 16, 1975) (revisions to Commission's net capital rule, pursuant to the Securities Acts Amendments of 1975, eliminating the exemption from the Commission's net capital rule for members of designated national securities exchanges required to comply with net capital rules of such exchanges).

34. *See infra* note 106. The Securities Investor Protection Corporation (SIPC) insures customer securities and cash balances through a fund maintained by assessments from its membership, which generally includes all registered broker-dealers. *See* 15 U.S.C. § 78ddd (2000). SIPC has significant powers to intervene in bankruptcy or insolvency proceedings involving its members and is responsible for the distribution of securities and funds to customers of an insolvent brokerage firm. *See* 15 U.S.C. §§ 78eee–78hhh (2000).

35. Steven L. Molinari & Nelson S. Kibler, *Broker-Dealers' Financial Responsibility under the Uniform Net Capital Rule—A Case for Liquidity*, 72 GEO. L.J. 1, 14–16 (1983–1984).

36. The Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999), is generally said to have repealed the long-standing prohibition under the Glass-Steagall Act against the

internationalization of investment firms, there have been parallel efforts to regulate financial responsibility on a groupwide basis rather than at the level of the individual SEC-regulated brokerage firm,[37] and to standardize capital requirements for all firms.[38] While SROs attempt to exercise some oversight over the corporate parents of their members,[39] the Commission is ultimately better positioned to enter into discussions with both domestic and foreign financial services regulators to harmonize such rules.

SRO *business conduct* regulation, while still the SROs' strongest suit, has also come under assault, particularly as a result of the expansion of private rights of action under Exchange Act Rule 10b-5 and increasing SEC rulemaking in all aspects of broker-dealers' customer relations. SRO rules continue to govern the gray area that does not rise to the level of fraud but nevertheless falls short of "just and equitable principles of trade."[40] SROs, such as the NASD, also play a significant compliance role with respect to newly registered brokerage firms, including screening for disqualifications, examining for competence, ensuring adequate supervisory personnel, and overseeing the use of advertising and sales literature. Even here, however, the Commission has stepped up its own efforts by dedicating compliance personnel to the oversight of broker-dealer operations.[41] The rise of

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affiliation of commercial and investment banking. The Act permits bank holding companies that qualify as "financial holding companies" to provide other financial services—such as underwriting, brokerage, and insurance—through subsidiaries functionally regulated by the appropriate federal or state regulatory authority and under the "umbrella" supervision of the Federal Reserve Board. *Id.* at pt. [1]. Although the Federal Reserve Board may not generally apply capital standards to SEC-registered broker-dealer subsidiaries of a financial holding company, or look to such subsidiaries as a "source of strength" for a bank affiliate, *id.* § 111(c), the Board has stated that it "is responsible for assessing consolidated capital adequacy for FHCs with the ultimate objective of protecting the insured depository subsidiaries from the effects of disruptions in the nonbank portions of the organization." Board of Governors of the Federal Reserve System, SR Letter, SR 00-13 (SUP) (Aug. 15, 2000), *available at* http://www.federalreserve.gov/boarddocs/SR LETTERS/2000/SR0013.HTM.

37. *See, e.g.*, 15 U.S.C. § 78*o*(i) (Supp. II 2002). This section was enacted as part of the Gramm-Leach-Bliley Act of 1999 to provide a framework for Commission supervision of investment bank holding companies, including recordkeeping and reporting requirements and examination authority. *See also* Supervised Investment Bank Holding Companies, Exchange Act Release No. 49,831, 69 Fed. Reg. 34,472 (June 21, 2004) (adopting final rules creating a new framework for supervising an investment bank holding company).

38. *Cf. States Demand Role in Basel II Plans, New York State Banking Regulator Says*, 87 Banking Daily (BNA) No. 10, at 388 (Sept. 18, 2006) (describing state bank regulators' concerns that the process by which the Basel II capital accord is being implemented in the United States has been dominated by federal regulators).

39. NASD Rule 1017, *Application for Approval of Change in Ownership, Control or Business Operation* (2006) (requiring NASD approval for change in ownership or control of member firms); NYSE Rule 304(E), *Allied Members and Approved Persons* (2006) (requiring Exchange approval of persons who control a member or member organization).

40. Commission efforts to characterize unethical business practices as fraud must be predicated on implied representations or non-verbal conduct. *See generally* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995) (describing the implied representations of broker-dealers that they will deal fairly with customers).

41. *See infra* Part III.A.

securities arbitration under SRO auspices may also have had the effect, at least in the context of private litigation, of eroding the boundary between SRO ethical norms and securities fraud. For example, arbitrators may, absent "manifest disregard of the law," inadvertently impose liability for conduct that falls short of the judicially developed contours of Rule 10b-5.[42]

Finally, the Commission's significant rulemaking in the area of *market structure* has considerably undermined the autonomy of exchanges to regulate the structure of their own market operations. The justification for conferring disciplinary authority on exchanges is their comprehensive ability to oversee and control participation in trading through their facilities; the power to exclude subsumes the power to discipline. Once exchanges are no longer able—or permitted—to mandate consolidation of order flow through their facilities, the source of self-regulatory authority wanes considerably. As others have discussed, over the past seventy years the Commission has cajoled or required the primary exchanges to abandon mandatory minimum commission schedules, off-board trading prohibitions (both with respect to other exchanges and the over-the-counter market), and restrictions on the ability of management or shareholders to delist companies from an exchange.[43]

Similarly, centralization of trading under Commission rules governing the national market system has supplanted the role traditionally played by exchanges and the NASD in developing priority, parity, and precedence rules for execution and execution quality and conflict-of-interest standards. Rules, such as the duty of best execution, order handling and routing obligations, and the prohibition against trading ahead of customer orders, are gradually being hardwired into inter-exchange communications systems built to Commission specifications.[44] Experts may disagree as to whether limiting the discretion of broker-dealers to choose among competing trading systems is appropriate, but a collateral effect of such initiatives is to minimize the roles of SROs in promulgating and enforcing "just and equitable principles of trade."[45]

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42. *See, e.g.*, Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415 (2003–2004).

43. Dale A. Oesterle, *Regulation NMS: Has the SEC Exceeded Its Congressional Mandate to Facilitate a "National Market System" in Securities Trading?*, 1 N.Y.U. J. L. & BUS. 613, 613–15 (2005); Laura Nyantung Beny, *U.S. Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition*, 2002 COLUM. BUS. L. REV. 399, 412–17, 462–63; Karmel, *supra* note 18, at 347–52.

44. *NYSE Sees Best Execution Differently from Amex, Nasdaq*, 38 Sec. L. Daily (BNA) No. 30, at 1278 (July 18, 2006). SEC Chief Economist Chester Spatt suggested that "Regulation NMS to some extent 'simplifies' a broker-dealer's duty of best execution by transferring some of the responsibility for best execution to the exchanges." *Id. See also* Simon & Colby, *supra* note 26, at 27–28.

45. *Compare* Lawrence E. Mitchell, *Structure as an Independent Variable in Assessing Stock Market Failures*, 72 GEO. WASH. L. REV. 547 (2004), Morris Mendelson & Junius W. Peake,

B. THE CHANGING FACE OF SELF-REGULATION

Another development affecting the vitality of SROs is their increasing bureaucratization. One of the core assumptions of self-regulation is that SROs will be representative of the industry they regulate. Each national securities exchange and registered securities association, for example, must "assure a fair representation of its members in the selection of its directors and administration of its affairs."[46] The public interest was to be advanced by requiring "one or more directors" who would be "representative of issuers and investors and not be associated with a member of the exchange, broker or dealer."[47] Moreover, an expectation existed that organizations representative of the securities industry would be involved in SRO governance, disciplinary activity, and day-to-day decisionmaking.[48]

With the increasing size and specialization of SRO staff, SRO governance threatens to lose its representative status. Industry representation is largely confined to board oversight and member participation in the committee structure and disciplinary proceedings at various SROs.[49]

Intermediaries' or Investors': Whose Market Is It Anyway?, 19 J. CORP. L. 443 (2000), *and* Yakov Amihud & Haim Mendelson, *A New Approach to the Regulation of Securities Trading Across Markets*, 71 N.Y.U. L. REV. 1411 (1996), *with* Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563 (2005), *and* Mark Klock, *The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753 (1999). *See, e.g.*, 15 U.S.C.S §§ 78f(b)(5), 78*o*-3(b)(6), 78*o*-4(b)(2)(B), 78*o*-5(b)(3) (LexisNexis 2006) (requiring national securities exchanges, national securities associations, and registered clearing agencies to have rules designated to promote "just and equitable principles of trade").

46. 15 U.S.C.S. §§ 78f(b)(3), 78*o*-3(b)(4) (LexisNexis 2006).

47. In practice, many exchanges sought to balance the number of "industry" directors on their boards with a comparable number of "public" (or "non-industry") directors. The proposed definition of "independent" directors in the SEC rules appears to be more restrictive than the traditional "public" or "non-industry" classification under prior exchange rules. *See* Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, Exchange Act Release No. 50,699, 69 Fed. Reg. 71,126, 71,135 n.101 (reciting requirements of the Boston Stock Exchange's Constitution and the former Pacific Exchange's By-Laws establishing an equal proportion of "public" or "non-industry" and "industry" directors); NYSE CONST. art. 4, § 2 (CCH May 2002) (requiring, prior to the governance reforms contained in Exchange Act Release No. 48,946, that the board of the NYSE include, in addition to senior officers, 12 industry and 12 public directors); Letter from Neal Wolkoff, Acting CEO, AMEX, to Jonathan G. Katz, Sec'y, SEC 2 (Mar. 8, 2005), *available at* http://www.sec.gov/rules/proposed/s73904/nwolkoff 030805a.pdf (reflecting on AMEX's experience with a "largely independent board composed of many highly respected and accomplished individuals with no ties to the securities industry"); Letter from Robert Glauber, Chairman and CEO, NASD, to Jonathan G. Katz, Sec'y, SEC 8 (Mar. 8, 2005), *available at* http://www.sec.gov/rules/proposed/s73904/rrglauber030805.pdf (noting that, pursuant to its undertakings in connection with the 1996 settlement described in the 21(a) Report, the "NASD maintains a majority Public and Non-Industry membership on its Board of Governors," as defined in its by-laws and rules).

48. S. REP. NO. 75-1455, at 4–5 (1938) (describing the Maloney Act as creating a program of "cooperative regulation . . . [in which the task will be largely performed by] representative organizations of investment bankers, dealers, and brokers").

49. *Walter Says NASD Committed to Keeping 'Self' in Self-Regulation*, 38 Sec. Reg. & L. Rep. (BNA) No. 37, at 1534 (Sept. 14, 2006) (describing member involvement in SRO governance).

Internal divisions between regulatory and operational arms further segregate persons involved in regulatory decisions from individuals with operational experience in the securities industry.[50] It has also long been observed that the need to develop specialized compliance inspection and enforcement functions within each SRO results in the delegation of responsibility to full-time paid staffs, who may or may not have managerial or operational experience in any of the SRO's member firms.[51] While this does not necessarily imply that familiarity with firm operations cannot be acquired, it does suggest a lack of identity on the basis of which to establish a claim of self-representation in self-regulation.

Recent SEC initiatives would increase this trend toward greater independence from the securities industry. Proposed rules respecting SRO governance, for example, would require SRO boards to consist of a majority of independent directors.[52] While the preference for outside directors is nothing new, stringent independence requirements would generally exclude individuals with any material ties to the securities industry.[53] When combined with the effect of the SEC's determination to permit for-profit exchanges (discussed below), member representation on SRO boards could decline to as little as 20%.[54] The SEC's SRO governance rules would also mandate greater separation between SROs' regulatory and operational functions,[55] and require internal controls to ensure regulatory monies do not subsidize operational activities.[56]

These developments will have numerous consequences on self-regulation. As SRO personnel begin to look more like the SEC, it will be increasingly difficult to envision SROs performing the traditional buffering function between industry competition and SEC regulation. Instead, SROs, such as the NASD, are likely to behave as if they are an extension of the Commission's own compliance and enforcement arms, with the added benefit that they are subsidized by industry fees and not constrained by the same statutory limitations on their power. NASD rulemaking initiatives, for

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50. *See infra* text accompanying notes 68–71.

51. *See, e.g.*, Sam Scott Miller, *Self-Regulation of the Securities Market: A Critical Examination*, 42 WASH. & LEE L. REV. 853, 862–63 (1985) (citing William L. Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244, 247 (1963); SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 4, at 602).

52. Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, 69 Fed. Reg. at 71,126.

53. *See id.* (defining "independent director"); *see, e.g.*, *Walter Says NASD Committed to Keeping 'Self' in Self-Regulation*, *supra* note 49 (noting that the NASD Board of Governors has 7 industry directors out of 18 and NYSE regulation has no industry representation).

54. *See* Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, 69 Fed. Reg. at 71,126 (to be codified at 17 C.F.R. § 240.6a-5(c)(5)).

55. *Id.* (to be codified at 17 C.F.R. §§ 240.6a-5(n)(1), 240.15Aa-3(n)(1)).

56. *Id.* (to be codified at 17 C.F.R. §§ 240.6a-5(n)(4), 240.15Aa-3(n)(4)).

example, may become increasingly driven by pressure from the Commission, rather than pressure for coordination by the industry.

More importantly, the agenda of self-regulators may retreat significantly from areas outside of the SEC's competence or expertise. Many aspects of today's securities markets are not subject to direct regulation by the Commission—such as over-the-counter derivatives transactions and corporate debt markets. These are areas in which SROs truly representative of the securities industry might make headway in spearheading the development of business conduct norms, much as the U.S. Treasury Department and Municipal Securities Rulemaking Board (MSRB) have developed idiosyncratic rules for the government and municipal securities markets. The NASD has made only modest forays into such issues, presumably because the industry has no desire to see Commission-dominated SROs creep into areas outside of the SEC's direct oversight.

C SELF-INTEREST

Even as recent trends have aligned the interests of SRO regulatory personnel with those of the SEC, they have created even greater opportunities for SRO operational personnel to leverage the value of their special statutory status. Historically, exchanges and other SROs were operated as not-for-profit organizations. While a limited number of exempt exchanges were permitted to operate on a for-profit basis outside of the statutory regime, exchanges largely existed to furnish facilities "for the convenient transaction of business by its members."[57] Abuses of exchange management, however frequent, were usually for the benefit of one faction (e.g., specialists or floor brokers) at the expense of another.[58] The profitability of a seat on the exchange and the access it conferred to its exclusive information and services, moreover, deterred members from "turning them into shares" that could be offered to the public.[59]

Although the Commission has acknowledged that national securities exchanges could be organized as for-profit entities, several factors contributed to the current trend to seek for-profit status.[60] First, technology made pure brokerage profitable. New electronic trading systems capitalized on technological improvements to offer more efficient, if non-traditional, venues for trade execution without sponsoring the intermediation of a dealer.[61] Virtually all of these systems were permitted to operate as

57. NYSE CONST. art. I, § 2(a).

58. *See* Seligman, *supra* note 22, at 1355.

59. Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L. REV. 367, 372–73 (2002). *See also* Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2564–66 (2006).

60. Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485, 30,486 (June 4, 1997).

61. *See, e.g.*, Macey & O'Hara, *supra* note 13 (describing technological advances that affect trading).

registered broker-dealers in the United States, rather than as exchanges, in order to facilitate their proliferation.[62] The mutual structure of the primary exchanges, encumbered as it was by members' (and in particular, specialists') self-interest, prevented the adoption of new execution technologies in favor of traditional intermediated trading. To the extent that many brokerage firms were investing in competing execution or market making technologies,[63] exchange members increasingly found themselves in direct competition with their regulators.[64]

Second, Commission rulemaking requires SROs to build linkage systems that would serve as the basis for intermarket connectivity. The Commission had long pressed exchanges and the NASD to develop technologies to improve execution quality for retail investors by facilitating access to their members' published quotations.[65] This eventually placed SROs—particularly, the NASD—in direct competition with members who operated electronic trading or market making systems, because they were essentially building systems that would eliminate internalization of orders in favor of a centralized (if not mandatory) limit order book.[66] In particular,

62. Exchange Act Release No. 38,672, 62 Fed. Reg. at 30,486. One system, the Arizona Stock Exchange, has been recognized as an "exchange" operating pursuant to a limited volume exemption from registration under section 5 of the Exchange Act. *See* Order Amending Exemption Order and Granting Amendment to Application for Exemption from Registration as an Exchange under section 5 of the Securities Exchange Act of 1934, Exchange Act Release No. 37,271, 61 Fed. Reg. 29,145 (June 3, 1996). To the extent that a limited-volume business model forecloses any benefits from economies of scale, it is not surprising that few trading systems have pursued such regulatory classification.

63. *See* Mark Borrelli, *Market Making in the Electronic Age*, 32 LOY. U. CHI. L.J. 815, 817 (2001).

64. *See* Gaston F. Ceron, *Moving the Market: Big Board Sets Expansion In Electronic Trading*, WALL ST. J, Aug. 28, 2006, at C3 (describing concerns of NYSE specialists and brokers that the lifting of the limits on electronic trading could sideline them and hurt their profits).

65. *See* Order Granting Temporary Approval, On An Accelerated Basis to a Proposed Rule Change by the National Association of Securities Dealers, Inc. to Establish the Order Confirmation Transaction Service Enhancement to the NASDAQ System, Exchange Act Release No. 25,263, 53 Fed. Reg. 1430 (Jan 19, 1988) (approving Nasdaq's SelectNet Service, formerly the Order Confirmation Transaction Service, on a temporary accelerated basis); National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change, Release No. 21,743, 50 Fed. Reg. 7432 (Feb. 22, 1985) (approving Nasdaq's Small Order Execution Service). *See also* Simon & Colby, *supra* note 26, at 73–76.

66. For example, in its application for registration as a freestanding national securities exchange, Nasdaq agreed to limit "Nasdaq Exchange transactions" to those trades that are "executed in the Exchange's systems and to amend its Exchange systems to require executions to occur pursuant" to price- and (with certain exceptions) time-priority rules. *See, e.g.*, In re Nasdaq Stock Market, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550, 3550–51 (Jan. 23, 2006). This amendment obviated the need for the Commission to reconsider whether exchanges must have a central limit order book that ensures some price/time priority over dealer trades on the exchange. *Id.* at 3550–51; *see also* 17 C.F.R. § 240.3b-16 (2006) (interpreting the statutory definition of an "exchange" in section 3 of the Exchange Act, 15 U.S.C. § 78c(1), to require the use of "established, non-discretionary methods . . . under which . . . orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade"). It eliminated, however, the ability of members (such as market makers) to "preference" execution of customer orders against a designated quoting market participant's quote, irrespective of time priority, as

SROs could offer the unique proposition of disintermediation and regulatory imprimatur. Why pay a market maker or an alternative trading system to display your order in Nasdaq when you can display your order directly in Nasdaq? Why risk a poor execution in an alternative trading system, when you are guaranteed an execution quality price on the NYSE? Together with trade-through rules that favor established markets, exchanges had a competitive edge over their members.[67]

Third, the Commission's separation of regulatory and operational functions within SROs made it possible for SROs to operate their facilities as profitable subsidiaries. In 1996, following the Nasdaq market making scandal, the NASD was required, inter alia, to segregate its market operations (which became the Nasdaq Stock Market) from its regulatory operations (NASD Regulation).[68] Parallel with, if not as a consequence of, the enactment of the Sarbanes-Oxley Act of 2002 and the governance reforms following the public debate over NYSE CEO Richard Grasso's compensation package, the Commission proposed to extend this structural segregation to other exchanges.[69] The Commission has also proposed to revamp the rules of exchange governance to require greater transparency and segregation of the regulatory and trading operations of SROs. And just as Nasdaq has spun off from the NASD to be a freestanding SRO (having delegated its self-regulatory responsibility to the NASD), the NYSE has formally separated its regulatory and business operations into independent subsidiaries to reduce conflicts of interest.[70]

With autonomy and the prospect of profitability, electronic trading could be used not only to improve member access to public quotes, but to supplant member activity in the over-the-counter markets. Nasdaq could transform its system for displaying and providing execution access to member quotations into an electronic trading system that would rival its

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long as the quote matched the contemporaneous best bid/best offer. *See, e.g.*, Former NASD Rule 4710(b)(1)(B)(ii)(b) (CCH Jan. 2005). Thus, a market maker may not preferentially execute customer transactions against its own quote "on or through" the facilities of the Nasdaq Exchange.

67. *See* 17 C.F.R. § 242.611 (2005) (requiring trading centers to establish, maintain and enforce policies reasonably designed to prevent transactions on their markets that "trade-through" the protected quotations of other markets in NMS stocks).

68. SEC, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET (Aug. 8, 1996), *available at* http://www.sec.gov/litigation/investreport/nasdaq21a.htm.

69. Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, Exchange Act Release No. 50,699, 69 Fed. Reg. 71,126, 71,129–30 (describing the proposed governance reforms adopted by the NYSE in December 2003 in the context of "Governance Concerns" relating to issuers of exchange-listed securities and to the NYSE itself in connection with its Chairman's compensation package, and the concomitant concerns over weaknesses in the regulatory programs of other SROs).

70. Order Granting Approval of Proposed Rule Change and Amendment Nos. 1, 3, and 5 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 6 and 8 Relating to the NYSE's Business Combination With Archipelago Holdings, Inc., Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251–52 (Mar. 6, 2006).

competitors in the over-the-counter market. NYSE, AMEX, and the regional exchanges, meanwhile, could build systems that would bypass exchange specialists or market makers, rather than rely upon their negative obligation to refrain from trading in an otherwise liquid market.[71]

Fourth, a for-profit structure was more conducive to expansion in the technology boom of the late 1990s. Raising capital as a non-profit membership organization would entail higher regulatory or trading fees, and thus would require membership and Commission scrutiny of each initiative. By contrast, a public offering, followed by strategic acquisitions for stock, allows SROs to expand operational capabilities rapidly by purchasing boutique technology firms rather than develop proprietary technologies.[72] Nasdaq's acquisition of Instinet and NYSE's merger with Archipelago—the two ECNs with the largest market share of National Market System (NMS) order flow—could not have taken place without access to capital markets.[73] Publicly held stock may also facilitate mergers with similarly structured international exchanges to the extent that cross-border trading or technological synergies exist.[74]

The potential adverse consequences of the for-profit transformation are manifest. SROs may lose their focus on serving as regulators for the securities industry and instead concentrate on maximizing shareholder revenues.[75] From an economic perspective, this is unobjectionable. There are many regulated industries (e.g., the telecommunications industry) where private companies operate public utilities and dictate (to a degree) the terms

71. The goal of the various "hybrid" market structures implemented in recent years by various stock exchanges (including the NYSE and AMEX) is to augment opportunities for automated execution of public orders at published quotations without eliminating the entry and execution of floor-based orders. Specialists would continue, in such systems, to commit capital to bridge temporary gaps in supply and demand—particularly for large transactions that may not be entirely filled at the national best bid and offer—in exchange for preferential access to information, exclusive interfaces with exchange systems for managing their trading interest, and the limited ability to suspend automated executions or to conduct parallel floor auctions. *See, e.g.*, Order Approving Proposed Rule Change and Amendments and Notice of Filing and Order Granting Accelerated Approval to Amendments to Establish the Hybrid Market, Exchange Act Release No. 53,539, 71 Fed. Reg. 16,353 (proposed Mar. 31, 2006) (approving NYSE's proposed rule changes to establish the hybrid market); Order Approving a Proposed Rule Change and Amendments, and Notice of Filing and Order Granting Accelerated Approval to Amendment, To Establish a New Hybrid Trading System Known as AEMI[SM], Exchange Act Release No. 54,552, 71 Fed. Reg. 59,546 (Oct. 10, 2006) (approving AMEX's proposed rule changes to establish the "Auction & Electronic Market Integration" system).

72. Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497, 513 (2001).

73. Brian Blackstone, *U.S. Approves Exchange Deals*, WALL ST. J., Nov. 17, 2005, at C3 (describing Nasdaq's acquisition of Instinet and NYSE's merger with Archipelago).

74. *See, e.g.*, Boston Options Exchange, http://www.bostonoptions.com/ove/ope.php (last visited Oct. 20, 2006) (describing Boston Options Exchange Group LLC, a joint venture among Montreal Exchange, Boston Stock Exchange and various member firms that manages all issues relating to trading on the options exchange).

75. James D. Cox, *Brands vs. Generics: Self-Regulation by Competitors*, 2000 COLUM. BUS. L. REV. 15, 19 (2000).

of competition for their competitors. But in no sense of the word are such specially licensed firms considered self-regulators representative of their customers—at least no more than a taxicab medallion transforms a New York cab driver into a traffic cop. Moreover, there is no consensus that stock exchanges are essential utilities, the quotations of which must be accessible by all broker-dealers, as long as common members are able to limit significant price variations across markets.[76]

A second consequence of this transformation is the impact on public perception of the fairness of the marketplace.[77] One of the important ceremonial duties of SROs is to take public remedial measures to address misconduct by their members and listed issuers so that Congress and the Commission do not have to resort to the more cumbersome combination of legislation and regulation. When exchanges themselves become the source of scandal, this function is lost. The scandal surrounding NYSE CEO Richard Grasso's compensation package, for example, while in theory solely a concern of the members of the exchange (as a private company), reflects the sense of civic responsibility to which SRO management is (thought to be) held.[78] This level of public accountability will no longer be tenable when SRO shareholders require that their agents operate with the morals of the marketplace.

D. CROSS-BORDER MERGERS AND JOINT VENTURES

The globalization imperative has permeated the financial services sector. Shareholders of both the NYSE Group and Euronext, one of the largest non-U.S. stock exchanges, have approved the merger of the two

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76. *Compare* Junius Peake, *Entropy and the National Market System,* 1 BROOK. J. CORP. FIN. & COM. L. 301 (2007) *with* Roger Blanc, *Intermarket Competition and Monopoly Power in the U.S. Securities Market*, 1 BROOK. J. CORP. FIN. & COM. L. 273 (2007).

77. Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?,* 21 NW. J. INT'L L. & BUS. 657, 658 (2001) (discussing the reasons behind the historical organization of certain financial services as mutual businesses).

78. *See, e.g.*, *The Post-Grasso Exchange*, N.Y. TIMES, Nov. 4, 2003, at A1 ("While unproven, the suggestion that the exchange's boss was compensated generously to perpetuate an outdated system that benefited insiders is potent because the institution is riddled with untenable conflicts of interest. The exchange must be drastically overhauled if it is to regain investors' trust."); Jesse Eisinger, *The Well-Paid Regulator*, WALL ST. J., Sept. 11, 2003, at C1 ("Whatever the NYSE wants to pay its CEO is fine. But only if the NYSE is stripped of its regulatory authority. It's untenable for a regulator to simultaneously be running a business, especially one besieged by superior competition. Investors need to trust that when those who run the markets throw out pieties about disclosure and fairness, they are sincere. The way to restore investor trust is not for Mr. Grasso to give back fractions of his wealth, but to give up a bit of his power."). At the time, the NYSE was a "Type A" not-for-profit corporation under section 402 of the N.Y. Not-For-Profit Corporation Law. The NYSE Group, Inc. (the new holding company of the NYSE and its affiliates) became a public corporation on March 8, 2006, following the completion of the merger of the New York Stock Exchange into Archipelago Holdings, Inc. the prior day. *See* Steve Gelsi, *Moving the Market: NYSE Begins Its Life Today as a Listed Stock,* WALL ST. J., Mar. 8, 2006, at C5; Aaron Lucchetti & Kara Scannell, *NYSE's Trading Overload Draws Attention of the SEC*, WALL ST. J., Mar. 1, 2007, at C1.

entities.[79] Deutsche Börse and Borsa Italiana have also at various times been in negotiations to join the NYSE-Euronext combination.[80] Meanwhile, Nasdaq has gradually increased its stake in the London Stock Exchange even as its increasing hostile takeover offers have been rebuffed.[81] More modest initiatives have also taken place, such as the Boston Stock Exchange's joint venture with the Montreal Stock Exchange to develop a common operating platform for options trading.[82] And yet, to date, the Commission has addressed only in the broadest terms how or on what terms a non-U.S. stock exchange can maintain a presence in the United States without running afoul of the statutory prohibition against trading by U.S. brokers on unregistered exchanges.[83]

On the one hand, the Commission cannot deny the inevitable conglomeration of national exchanges into transnational exchanges.[84] Investors have reaped significant benefits from the consolidation of regional exchanges in the United States and national exchanges in the EU in terms of

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79. *See generally* Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355 (2007).

80. Gaston F. Ceron, *NYSE Group's Shareholders Approve Takeover of Euronext*, N.Y. TIMES, Dec. 21, 2006, at C3.

81. Alistair MacDonald & Gren Manuel, *Nasdaq Gets Tough in LSE Bid*, WALL ST. J., Dec. 13, 2006, at C3 (describing Nasdaq's hostile £2.7 billion bid to acquire a simple majority of LSE's shares); *Britain Hopes to Limit Changes at Exchange*, REUTERS, Sept. 14, 2006 (noting U.K. officials' concern that ownership of the LSE by Nasdaq could trigger the application of U.S. law). *See also* Alistair MacDonald, *With Nasdaq-LSE Deal Doubtful, Exchanges' Next Steps are Unclear*, WALL ST. J., Feb. 10, 2007, at B3; Alistair MacDonald, *LSE, Available Again, May Seek New Partner—After Nasdaq Bows Out, Local Deals Could Prove Difficult to Put Together*, WALL ST. J., Feb. 13, 2007, at C2.

82. *See* Boston Options Exchange, http://www.bostonoptions.com/ove/ope.php (last visited Oct. 20, 2006).

83. 15 U.S.C. § 78e (2000) (prohibiting any broker, dealer, or exchange from using any facility of an exchange within or subject to U.S. jurisdiction unless such exchange is registered under section 6 of the Exchange Act or exempted by the Commission upon application). Only one non-U.S. exchange currently operates pursuant to a limited-volume exemption. *See* Order Granting Limited Volume Exemption From Registration as an Exchange Under Section 5 of the Securities Exchange Act, Exchange Act Release No. 41,199, 64 Fed. Reg. 14,953 (Mar 29, 1999); Letter from Robert L. D. Colby, Deputy Director Division of Market Regulation, SEC, to Steven Lofchie, Partner, Davis, Polk & Wardwell (June 21, 2001) (commenting on an SEC no-action position relating to Tradepoint Stock Exchange/virt-x exchange); Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485, 30,486 (proposed June 4, 1997).

On March 1, 2007, Erik R. Sirri, Director of the SEC's Division of Market Regulation, revived discussion of proposals to exempt foreign exchanges from registration under section 6 subject to conditions established by rule. Erik R. Sirri, Dir., SEC Division of Market Regulation, Trading Foreign Shares, Speech in Boston, Massachusetts (Mar. 1, 2007), *available at* http://www.sec.gov/news/speech/2007/spch030107ers.htm. *See also* Regulation of Exchanges, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485, 30,522–23 (Part VII.B.1) (June 4, 1997) (soliciting comment on a proposal to rely on home-country regulation of non-U.S. securities exchanges).

84. Christopher Cox, Chairman, SEC, Speech at Harvard Business School Global Leadership Forum, Ronald Reagan International Center: Cross-Border Exchange Mergers in the Context of Global Trade (June 22, 2006), *available at* http://www.sec.gov/news/speech/2006/spch062206cc.htm.

access to trading opportunities, variety of listed securities, and improvements in exchange technology and services.[85] At present, cross-border synergies must come primarily from the latter, since the resulting business combinations will operate largely as holding companies for separately regulated and operated national exchanges.[86] But cross-border mergers would ultimately prove meaningless if U.S. institutional and retail investors were unable to trade directly with European investors or if the current restrictions on contact between non-U.S. brokers and exchanges were to remain in place.

On the other hand, the Commission is reluctant to concede that U.S. federal regulation or self-regulation stops at the U.S. border. U.S. disclosure standards for exchange-listed companies would rapidly lose significance if the SEC did not hold all companies listed on cross-border exchanges up to the same standards as if they had a significant U.S. shareholder base. U.S. investors would potentially be exposed to more manipulative or deceptive conduct (as defined by the Commission) if foreign exchanges are subject to laxer standards than U.S. markets. One might expect that international efforts at harmonizing regulatory standards will pave the way for common rules of market conduct,[87] but the longstanding difficulties in reaching an agreement on accounting standards suggests that such efforts will be protracted.[88]

Exchanges face a dilemma of sorts as well. They could, consistent with current regulations, attempt to rig cross-border trading and listing mechanisms that provide some appearance of cross-border activity to U.S. investors. Prior to the Sarbanes-Oxley Act of 2002, for example, the NYSE had developed a special body of listing standards that it had aggressively marketed to non-U.S. companies.[89] Exchanges could quietly offer cross-border trading opportunities in non-U.S. securities through the facilities of their members with U.S. affiliates, in the same manner as many electronic

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85. Karmel, *supra* note 79, at 356–58.

86. *See* Aaron Lucchetti, *NYSE-Euronext: One, but Two*, WALL ST. J., Sept. 22, 2006, at C4 (describing the holding company structure developed by NYSE Group and Euronext NV to avoid U.S. regulation of European market operations and vice versa).

87. Caroline Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L.J. 127, 130–31 (2005).

88. *See* SEC, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM 38 (Jul. 25, 2003) (describing efforts between the Financial Accounting Standards Board and the International Accounting Standards Board to seek greater convergence of U.S. and international accounting standards as "long-term").

89. NYSE LCM § 103.00 (2006) (discussing the NYSE's Alternate Listing Standards for "foreign private issuers," which among other things, apply quantitative standards regarding share distribution based on global rather than U.S. share volume and limit interim financial disclosures or corporate governance standards that may conflict with home country laws or practices); *see also* John C. Coffee, Jr., *supra* note 18, at, 1830 (discussing the "inconsistent distinction" that U.S. law makes between foreign and domestic issuers and its adverse impact on attempts by non-U.S. exchanges to improve listing standards).

trading systems operated by U.S. investment banks and brokerage firms provided access to foreign markets.[90] Foreign derivatives exchanges, conversely, could to a limited extent familiarize U.S. investors and intermediaries with their products even though they could not be "offered" in the United States.[91]

A full-scale cross-border linkage, however, would either entail enforcing U.S. regulation abroad (consistent with SRO's gatekeeping responsibilities), or require exchanges to shed their own SRO responsibilities (at least with respect to federal law).[92] In other contexts, the lower standard of gatekeeping responsibility has made it easier to permit such cross-border access. In the U.S. commodity futures markets, where the regulatory responsibilities of designated contract markets are more limited, the Commodity Futures Trading Commission (CFTC) has permitted foreign exchanges to offer electronic access to U.S. Future Commissions Merchants (FCMs) through an informal regulatory process.[93] In the EU, the Investment Services Directive (soon to be replaced by the even more ambitious Markets in Financial Instruments Directive, or MiFID) has similarly permitted investment firms in any EU member state to obtain remote access to the regulated markets of any other EU member state based on a system of coordinated home/host country regulation.[94] Because listing and trading on U.S. exchanges triggers the full application of U.S. federal securities law—and requires U.S. exchanges to enforce that law as part of their statutory mandate[95]—U.S. exchanges have struggled to keep up in the global mergers race.

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90. John Ramsay, *Rule 15a-6 and the International Marketplace: Time for A New Idea?*, 33 LAW & POL'Y INT'L BUS. 507, 517–22 (2002).

91. *See, e.g.*, Eurex, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 662 (July 27, 2005); London International Financial Futures and Options Exchange, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 359 (Mar. 6, 1996) (permitting non-U.S. exchanges to familiarize certain registered broker-dealers and large financial institutions in the United States with certain of their equity, index, and exchange-traded fund options).

92. Poser, *supra* note 72, at 534–35. At present, the only available option is for exchanges to deregister and operate as "alternative trading systems" or brokerage firms. To do so, however, would require that exchanges give up the authority to regulate their members' business conduct and discipline their members. *See* Regulation ATS, 17 C.F.R. § 242.300(a)(2) (2005) (defining the types of alternative trading system that may elect to register as a broker-dealer rather than as an exchange).

93. The CFTC has recently reaffirmed that it will continue to grant no-action relief permitting foreign commodity exchanges to provide direct access to their electronic trading systems to U.S. firms and their associated persons. *See* Boards of Trade Located Outside of the United States and No-Action Relief From the Requirement To Become a Designated Contract Market or Derivatives Transaction Execution Facility, CFTC Policy Statement, 71 Fed. Reg. 64,443 (Nov. 2, 2006).

94. Council Directive 2004/39, arts. 33, 2004 O.J. (L145) 1, 26 (EC) (Apr. 21, 2004).

95. Exchange Act § 6, 15 U.S.C. § 78f(b)(1) (2000); Exchange Act 15A(b)(2), 15 U.S.C. § 78*o*-3(b)(2) (2000); Exchange Act § 19(h), 15 U.S.C. § 78s(h) (2000).

III. SELF-IMPROVEMENT

Despite significant ambivalence about the future of self-regulation, the reform proposals advanced by the industry and the Commission do not break new ground.[96] This is in part because the NASD and the Commission have subtly transformed themselves to fill the gaps in traditional market-based self-regulation. Given the Commission's SRO governance initiatives and the NASD's own reputation of being too removed from its membership's interests, it is hard to see any benefit from completely revamping the Exchange Act to eliminate or curtail self-regulation.[97] Indeed, the presence of multiple SROs under one or more hybrid models might well complement the Commission's and the NASD's authority by providing a greater degree of responsiveness and representativeness to the regulatory framework. The success of any such model would depend on an appropriate allocation of responsibilities.

A. NO SRO?

Proposals for reforming regulation of the securities industry with a dominant regulator not beholden to the industry would replace SROs with direct Commission regulation or a new non-industry regulator along the lines of the PCAOB. It is difficult to believe that *direct Commission regulation* of registered broker-dealers alone could replace self-regulation. It may appear inevitable that the Commission will continue to take steps in this direction,[98] given the international trend of replacing self-regulation of individual markets with oversight by a single governmental or non-governmental regulator.[99] In addition to its traditional enforcement

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96. For example, the Securities Industry Association's Ad Hoc Committee on the Regulatory Implications of Demutualization proposed five alternative models, including (1) multiple exchanges with separate boards and information barriers, as is the case with the NASDR and Nasdaq; (2) multiple SROs with firms designated to a single SRO for examination purposes; (3) a hybrid model, in which member regulation is effected by a single SRO, and individual markets regulate their own trading; (4) a single SRO for all purposes; and (5) SEC regulation. *See* SIA White Paper, *supra* note 1, at 14. The Commission published a modified version of these alternatives in its concept release on SRO governance. *See* Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700 (Nov. 18, 2004), 69 Fed. Reg. 71,256 (Dec. 8, 2004).

97. *Cf.* Letter from Thomas W. Sexton, III, Vice President and General Counsel, Nat'l Futures Ass'n, to Eileen Donovan, Acting Secretary, CFTC (Sept. 6, 2006), *available at* http://www.nfa.futures.org/news/newsComment.asp?ArticleID=1640 ("[A]pplaud[ing] the Commission's decision not to include registered futures associations in the current proposed acceptable practices for exchange governance and conflicts of interest.").

98. Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 775 (2006).

99. *See id.* at 833–34 (listing various nations that have opted to create "central agencies" for the supervision of capital markets in emulation of the SEC). One frequently cited example is the creation of the U.K. Financial Services Authority (FSA), which replaced or assumed the powers of

activities under the antifraud laws, the Commission has established an Office of Compliance Inspections and Examinations (OCIE) to administer a "nationwide examination and inspection program for registered self-regulatory organizations, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers."[100] The Commission staff also frequently consults with industry personnel about risk management issues, in part under the aegis of its material associated persons reporting requirements. The Commission's unpleasant experience with the short-lived SECO program, however, has discouraged it from arrogating an exclusive role in the regulatory process.[101] In addition to the significant financial cost of maintaining the compliance and enforcement staff necessary to make such regulation feasible, there is the added difficulty of adopting and interpreting rules to govern industry conduct within the confines of the Administrative Procedure Act.[102]

Moreover, if a new *non-governmental regulator* were employed, it is hard to see how any such regulator would differ significantly from the NASD, which has already emerged as the de facto exclusive regulator of

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the individual U.K. self-regulatory bodies for financial services in 2000. The FSA describes itself as:

> [A]n independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000. We are a company limited by guarantee and financed by the financial services industry. The Treasury appoints the FSA Board, which currently consists of a Chairman, a Chief Executive Officer, three Managing Directors, and 10 non-executive directors (including a lead non-executive member, the Deputy Chairman). This Board sets our overall policy, but day-to-day decisions and management of the staff are the responsibility of the Executive.

FSA, Who Are We, http://www.fsa.gov.uk/Pages/About/Who/index.shtml (last visited Jan. 29, 2006).

100. SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, *available at* http://www.sec.gov/about/whatwedo.shtml (last visited Jan. 29, 2006). In a recent report, the U.S. Chamber of Commerce has proposed that the "SEC should realign its organizational structure to improve its efficiency and mirror the contours of the current capital markets, including, for example, by folding [OCIE] back into the operating divisions to facilitate consistent interpretations of applicable rules." COMM'N ON THE REG. OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 6 (Mar. 2007), *available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.

101. Proposed Rule Change National Association of Securities Dealers, Inc.; Conversion of SECO Broker/Dealers, Exchange Act Release No. 20,273, 1983 SEC LEXIS 569 (Oct. 12, 1983) (converting SECO broker-dealers into NASD members).

102. For example, while OCIE routinely examines registered broker-dealers for compliance with the requirement to obtain best execution for customer transactions, the Commission has never adopted a best execution rule, preferring instead to rely upon SRO rulemaking and enforcement actions. *See, e.g.*, OCIE, Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations (Jan. 25, 2001), *available at* http://www.sec.gov/news/studies/online.htm (discussing OCIE staff reviews of best-execution practices at on-line brokerage firms).

brokerage firms for most aspects of broker-dealer business conduct.[103] The allure of a universal non-industry regulator would appear to be twofold: its members would be appointed by the Commission, and it would derive its funding from a statutory levy on broker-dealers, rather than membership dues and service fees.[104] Putting aside concerns about the constitutionality of such a structure,[105] legislatively chartered self-regulatory organizations such as the MSRB as well as quasi-SRO membership organizations such as SIPC have long successfully combined executive/Commission appointments and industry representation.[106] Preserving a general statute of SRO registration, rather than chartering individual SROs by legislation, may also facilitate the formation, consolidation, and dissolution of specialty SROs without the need for Congressional intervention.

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103. Within days of this Symposium, the NASD and the NYSE announced the signing of a "letter of intent" to merge their oversight functions into a new self-regulatory organization. *See* Gaston F. Ceron, *NYSE, NASD Link Regulatory Arms*, WALL ST. J., at C4 (Nov. 28, 2006). As part of the merger, NYSE Regulation announced that "approximately 470" staff members in its regulation, arbitration, risk assessment and related enforcement units would join the new SRO. *See* News Release, NYSE Regulation Consolidation Plan by Richard G. Ketchum, Chief Executive Officer, NYSE Regulation, Inc. (Nov. 28, 2006) *available at* http://www.nyse.com/Frameset.html?nyseref=&displayPage=/content/articles/1164712197534.html.

104. At present, SROs cover the costs of self-regulation through regulatory fees assessed on members, listing fees assessed on issuers, market data fees assessed on the sale of quotation and transaction information to the public, and transaction fees assessed on transactions executed through their facilities. To ensure adequate funding for SRO services, SROs have, inter alia, been given the right to sell consolidated quotation and a privilege to sell transaction information collected from their members under national market system plans. *See* Regulation NMS, 17 C.F.R. §§ 243.601–243.602 (2000). As described above, however, proposed Commission rules would specifically prohibit the use of regulatory fees, fines, and penalties to fund operational activities. *See supra* p. 332; *see also supra* notes 55–56 and accompanying text.

105. Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1029–60 (2005). *See* Free Enterprise Fund v. PCAOB, 2007 WL 891675 (D.D.C. Mar. 21, 2007) (granting summary judgment to PCAOB on question of its constitutionality under "separation-of-powers principles," the Appointments Clause, and the "non-delegation doctrine").

106. The MSRB is a board composed of fifteen members that has the powers and duties of a self-regulatory organization under the Exchange Act and whose rules are enforceable against any broker, dealer or municipal securities dealer (including the municipal securities division of a bank) that effects transactions in municipal securities. *See* Exchange Act § 15B(b), (c)(1), 15 U.S.C. § 78*o*-4(b), (c)(1) (Supp. II 2002); Exchange Act § 3(a)(26), 15 U.S.C. § 78c(a)(26) (2000) (defining "self-regulatory organization"). SIPC, while not a "self-regulatory organization" under the Exchange Act, is a nonprofit membership organization "the members of which shall be all persons registered as brokers or dealers under section . . . 78*o*(b) of the 1934 Act" (with exceptions) and whose by-laws and rule changes are generally subject to Commission approval. 15 U.S.C. § 78ccc(a)(2)(A), (e) (2000) The MSRB's board is composed of fifteen members appointed by the Commission, five of whom are representatives of the broker-dealer industry and five of whom are representatives of the banking industry. Exchange Act § 15B(b)(1), 15 U.S.C. § 78*o*-4(b)(1) (Supp. II 2002). SIPC's board is composed of seven persons, five of whom appointed by the President with the advice and consent of the Senate (three of whom are "associated with, and representative of different aspects of, the securities industry") and two of whom are appointed by the Federal Reserve Board and the Secretary of the Treasury, respectively. 15 U.S.C. § 78ccc(c)(2).

While it is in the Commission's interest to reduce the reliance upon cross-subsidization of SRO regulatory activities, the necessity of formally removing this authority from the regulatory body—by establishing statutory assessments or levies on members or market participants—is unclear. To a degree, the regulatory monopoly on other revenue sources has distorted the efficiency of market operations because the Commission has never sought to ensure that SROs will dedicate those funds for regulatory purposes rather than operational objectives.[107] Disentangling SRO services from SRO funding and requiring a separate source of funding for member regulation would improve SRO accounting and accountability. But this is unrelated to whether SROs are able to set appropriate fees for the regulation of their members. It may be far more efficient to eliminate cross-subsidies for regulation and allow SROs to set membership fees, than to mandate member assessments or a statutory levy.

B. IS THERE A NEED FOR "MARKET BASED" SELF-REGULATION?

If some consolidation of member supervision is desirable, should other self-regulatory responsibilities also be consolidated? "Market based" self-regulation may be justified by a desire on the part of the Commission and individual exchanges to retain flexibility in governing the obligations of market makers and specialists and to facilitate variety in trading rules while ensuring compatibility with intermarket systems.[108] For example, the Commission has expressed concern that since trading rules currently governing the conduct of market makers and specialists differ to a sufficient degree from exchange to exchange that it might be difficult to implement a single SRO model.[109] In practice, such trading rules may not need to be subject to Commission approval if the Commission were to use its authority to define what the affirmative and negative obligations (if any) of market makers and specialists should be.[110] Given the difficulty of drafting such rules, the Commission has preferred to exercise the right to disapprove of individual rule changes.

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107. *See, e.g.*, Joel Seligman, *Rethinking Securities Markets: The SEC Advisory Committee on Market Information and the Future of the National Market System*, 57 BUS. LAW 637, 659–61 (2002).

108. *See, e.g.*, SIA White Paper, *supra* note 1, at pt. III.E.3 ("[A disadvantage of a single SRO model is that under] "under the current regulatory system . . . , the technical details of trading regulation remain with the entities actually engaged in the trading activity. By removing the trading regulation to a remote entity, the synergy between the trading systems and the regulation is lost. For example, as exchanges and other market participants innovate, their systems would not be as well designed for easy surveillance because regulators could no longer shape development of the technology. The coordinated and concurrent innovation of the trading systems and their corresponding surveillance programs is forfeited.").

109. Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256, 71,280 (Dec. 8, 2004).

110. *See, e.g.*, 17 C.F.R. § 240.11b-1 (2006); Simon & Trkla, *supra* note 15, at 346–47.

The Commission's wariness is not altogether unreasonable, given that different products will require different levels of intermediation as circumstances change. For example, the Commission has observed that options exchanges may require different trading rules than stock exchanges because of the greater need for market intermediaries and member-generated quotations in less liquid options markets.[111] But this is equally true for other products which do not necessarily trade on exchanges. As discussed below, it may be preferable to develop uniform criteria for intermediation by product, rather than through a system in which the Commission haggles with individual SROs over rule changes in an attempt to ensure no one exchange has an advantage over the others.[112] Individual markets may then seek no-action or exemptive relief if their proposed trading rules come into conflict with Commission or SRO rules, much as other securities intermediaries do today.

Second, uniformity in market structure does not necessarily require exchange-based self-regulation. If a central limit order book or display facility for all securities were envisioned, it would make sense for a single utility or regulator to take charge of the operation of that system (whether it be the NASD or a separately constituted SRO for that purpose). Likewise, if the Commission were ultimately to determine that competitive forces should guide the centralization of order flow, the role of a market utility SRO would consist exclusively of collecting and displaying market information (much like the NASD's Alternative Display Facility or SIAC's CQ and CT Services). In such a world, exchange markets would essentially be first among equals, but would not enjoy special privileges (or incur special obligations) as a result of their primacy in the marketplace.

The Commission's pursuit of an intermediate market structure—involving automated execution of public orders across markets through intermarket linkages[113]—creates the need for a series of hubs through which orders may be publicly displayed and accessed by other market centers and broker-dealers. Regulation of SRO "market" rules provides a convenient way for the Commission to ensure enhanced oversight over the critical joints in the marketplace while continuing to espouse a policy of competing trading venues with hardwired linkages. But other regulatory categories

111. Competitive Developments in the Options Markets, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124, 6128–30 (Feb. 9, 2004) (describing institutionalized payment for order flow arrangements, specialist guarantees, and internalization on options markets).

112. For example, if certain thresholds of payment for order flow or internalization are tolerated on options exchanges as a means of encouraging market maker participation, such standards could be developed by an options SRO, independent of any single options market, and applied across the board to all options exchanges. *See id.* at 6130–31 (discussing concerns with exchange payments for order flow, specialist guarantees, and internalization on options exchanges and the options exchanges' conflicts of interest).

113. Of course, that is the Commission's mandate under section 11A of the Exchange Act. *See* 15 U.S.C. § 78k-1(a)(1)(d) (2000).

exist—such as the securities information processor (SIP)—which could perform the same function (with some legislative modification). A network of registered SIPs, like telecommunications providers or public utilities, could be regulated as essential facilities of the marketplace—subject to fair access requirements and reasonable rates—without the need for the full complement of SRO rules.[114] More importantly, such franchises could be awarded on the basis of the superiority of their connectivity, rather than be awarded by default to legacy exchanges who have had significant incentives to diminish interaction of their captive order flow with the rest of the market.

C. SEPARATION OF PROMULGATION, COMPLIANCE, AND ENFORCEMENT

Another frequently mentioned approach to reforming self-regulation is to separate SRO functions by process, rather than subject matter. The Exchange Act currently exposes SROs to disciplinary sanction if they fail to enforce the rules they promulgate.[115] Some commentators have suggested that the task of promulgating rules need not be performed by the same entity that is responsible for ensuring compliance with or prosecuting violations of those rules.[116] Thus, one could employ a universal regulator for compliance inspections and enforcement of the rules of several different SROs. In other situations, SRO standard setting—without any formal compliance or enforcement process—might permit a degree of regulatory supervision over activities that would not be feasible if the SRO were compelled by the Exchange Act to enforce such rules through formal disciplinary action.

This model is in use today in areas where the Commission's jurisdictional authority brushes against other domestic regulatory authorities. For example, in the government and municipal securities markets, where both banks and broker-dealers are able to act as government or municipal securities brokers and dealers, rulemaking authority is given to one body (the MSRB and the Secretary of the Treasury, respectively), while compliance and enforcement activities are undertaken by an "appropriate regulatory authority."[117] Regional exchanges have outsourced many of their compliance and enforcement functions to the NASD,[118] while the SEC has

114. Onnig H. Dombalagian, *Licensing the Word on the Street: The SEC's Role in Regulating Information*, 55 BUFF. L. REV. 1 (2007).

115. *See* 15 U.S.C. § 78s(g) (2000).

116. Ernest E. Badway & Jonathan M. Busch, *Ending Securities Industry Self-Regulation as We Know It*, 57 RUTGERS L. REV. 1351, 1351 (2005).

117. The Exchange Act defines the "appropriate regulatory authority" for these purposes as the Commission for registered broker-dealers and the relevant federal or state bank regulator for banks and departments or divisions thereof. *See* 15 U.S.C. § 78c(a)(34) (Supp. IV 2004).

118. *See* 15 U.S.C.S. § 78q(d) (LexisNexis 2006), and 17 C.F.R. § 240.17d-2 (2007) promulgated thereunder. *See also* Regulation of Exchanges, Exchange Act Release No. 38,672, 62

long required the selection of an exclusive "designated examining authority" for monitoring compliance with financial responsibility rules.[119] The SEC and Department of Justice are responsible for civil and criminal enforcement actions, respectively, under the federal securities laws.[120] The CFTC and SEC jointly promulgate rules for security futures products and security futures exchanges, while each separately undertakes disciplinary and enforcement action with respect to registered FCMs and broker-dealers respectively.

There are clear advantages to such a model. Industry participants in SRO governance are best positioned to identify emerging practices that require greater regulatory scrutiny and to define appropriate norms of business conduct. They may, however, be more reluctant to explore new theories of liability if there is a possibility that their own firms may have engaged in similar conduct. To the extent that securities markets become increasingly specialized, it may be desirable to have SROs composed of representative industry members dedicated to rulemaking for particular products or market sectors, as discussed in Part IV, *infra*.[121] Subject to the SEC's oversight and coordination, a universal compliance and enforcement SRO could make it easier for industry leaders to participate more effectively in the articulation of "just and equitable principles of trade" without the duplication of enforcement personnel.

For instruments that are not directly subject to regulation by financial regulators, industry SROs may provide some market discipline for intermediaries even in the absence of a formal compliance or enforcement regime. There may be areas where SROs might be more willing to undertake information-gathering initiatives—such as centralized monitoring of credit exposure—if the information gathered thereby will not be used for enforcement purposes other than determining eligibility for continued SRO membership or initiating internal disciplinary proceedings. Many such functions are performed under the aegis of trade associations today, but an

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Fed. Reg. 30,485, 30,159 (June 4, 1997) (listing the existing agreements under Exchange Act Rule 17d-2 between various exchanges, the NYSE and the NASD).

119. *See* 15 U.S.C. § 78q(d)(1), (k)(5) (Supp. IV 2004) ("[T]he term 'examining authority' means a self-regulatory organization registered with the Commission under this title (other than a registered clearing agency) with the authority to examine, inspect, and otherwise oversee the activities of a registered broker or dealer."); *see also* 17 C.F.R. § 400.3 (2006) ("Designated examining authority and Examining Authority mean (1) in the case of a registered government securities broker or dealer that belongs to only one self-regulatory organization, such self-regulatory organization, and (2) in the case of a registered government securities broker or dealer that belongs to more than one self-regulatory organization, the self-regulatory organization designated by the Commission pursuant to section 17(d) of the Act (15 U.S.C. § 78q(d)) as the entity with responsibility for examining such registered government securities broker or dealer.").

120. *See* 15 U.S.C. § 78u (Supp. II 2002) (providing the SEC the authority to investigate and bring civil enforcement actions); *id.* § 78ff (Supp. II 2002) (providing criminal penalties for willful violations).

121. Joel Seligman, *Should Investment Companies Be Subject to a New Statutory Self Regulatory Organization?*, 83 WASH. U. L. Q. 1115, 1125 (2005).

"SRO-lite" regime would provide a modicum of public accountability and SEC involvement.

This model also has the potential to simplify cross-border regulation. SROs might, for example, adopt rules governing the conduct of their U.S. and non-U.S. members, which could be enforced under each country's securities or commercial law regime. For example, the Commission and the NASD could serve as the enforcement authorities for such SRO rules in the United States, while other jurisdictions might elect to provide for the enforcement of SRO rules through disciplinary action by a regulated market or government regulator, private rights of action under contract or commercial fraud regimes, or some other industry sanction. Current memoranda of understanding among securities regulators could be amplified, as cross-border activities expand, to facilitate parallel enforcement and, where necessary, negotiate the minimum level of protection U.S. and non-U.S. regulators might require for any self-regulatory regime. The Commission could thus maintain the view that such markets are governed by uniform rules, although the details of inspections and enforcement would vary by jurisdiction.

The risks of this model are evident. Any separation of rulemaking and enforcement powers would raise concerns about inconsistent interpretation, underallocation or overallocation of enforcement resources to particular rules, and the resolution of redundancies across multiple SROs.[122] The Commission (in coordination with foreign regulatory or self-regulatory authorities) would have to exert significant authority both upon the approval of promulgated rules and in the course of its oversight of SRO disciplinary and enforcement actions to ensure that consistency is maintained. The Commission would also have to orchestrate the allocation of responsibilities among substantive rule promulgators to avoid gaps and conflicts. For example, different products may entail different rules governing advertising, capital and margin requirements, execution standards, and clearance and settlement mechanisms. Ensuring that such rules operate as interoperable modules in the face of latent conflicts or conflicting interpretive guidance would require the Commission to use its authority to modify or amend SRO rules more aggressively than it has in the past.

IV. SELF-ACTUALIZATION

There are many directions that the self-regulatory structure of the marketplace could take, depending largely on whether the securities

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122. One possibility is to take advantage of the Exchange Act's existing if neglected concept of "affiliated securities associations," which might seek to register for the purpose of drafting specialized rules for enforcement by the NASD or other registered affiliate. *See* 15 U.S.C. § 78*o*-3(c), (d) (2000).

industry prefers predictability and certainty to autonomy and accountability. If the fundamental concept of self-regulation remains valid, the task is to define those circumstances in which the industry's efforts may be deployed to serve the shared collective interest in minimum standards of conduct, while centralizing or even federalizing other areas where greater conflicts with the public interest are perceived to arise.

A. SRO v. Non-SRO Activities

As discussed in Part I, *supra*, self-regulation stands the best chance of succeeding when the SRO is responsible for enforcing mutual or reciprocal norms of conduct which require industry expertise to administer. Thus, execution protocols, clearance and settlement functions, risk management, and sales and marketing practices for emerging products are all likely to remain within SRO control. By contrast, there are several aspects of the current self-regulatory system, where as a result of Congressional or Commission action, the potential for an effective self-regulatory role has gradually disappeared. In these cases, one can envision replacing SRO regulation with a combination of Commission regulation and a universal NASD-like regulator or a licensed technology provider.

A national market system mechanism for disseminating quotation and transaction information mandated by the Commission could be centralized and operated independently of existing SROs.[123] While individual markets remain free to choose the types of information they would like to disclose and on what terms, the Commission has preempted the role of self-regulation by dictating the minimum information that must be disclosed: by all market centers through intermarket mechanisms: SROs exercise at best residual authority to implement the technical requirements of those mandates—for example, distinguishing reportable trades from non-reportable ones, specifying the information to be provided and the timeframes within which they must be reported. These functions, however, could best be performed by the Commission or single regulator, or by a national market system plan with broad industry representation.[124] Alternatively, rules could be established by individual product regulators for the industry, but actual systems would be maintained (and revenues would be collected and distributed) by an independent service provider.

Corporate governance standards are another area where the mandate for centralization under the Sarbanes-Oxley Act increasingly makes SRO regulation an artifact. Congress and the Commission have increasingly resorted to codifying the costs and benefits of exchange listing—e.g.,

123. Onnig H. Dombalagian, *Demythologizing the Stock Exchange,* 38 U. RICH. L. REV. 1069, 1146 (2006).
124. *Id.*

exemption from blue-sky rules[125] in exchange for heightened corporate governance standards.[126] Exchanges, meanwhile, have shown increasingly less stomach for enforcing rules that threaten to erode the number of new and existing listed companies.[127] Codifying higher corporate governance standards for companies that trade in highly liquid markets can take place in other fora—such as an NMS plan or as a condition of becoming a publicly quoted company. Markets again would remain free to set their own additional standards, but would be relieved of their historical gatekeeping function.

More generally, an attitudinal shift should take place in which an SRO's enforcement obligations do not include policies and procedures to monitor for compliance with and enforce Commission rulemaking. SROs are more than capable of undertaking a cost/benefit assessment with respect to the enforcement of their rules, but have no real discretion with respect to their statutory obligation to enforce federal law. This creates an exceptional hurdle for any new SRO that seeks to register as an exchange or national securities association, while imposing little, if any, real sanctions on existing SROs that fail to live up to that responsibility. If any of the hybrid models is adopted, a single self-regulator such as the NASD could be made responsible for this statutory mandate, while allowing other SROs the freedom to devote limited resources to achieve more modest regulatory goals.

B. MULTIPLE REGULATORS

As suggested above, if a single regulator system is adopted, other SROs could play an important, if peripheral, role in setting standards for industry conduct. Many complaints are raised about the monolithic nature of SRO rulemaking, whether it be domination of self-regulatory bodies by major investment firms, the imposition of uniform rules on dissimilar products, or structural differences in business practices. A system of multiple SROs with clear mandates, minimal overlap, and sufficient members to demonstrate credibility and minimize abuse may assuage some of these concerns.

One possible demarcation would be based on *size and geographic scope*. The Maloney Act contemplated the registration of multiple national securities associations, as long as "the number and geographical distribution of its members and the scope of their transactions" was sufficient to enable each such association to carry out the purposes of the Act.[128] A case could be made that smaller or regional brokerage firms might prefer a degree of autonomy to define their own business practices, or at least to distance

125. 15 U.S.C. § 77r(a)–(b) (2000).
126. *See id.* § 78j-1(m) (Supp. II 2002).
127. *See, e.g.*, Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).
128. 15 U.S.C. § 78*o*-3(b)(1) (2000).

themselves from the bulge bracket firms that are perceived to exercise inordinate influence over the NASD and NYSE. Such arrangements could also facilitate the de-registration of regional exchanges by allowing their members to reorganize as a looser regional securities association with a more limited set of rules enforced by the NASD.

In principle, such associations should not be objectionable since the informal segregation of bulge bracket and smaller brokerage firms exists today to a certain degree. The roster of NYSE member organizations includes nearly all of the bulge bracket investment banks headquartered in New York City.[129] As a result, these firms are subject to NYSE rules (as well as NASD rules, if they are engaged in public business) and NYSE enforcement, while the nation's remaining broker-dealers are subject to NASD rules (as well as regional exchange rules) and NASD enforcement.[130] Federal financial responsibility rules also provide special provisions for computing the net capital and customer reserve requirements of the largest investment banks.

The question remains, of course, whether regional associations would promote better business practices, or simply create opportunities to dilute existing principles of trade. A strong case would need to be made that the rules of any regional securities association that differ from NASD business conduct rules are necessary or desirable for the particular region or class of brokers or otherwise outweigh the benefits obtained through standardization of NASD compliance and enforcement practices. To the extent, however, that the NASD's regional district personnel have developed unique practices or procedures, the codification of such practices or procedures in regional SRO rules may have some benefit.

A second possible categorization of special purpose SROs might turn on the *business model* of their members. Today, for example, carrying brokers responsible for handling customer funds and securities and collecting margins for leveraged accounts are generally regulated under NYSE and DTCC or OCC rules. While, one could envision SROs that develop specialized rules for electronic trading systems, market makers and specialists, and other standard business models in the broker-dealer community, the formation of such SROs is unlikely for a number of reasons. First, the rapid consolidation of firms that perform similar activities may undermine the fundamental criterion that an SRO possess the necessary diversity of membership to avoid domination by a handful of

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129. As of this writing, the NYSE's member firm directory includes approximately 206 companies that conduct business with the public. *See* News Release, New York Stock Exch., NYSE Firms Report Third-Quarter 2006 Results (Dec. 6, 2006), *available at* http://www.nyse.com/press/1165317470489.html.

130. Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485 (June 4, 1997) (describing the existing agreements under Exchange Act Rule 17d-2 between various exchanges, the NYSE and the NASD).

powerful interests. Second, to the extent that markets must be designed to facilitate the interaction of different business models (e.g., specialists and public brokers), allowing each to define the parameters of their business conduct without the participation of the other would create opportunities for overreaching or abuse. Third, the integration of different business models with individual firms could enhance the potential for redundant rules.

The most compelling case for the creation of limited purpose SROs is *product regulation*. As discussed above, special SROs have been created for the regulation of various products that may be traded both by broker-dealers and by other financial intermediaries. Thus, the MSRB regulates banks and broker-dealers trading municipal debt, and security futures exchanges jointly regulated by the SEC and CFTC regulate broker-dealers and futures commission merchants that trade security futures products. Within the securities markets, separate SROs exist that focus on the regulation of options markets (e.g., CBOE) and options transactions (e.g., OCC), equity markets and equity transactions (e.g., DTCC), and other products.[131]

Products that might benefit from special purpose SROs are corporate debt and exchange-traded and over-the-counter derivatives. While exchanges historically traded government and corporate bonds as well as listed stocks, the migration of debt trading into institutional over-the-counter markets has had both benefits and disadvantages. Debt securities had largely escaped national market system regulation until the late 1990s because such rules were predicated upon the ability to build upon existing quotation and execution mechanisms of stock exchanges. The Commission prodded the NASD to build display and execution mechanisms for listed and unlisted equity securities in the over-the-counter market, but these mechanisms could not be easily grafted to the even more decentralized world of debt. Only recently, with the increasing automation of the debt market, has the NASD undertaken to extend such mechanisms to debt securities.

On the other hand, the extension of regulatory approaches devised for equity securities to debt securities without the opportunity for the industry to develop alternative approaches can have unfavorable consequences.[132] The obligation to obtain the best execution of a debt transaction reasonable under the circumstances poses particular difficulties in debt markets, where

131. The Fixed Income Clearing Corporation, a subsidiary of the Depositary Trust & Clearing Corporation, performs post-trade comparison, netting and settlement of government and mortgage-backed securities transactions. Each division offers “product-specific services” to its members—such as pool notification for mortgage-backed securities transactions—and maintains separate rules and a separate collateral margin pool. *See* The Fixed Income Clearing Corporation, http://www.ficc.com (last visited Feb. 22, 2007).

132. Letter from Marjorie Gross, Bond Market Association, to Jonathan Katz, Sec’y, SEC (Mar. 8, 2005), *available at* http://www.sec.gov/rules/concept/s74004/mgross030805.pdf (commenting on SRO Concept Release and advocating a “debt market SRO” along the lines of the MSRB).

dealer quotations are not centralized.[133] Transaction reporting protocols for debt securities underwent several rounds of modification and remains subject to criticism because of the greater volatility of debt prices resulting from the relative illiquidity and size of debt transactions.[134] As the retailization of corporate debt continues, however, the Commission and self-regulators are likely to face even greater pressure to adopt rules governing corporate debt transactions. As with the MSRB, a specialty regulator for corporate debt—or an SRO dedicated to drafting specific rules governing all debt transactions—might be the optimal approach.

Exchange-traded options and derivatives also operate pursuant to unique rules driven by the nature of options markets that may merit a single derivatives market self-regulator. As discussed above, special trading rules have been developed by options exchanges to induce greater participation by market making and order routing intermediaries on options exchanges.[135] Portfolio margining systems for options and derivatives transactions in U.S. securities markets have not developed as quickly as in U.S. futures markets in part because of the need for multiple options and non-options SROs to amend their rules in concert.[136] Options firms have also had difficulty in "regularly and rigorously" reviewing their order routing practices in part because of the lack of uniformity in current execution quality reporting practices by options exchanges.[137]

Over-the-counter derivatives present an even more compelling case for a self-regulatory scheme because such products are subject to minimal regulation by federal financial regulators. The Commodity Futures Modernization Act of 2000 has exempted "swap agreements" among "eligible contract participants" from off-board trading restrictions on financial futures and most federal securities regulation (other than certain

133. *Changes to NASD's Best Execution Rule Okayed by SEC Over BMA, Others' Concerns*, 38 Sec. Reg. & L. Rep. (BNA) No. 36, at 1504 (Aug. 30, 2006).

134. *See* Order Approving a Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to the Dissemination of TRACE Trade Information, Exchange Act Release No. 53,031, 71 Fed. Reg. 634 (Jan. 5, 2006) (recounting history of TRACE facility for reporting of corporate debt transactions).

135. *See* Competitive Developments in the Options Markets, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124 (Feb. 9, 2004).

136. *See e.g.*, Notice of Filing of Proposed Rule Change Relating to Customer Portfolio Margining Requirements, Exchange Act Release No. 53,576, 71 Fed. Reg. 17,519, 17,527 (Apr. 6, 2006) and Exchange Act Release No. 53,577, 71 Fed. Reg. 17,539, 17,547 (Apr. 6, 2006) (filing of proposed rule changes by the NYSE and the CBOE relating to portfolio margining, both noting the role of the NYSE's Rule 431 Committee—composed of several member organizations and several SROs including the NYSE, CBOE, and NASD as well as representatives from the SIA Ad Hoc Committee on Portfolio Margining—in making recommendations for portfolio margining).

137. OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC, REPORT CONCERNING EXAMINATIONS OF OPTIONS ORDER ROUTING AND EXECUTION 10 (Mar. 8, 2007) ("The Staff also found that because standardized execution quality statistics are not provided by each of the options exchanges, most firms analyze only the execution quality provided to their own customer orders. The lack of standardized, widely available execution quality data may affect thorough best execution reviews by firms.").

antifraud rules for equity-based swaps).[138] While such exemptions may be appropriate in light of the wide range of financial institutions that trade such products and their relative sophistication, there is no recognized public forum in which industry members may seek to self-regulate. Standard agreements developed by the International Swaps and Derivatives Association and voluntary disclosure efforts encouraged by the Federal Reserve Board and others to control counterparty credit exposure provide some mutual self-regulation,[139] but only modest effort has been undertaken to develop business conduct standards or other forms of reciprocal self-regulation despite frequently recited concerns about the leverage of hedge funds, institutional investors, and other swap counterparties and the lack of infrastructure in the swaps marketplace.[140]

The advantage of a self-regulatory scheme over informal industry coordination is the antitrust immunity conferred by the SRO structure. As with the original arrangements that led to the creation of the NASD under the Maloney Act, banks and broker-dealers that act as swap intermediaries could agree to transact on more favorable terms with one another than with non-SRO members as a means of encouraging compliance with industry norms. Such arrangements could include the participation in black-box or other mechanisms that monitor direct and indirect counterparty credit exposure as a supplement to bilateral risk management measures. Swap intermediaries that failed to adhere to such standards would not be subject to civil or criminal enforcement, but rather the traditional SRO sanction: paying higher fees to lay off positions with member intermediaries.

C. BETTER ENFORCEMENT TOOLS

Congress and the Commission may also wish to consider whether concurrent public or private enforcement of SRO rules would improve the self-regulatory model, particularly if self-regulatory concepts are to be leveraged to international linkages. The conceptual core of SRO regulation is standard-setting. Delegating compliance and enforcement functions to SROs has some theoretical basis—to the extent that industry members have

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138. *See* 7 U.S.C. § 2(g) (2006). The Commodity Exchange Act's off-board trading prohibition does not apply to or govern, among other transactions, any non-agricultural commodity transaction between certain "eligible contract participants" that is subject to individual negotiation by the parties and is not executed or traded on a trading facility.

139. *See, e.g.*, COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE 11 (July 27, 2005) (presenting recommendations and guiding principles, classified as (i) "actions that individual institutions can and should take at their own initiative," (ii) "actions which can be taken only by institutions collectively in collaboration with industry trade groups," and (iii) "actions which require complementary and/or cooperative actions by the official sector").

140. *Lawmakers Seek GAO Report on Tech Woes in Derivatives Market*, 38 Sec. Reg. & L. Rep. (BNA) No. 24, at 1008 (June 9, 2006) (requesting that GAO determine the adequacy of the legal, technological and paperwork handling infrastructure of credit derivatives markets).

a mutual or reciprocal interest in the regulation of their competitors—but has largely been viewed as a means of avoiding the direct financial and political costs to the SEC of policing the securities industry's business conduct. At the same time, given the significant skepticism about the efficiency of private litigation, it is unlikely that private rights of action for infringement of SRO rules would be viewed as a favorable option.

One approach would be to undertake concurrent public enforcement action against firms that willfully violate SRO rules, either through a pattern of misconduct or egregious violations. The unrestricted scope of Rule 10b-5 and varying standards of scienter makes it an undesirable tool for regulation of securities intermediaries, but a more focused Commission rule that targets abusive business conduct defined by a registered standard-setter presents a more compelling case for Commission action. A new Commission rule to supplant Rule 10b-5 enforcement actions would also create a fresh opportunity to deter the implication of private rights of action. SROs may also wish to consider whether there are market-oriented approaches to enforcing SRO rules. Greater disclosure in confirmation statements regarding execution quality—such as presenting contemporaneous price quotations, realized spreads, or other information—would create a powerful disincentive to violate best execution rules, even if private enforcement action against questionable transactions is generally prohibited for conduct short of fraud.

V. CONCLUSION

The irony should not be lost that the Commission is considering whether to write exchanges out of the Exchange Act: It suggests that in harnessing the power of exchanges for the benefit of investors, we have extinguished their innate incentives to bring order to the securities markets. The concept of self-regulation, however, has permeated so many operational aspects of the securities industry that it would be very difficult to eliminate it entirely from the federal regulatory framework. Investors have benefited from the continuing dialogue between the Commission and self-regulatory bodies as listings have multiplied, securities grown more complex, and market structures evolved in various product areas. A product-oriented system of self-regulation, with consolidated NASD enforcement, might serve as a worthy heir to the legacy of self-regulatory exchanges.

THE ONCE AND FUTURE NEW YORK STOCK EXCHANGE: THE REGULATION OF GLOBAL EXCHANGES

Roberta S. Karmel[*]

I. INTRODUCTION

On June 2, 2006, NYSE Group, Inc. (NYSE Group), the parent of the New York Stock Exchange, Inc. (NYSE), announced a plan to merge with Euronext NV (Euronext), creating the first trans-Atlantic linkup of stock and derivatives markets.[1] Euronext is a Dutch holding company that, since 2000, has been operating, through subsidiaries, the former stock exchanges of Amsterdam, Paris, Brussels and Lisbon. In 2001, Euronext also acquired the London International Financial Futures and Options Exchange (LIFFE).[2] Euronext is the first pan-European exchange trading cash and derivatives and equities and bonds. The London Stock Exchange (LSE) also has been the object of trans-national takeover attention, having received bids from Deutsche Borse, Macquarie Bank of Australia and the Nasdaq Stock Market (Nasdaq).[3]

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1. *See* Bernard Wysocki Jr. & Aaron Lucchetti, *Without Borders: Global Exchanges Pose a Quandary for Securities Cops,* WALL ST. J., June 5, 2006, at A1; Ian McDonald & Aaron Lucchetti, *Will the NYSE's Colossal Merger Help Investors?,* WALL ST. J., June 4, 2006, at B1. This article is dated as of November 2006. Since then, the merger of the NYSE and Euronext has been accomplished and a bid by Nasdaq for the LSE appears to have failed. These events do not alter the analysis in the article. *See* Order Granting Approval of Proposed Rule Change and Notice of Filing and Order Granting Approval to Amendment No. 1 Regarding the Proposed Combination Between NYSE Group, Inc. and Euronext N.V., 72 Fed. Reg. 8033 (Feb. 22, 2007); Press Release, N.Y. Stock Exch., NYSE Euronext Celebrates Completion of NYSE Group, Inc./Euronext N.V. Merger (Apr. 4, 2007), *available at* http://www.nyse.com/events/1175251256417.html.

2. In October of 2001, Euronext—created only a year earlier through a merger of the Paris, Amsterdam, and Brussels securities exchanges—out-bid the LSE and Deutsche Borse to acquire LIFFE. *See* Vincent Boland & Charles Pretzlik, *Euronext Wins Battle for Liffe: Paris-Based Operator Beats Rivals with Pounds 555m bid for exchange,* FIN. TIMES (London), Oct. 30, 2001, at 1. Acquiring LIFFE, the second largest derivatives market in Europe, allowed Euronext to boast diverse products—securities and derivatives—across diverse markets—French, Belgian, Dutch, and now British constituents, giving Euronext LIFFE a significant place in the world of consolidating financial markets. *See* Peter Martin, *The End of Liffe As We Know It: Euronext's Deal Has Given it an Edge in the Consolidation of European Financial Markets but There is Much Still to Play For*, FIN. TIMES (London), Oct. 30, 2001, at 23.

3. *See* Aaron Lucchetti & Alistair MacDonald, *Ready to Deal: $60 Billion in Two Days*, WALL ST. J., Nov. 21, 2006, at C1; Alistair MacDonald & Aaron Lucchetti, *Nasdaq Stock Market is Cleared to Launch a Bid for the LSE,* WALL ST. J., Sept. 30, 2006, at B2; *Battle of the Bourses,* ECONOMIST, May 27, 2006, at 65; *Crossing the Pond,* ECONOMIST, Mar. 18, 2006, at 67. Deutsche Borse and Euronext also considered a merger. *See* David Reilly & Jason Singer, *Moving the Market: Euronext, Deutsche Borse Are Urged to Merge,* WALL ST. J., Jan. 18, 2006, at C5.

Whether any of these or other cross-border exchange consolidations will come to fruition, and the future structure of such transactions, is probably more a matter of politics and regulation than business exigencies and is therefore difficult to predict. National political opposition to the development of global exchanges is strong.[4] But as John Thain, the CEO of the NYSE remarked, "Most countries have an army, a flag, an airline and an exchange. . . . As the markets have become more global, that nationalist tendency on the part of exchanges—at least those that want to compete globally—has to break down."[5]

Another factor in the inevitable globalization of exchanges is that exchanges have demutualized and become public companies. They need to please their shareholders as well as their customers. Further, in the process of moving from mutual not-for-profit citadels of capitalism to public companies, national exchanges have lost their exclusivity and their mystique. Consequently, they should no longer be regarded as national champions, but permitted to function as ordinary companies. Although they play a key role in capital formation, the capital markets are no longer national. Although the images of the NYSE and Nasdaq were both tarnished by the scandals of recent years, they can probably best restore their former luster by competing as successful businesses in the global marketplace.[6]

At least three reasons for a merger between the NYSE and Euronext have been put forward. First, is the idea that investors will be able to buy stocks in the United States and Europe, thus making it more attractive and cheaper for them to buy foreign shares.[7] The NYSE and other U.S. exchanges have been losing listings, and especially IPOs, to European exchanges; merging with a European exchange may be a way to recapture the fees and trading profits from these listings.[8] However, the primary reasons why the NYSE has been losing listings is that foreign issuers are disenchanted with the U.S. stock market because of the costs of compliance

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4. *See* Jenny Anderson & Heather Timmons, *NYSE's Coup Stirs Political Opposition in Europe*, N.Y. TIMES, June 15, 2006, at C1; Alstair MacDonald, *U.K. Frets Over LSE Takeover*, WALL ST. J., Sept. 14, 2006, at C12; Aaron Lucchetti, *Big Board Sees a Bond Bonanza*, WALL ST. J., June 21, 2006, at C1; *see also* Heather Timmons, *Skeptics Blunting Rumor Mill*, N.Y. TIMES, Mar. 23, 2006, at C6.

5. Lucchetti, *supra* note 4, at C2.

6. *See* In the Matter of Nat'l Ass'n of Sec. Dealers, Exchange Act Release No. 37,542, 1996 SEC LEXIS (Aug. 8, 1996) (investigating anti-competitive practices by Nasdaq market makers); Press Release, SEC Charges the NYSE with Failing to Police Specialists (Apr. 12, 2005), *available at* http:/www.sec.gov/news/press/2005-53.htm; Jenny Anderson, *S.E.C. Asked Grasso if He Buoyed Stock*, N.Y. TIMES, June 15, 2006, at C1.

7. *See* Aaron Lucchetti, *Global Investing Made Easy*, WALL ST. J., Aug. 12, 2006, at B1; McDonald & Lucchetti, *supra* note 1, at B1.

8. *See* Jenny Anderson & Heather Timmons, *NYSE Group Aims to Buy European Exchange*, N.Y. TIMES, May 22, 2006, at Cl; Aaron Lucchetti, *NYSE, via Euronext, Aims to Regain Its Appeal for International Listings*, WALL ST. J., June 30, 2006, at C1.

with the requirements of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)[9] and because of the U.S. culture of shareholder litigation.[10] The merger of the NYSE and Euronext will not result in the automatic dual listing of issuers in Europe and the United States, a result that is not even desired at this time, but the potential for giving U.S. investors easier and cheaper access to investments in foreign securities is important.

A second justification for the NYSE-Euronext merger is that it will give the NYSE a derivatives platform. Although the NYSE launched a commodity futures exchange in 1979, this was not a successful business venture and was sold to the New York Cotton Exchange (NYCE) in 1993.[11] In the meantime, the trading of derivatives has skyrocketed and the NYSE would like to participate in this business. In the past, the Securities and Exchange Commission (SEC) was opposed to side-by-side trading of equities and derivatives at an exchange because it considered such trading to have the potential for giving unfair informational advantages to an exchange that traded both equities and options or futures on such equities.[12] Given the changes that have since occurred in the markets, the SEC should not impose constraints on the ownership of a derivatives exchange by the NYSE so as to make such a venture uneconomic.

When two exchanges combine, they can cut staff and share technology. Thus, a third reason that has been asserted for the creation of a global exchange by the NYSE is that the NYSE and Euronext will be able to operate from a common trading platform. This could expand the NYSE's

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9. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28 and 29 U.S.C.). *See* Nelson Schwartz, *IPOs are picking London Over New York*, CNNMONEY.COM, Dec. 15, 2005, *available at* http://money.cnn.com/2005/12/15/commentary/pluggedin_fortune/index.htm.

10. *See* Greg Ip, Kara Scannell & Deborah Solomon, *Panel Urges Relaxing Rules for Oversight*, WALL ST. J., Nov. 30, 2006, at C1; Richard Hill, *Regulatory, Litigation Costs Seen as Causing Loss of U.S. Listings*, 38 Sec. Reg. & L. Rep. (BNA) No. 18, at 750 (May 1, 2006).

11. In 1980, the NYSE took aim at the financial futures market with the launch of the New York Futures Exchange (NYFE). The NYFE represented the NYSE's attempt to capture some of the futures market that was dominated by two Chicago exchanges—the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME). *See* Steve Lohr, *Debut for City's Futures Board*, N.Y. TIMES, Aug. 7, 1980, at D1. On opening day of the new exchange, membership was offered at $10,000 to NYSE members and $20,000 to nonmembers. *See id.* A little over a year later, the NYFE was already in trouble, with membership fees to non-NYSE members dropping to $8,000. *See* Paul Betts, *The Winners in Oil and Metals*, FIN. TIMES (London), Feb. 1, 1982, at 9. By the early 1990's, membership was offered for only $100, and average daily volume dwindled to 5,000 contracts (down from roughly 180,000 in its first year). Conceding the NYFE's failure, in September of 1993, the NYSE spun off the NYFE and merged it with the New York Cotton Exchange. *See* William B. Crawford Jr., *N.Y. Futures Exchange Near Deal with Cotton Exchange*, CHI. TRIB., Aug. 26, 1993, at 3N.

12. *See* Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK. J. INT'L L. 319, 328 n.42 (2003). Arca recently became the "first integrated equities and options exchange in the U.S." Andrei Postelnicu, *Archipelago Buys Pacific Exchange*, FIN. TIMES (London), Jan. 5, 2005, at 29.

bond trading business as well as its equities business.[13] Whether these synergies will be able to be fully realized in the face of different trading systems and different regulatory requirements for the trading of securities in the United States and Europe remains to be seen.

Despite the several sound reasons for a trans-national merger between exchanges, stock exchanges cannot compete as ordinary business enterprises because of the manner in which they are regulated and because they function as self-regulatory organizations (SROs). Unless such regulation is significantly changed, the effort by exchanges to become global companies will be impeded. This Article will discuss the impediments to the creation of a global exchange posed by the U.S. federal securities laws and how these laws could be changed to permit the possible synergies of a combination between the NYSE or Nasdaq and a foreign exchange to be better achieved.

Even if the NYSE and Euronext merge, or some other consolidation between a U.S. exchange and a foreign exchange comes about, securities listed on Euronext will not be able to trade on the NYSE and Euronext will not be recognized as a U.S. securities exchange. Further, neither Euronext's issuers nor Euronext wish to be regulated by the U.S. SEC, and there have been assurances from SEC officials that they would not assert jurisdiction over Euronext or its listed companies.[14] Part II of this Article will discuss the regulation of foreign issuers and inquire whether the creation of a global exchange finally will lead to convergence between U.S. and European regulation and the development of a regime of mutual recognition.

In addition to the divergence of regulation of issuers in the United States and elsewhere, the United States and Europe have both recently passed regulations covering the trading of securities in the public securities markets, these regulations also diverge. Part III of this Article will discuss the differences between such regulation of trading in the context of foreign exchange access issues. Although much has been made of the possibilities of synergies in a NYSE-Euronext combination, the development of a common trading platform may be impeded by regulatory constraints on the trading of securities.

Part IV of this Article will discuss the approach of the Commodity Futures Trading Commission (CFTC) with regard to foreign exchange access, in contrast to the approach of the SEC and inquire whether the SEC should adopt the approach of the CFTC. Yet, while it might be easier for LIFFE to enter the U.S. markets than it would be for Euronext to do so,

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13. *See* Lucchetti, *supra* note 4, at C2.

14. *See* Kip Betz & Rachel McTague, *NYSE, Euronext $208 Merger Plan Would Create World's Largest Exchange*, 38 Sec. Reg. & L. Rep. (BNA) No. 23, at 962 (June 5, 2006); Judith Burns, *SEC Aims to Ease Europe's Fears On Cross-Border Market Merger*, WALL ST. J., June 17, 2006, at B2.

such a move would likely generate opposition from U.S. commodities exchanges.

A discussion of the need for a reworking of the regulation of listed companies and exchange trading would be incomplete without reference to the potential changes in the SRO's functions of exchanges. Part V of this Article will discuss the future of self-regulation by exchanges. Although self-regulation is deeply imbedded in the federal securities laws and the structure of the securities industry, it could become a casualty of the dramatic changes in the organization and functioning of exchanges. Although the author is loathe to see the end of exchanges as SROs, and believes that self-regulation has served the country well for all of its flaws, as the conflicts between the operation of exchanges as global businesses and regulators become more apparent, a serious reworking of how exchanges operate as regulators is in order.

If the NYSE-Euronext merger goes through, or even if it fails, now that the creation of a global exchange is a serious business plan by the NYSE Group, and by Nasdaq, bold action by the SEC will be required for the United States to remain a dominant competitor in the global markets. Whether the SEC will have the political backbone to take such action remains to be seen. If it does not, a deterioration in the power and efficiency of the NYSE and Nasdaq as leading exchanges could be a consequence, with a possible adverse effect on U.S. capital formation and the national economy.

II. SEC REGULATION OF FOREIGN ISSUERS

A. POLICY OF NATIONAL TREATMENT WITH EXEMPTIONS

Generally, the most common approaches to regulating foreign issuers which sell securities to domestic investors are: requiring compliance with host country laws (national treatment);[15] creating special host country rules for them;[16] developing harmonized international standards;[17] and accepting compliance with home country standards (mutual recognition).[18] The United States has approached this problem through national treatment, with some special rules to ameliorate the problems of compliance for foreign issuers. By contrast, the European Union (EU) has a regime of mutual

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15. *See* Roel C. Campos, Comm'r, SEC, Remarks before the Centre for European Policy Studies: Embracing International Business in the Post-Enron Era (June 11, 2003), *available at* www.sec.gov/news/speech/spch061103rcc.htm.

16. *See id.* This has been the SEC's approach to some extent.

17. *See* Manning Gilbert Warren III, *Global Harmonization of Securities Laws: The Achievement of the European Communities*, 31 HARV. INT'L L. J. 185, 191 (1990).

18. *See id.* at 191–92.

recognition.[19] While there is no international securities regulator with the ability to impose a disclosure or other regulatory regime on all issuers worldwide, the International Organization of Securities Commissions (IOSCO) has developed a template for basic disclosure standards and the International Accounting Standard Committee (IASC) is developing international accounting standards (formerly known as IASs and now known as international financial reporting standards, or IFRS).[20]

When the Securities Act of 1933 (the Securities Act) was passed, Congress contemplated that foreign issuers might make offerings into the United States and provided a special disclosure regime for sovereign debt.[21] Further, the jurisdictional reach of the law extended to interstate and foreign commerce.[22] The SEC has the authority to impose its disclosure obligations on any foreign company that sells shares to U.S. nationals.[23] Similarly, the SEC could require any foreign issuer with more than 500 shareholders worldwide, of which 300 are U.S. investors, and which has $10 million in assets to register its equity securities pursuant to the Exchange Act, and thereafter be required to make annual and periodic reports to the SEC.[24] The SEC has not exerted its jurisdiction to this extent. Foreign issuers that would be required to file under the Exchange Act because they have $10 million in assets and 300 out of 500 U.S. shareholders can file for an exemption from such registration by filing all documents they are required to file in their home jurisdiction in English translation.[25] However, their securities cannot then trade on an exchange, but only in the pink sheets bulletin board. Therefore, if a company wishes to have an active trading market for its securities in the United States, it must register under the Exchange Act.

Further, the SEC compels foreign issuers desiring to raise capital in the United States or list on a U.S. exchange to enter the SEC disclosure system. The attitude of the SEC staff long has been that if a foreign issuer was going to tap the U.S. capital markets then it should play by the SEC's rules.

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19. *See* Marc I. Steinberg & Lee E. Michaels, *Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity*, 20 MICH. J. INT'L L. 207, 255–61 (1999).

20. *See* MARC I. STEINBERG, INTERNATIONAL SECURITIES LAW, A CONTEMPORARY AND COMPARATIVE ANALYSIS 27–38 (1999).

21. *See* Securities Act, Schedule B, 15 U.S.C. § 77aa (2000).

22. *See* Securities Act § 2, 15 U.S.C. § 77b(7) (2000).

23. *See* Europe and Oversees Commodity Traders, S.A. v. Banques Paribas London, 147 F.3d 118 (2d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999) (suggesting that the Securities Act applies when both the offer and sale of a security are made in the United States); Consol. Gold Fields PLC v. Minorco, S.A., 871 F.2d 252 (S.D.N.Y. 1988), *modified*, 890 F.2d 569 (2d Cir. 1989), *cert. dismissed*, 494 U.S. 939 (1989).

24. *See* Exchange Act § 12(b), (g), 15 U.S.C. § 78*l*(b), (g) (Supp IV 2004); Exchange Act § 13, 15 U.S.C. § 78m (Supp. II 2002); Exchange Act § 15(d), 15 U.S.C.S. § 78*o*(d) (LexisNexis 2006).

25. *See* Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2(b) (2007).

In the mid-1970's, the SEC requested public comment on improving the disclosure required by foreign issuers, noting that the registration forms used by the foreign issuers required substantially less information than required of U.S. domestic issuers.[26] The SEC then adopted Form 20-F as a combined registration and annual reporting form;[27] but, since corporate governance regulation generally was left to the states under U.S. law, it was similarly left to the national law of foreign issuers. Among other things, foreign issuers were exempted from SEC proxy solicitation regulations and short-swing insider transaction reporting requirements.[28] Further, in Form 20-F, the SEC bowed to some of the objections of foreign issuers and deleted certain proposed disclosures relating to corporate governance, in particular, the disclosure of the business experience and background of officers and directors, and the identification of the three highest paid officers and directors and the aggregate amount paid to them. In addition, it conditioned a material transactions disclosure to the requirements of applicable foreign law.[29]

Although the SEC generally refused to accord foreign regulators mutual recognition with respect to foreign issuer disclosure standards, it accommodated them to some extent by developing special registration and disclosure requirements for foreign issuers.[30] Additionally, following a policy of international cooperation during the 1980s and 1990s, the SEC fashioned special exemptions for foreign issuers[31] and amended its foreign issuer disclosure forms to comply with disclosure standards endorsed by IOSCO.[32] Also, prior to the enactment of Sarbanes-Oxley, the SEC had been working toward an international accounting regulatory regime pursuant to which foreign issuers might be able to file documents with the SEC using IAS (now IFRS) rather than U.S. Generally Accepted Accounting Principles (GAAP).[33] Similarly, SROs permitted foreign issuers

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26. *See* Means of Improving Disclosure by Certain Foreign Private Issuers, Exchange Act Release No.14,056, 41 Fed. Reg. 55,012, 55,013 (Dec. 16, 1976).

27. *See* 17 C.F.R. § 249.220f (2005). This continues to be the primary reporting form for foreign issuers.

28. *See id.* § 240.3a12-3 (2007).

29. *See* Rules, Registration and Annual Report Form for Foreign Private Issuers, Exchange Act Release No. 16,371, 44 Fed. Reg. 70,132, 70,133–35 (Dec. 6, 1979).

30. *See* Adoption of Foreign Issuer Integrated Disclosure System, Securities Act Release No. 6437, Exchange Act Release No. 19,258, Investment Company Act Release No. 774, 47 Fed. Reg. 54,764 (Dec. 6, 1982).

31. *See, e.g.*, Regulation S, 17 C.F.R. §§ 230.901–230.904 (2007); Rule 144A, 17 C.F.R. § 230.144A (2007); Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2(b) (2007); Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings, Securities Act Release No. 7759, Exchange Act Release No. 42,054, Investment Company Act Release No. 2378, 64 Fed. Reg. 61,382 (Nov. 10, 1999).

32. *See* International Disclosure Standards, Securities Act Release No. 7745, Exchange Act Release No. 41,936, 64 Fed. Reg. 53,900 (Oct. 5, 1999).

33. *See* International Accounting Standards, Securities Act Release No. 7801, Exchange Act Release No. 42,430, 65 Fed. Reg. 8896 (Feb. 23, 2000).

to obtain a waiver from many corporate governance requirements, although some minimal corporate governance requirements, such as holding an annual meeting and maintaining an audit committee, could not be waived.

B. IMPACT OF SARBANES-OXLEY

After 2002, foreign issuers were shocked to discover that various corporate governance provisions of Sarbanes-Oxley applied to them. They had become accustomed to a regime in which the SEC and the NYSE "assiduously avoided imposing governance requirements on foreign issuers."[34] Foreign issuers viewed the context for Sarbanes-Oxley to be U.S. financial scandals and failures, and argued that the SEC should not be imposing corporate governance regulations on corporations that functioned in very different corporate finance systems and with very different structures than U.S. firms.[35] Congress and the SEC took a unilateralist approach to corporate governance regulation, however, retreating to the view that if foreign issuers wish to tap the U.S. capital markets, they need to play by U.S. rules. Despite prior SEC reluctance to interfere in the corporate governance of foreign corporations, the automatic application of many provisions of Sarbanes-Oxley to all SEC registered companies made the SEC unwilling to craft exemptions for foreign issuers. Although the SEC did exempt foreign issuers from the requirement that their audit committees have independent directors if their governance structures achieved the same goals as the Sarbanes-Oxley audit committee provisions,[36] the SEC required foreign issuers to comply with other provisions such as the CEO-CFO certification requirements.[37]

Compliance with the internal control provisions of section 404 of Sarbanes-Oxley[38] proved particularly troublesome for foreign issuers. This section requires management to examine the effectiveness of a company's internal controls over financial reporting. Not only must the company report on such internal controls, but its auditors must attest to them.[39] Outside audit fees of U.S. companies subject to section 404 have greatly increased, and many argue that the costs of compliance with this provision are not

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34. *See* John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1824 (2002).

35. *See* Kathryn Stewart Lehman, *Executive Compensation Following the Sarbanes-Oxley Act of 2002*, 81 N.C. L. REV. 2115, 2132–33 (2003).

36. *See* Final Rule: Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, 68 Fed. Reg. 18,788 (Apr. 16, 2003).

37. *See* Sarbanes-Oxley § 302, 15 U.S.C. § 7241 (Supp II 2002); Sarbanes-Oxley § 906, 18 U.S.C. § 1350 (Supp. II 2002).

38. *See* 15 U.S.C. § 7262 (Supp. II 2002).

39. *See id.*

worth its benefits.[40] Thus far, the SEC has granted foreign issuers an extension of time for compliance with this provision, but a permanent exemption seems unlikely.[41] The SEC may not have the statutory power to exempt foreign issuers from section 404[42] and, in addition, in 2004 there were 1,200 foreign issuers registered with the SEC and foreign issuers comprised 16% of the NYSE's list.[43] Further, even if the SEC were now to craft exemptions for foreign issuers from the corporate governance and internal control provisions of Sarbanes-Oxley, foreign issuers would remain suspicious of the SEC's political will or ability to protect them from drastic changes in legal requirements in the future.

Marketplace developments in recent years also made a U.S. listing less attractive for foreign issuers. The European markets have matured to a point where capital can be raised there to meet the needs of most companies.[44] Foreign, and even some U.S. companies, engaging in IPOs or stock exchange listings have done so in Europe, rather than in the United States.

In 1999 and 2000, foreign IPOs on U.S. exchanges exceeded $80 billion—ten times the amount raised in London, but in 2005 London exchanges raised over $10.3 billion in foreign IPOs compared to $6 billion on U.S. exchanges.[45] In 2004, only three out of the twenty-five largest IPOs were listed on U.S. exchanges, in 2005 none of the twenty-five largest IPOs were listed on U.S. exchanges, and during the first half of 2006, only two of the largest twenty-five international IPOs were listed on U.S. exchanges. By contrast, in 2000, eleven of the twenty-five largest IPOs were listed on U.S.

40. Many have asserted that Sarbanes-Oxley adds tremendous cost—estimated to be in the tens of millions of dollars per year in legal and accounting fees—to compliance in the US. *See* Francesco Guerrera & Andrei Postelnicu, *A Not So Foreign Exchange: China Shuns the West as a Location for Its Big Corp. Share Offers*, FIN. TIMES (London), Nov. 18, 2005, at 17. A high powered panel of experts is now examining whether Sarbanes-Oxley needs revision. *See* Rachel McTague, *New Panel to Study SOX, Competitiveness of U.S. Public Capital Markets, Issue Report,* 38 Sec. Reg. & L. Rep. (BNA) No. 37, at 1569 (Sept. 18, 2006); *Panel to Seek Changes to Sarbanes-Oxley,* WALL ST. J., Sept. 12, 2006, at A2.

41. *See* Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Foreign Private Issuers That Are Accelerated Filers, Securities Act Release No. 8730, Exchange Act Release No. 54,294, 71 Fed. Reg. 47,056 (Aug. 15, 2006).

42. *See* Rachel McTague, *Sarbanes Defends SOX, Lauds Letter Saying SEC Lacks Power for 404 Exemptions,* 38 Sec. Reg. & L. Rep. (BNA) No. 13, at 539 n.13 (Mar. 27, 2006).

43. *See* Proposed Rule: Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 53,020, 70 Fed. Reg.77,688, 77,689–90 (Dec. 30, 2005).

44. *See* Kip Betz, *Former SEC Official Sees New Realities For Foreign Issuers Seeking to Raise Capital,* 38 Sec. Reg. & L. Rep. (BNA) No. 20, at 852 n.20 (May 15, 2006); *see also* Greg Ip, *Is a U.S. Listing Worth the Effort?,* WALL ST. J., Nov. 28, 2006, at C1.

45. *See* Stephen Fidler, *How the Square Mile Defeated the Prophets of Doom,* FIN. TIMES (London), Dec. 10, 2005, at 11.

exchanges.[46] Not only have foreign issuers declined to enter the U.S. trading markets since 2002, but they have also been lobbying for the ability to exit the U.S. disclosure system.

C. CONVERGENCE OF ACCOUNTING PRINCIPLES

Since 1982, the SEC has required all foreign companies which enter the SEC disclosure system to reconcile their financial statements to U.S. GAAP.[47] Foreign issuers have always found this requirement burdensome, but since last year it has become even more burdensome because the EU, in its Transparency Directive,[48] adopted IFRS as the applicable disclosure standard for all issuers across the EU,[49] which is applicable to consolidated financial reports and annual and half-yearly statements.

The SEC was given the statutory power to define accounting terms in the Securities Act.[50] The SEC, therefore, could have prescribed the substantive content of U.S. GAAP, but it delegated this power to the FASB and then enforced this regime by accepting U.S. GAAP financials as "authoritative" for purposes of SEC filings.[51] At one time there was hope that U.S. GAAP and IFRS would be harmonized and all companies in the international capital markets would report to investors in the same accounting language and format.[52] Alternatively, the SEC could accept IFRS as "authoritative" for purposes of SEC filings without any Congressional action and then foreign issuers which report their financial statements in IFRS would not have to reconcile to U.S. GAAP. Then U.S. issuers would continue to report in U.S. GAAP and foreign issuers wishing to list on a U.S. exchange or otherwise enter the U.S. disclosure system would report in IFRS if they preferred not to reconcile their financial statements to U.S. GAAP.

Although there has been considerable discussion of a regime under which U.S. GAAP and IFRS would have sufficient convergence so that the

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46. *See* Lucchetti, *supra* note 8, at C1. *See also* Rachel McTague, *Citigroup General Counsel Blames SEC, In Part for Loss of Global Edge in Markets*, 38 Sec. Reg. & L. Rep. (BNA) No. 46, at 1944 n.46 (Nov. 20, 2006).

47. *See* William C. Freund, *That Trade Obstacle, the SEC*, WALL ST. J., Aug. 27, 1993, at A6; Annette Nazareth, Comm'r, SEC, Remarks Before the Institute for International Bankers Annual Conference (Mar. 13, 2006), *available at* http://www.sec.lgov/news/speech/spch031306aln_iib.htm [hereinafter Nazareth Remarks].

48. *See* Directive 2004/109/EC of the European Parliament and of the Council on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, 2004 O.J. (L 390) 38, *available at* http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_390/l_39020041231en00380057.pdf.

49. *See* Stuart H. Deming, *Int'l Accounting Standards*, 40 INT'L LAWYER 363, 364 (2006).

50. *See* Securities Act § 19(a), 15 U.S.C. § 77s(a) (Supp II 2002).

51. *See* Securities Act § 19(b); Rule 4-01(a) of Regulation S-X, 17 C.F.R. § 210.4-01 (2005).

52. *See* Facilitation of Multinational Securities Offerings, Securities Act Release No. 6568, 50 Fed. Reg. 9281, 9283 (1985).

SEC would accept IFRS financial statements, there continue to be impediments to doing so. First, the IASB does not have a mechanism for interpreting IFRS and Europe does not have a securities commission at the EU level which could undertake such a task. Because there are now 25 member states of the EU it is unclear whether IFRS will be consistently interpreted. If IFRS is not consistently interpreted, it may be difficult for the SEC to accept IFRS as authoritative.[53]

Second, auditing standards are not included in the IASB's mandate and these vary considerably. There is no international body to oversee auditing. The establishment of the Public Company Accounting Oversight Board (PCAOB) in the United States pursuant to Sarbanes-Oxley, makes convergence of auditing standards between the United States and EU subject to some new and difficult dynamics. The EU Commission's proposal for a directive on statutory audits has been justified as "a basis for effective and balanced international regulatory cooperation with oversight bodies of third countries such as the [PCAOB]."[54] Although the PCAOB and the EU have worked out some of the problems with regard to the registration and inspection of foreign auditing firms which work on SEC filings, European issuers were left with a negative feeling regarding these problems.[55]

An agreement between the Chairman of the SEC and the Internal Market Commissioner for the EU as to a roadmap to end the need for EU issuers to continue to reconcile to U.S. GAAP was reached in 2005.[56] Then on February 27, 2006, European and U.S. accounting rule-makers announced a new memorandum of understanding regarding convergence of U.S. GAAP and IFRS. The agreement set forth their plan to develop a common set of standards over the next two years, rather than eliminating differences between their standards.[57] The SEC staff is now examining financial statements reported in IFRS to determine the extent to which they

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53. *See* Nazareth Remarks, *supra* note 47.

54. *See* Commission Proposal for a Directive on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC, COM (2004) 2, *available at* http://europa.eu.int/eur-lex/en/com/pdf/2004/com2004_0177en01.pdf.

55. *See E.U., U.S. Resolve Dispute Over Regulation of Audit Firms*, World Sec. L. Rep. (BNA), at 27 (Apr. 4, 2006).

56. *See* Press Release, SEC, Chairman Donaldson Meets with EU Internal Market Commissioner McCreevy (Apr. 21, 2005), *available at* http://www.sec.gov/news/press/2005-62.htm.

57. *See FASB, IASB Set Guideposts in Following Roadmap to Convergence Through 2008*, 38 Sec. Reg. & L. Rep. (BNA) No. 10, at 397 (Mar. 6, 2006); Press Release, SEC and CESR Launch Work Plan Focused on Financial Reporting (Aug. 2, 2005), *available at* http://www.sec/gov/news/press/2006/2006-130htm. In October 2006, the European Parliament agreed to wait until January 1, 2009 to secure a trans-Atlantic agreement on IFRS/U.S. GAAP convergence before requiring U.S. issuers to report in IFRS. *See Parliament Oks Accounting Rules to Implement Transparency Directive,* World Sec. L. Rep. (BNA), at 3 (Nov. 2006).

converge with U.S. GAAP. Although IFRS and U.S. GAAP are converging, there are still significant differences between these two systems.[58]

Foreign companies do not want to become subject to U.S. accounting and auditing rules. The CEOs of both the NYSE and Euronext have stated that U.S. accounting regulations would not be extended to European companies as a result of the NYSE-Euronext merger.[59] The SEC is aware of this strongly felt view and has attempted to reassure foreign issuers listed on Euronext that they will not become subject to the SEC reporting requirements merely because they are listed on Euronext.[60] The U.S. litigation system is also anathema to foreign issuers. While the SEC may attempt to reassure foreign issuers that the SEC will not impose registration requirements on them, the SEC cannot exempt foreign issuers from the reach of the anti-fraud provisions of the securities laws. Yet, as long as EU issuers have a significant number of U.S. security holders, they become subject to suit under the anti-fraud provisions whether or not they are listed in the United States.[61]

D. DEREGISTRATION OF FOREIGN ISSUERS

European and other foreign issuers have been vociferous in complaining about their inability to exit the SEC disclosure system if and when they no longer wish to have their shares listed or traded in the United States. The desire of foreign issuers to deregister may arise because of flow back of their securities to their home markets and an unsatisfactory trading record in the U.S. markets. Alternatively, it may be due to the reluctance of foreign issuers to become subject to the corporate governance listing standards imposed by Sarbanes-Oxley or the need to comply with the section 404 internal controls provisions of Sarbanes-Oxley.

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58. *See* Deming, *supra* note 49, at 367–68; *see generally* PRICEWATERHOUSECOOPERS, SIMILARITIES AND DIFFERENCES: A COMPARISON OF IFRS AND US GAAP (2004), *available at* http://www.pwc.com/gx/eng/about/svcs/corporatereporting/SandD_04.pdf.

59. *See* Aaron Lucchetti, *Investors Sour on Exchange Shares,* WALL ST. J., June 14, 2006, at C3; Aaron Lucchetti, *NYSE-Euronext: One, But Two,* WALL ST. J., Sept. 22, 2006, at C4.

60. *See* Kip Betz & Rachel McTague, *NYSE, Euronext $20B Merger Plan Would Create World's Largest Exchange,* 38 Sec. Reg. & L. Rep. (BNA) No. 23, at 962 (June 5, 2006); Judith Burns, *SEC Aims to Ease Europe's Fears On Cross-Border Market Merger,* WALL ST. J., June 17, 2006, at B2; *Campos Reassures Europeans About Motives in Trans-Atlantic Financial Exchange Mergers,* 38 Sec. Reg. & L. Rep. (BNA) No. 30, at 1267 (July 24, 2006). The only exchange offering investors a combined list with harmonized listing standards is OMX AB, the operator of the Scandinavian and Baltic markets. *See* Alastair MacDonald, *Multiple Markets, One Listing,* WALL ST. J., Oct. 2, 2006, at C14.

61. *See* In re Vivendi Universal, S.A. Sec. Litig., 381 F. Supp. 2d 158 (S.D.N.Y. 2003); Parmalat Finanziaria Agrees to Entry of Permanent Injunction and Corporate Undertakings, SEC Litigation Release No. 18,803, 2004 SEC LEXIS 1631 (July 28, 2004); Press Release No. 2003-184, SEC, Commission Settles Civil Fraud Action Against Vivendi Universal, S.A., Its Former CEO, Jean-Marie Messier, and Its Former CFO, Guillaume Hannezo (Dec. 23, 2003), *available at* http://www.sec.gov/news/press/2003-184.htm.

Bowing to the pressure from foreign issuers, the SEC has proposed rules allowing a foreign issuer to terminate its registration under the Exchange Act and to cease its reporting obligations regarding a class of equity or debt securities under certain conditions.[62] Currently, in order to exit the SEC reporting regime, a foreign private issuer generally must, among other things, certify that it has fewer than 300 resident U.S. shareholders, and it must look through the record ownership of its shares to make this determination.[63] The SEC has issued a proposal to make de-registration no longer turn on the number of U.S. residents holding a foreign issuer's shares. Whether this proposed rule would permit very many foreign issuers to exit the SEC disclosure system is questionable. A better solution would probably be to exempt foreign issuers from the corporate governance provisions and section 404 of Sarbanes-Oxley, but this solution seems politically infeasible at this time.[64] Nevertheless, the SEC has issued a Concept Release in an effort to make section 404 compliance less costly and more practicable for all public companies, and implementation of some of the ideas in this release could alleviate some of the tensions between the SEC and foreign issuers.[65]

Over the long term, one would hope that there will be greater regulatory convergence between the SEC and European regulators with regard to disclosure and corporate governance policy for foreign issuers, but thus far this has not occurred. Disclosure regulation has become somewhat more compatible under the influence of IOSCO and recent EU directives, but corporate governance regimes within Europe and in Europe and the United States are still far apart.[66] Whether a merger between the NYSE and Euronext would help to spur such convergence is an interesting question. One would hope so.

III. FOREIGN EXCHANGE ACCESS

A. THE DEMAND FOR ACCESS

A persistent idea for cutting through the regulatory red tape, when a foreign issuer lists on a U.S. exchange, is foreign exchange access. So far

62. *See* Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 53,020, 70 Fed. Reg. 77,688 (Dec. 30, 2005).

63. *See* 17 C.F.R. § 240.12g3-2(a) (1996); *id.* § 240.12g-4(a)(2) (2000). If a foreign issuer has made a public offering into the United States, de-registration is even more difficult.

64. *See* Rachel McTague, *Sarbanes Defends SOX, Lauds Letter Saying SEC Lacks Power for 404 Exemptions*, 38 Sec. Reg. & L. Rep. (BNA) No. 13, at 539 (Mar. 27, 2006).

65. *See* Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, Exchange Act Release No. 54,122, 71 Fed. Reg. 40,866 (July 18, 2006).

66. *See generally* Roberta S. Karmel, *Reform of Public Company Disclosure in Europe*, 26 U. PA. J. INT'L ECON. L. 379, 388–403 (2006).

this idea has been persistently rejected by the SEC.[67] Until recently, stock exchanges were floor-based membership organizations that traded primarily domestic securities. Today, however, stock exchanges compete for international listings.[68] Further, stock exchanges around the world have become electronic markets and no longer have floors.[69] Even the NYSE, the last major exchange with a trading floor, after its merger with Archipelago Holdings, Inc. (Arca)[70] is creating a hybrid market and may eventually become an electronic exchange.[71] Financial regulators, and the SEC in particular, have only begun to address the problems of regulating such cyber-markets.[72]

Foreign exchanges which now engage in screen trading have been desirous of placing their screens in the United States and signing up U.S. members, without registering as exchanges with the SEC and without requiring all of their listed companies to become registered and reporting companies in the United States pursuant to the Exchange Act.[73] Former EU Commissioner Frits Bolkestein strongly advocated a transatlantic financial community that would permit foreign market access in the United States by European exchanges based on the principle of mutual recognition.[74] Some critics of the SEC and the NYSE have suggested that the SEC's refusal to allow free access to foreign exchanges is protectionist and anti-competitive.[75] SEC Commissioner Roel C. Campos responded to pressure for foreign market access by explaining that the SEC "imposes significant regulatory requirements on exchanges, as well as on issuers who list on those exchanges, whether foreign or domestic. The exemptions being requested by some foreign exchanges would create access to U.S. investors on different terms than those available to U.S. exchanges. This, in turn, puts

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67. *See, e.g.*, Benn Steil, *Is Exchange Reciprocity Doomed? Not at All: The Goal of a Vast, Integrated Transatlantic Securities Market Would Increase Investment Returns, Lower Capital Costs and Increase Growth*, FIN. POST (Canada), Mar. 27, 2003, at FP15.

68. *See* Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2572–74 (2006); *Good-bye to All That*, ECONOMIST, Jan. 30, 1999, at 67.

69. *See* Fleckner, *supra* note 68, at 2566–67; Suzanne McGee, *Stock Markets May Look Nothing Like They Used To; But They Still Serve the Same Crucial Role*, WALL ST. J., Jan. 11, 1999, at R42.

70. *See* Fleckner, *supra* note 68, at 2559.

71. *See* NYSE Group, Inc., Annual Report (Form 10-K), at 6 (Mar. 31, 2006), *available at* http://www.nyse.com/pdfs/2502T05_CNB.PDF [hereinafter NYSE Form 10-K].

72. *See* Paul Cohen, *Securities Trading Via the Internet*, 4 STAN. J. L. BUS. & FIN. 1, 34–35 (1998); Tamar Frankel, *The Internet, Securities Regulation and Theory of Law*, 73 CHI.-KENT L. REV. 1319, 1345 (1998); Jane Kaufman Winn, *Regulating the Use of the Internet in Securities Markets*, 54 BUS. LAW. 443, 443–45 (1998).

73. Foreign issuers with $10 million and 300 (out of 500) U.S. shareholders become subject to SEC registration unless they file for an exemption. *See* Exchange Act Rule 12g-3(2)(b), 17 C.F.R. § 240.12g-3(b)(2) (2005).

74. *See* Frits Bolkestein, Towards an Integrated European Capital Market, Keynote Address at Federation of European Securities Exchange Convention, London (June 13, 2003), *available at* http://www.fritsbolkestein.com/speeches.htm.

75. *See* Chris Huhne, *Atlantic Trade Wars Loom Again*, FIN. NEWS, June 22, 2003.

considerable stress on our system of regulation, disrupting the level playing field we have created for all market participants."[76]

There are two problems with regard to giving foreign securities exchanges access to the United States. The first is how to fit such exchanges into national market system (NMS) regulation. Domestic electronic communications networks (ECNs) or alternative trading systems (ATSs) have been brought into the NMS regulatory framework through the adoption of Regulation ATS[77] and a revised definition of the term "exchange" under the Exchange Act.[78] In its concept release proposing that ATSs should either register as exchanges or undertake new responsibilities as broker-dealers, the SEC addressed the problem of foreign exchanges wishing to access the U.S. capital markets.[79] As the SEC suggested in its concept release, today's technology enables market participants to tap simultaneous and multiple sources of liquidity from remote locations.[80] It is therefore possible for U.S. investors to obtain real-time information about trading on foreign markets from a number of different sources and to enter and execute their orders on those markets electronically from the United States.[81]

The second major problem preventing foreign stock exchange access is that thousands of foreign securities, which are not registered with the SEC and whose issuers do not meet SEC disclosure and accounting standards, would become tradeable.[82] The SEC has suggested several possible solutions to this problem. First, the SEC could subject foreign exchanges to registration as "exchanges" under the Exchange Act and prevent them from trading any securities not registered with the SEC under the Exchange Act. Second, the SEC could limit cross-border trading by ECNs, ATSs, or foreign exchanges seeking U.S. investors to operations through an access provider which would be a U.S. broker-dealer or ECN. Third, the SEC could limit trading in foreign securities by foreign exchanges to transactions

76. Commissioner Roel C. Campos, Speech at the Centre for European Policy Studies: Embracing International Business in the Post-Enron Era (June 11, 2003), *available at* http://www.sec.gov/news/speech/spch061103rcc.htm.

77. *See* Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 70,843, 70,844 (Dec. 22, 1998).

78. *See* Exchange Act Rule 3b-16, 17 C.F.R. § 240.3b-16 (2006). For a criticism of the SEC's approach of imposing more regulation upon ATS, see Mark Klock, *The SEC's New Regulation ATS: Placing the Myth of Market Regulation Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753 (1999).

79. *See* Regulation of Exchanges, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485 (June 4, 1997) [hereinafter ATS Concept Release]. The problems of dealing with ATS facilities has troubled regulators world-wide. *See* Alexis L. Collins, *Regulation of Alternative Trading Systems: Evolving Regulatory Models and Prospects for Increased Regulatory Coordination and Convergence*, 33 LAW & POL'Y INT'L BUS. 481, 489 (2002).

80. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844, 70,847 (Dec. 22, 1998).

81. *See* ATS Concept Release, 62 Fed. Reg. at 30,521 n.213.

82. *See id.* at 30,528.

with sophisticated U.S. investors so that some exemption from Securities Act registration might be available.[83]

In granting an exemption from registration as an exchange to Tradepoint Financial Networks plc (Tradepoint) so it could operate a limited volume securities exchange in the United States, the SEC combined these various approaches.[84] Tradepoint was an electronic market maker system that allowed investors to trade securities listed on the LSE. The company also proposed to operate a specialist system for certain securities. The basis on which the SEC allowed Tradepoint to put its screens into the United States had two important limitations. Tradepoint had two levels of service for its members: one for the public market and one only to qualified institutional buyers (QIBs) as defined in Rule 144A.[85] Bids and offers for securities not registered under the Exchange Act could be made only by QIBs, and any such securities could only be resold outside the United States.[86] Further, access was effectively limited to broker-dealers and other sophisticated investors.[87]

While the SEC, as a practical matter, may currently be able to limit access to the U.S. markets by foreign exchanges to transactions with QIBs or other institutional investors, or to trading only in Exchange Act registered securities, this may not always be the best approach. As ECNs proliferate and retail investors become interested in buying foreign securities on foreign exchanges in the middle of the night, the SEC may find the approach it adopted in the Tradepoint exemption difficult to maintain and try some other approach to the problem of foreign exchange access.

B. TRANSPARENCY OF QUOTES AND PRICES

Since the SEC's Concept Release discussing foreign exchange access, the problems involved in allowing foreign exchanges into the United States have become even more intractable because the SEC has passed Regulation NMS,[88] and the EU has passed the Markets in Financial Instruments

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83. *See id.* at 30,529. In 2003 the staff of the Ontario Securities Commission recommended a new approach to the recognition of foreign based stock exchanges based on mutual recognition. *See* Ontario Sec. Comm'n, OSC Staff Notice 21-702, Regulatory Approach for Foreign-Based Stock Exchanges (Oct. 31, 2003), *available at* http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/sn_20031031_21-702_foreignbased.pdf.

84. *See* Order Granting Limited Volume Exemption from Registration as an Exchange Under Section 5 of the Securities Exchange Act, Exchange Act Release No. 41,199, 64 Fed. Reg. 14,953 (Mar. 29, 1999).

85. *See* 17 C.F.R. § 230.144A (2000).

86. Order Granting Limited Volume Exemption from Registration as an Exchange, 64 Fed. Reg. at 14,957.

87. *See id*. at 14,954–55. For further developments concerning Tradepoint, see Craig Karmin, *Tradepoint and Swiss Bourse Join to Expand System,* WALL ST. J., July 11, 2000, at C21.

88. *See* Regulation NMS, 17 C.F.R. § 242.600 (2005).

Directive (MiFID).[89] Although both laws are to some extent aimed at enforcing best execution obligations in the face of the threat of internalization and fragmentation[90] of securities price discovery mechanisms, they are based on different legal systems, and they are not necessarily compatible.

Regulation NMS is the most far reaching market structure initiative of the SEC since the 1970s. It is comprised of four new market structure rules reaffirming the SEC's interpretation of its mandate to facilitate the establishment of a national market system, as promoting a balance between fair competition among individual markets and assuring that such markets are linked together in a unified system that promotes interaction among orders in an NMS stock.[91] The four rules are: (1) an order protection rule; (2) an access rule; (3) a sub-penny rule (not relevant to this Article); and (4) market data rules and plans.

The SEC's mandate to facilitate the establishment of the NMS was added to the Exchange Act in 1975.[92] In a 1978 Policy Statement, the SEC asserted that Congress supported three major principles when directing the SEC to facilitate the development of the NMS. These were: (1) creating an ideal auction type market by implementing a nationwide system according to price and time priority for all limit orders of public investors over all professional orders; (2) the types of securities qualified to be included in an NMS should depend on their characteristics rather than where they were traded; and (3) a refusal to achieve a nationwide centralized auction-type market for qualified securities by abolishing over-the-counter trading in listed securities.[93] The SEC put down several building blocks for the NMS in the late 1970s, including: (1) the development of a composite quotation system; (2) the development of comprehensive market linkage and order routing systems in the form of the Intermarket Trading System (ITS); (3) a recommendation that all agency orders in NMS securities receive the benefit of auction-type trading protections; (4) the elimination of off-board

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89. *See* Directive 2004/39/EC of the European Parliament and of the Council of 21 Apr. 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, 2004 O.J. (L 145/1), *available at* http://www.mifid.ie/MiFIDLinks.html [hereinafter MiFID].

90. Internalization generally refers to the practice of a "broker-dealer who executes its customer order flow as principal without exposing that order flow to other market participants." DIV. OF MKT. REG., SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS, Study I, at I-18 n.59 (Jan. 1994), *available at* http://www.sec.gov/divisions/marketreg/market2000.pdf. When such orders are internalized, the pricing mechanism may become fragmented because all orders do not interact with one another. Securities market regulators have long had to balance the desirability of market maker competition against the dangers of internalization and fragmentation. *See id.* at I-9.

91. *See id.* at I(B)(1).

92. *See* 15 U.S.C. § 78k-1 (2000).

93. *See* Development of a National Market System, Exchange Act Release No. 14,416, 1978 SEC LEXIS 2339 (Feb. 1, 1978).

trading prohibitions; and (5) a consolidated transaction reporting system. Regulation NMS is an effort to update this vision in light of changes in the markets over the last quarter of a century.

The most controversial part of Regulation NMS is the order protection rule, also known as the trade-through rule,[94] which establishes intermarket protection against trade-throughs for all NMS stocks.[95] A trade-through is the execution of an order by one trading center at a price that is inferior to the price of a protected quotation, often representing an investor limit order, displayed by another trading center.[96] The trade-through rule protects only quotations that are immediately accessible through automatic execution, and thereby eliminates any potential advantage that manual or floor based markets had over automated markets in the ITS system. The trade-through rule applies to all trading centers, including Nasdaq and broker-dealers acting as off-exchange block positioners in exchange listed stocks.[97] A protected bid or protected offer is an automated quotation displayed by an automated trading center that is the best bid or best offer of an exchange or Nasdaq.[98]

The SEC justified the order protection rule on the ground that it will encourage greater use of limit orders, which will help improve the price discovery process and contribute to increased liquidity and depth in the securities markets.[99] To the extent that conflicts between short-term and long-term investors occur in trading markets, the SEC opted to protect long-term investors by attempting to minimize volatility.[100] The SEC also asserted that the rule will promote intermarket competition by leveling the

94. 17 C.F.R. § 242.611 (2005).

95. An NMS security has been redefined 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." *Id.* § 242.600(b)(46).

96. Currently, trade-throughs are protected by reason of the ITS Plan, which was established by the markets in 1978 and applies only to listed securities. *See id.* § 242.600(b)(77); *see also* American Stock Exchange, Inc., Exchange Act Release No. 14,661, 43 Fed. Reg. 17,419 (Apr. 24, 1978). Problems with the operation of the ITS Plan and threats by the NYSE to withdraw from ITS were some of the factors leading to the Regulation NMS initiative.

97. *See* Rules 600(b)(78) & 611, 17 C.F.R. §§ 242.600(b)(78), 242.611 (2005). The order protection rule as initially proposed included a general opt-out exception; the final rule eliminated this exception in favor of more tailored exceptions, including intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations and flickering quotations with multiple prices displayed in a single second. If the dealer simultaneously routes one or more intermarket sweep orders to execute against the full displayed size of each better priced, protected quotation, the exception for intermarket sweep orders will allow dealers to execute block orders for institutional clients internally at a price that would trade-through protected quotations. *See* Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,524, 37,535–36 (June 29, 2005); 17 C.F.R. § 242.600 (2005).

98. *See* 17 C.F.R. § 242.600(b)(7), (57) (2005).

99. *See* Regulation NMS, 70 Fed. Reg. at 37,594.

100. *See id.* at 37,500.

playing field between automated and non-automated markets.[101] According to the SEC, the trade-through rule does not lessen the duty of best execution, which "requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances."[102] The SEC does not view the duty of best execution as inconsistent with manual routing, but believes that broker-dealers must take into account price improvement execution possibilities. According to the SEC, the new order protection rule undergirds the duty of best-execution by helping to ensure that customers' orders are not executed at prices inferior to the best protected quotations.[103]

Protecting the best displayed prices against trade-throughs necessitates giving broker-dealers and trading centers fair and efficient access to quotations. The access rule[104] is designed to promote access to quotations in three ways. First, it enables the use of private linkages, rather than mandating a collective linkage facility such as ITS. Using private linkages, market participants may obtain indirect access to quotations displayed by a trading center through the members, subscribers or customers of that trading center.[105] Second, the access rule limits the fees that any trading center can charge for accessing its protected quotations.[106] Third, the rule requires SROs to have rules that prohibit their members from displaying quotations that lock or cross protected quotations of other markets.[107]

Regulation NMS also updates the requirements for consolidating, distributing and displaying market information and amends the joint industry plans for disseminating market information. The allocation of market data revenues by exchanges and Nasdaq has been a source of controversy for some time.[108] In Regulation NMS, the SEC declined to go to a model based on market forces, taking the view that investors, and

101. *See id.* at 37,594.
102. *Id.* at 37,537–38.
103. *See id.* at 37,538.
104. *See* 17 C.F.R. § 242.610 (2007).
105. *See* Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,502 (June 29, 2005).
106. *See id.*
107. *See id.* at 37,503.
108. Several years ago, an Advisory Committee that addressed the question of market data fees recommended that the SEC permit a new system of competing consolidators to evolve from the unitary model of the Consolidated Tape Association (CTA), so that each market center would be permitted to sell its market information to any number of competing consolidators, which in turn could sell to vendors and subscribers. *See* Letter from Joel Seligman, Dean, Wash. Univ. Sch. Of Law, to Harvey Pitt, Chairman of the SEC, Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (Sept. 14, 2001), *available at* http://www.sec.gov/divisions/marketreg/market info/finalreport.htm. The CTA, a single source monopoly established in 1979, had, like ITS, become outdated, and the NYSE threatened to withdraw from it. In Regulation NMS, the SEC took a much more complicated approach, making changes not only to the CTA Plan, but also to the CQ Plan, which disseminates consolidated transaction and quotation information for exchange-listed securities. *See* Regulation NMS, 70 Fed. Reg. at 37,503 n.40.

particularly retail investors, benefit from the current consolidated system.[109] The Regulation NMS amendments to the joint industry plans[110] are designated to strengthen the existing market data system and preserve its integrity and affordability. The amendments update the formulas for allocating revenues generated by market data fees to the various SRO participants in the plans, based on the usefulness to investors of each SRO's market information, rather than the number of trades. The amendments also broaden participation in the governance of the plans by creating advisory committees composed of non-SRO representatives. The amendments also promote the wide availability of market data by authorizing markets to distribute their own data independently of the plans.[111]

Although Regulation NMS attempted to settle market structure issues for the near term, it has not yet become fully effective[112] and it accelerated so many changes in the configuration of the trading markets that it may be obsolete before it is implemented. Immediately after Regulation NMS was adopted, the NYSE merged with Arca[113] and Nasdaq acquired the ECN of Instinet Group, Inc.[114]—transactions that can be attributed at least in part to the importance Regulation NMS put on automated trading systems. Other consolidations among exchanges, in Europe as well as in the United States, are also reactions to the new regulations affecting the trading markets.

MiFID, like Regulation NMS, is a far reaching regulation designed to eliminate national rules which concentrate trading on official stock exchanges and enable real competition between different market execution centers, through pre- and post-trade transparency rules. It is part of the EU's Financial Services Action Plan (FSAP), and it will replace the Investment Services Directive (ISD), passed in 1993. MiFID was intended to promote a single market for both wholesale and retail transactions in financial instruments. It sets forth requirements for investment advice, the operation of multilateral trading facilities (MTFs) and services related to commodity derivatives.[115] This will give financial services firms more reliable passports for cross-border activity than existed under the ISD. The substantial changes MiFID is expected to make include a broader definition of "investment advice," client classification criteria, a revised approach for dealing with conflicts of interest, a new approach to best execution, and new requirements in relation to equity market transparency, especially for

109. *See* Regulation NMS, 70 Fed. Reg. at 37,504.
110. *See* Rules 601 & 603, 17 C.F.R. §§ 242.601, 242.603 (2005).
111. *See* Regulation NMS, 70 Fed. Reg. at 37,504.
112. *See* Mohammed Hadi, *CBOE to Start Trading Stocks, Following Similar Plan by Rival*, WALL ST. J., July 28, 2006, at C3.
113. *See* Fleckner, *supra* note 68, at 2559; *see also* NYSE Form 10-K, *supra* note 71, at 6.
114. *See* Gaston F. Ceron, *Megamergers Roil Stock-Trading Scene*, WALL ST. J., June 1, 2005, at A6A.
115. *See* MiFID arts. 27, 28; EMILIOS AVGOULEAS, THE MECHANICS AND REGULATION OF MARKET ABUSE 298–99 (2005).

"systematic internalisers."[116] The trading transparency requirements and their application to internalisers have proved particularly controversial, and such controversy resonates with respect to the controversies over the trade through rule in the United States.

In 1993, when the ISD was adopted, securities trading in Europe was conducted on stock exchanges, also called "regulated markets," or by way of block trades executed upstairs by securities dealers. At that time, there was considerable controversy over a requirement to "concentrate" transactions on exchanges. Over a decade later, MiFID formally recognized the role of MTFs and directly addressed the responsibilities of "systematic internalisers." An MTF is defined as "a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments . . . in a way that results in a contract . . . ."[117] A "systematic internaliser" is defined as "an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MFT."[118] In 1993, when the ISD was adopted, competition between exchanges and MFTs were relatively unknown in Europe. Further, internalization was not common. Today, in jurisdictions where there is no concentration rule requiring orders to be brought to regulated markets, the EU Commission estimates that fifteen to thirty per cent of orders are internalized.[119] Since the MiFID abolishes the concentration rule, internalization may increase.

The political compromise that led to the abolition of the concentration rule, however, was the adoption of strict transparency rules.[120] Such rules will not only apply to regulated markets, but also to MFTs and investment firms. All of these rules are related to best execution responsibilities. The MiFID obligates EU member states to require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients.[121] This best execution standard can take into account price, costs, speed, likelihood of execution and settlement, size, nature, or other considerations relevant to order execution. Nevertheless, order handling and transparency rules limit the ability of investment firms to internalize orders.

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116. Hector Sants, Speech at the FSA Annual Public Meeting, Implementation of the Markets in Financial Instruments Directive and Capital Requirements Directive: State of Play (July 21, 2005), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/0721_hs.shtml.

117. *See* MiFID art. 4(15), 2004 O.J. (L 145/10). It is interesting to compare this definition with the definition of an alternative trading system in SEC regulations. *See* 17 C.F.R. § 242.300(a) (2005).

118. *See* MiFID art. 4(7), 2004 O.J. (L 145/10).

119. Emilios Avgouleas, *The New EC Financial Markets Legislation and the Emerging Regime for Capital Markets*, 23 Y.B. EUR. L., 321, 336 (2004).

120. *See Council Approves ISD Compromises; Dispute Remains Over Share Trading*, World Sec. L. Rep. (BNA), at 3 (Oct. 2003).

121. *See* MiFID art. 21(1), 2004 O.J. (L 145/18).

Member states must require investment firms to execute customer orders according to procedures or arrangements which provide for the "prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm."[122] These procedures must allow for the execution of comparable orders according to time priority. In the case of a client limit order, if an order in listed shares is not immediately executed, unless the client otherwise directs, the investment firm must make the order public in a manner which is easily accessible to other participants. This may mean sending the order to an exchange or MTF.[123]

Regulated markets are required to make public, on reasonable commercial terms and on a continuous basis, current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems.[124] In addition to such pre-trade transparency, regulated markets must publish the price, volume, and time for all equity trades executed in listed equities.[125] In order to ensure fair, orderly, and transparent operations, and fair access to regulated markets, the MiFID sets forth organizational requirements for such markets.[126]

The MiFID also requires systematic internalisers to publish a firm quote in listed shares for which they are internalisers and for which there is a liquid market. These quotes must be made available on a regular and continuous basis during normal trading hours.[127] Time priority is set forth as a standard for best execution. Nevertheless, systematic internalisers are allowed to decide, on a commercial basis, but in an objective and non-discriminatory way, the investors to whom they will give access to their quotes. Accordingly, systematic internalisers may decide to give access to their quotes only to retail clients, only to professional clients, or both, providing they do not discriminate within those categories.[128] One of the permitted methods for making quotes available is through a regulated market or exchange. Post-trade, as well as pre-trade disclosure, is mandated. Member states must require investment firms which effect transactions in listed shares off an exchange or MTF to make public the volume and price of those transactions and the time at which they were concluded. Further, this information must be made public on a real-time basis in a manner easily accessible to other market participants.[129] MTFs are similarly subject to pre-trade and post-trade transparency requirements.[130]

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122. *See id.* art. 22(1).
123. *See id.* art. 22(2).
124. *See id.* art. 44(1).
125. *See id.* art. 45(1).
126. *See* Avgouleas, *supra* note 119, at 342.
127. *See* MiFID art. 27(1)–(2), 2004 O.J. (L 145).
128. *See id.* pmbl.(5).
129. *See id.* art. 28(1).
130. *See id.* arts. 29, 30.

As pointed out by the U.S. Securities Industry Association (SIA), in a comment letter to the EU on an earlier draft of the MiFID, best execution and pre-trade and post-trade transparency requirements in the United States are "inextricably linked to the information and trading infrastructure in the United States," including the consolidated quotation system, the consolidated tape, intermarket linkages, automatic order routing and execution systems, electronic communication networks and a central clearing and settlement system.[131] Although regulations can remove barriers to competition, they cannot create market linkages. The MiFID asserts that fair competition requires that market participants and investors be able to compare the prices that intermediaries and trading venues must publish, but then merely recommends that Member States "remove any obstacles which may prevent consolidation at European level of the relevant information and its publication."[132] Similarly, the MiFID provides that Member States require that investment firms from other Member States have the right of membership or access to regulated markets in their territories, as well as the right of access to central counterparty, clearing, and settlement systems in their territories.[133]

MiFID is part of the FSAP, which consists of a series of policy objectives and specific measures to improve the single market for financial services in the EU. It is comprised of forty-two separate measures designed to harmonize EU Member States' regulation of securities, banking, insurance, mortgages, pensions and all other forms of financial transactions.[134] The goal of the FSAP is to create integrated, efficient, deep, and liquid financial markets in the EU in order to deliver a broad range of safe and competitive products to consumers and to achieve easier access to a single market for investment capital. Among the priorities of the FSAP are: revising the common legal framework for integrated securities and derivatives markets; removing outstanding barriers to raising capital on an EU-wide basis; ensuring the continued stability of the European markets; moving toward a single set of financial statements for listed European companies; creating a secure and transparent environment for cross-border restructuring; and providing legal security for cross-border security trading.[135]

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131. Letter from David Strongin, Vice President and Dir., Int'l Fin., Sec. Indus. Ass'n, to Dr. Alexander Schaub, Dir. General, Internal Mkt. of Directorate Gen. (Mar. 17, 2003), *available at* http://www.sia.com/2003_comment_letters/pdf/30545513.pdf.

132. MiFID pmbl.(34), 2004 O.J. (L 145/4).

133. *See id.* arts. 33, 34.

134. *See* Markets in Financial Instruments Directive, MiFID Links, http://www.mifid.ie/MiFIDLinks.html (last visited Mar. 31, 2007).

135. *See* SECURITIES EXPERT GROUP, FINANCIAL SERVICES ACTION PLAN: PROGRESS AND PROSPECTS, FINAL REPORT 6 (2004), *available at* http://www.europeansecuritisation.com/pubs/FSAP_stocktaking_Report.pdf.

One of the effects of the FSAP has been a consolidation of stock exchanges within Europe, of which Euronext is an example. While each exchange within Euronext operates as a separate subsidiary in its own country, governed and licensed by local regulators, all exchanges within Euronext have centralized their trading operations.[136] They utilize a common trading platform to create a single trading price for each security, and a broker-member of Euronext is able to trade all securities listed on any of the subsidiary exchanges.[137]

As can be seen, the goals and politics of Regulation NMS and the MiFID are quite disparate. Further, the history of exchanges in the United States and Europe and the problems of reconciling competition between evolving market centers—ATSs in U.S. terminology and MTFs in EU terminology—and maintaining best execution, especially for retail customers, is different in the two jurisdictions. Although both Regulation NMS and MiFID are efforts by regulators to incorporate ECNs into the equity trading markets, they approach this task differently, in part because the SEC traditionally has been more concerned about protecting retail investors and European regulators have been more concerned about preserving the wholesale markets. Accordingly, Regulation NMS includes ECNs in its trade-through requirements in a way which prodded exchanges and ECNs to consolidate, whereas in Europe ECNs were permitted to continue to deal with institutional investors outside of MiFID's transparency requirements.[138] Ironically, many of the major players in the European capital markets are affiliates of U.S. investment banks, and to some extent their trading activities in both the United States and Europe are in competition with the NYSE. The NYSE's efforts to expand into Europe should be viewed in the context of this competition.

Exchanges and their members are now confronted with the challenges of complying with both Regulation NMS and MiFID. Perhaps a merger between the NYSE and Euronext could precipitate a movement to harmonize or converge Regulation NMS and the MiFID. However, this is an unlikely prospect because of the tremendous complexity of both regulations and their differing treatment of institutional orders. An interesting question is whether the NYSE and Euronext will be able to construct a single trading platform to realize the synergies of their merger in the face of the different requirements of Regulation NMS and the MiFID. The Deputy Director of the SEC's Division of Market Regulation had

136. *See* Euronext, About Us: Our Business, History, http://www.euronext.com/editorial/wide/0,5371,1732_4427342,00.html (last visited Jan. 29, 2007).

137. *See* Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497, 505 (2001).

138. *See* AVOGOULEAS, *supra* note 115, at 299.

questioned how a common trading platform would be developed without significant regulatory change.[139]

IV. THE POLICIES OF THE CFTC

A. CROSS-BORDER ACTIVITIES

Commodity exchanges began to negotiate cross-border linkages prior to such transactions between security exchanges. In 1984, the Chicago Mercantile Exchange (CME) and the Singapore Monetary Exchange (SIMEX) instituted their mutual offset system, the first international linkage between exchanges.[140] In 1987, in conjunction with Reuters Holdings PLC, the CME pioneered GLOBEX, the first worldwide after hours electronic trading system.[141] In 1995, the CME launched the Growth and Emerging Markets (GEM) division to provide access to investment in emerging market countries.[142] In 1998, the CME launched GLOBEX2 based on a technology swap with the Paris Bourse and MATIF.[143]

Then in early 1998, Eurex, the all-electronic German/Swiss derivatives exchange, began talks with the Chicago Board of Trade (CBOT) regarding a joint venture to create a single global electronic trading system.[144] Two years later, CBOT members voted to discontinue the proposed alliance only to reconsider it six months later. Finally, on August 28, 2000, the CBOT Eurex Alliance was launched.[145] But this venture floundered, and on January 10, 2003, Eurex, the world's largest derivatives exchange, announced plans to open a U.S. exchange in Chicago.[146] Establishing a U.S. exchange was designed to allow Eurex to directly offer U.S. products such as U.S. Treasury securities, challenging older U.S. exchanges such as the CBOT and the CME.[147]

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139. *See Crossing the Pond*, *supra* note 3.

140. *See* Chris Sherwell, *Singapore Bridges a Time Gap*, FIN. TIMES (London), Sept. 7, 1984, at 1.

141. GLOBEX launched in June of 1992. *See* Jeffrey Taylor, *Futures Firms Banking on Globex Debut*, WALL ST. J., June 24, 1992, at C1.

142. *See Merc Expands; Emerging Markets Division Gets OK*, CHI. TRIB., Nov. 3, 1995, at 3N.

143. More recently, the New York Mercantile Exchange has proposed North America's first stock-futures combination with the Toronto Stock Exchange, Inc. *See* Leah McGrath Goodman, *Nymex Considers a Partnership With Owner of Toronto Exchange*, WALL ST. J., June 3, 2006, at B5.

144. Both parties reached an agreement in principle on the electronic platform in March of 1998. *See* Nikki Tait, *CBOT Link with Eurex Delayed to 2000*, FIN. TIMES (London), Dec. 28, 1999, at 19.

145. *See* Daniel Rosenberg, *CBOT's First Day of Eurex Alliance Gets Good Reviews*, WALL ST. J., Aug. 29, 2000, at C15.

146. *See* Press Release, Eurex to Launch U.S. Exchange (Jan. 10, 2003), *available at* http://www.eurexchange.com/about/press/press_231_en.html.

147. *See id.*; Joseph Weber, *A Battle Royal Is Brewing in Chicago*, BUS. WK. ONLINE, Sept. 18, 2003, http://www.businessweek.com/bwdaily/dnflash/sep2003/nf20030918_2279_db035.htm.

Shortly after the Eurex announcement, the CBOT and the CME went to Washington. Testifying before the U.S. House Agricultural Committee and the CFTC, the CBOT and the CME urged that Eurex's application to become a registered U.S. futures exchange be carefully reviewed. The Chicago exchanges raised concerns over the potential lack of transparency in the Eurex model, and questioned Eurex's compliance with U.S. law since some market surveillance functions would be performed in Europe.[148] Ultimately, these efforts proved unsuccessful as the CFTC later designated Eurex—by way of its subsidiary, the U.S. Futures Exchange, L.L.C. (USFE)—a contract market for the automated trading of futures and options on futures contracts.[149] While Eurex was successful in establishing a U.S. exchange, it failed in its attempt to win CBOT's U.S. Treasury futures market. In 2005, Eurex announced that it would shift its focus to foreign exchange futures, rather than commit to treasuries. Some suggested that the CBOT's efforts against Eurex's entrance into the U.S. market may have bought it enough time to mount a competitive response, which has allowed CBOT to remain the top U.S. Treasury exchange.[150]

Eurex is not the only European exchange raising hackles at U.S. commodity exchanges. The IntercontinentalExchange, Inc. (ICE) is an electronic trading network based in Atlanta, which matches buyers and sellers of energy contracts around the world. After being rebuffed by the New York Mercantile Exchange (Nymex), when Nymex was offered an investment in ICE, ICE began to compete with Nymex. Then ICE purchased the International Petroleum Exchange in London, best known for trading Brent crude oil futures, which was regulated in the United Kingdom. ICE then shut down its trading floor, and continued to operate under the aegis of the U.K. Financial Services Authority in the United States.[151] It could do so because of CFTC policies, which will be explained below.

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148. *See The Application for Contract Market Designation of the U.S. Future Exchange, LLC Before the Commodity Futures Trading Commission, Hearing Before the H. Comm. on Agriculture*, 108th Cong. 1 (2003) (statements of Charles P. Carey, Chairman, Chicago Board of Trade & Terry Duffy, Chairman, Chicago Mercantile Exch.); Press Release, Commodity Futures Trading Comm'n, U.S. Futures Exchange, LLC (USFE) Contract Market Designation Application (Sept. 16, 2003), *available at* http://www.cftc.gov/dea/deausfesubmissions_and_comments_table.htm.

149. *See* Press Release, Commodity Futures Trading Comm'n, CFTC Designates New Exchange (Feb. 4, 2004), *available at* http://www.cftc.gov/opa/press04/opa4886-04.htm.

150. *See* Chris Clair, *Ferscha Out at Eurex*, HEDGEWORLD DAILY NEWS, Dec. 29, 2005. On July 27, 2006, Man Group, a hedge fund manager and futures broker, purchased 70% of Eurex U.S. The new company, U.S. Futures Exchange, will not follow Eurex U.S.'s failed strategy of competing directly with other exchanges. Instead, the new venture plans on creating innovative products aimed at hedge funds. *See* Jeremy Grant, *Man Group Nabs 70% of Eurex U.S.*, FIN. TIMES (London), July 28, 2006, at 38.

151. *See* Bernard Wysocki Jr. & Aaron Lucchetti, *Global Exchanges Pose a Quandary For Securities Cops*, WALL ST. J., June 5, 2006, at A1.

B. CFTC INITIATIVES

The CFTC permits a foreign commodities exchange to install an electronic trading terminal in the United States based on various conditions and representations by that foreign exchange as to how it will conduct trading. This policy dates back to 1999, when the CFTC instructed its staff to process "no-action letter" requests from foreign boards of trade seeking to place terminals in the United States.[152] The first of these letters, issued prior to this policy statement, was given to Eurex.[153]

In 2000, the CFTC issued a policy statement allowing foreign boards of trade that had placed automated trading systems in the United States to list certain additional futures and options contracts without further regulatory approvals.[154] However, because of differences in philosophy between the CFTC and the SEC, which have shared jurisdiction over security futures, financial regulators were unable to reach agreement on rules that would allow security futures listed on foreign exchanges to be traded in the United States.[155] CFTC commissioners advocated cooperation across markets and national borders to deal more efficiently and effectively with expanding global markets and advances in technology. On May 15, 2006, the CFTC and the Committee of European Securities Regulators published online guides for conducting derivatives business in the United States and the EU.[156]

This internationalism has been interrupted by the complaints of Nymex that it is a victim of unfair competition from ICE. In January 2006, the CFTC approved, over Nymex's objection, ICE's application to list West Texas crude oil futures—the U.S. benchmark which Nymex trades—

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152. *See* Access to Automated Boards of Trade, 64 Fed. Reg. 32,829 (June 18, 1999).

153. *See id.* at 32,830 n.l; Press Release, Commodity Futures Trading Comm'n, CFTC's Trading & Markets Division Authorized the DTB to Install and Utilize Computer Terminals in the United States (Mar. 4, 1996), *available at* http://www.cftc.gov/opa/press96/opa3893–96.htm.

154. *See* Press Release, Commodity Futures Trading Comm'n, CFTC Issues Statement of Policy Permitting Certain Foreign Boards of Trade to List New Futures and Option Contracts through U.S.-Located Trading Systems, (July 3, 2000), *available at* http://www.cftc.gov/opa/press00/opa4414-00.htm.

155. *See* Patrick Tracey, *Rulemaking for Foreign Security Futures Eludes SEC-CFTC Agreement, Newsome Says*, 35 Sec. Reg. & L. Rep. (BNA) No. 24, at 1011 (July 1, 2003).

156. *See* Press Release, Commodity Future Trading Comm'n, Release No. 5182-06, Facilitating Transatlantic Derivatives Business: U.S. (CFTC) and EU Regulators, Through CESR, Take Joint Steps to Respond to Industry Concerns and to Facilitate Transatlantic Business by Use of Online Guides (May 15, 2006), *available at* http://www.cftc.gov/opa/press06/opa5182-06.htm. IOSCO, as long ago as 1990, succeeded in establishing principles for the oversight of screen-based trading systems for derivative products. *See* INT'L ORG. OF SEC. COMM'NS (IOSCO), A RESOLUTION ON PRINCIPLES FOR THE OVERSIGHT OF SCREEN-BASED TRADING SYSTEMS FOR DERIVATIVE PRODUCTS (Nov. 1990), *available at* http://www.iosco.org/library/resolutions/pdf/IOSCO RES3.pdf. The former Director of the Office of International Affairs of the CFTC once expressed the view that electronic markets are perfect international trading vehicles. *See* Andrea M. Corcoran, *The Uses of New Capital Markets: Electronic Commerce and the Rules of the Game in an International Marketplace*, 49 AM. U. L. REV. 581, 583 (2000).

without U.S. regulation. ICE's West Texas contract, unlike Nymex's, does not involve physical delivery of oil, but rather it is limited to cash settlements of each contract tied to the price of West Texas oil on Nymex. Nymex, unsuccessfully, went to court claiming that its prices were trademarked and could not be copied by a rival exchange.[157] Nymex now claims that the CFTC should not allow ICE the unfair advantage of looser U.K. regulations that impose no limit on the size of positions that investors can take. As a result of this regulatory loophole, hedge funds have abandoned Nymex for ICE, which has captured almost a third of the market.[158] Nymex points out that ICE is currently enjoying less stringent U.K. regulations through no-action relief despite the fact that it is based in the United States (and no longer runs a physical exchange in London), and ICE's contracts are based on a product that is produced, stored, and delivered in New York.[159]

The dispute between Nymex and ICE highlights the ambiguity of CFTC's no-action relief. The CFTC has never defined "the point at which . . . [a foreign board of trade] that makes its products available for trading in the U.S. [through an] . . . electronic trading system . . . is no longer 'located outside the U.S.' for purposes" of CFTC regulation.[160] While most foreign boards of trade that are granted no-action relief are regulated abroad, some foreign exchanges, such as Eurex, are subject to U.S. regulation. The CFTC therefore scheduled a public hearing for June 27, 2006 addressing this issue.[161] At the opening of the hearing, one of the CFTC commissioners remarked that "[d]etermining where an [electronic] exchange is located is difficult, if not impossible."[162]

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157. *See* Gillian Tett, *Stock Markets and Currencies: ICE-Nymex Saga Exposes New Problems for Regulation*, FIN. TIMES (London), June 16, 2006, at 38.

158. *See* Wysocki & Lucchetti, *supra* note 151; Jeremy Grant and Gillian Tett, *Capital Markets and Commodities*, FIN. TIMES (London), June 27, 2006, at 45.

159. Senator Charles Schumer expressed concern that, without U.S. regulations, purchasers on ICE could potentially drive the price of oil up to $100/barrel or higher. In response, ICE argues that oil is a globally traded commodity, and U.S. and U.K. regulators have information-sharing agreements and a strong working relationship. *See* Wysocki & Lucchetti, *supra* note 151, at A1. Since the CFTC has authorized ICE to list West Texas under U.K. regulations, Nymex has launched its own electronic trading of twelve energy contracts on the Chicago Mercantile Exchange's Globex platform. The strong early reports by Nymex coupled with the possibility that the CFTC might tighten regulation of ICE suggest that Nymex might soon recapture the West Texas market share it lost earlier this year. *See* Gerelyn Terzo, *A Bad Week for the ICE: Shares Fall as Rival Nymex Goes Electronic and CFTC Considers a Tighter Rein*, INV. DEALERS' DIG., June 19, 2006. This saga continues as ICE has agreed to purchase the New York Board of Trade. *See* Aaron Lucchetti & Susan Buchanan, *ICE Agrees to Buy Nybot, Whose Members Will Meet to Weigh Offer*, WALL ST. J., Sept. 15, 2006, at C3.

160. Boards of Trade Located Outside of the United States and the Requirement to Become a Designated Contract Market or Derivatives Transaction Execution Facility, 71 Fed. Reg. 34,070 (June 13, 2006).

161. *See id.*

162. Bernard Wyosocki, *CFTC Wrestles With Regulatory Turf In Age of Electronic Futures Trading*, WALL ST. J., July 3, 2006, at C1.

If one of the major purposes of the NYSE-Euronext merger is to capture the derivatives trading on LIFFE for U.S. investors, this jurisdictional hassle could become critical. Would LIFFE continue to be regulated by the Financial Services Authority in London, or would it come under the jurisdiction of the CFTC? This controversy also holds a lesson for the SEC. If the SEC were to reverse some of its prior policies and allow foreign exchange access so that Eurex could place terminals in the United States for direct trading access, such a policy would give thousands of foreign issuers not registered with the SEC direct trading access to the U.S. capital markets. U.S. issuers might complain and businesses that think such a policy would be a competitive threat might sue. If Congress became involved, internationalism would likely give way to nationalism. On the other hand, the business most likely to be at a competitive disadvantage in such a scenario is the NYSE itself because foreign issuers would have much less of an incentive to list on the NYSE.

V. THE FUTURE OF SELF-REGULATION BY THE NYSE

A. THE HISTORIC ROLE OF SELF-REGULATION

The NYSE was an SRO prior to the adoption of the federal securities laws. While the SEC has assumed greater responsibility for the regulation of listed companies, exchange members and trading markets than was once the case, Euronext has ceded most of its SRO functions to government regulators. The anticipation of a NYSE and Euronext merger raises a question as to whether the NYSE will be able to continue functioning as an SRO to the same extent as it does presently. This question is already in the air because of other developments.

Prior to the enactment of the Exchange Act, stock exchanges were private membership organizations under state law. When the federal securities laws were passed, stock exchanges were required to register with the SEC.[163] The SEC thus obtained oversight authority over stock exchanges, but the stock exchanges continued to have rulemaking and regulatory authority with respect to their members, their trading markets and their listed companies. Before 1934 no analogue to stock exchanges for the over-the-counter (OTC) market existed, but in 1938 Congress passed the Maloney Act to establish a framework for an OTC SRO.[164] Only one such association, the NASD, exists for OTC brokers and dealers. All broker-dealers registered with the SEC, except those doing business exclusively on a securities exchange, are required to join the NASD.[165]

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163. *See* Exchange Act §§ 5–6, 15 U.S.C. §§ 78e–78f (2000).

164. Exchange Act § 15A, 15 U.S.C. § 78*o*-3 (2000).

165. *See* Exchange Act § 15(b)(8), 15 U.S.C. § 78*o*(b)(8) (Supp. II 2002). Before 1983, the NASD did not have this kind of an SRO monopoly. *See* Pub. L. No. 98-38, § 3(a), 97 Stat. 206 (1983).

Although the efficacy of self-regulation was called into question by stock market abuses reported in the 1963 SEC Special Study,[166] that Study concluded that self-regulation should be maintained and strengthened.[167] The Securities Acts Amendments of 1975[168] further enlarged the SEC's oversight role over the stock exchanges and the NASD by, among other things, giving the SEC the power to initiate, as well as approve, SRO rulemaking,[169] expanding the SEC's role in SRO enforcement and discipline,[170] and by allowing the SEC to play an active role in structuring the market.[171] For the first time, the statute set forth requirements with respect to the composition of exchange and association boards of directors.[172]

Sarbanes-Oxley both diminished and strengthened self-regulation. On the one hand, the SEC was authorized to administer regulations regarding aspects of corporate governance that previously had been left to state law.[173] On the other hand, many of the new corporate governance regulations were imposed upon public companies by way of NYSE listing requirements dictated by Sarbanes-Oxley and the SEC. The SRO listing rules, as approved by the SEC implementing Sarbanes-Oxley, include provisions mandating executive sessions of non-management directors, define committee independence for audit and nominating committee members, define audit committee financial experts, set forth specific size requirements and obligations of the audit committee, and require companies to have codes of business conduct and ethics.[174] Continuing education for directors is suggested.[175]

166. SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKET, H.R. DOC. NO. 88-95, pt. 4, at 502 (1963).

167. *See id.* pt. 5, at 201–02.

168. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97.

169. *See* Exchange Act § 19(c), 15 U.S.C. § 78s(c) (2000).

170. *See id*. § 19(c), (d), (g).

171. *See* Exchange Act § 11A, 15 U.S.C. § 78k-1 (2000).

172. *See* Exchange Act § 6(a)(3), 15 U.S.C. § 78f(a)(3) (2000); Exchange Act § 15A(b)(4), 15 U.S.C. § 78*o*-3 (2000).

173. For example, provisions on certifications, loans to executives, and bonuses are all now subject to Sarbanes-Oxley. *See generally* Jonathan Shirley, *International Law and the Ramifications of the Sarbanes-Oxley Act of 2002*, 27 B.C. INT'L & COMP. L. REV. 501, 524–25 (2004) (describing the broad impact of the Sarbanes-Oxley Act).

174. *See* Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 47,516, 68 Fed. Reg. 14,451 (Mar. 25, 2003).

175. Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, Exchange Act Release No. 47,672, 68 Fed. Reg. 19,051, 19,057 (Apr. 1, 2003) (noting that director orientation and continuing education must be described in corporate governance guidelines); Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the American Stock Exchange LLC Relating to Enhanced Corporate Governance Requirements Applicable to Listed Companies, Exchange Act Release No. 48,706, 86 Fed. Reg. 62,109, 62,114 (Oct. 31, 2003) (noting that listed companies are urged to develop and implement continuing education programs for all directors).

In Europe, implementation of the EU's securities law directives—starting with the ISD in the early 1990s, and more recently the FSAP directives—have resulted in the creation of new and strengthened national securities regulators. Regulatory functions previously exercised by stock exchanges with respect to listed companies and trading members are now exercised by government commissions. This change in the balance between government and self-regulation was a by-product of the harmonization of the securities laws and the requirements for their enforcement. The ISD, the Insider Dealing Directive, the Public Offering Prospectus Directive and the Market Abuse Directive all require supervision and enforcement by government securities regulators.[176] Referring to the likelihood of a transatlantic combination of exchanges, and the differences between U.S. and foreign regulation, SEC Commissioner Annette L. Nazareth stated:

> If, in an international market, the jurisdiction in which a company lists becomes less important, the SEC may not be able to impact corporate governance or effect other reforms through listing standards. And, even if foreign jurisdictions have strong corporate governance requirements, fundamental differences exist between U.S. and foreign reporting and disclosure regimes.[177]

The same could probably be said for stock exchange regulation of its members and trading markets.

B. THE ORGANIZATION AND REORGANIZATION OF THE NYSE

Until 1972, the NYSE Constitution consisted of thirty-three members, composed of the chairman, the president, three representatives of the public and twenty eight members' representatives. Significant changes were made to the NYSE Constitution in 1972, after the NYSE incorporated and adopted a new governance structure. When the NYSE was incorporated in 1971, the SEC expressed some doubts as to whether this step would impair the effectiveness of the exchange as a self-regulator.[178] By the time the 1975 Act was passed Congress was not inclined to put rigorous corporate governance standards into the Exchange Act. In part, this was not necessary because the term "member" of an exchange was defined in such a way as to divorce it from the concept of a "seat"[179] and the SEC was given plenary control over specialists' activities.[180] In addition, the SEC was given the

176. *See* Council Directive 89/592, 1989 O.J. (L 334) 30 (EC); Council Directive 2003/71, 2003 O.J. (L 345) 64 (EU); Council Directive 2003/6, 2003 O.J. (L 096) 16 (EU).

177. Annette L. Nazareth, Speech by SEC Commissioner: Remarks Before the Securities Industry Association Market Structure Conference (May 24, 2006), *available at* http:www.sec.gov/news/speech/2006/spch052406aln.htm.

178. *See* Exchange Act Release No. 9112, 1971 SEC LEXIS 98 (Mar. 17, 1971).

179. *See* Exchange Act § 3(a)(3), (9), (19), 15 U.S.C. § 78c(a)(3), (9), (19) (Supp. IV 2004).

180. *See* Exchange Act § 11(b), 15 U.S.C. § 78k (2000). Previously exempt specialists, floor traders and floor brokers were required to register with the SEC.

power to abrogate, amend or add to the rules of any SRO.[181] Although self-regulation was preserved, and in some ways strengthened, a new emphasis on competition, investor protection and fair procedures changed the manner in which exchanges and associations could operate. Access to the market was opened up[182] and standards were put in place for the design of exchange and NASD rules and disciplinary proceedings.[183]

With specific reference to exchange boards of directors, the Exchange Act was amended in 1975 to provide that the rules of an exchange must "assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer."[184] A corresponding provision was inserted for associations.[185] The House bill had required that exchanges and associations include public representatives and further required that these SROs appropriate sums for use of public directors to employ staff independent of the exchange or association, but such provisions were dropped in the conference committee.[186]

The NYSE went beyond the requirements of the Exchange Act. Until its 2003–2004 reorganization, the NYSE had a constituency board composed of half public directors not associated with the securities industry, while the half that was so associated remained a constituency board.[187] There were requirements for industry directors from firms that had substantial direct contact with securities customers, for specialist members and non-specialist floor members and geographical specifications.[188] Most of the non-industry directors were associated with listed companies. Disciplinary matters were conducted by exchange committees. Appeals from disciplinary matters were heard by the committee for review, a board committee which acted for the NYSE board in deciding such appeals. The enforcement group was not organizationally separate from the rest of the NYSE staff. The SEC conducted regular oversight inspections of NYSE enforcement matters.

On September 17, 2003, Richard Grasso resigned as chairman and CEO of the NYSE in the midst of a storm of criticism over his compensation. Public focus on his outsized retirement pay package obscured some of the

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181. *See* Exchange Act § 19(c), 15 U.S.C. §.78s(c) (2000).
182. *See* Exchange Act § 11A(b)(5)(A), 15 U.S.C. § 78k-1 (2000); Exchange Act § 19(f), 15 U.S.C. § 78s(f).
183. *See* Exchange Act § 6(b)(7), 15 U.S.C. § 78f(b)(7) (2000); Exchange Act § 15A(b)(8), 15 U.S.C. § 78*o*-3 (2000); Exchange Act § 19(b), (d), 15 U.S.C. § 78s(b), (d).
184. *See* Exchange Act § 6(a)(3).
185. *See* Exchange Act § 15A(b)(4).
186. *See* H.R. REP. No. 94-229 (1975).
187. *See* NYSE CONST., art. IV, § 2(a)–(b) (2003) (NYSE Guide (CCH) ¶ 1151 (2003)).
188. *Id.*

more fundamental issues the NYSE was then facing.[189] At the time, the NYSE was examining its own corporate governance policies, at the behest of the SEC and the Council of Institutional Investors.[190] The SIA had raised some serious questions about the future of self-regulation.[191] Important changes in the securities trading markets and SEC market structure regulation threatened the way in which the NYSE had functioned for a very long time.[192] Relevant to the NYSE's continuation as an SRO were a series of major securities scandals concerning questionable and illegal behavior by securities firms and stock exchange specialists.[193] The inquiry into trading ahead of customer orders and other problematic specialist activity raised questions not only about the NYSE's effectiveness as a regulator, but also about the long term viability of the exchange's floor trading system.[194]

Almost as soon as John Reed was named Interim Chairman and CEO of the NYSE, a proposal was put forth to reorganize the NYSE's board of directors and alter its enforcement arm. A reconstituted board of directors, of six to twelve members plus a chairman and CEO, was put into place.[195] All of the board members other than the CEO were required to be independent of management, members, and listed companies. This board was then given the responsibility for appointing a board of executives of

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189. *See* Kate Kelly & Susanne Craig, *Weakened NYSE Faces Host of Challenges*, WALL ST. J., Sept. 18, 2003, at C1.

190. *See* COUNCIL OF INSTITUTIONAL INVESTORS, PRIVATE ENTITY WITH A PUBLIC PURPOSE: GOVERNANCE OF THE NEW YORK STOCK EXCHANGE (July 2003), *available at* http://www.cii.org/library/publications/nyse_governance.htm.

191. *See* SEC. INDUS. & FIN. MKTS. ASS'N, REINVENTING SELF-REGULATION: WHITE PAPER FOR THE SECURITY INDUSTRY ASSOCIATION'S AD HOC COMMITTEE ON REGULATORY IMPLICATIONS OF DE-MUTUALIZATION (Oct. 14, 2003), *available at* http://www.sia.com/market_structure/html/siawhitepaperfinal.htm. *See also* Roberta S. Karmel, *Should There Be a Single SRO*, N.Y.L.J., Oct. 21, 1999.

192. Proposed changes to the national market structure regulations were made in February 2004, but had been brewing for some time. *See* Regulation NMS, Exchange Act Release No. 49,325, 69 Fed. Reg. 11,126 (Mar. 9, 2004) (releasing proposed rules for public comment).

193. *See* Laurie P. Cohen & Kate Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, WALL ST. J., Dec. 31, 2003, at A1. In 2005, the United States Attorney's Office and the SEC charged fifteen specialists for violating federal securities laws through patterns of fraudulent and improper trading. *See* Press Release, U.S. Attorney's Office, S.D.N.Y., 15 Current and Former Registered Specialists on the New York Stock Exchange Indicted on Federal Securities Fraud Charges 1 (Apr. 12, 2005), *available at* http://www.usdoj.gov/usao/nys/pressreleases/April05/specialistindictmentpr.pdf; Press Release, SEC Institutes Enforcement Action Against 20 Former New York Stock Exchange Specialists Alleging Pervasive Course of Fraudulent Trading (Apr. 12, 2005), *available at* http://www.sec.gov/news/press/2005-54.htm. In addition, the SEC charged the NYSE with failing to police the accused specialists. *See* Press Release, SEC Charges the New York Stock Exchange With Failing to Police Specialists (Apr. 12, 2005), *available at* http://www.sec.gov/news/press/2005-53.htm.

194. *See* Aaron Lucchetti & Kara Scannell, *Fifteen Indicted in NYSE Case*, WALL ST. J., Apr. 13, 2005, at C1; *New Order At Big Board, Years of Turmoil Give Chief Opening for Change*, WALL ST. J., Apr. 22, 2005, at A1.

195. *See* 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, Exchange Act Release No. 48,946, 68 Fed. Reg. 74,678, 74,679 (Dec. 24, 2003).

twenty-two members, responsive to the exchange's various constituencies and comprised of institutional investors, listed company CEOs, lessor members, upstairs firm CEOs, specialist firm CEOs, floor brokers and the NYSE Chair and CEO.[196] The board of executives meets with the board of directors at least six times a year to discuss exchange performance, membership issues, listed-company issues, and public issues relating to market structure and performance. This new structure took much of the "self" out of self-regulation. After this reorganization, John Reed remained Chairman; John Thain was appointed CEO by the new board.[197] Richard Ketchum was shortly thereafter named Chief Regulatory Officer, and his office was structured so that he would report directly to the Regulatory Oversight & Regulatory Budget Committee of the NYSE board of directors, rather than to the NYSE's CEO.[198]

These governance changes set the stage for far reaching changes in the NYSE's business model. In April 2005, the NYSE announced a plan to acquire Arca, a deal designed to transform the NYSE from a mutual organization to a public company.[199] Due in part to litigation against the NYSE, this transaction was not completed until March 7, 2006, but in the meantime, NYSE Group was organized on May 2, 2005 as a holding company. NYSE Group now operates NYSE and NYSE Arca as two securities exchanges, the former, for the time being, continuing as an agency auction floor based marketplace, and the latter operating as an all-electronic stock exchange.[200] The planned NYSE Hybrid Market is designed to emulate, in a primarily automatic-execution environment, a traditional auction market.[201]

Both NYSE and NYSE Arca are SROs. In connection with the merger of the NYSE and Arca, NYSE Regulation, Inc. (NYSE Regulation) was formed as a separate not-for-profit subsidiary of NYSE Group. It has a number of structural and governance features designed to ensure its independence, in addition to its separate non-for-profit form. Each director of NYSE Regulation, other than its CEO, must be independent and a majority of the members of NYSE Regulation's board and its compensation nominating committees must be persons who are not directors of NYSE Group. Its programs are funded primarily through fees assessed directly on

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196. *See id*.

197. *See* Kate Kelly, Greg Ip & Ianthe Jeanne Dugan, *For NYSE New CEO Could Be Just the Start*, WALL ST. J., Dec. 19, 2003, at C1.

198. *See* Press Release, New York Stock Exch., NYSE Board Names Richard G. Ketchum as Chief Regulatory Officer and Takes Other Regulatory Action (Jan. 8, 2004). Ketchum began serving as Chief Regulatory Officer in March 2004. *See* Press Release, New York Stock Exch., Richard G. Ketchum to Assume Role as NYSE Chief Regulator Effective March 8 (Mar. 8, 2004).

199. *See Redrawing the battle lines*, ECONOMIST, Apr. 30, 2005, at 70.

200. *See* NYSE Form 10-K, *supra* note 71, at 4.

201. *See id.* at 16.

member organizations.[202] The regulatory activities of NYSE Regulation include: listed company compliance, member firm regulation, market surveillance, enforcement, and dispute resolution/arbitration.[203]

Under the merger plan of NYSE and Euronext, a holding company would be formed. Initially this parent was to have twenty directors—eleven from NYSE Group and nine from Euronext. This was later changed to a board of twenty-two directors, with half from NYSE Group and half from Euronext. The current CEO of NYSE—John Thain—would become CEO of this new company and the current CEO of Euronext—Jean-Francois Theodore—would become deputy CEO. The current Chairman of Euronext would become the Chairman of the Board and the current Chairman of NYSE Group would become Deputy Chairman. The two exchanges would be run as distinctly separate companies.[204] How NYSE Regulation would fit into this new corporate structure is unclear. Should it be completely separated from the NYSE as will be the case with the NASD and Nasdaq, or should it remain under the umbrellas of NYSE Group? Would there be any securities industry members or listed company executives on the board of directors?

C. THE SEC'S CONCEPT RELEASE ON SELF-REGULATION

The SEC has issued proposed governance rules for stock exchanges that would require that these SROs and any of their affiliates have boards with a majority of independent directors and that their nominating, governance, compensation, audit and regulatory oversight standing committees be composed of independent directors. These standing committees would be mandated, and the SEC sets forth in its proposal their minimum purposes and responsibilities.[205] An "independent director" is defined as a director who has no material relationship with an exchange or affiliate of an exchange, any member of the exchange or affiliate of a member, or any issuer listed or traded on the exchange.[206] Further, employment by an exchange or member within the past three years, or the receipt of $60,000 by the director or an immediate family member from the exchange or a member within the past year makes a director not independent. There is a similar definition of an "independent director" for the NASD.[207] This proposal is essentially based on the NYSE's reorganized board as described above.

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202. *See id.* at 41–42.
203. *See id.* at 39–40.
204. Press Release, New York Stock Exch., Announcement Related to NYSE Group-Euronext Combination (Nov. 21, 2006), *available at* http://www.nyse.com/press/1164064471943.html; Betz & McTague, *supra* note 60.
205. *See* Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 50,699, 69 Fed. Reg. 71,126, 71,134–40 (Dec. 8, 2004).
206. *Id.* at 71,214–15.
207. *Id.* at 71,219.

Section 6(b)(3) of the Exchange Act requires that the rules of an exchange assure a fair representation of its members in the selection of its directors and the administration of its affairs. Further, an exchange must provide that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, broker or dealer.[208] Although the NYSE board of executives is a traditional constituency group, which has a fair representation of exchange members, it is an advisory board, not an operating board with ultimate decision making authority. The SEC's rule proposal regarding exchange governance would require that the nominating committee of the board administer a fair process that provides members with the opportunity to select at least 20% of the total number of directors.[209] The SEC asserts that the board could nevertheless be composed solely of independent directors, so long as 20% of those independent directors are selected by the exchange's members. This may not be consonant with the statute, and in addition, it transforms the NYSE into an organization without securities industry members and therefore raises an issue as to whether it continues to be an SRO.[210]

Both Nasdaq and the SIA strongly objected to the SEC's proposal that exchange boards not include issuer or member firm representatives. Nasdaq argued that such a regulation would "either marginalize members and issuers or result in an unwieldy and excessively bureaucratic decision-making process that is ill suited to a public company . . . ."[211] The SIA argued that any governance reforms should be consistent with the balance between SEC oversight of SROs and regulation guided by the direct involvement of industry participants in both SRO and market functions.[212]

In addition to mandating a board of independent directors, the SEC proposed that exchanges and associations must effectively separate their regulatory functions from their market operations and other commercial interests, use regulatory funds only to fund regulatory obligations and establish procedures to prevent the dissemination of regulatory information to third parties.[213] In the SEC's view, the conflicts between an exchange as a market operator and as a regulator, and as a membership organization and

208. *See* 15 U.S.C. § 78f(b)(3) (2000). Section 15A(b)(4) of the Exchange Act contains an identical requirement applicable to the NASD. *See* 15 U.S.C. § 78*o*-3(b)(4) (2000).

209. *See* Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,137.

210. *See* Comment Letter from Edward S. Knight, Exec. Vice President and Gen. Counsel, Nasdaq, to Jonathan G. Katz, Sec'y, SEC 10–13, 21 (Mar. 8, 2005) (regarding the Proposed Rulemaking on SRO Governance (File No. S7-39-04), as well as the Concept Release concerning Self-Regulation (File No. S7-40-04)).

211. *Id.* at 12.

212. *See* Comment Letter from Marc E. Lackritz, President, SIA, to Jonathan G. Katz, Sec'y, SEC, 4 (Mar. 9, 2005) (regarding the SRO Governance and Transparency Proposal (File No. S7-39-04), as well as the SRO Concept Release (File No. S7-40-04)).

213. *See* Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,141.

as a regulator, are exacerbated if an exchange becomes demutualized and also has shareholders to whom it is responsible, and so separation of the regulatory component of an exchange or association's functions is therefore necessary.[214] The separation of the regulatory function of an SRO could be achieved by spinning off the regulatory organization into a separate entity, as is now the case at the NASD, though a functional separation within a single entity, or through a subsidiary of a holding company, as now the case at the NYSE. In either case, the SRO must appoint a chief regulatory officer who would report directly to the proposed independent regulatory oversight committee.[215]

Another important part of the SEC's proposal is a limitation on the amount of stock in an exchange or association that could be owned or voted by any one broker-dealer.[216] The SEC also has proposed special rules for exchanges or associations that go public and list on their own boards.[217] Finally, the SEC has proposed a complete overhaul of the public disclosures made by exchanges and associations, as well as the disclosures made by them to the SEC on a confidential basis. Some of the disclosures that could be of interest include what proportion of an exchange or association's total budget is devoted to regulatory expenses, as well as the dollar amounts of regulatory revenues and expenses. Other relevant financial information required to be disclosed on an annual basis would include revenues from regulation, transaction fees, market information fees, fines and penalties, listing fees and other fees paid by issuers, and investments.[218] There has long been speculation about how different sources of exchange revenue contribute to an exchange's operations and regulatory activities. Once such information is made public, some of the exchange's constituents might well demand changes in how the exchange is run, especially if exchanges become public companies.

The SEC's current preoccupation with the conflicts between an exchange's regulatory functions and its members, market operations, listed issuers, and shareholders prompted the issuance of a concept release on the future of SROs, in addition to the SEC's rule proposals described above.[219] Although the concept release details these conflicts, it is worth noting that all of these conflicts have existed for many years, except for the conflict between an exchange's regulatory functions and shareholders. Further, it can be argued that the conflicts between exchange regulatory functions and

214. *See id.*

215. *See id.* at 71,142.

216. The proposal is twenty percent, with a request for comment as to whether this should be lower. *See id.* at 71,143–46.

217. *See id.* at 71,227–28 (to be codified at 17 C.F.R. § 242.800).

218. *See id.* at 71,241–54 (to be codified at 17 C.F.R. § 249.2).

219. Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256 (proposed Dec. 8, 2004).

shareholders is a less acute conflict than between exchange regulatory functions and members. What has changed is the context of self-regulation.

In a global market where exchanges are public companies, it is difficult for them to continue to operate as SROs to the extent they have done so in the past. Further, the scandals of the past several years have raised serious questions about the ability of exchanges to regulate their members, their markets, or their listed companies. The SIA has been lobbying for a single regulator for broker-dealers in order to decrease the duplication and costs of regulation by several SROs.[220] The latest iteration of this idea is for a hybrid SRO structure, where market regulation would remain with exchanges, but there would be one SRO to deal with broker-dealer issues currently handled by the NYSE and NASD.[221] The NYSE now has a board with no securities industry members. While regulation has been delegated to NYSE Regulation, this non-profit subsidiary also does not have industry board members. Further, in Europe, its counterparts are government regulators. While good arguments can still be made for self-regulation as opposed to a system of direct government regulation, and SROs are deeply embedded in the U.S. system of securities regulation, if exchanges become global, regulators will also have to operate on a global level. Whether it is more efficient and effective for such regulators to be SROs rather than government agencies remains to be seen.

VI. CONCLUSION

Both individual and institutional investors are purchasing securities abroad in record numbers.[222] Although the securities markets have become global, the SEC's policies remain focused on the construct of protecting U.S. investors by regulating U.S. public corporations and markets. Almost twenty years ago, the author made some recommendations to facilitate foreign issuer trading and listing in the United States. One of these recommendations was that the SEC should amend Rule 12g3-2 under the Exchange Act to permit any world class foreign issuer whose securities are traded on a principal foreign market, including listed companies, to be exempt from section 12 of the Exchange Act.[223] Another recommendation was that the SEC should develop a new "wraparound form" for foreign issuers, recognizing international GAAP standards as "authoritative" within

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220. *See* Randall Smith, Aaron Lucchetti & Suzanne Craig, *Wall Street Pushes for Fewer Market Masters*, WALL ST. J., June 20, 2006, at C1.

221. Press Release, Sec. Indus. & Fin. Mkts. Ass'n, NYSE/NASD Regulatory Merger Endorsed by SIFMA (Nov. 28, 2006), *available at* http://www.sia.com/SIFMA_Press/2006_press_releases/35254696.html; Rachel McTague, *SIA Hammerman Says Association Seeks Internet Disclosure, Hybrid SRO*, 38 Sec. Reg. & L. Rep. (BNA) No. 26, at 1114 (June 26, 2006).

222. Ian McDonald, *Forget Xenophobia: Go Abroad for Gains*, WALL ST. J., Mar. 6, 2006, at R1.

223. *See* Roberta S. Karmel & Mary S. Head, *Barriers to Foreign Issuer Entry Into U.S. Markets*, 24 LAW & POL'Y INT'L BUS. 1207, 1226 (1993).

the meaning of Rule 4-01 of Regulation S-X. The wraparound form would be designed for use as a Securities Act registration statement for multi-jurisdictional offerings by world class foreign issuers and as an Exchange Act registration statement for foreign issuers other than world class issuers.[224] Other commentators similarly suggested that the SEC should engage in some form of mutual recognition in order to permit foreign issuers to trade on the NYSE or other U.S. markets.[225] Instead of following this type of policy, the SEC attempted to squeeze foreign issuers into the mold of U.S. issuers for purposes of Securities Act offering documents and annual and periodic reporting statements.

This policy was reasonably successful to the extent U.S. capital markets were far deeper and more liquid than foreign markets, and foreign issuers needed to come to New York regardless of the cost of complying with U.S. regulations. But markets in Europe and elsewhere are now viable alternatives to the U.S. markets. Furthermore, U.S. investors are more interested in buying foreign securities than they were in the past.

Frequently the SEC is more interested in protecting its jurisdiction and procedures for regulated entities and transactions than in adopting alternative regulations for companies that cannot or will not comply with the SEC's rules, even if this results in an enormous unregulated market. This occurred with the development of the private placement markets as an alternative to the market for registered offerings. It has also occurred with the exodus of U.S. investment banks abroad doing business through foreign subsidiaries that they are not able to do in a differently regulated environment. The NYSE has determined to go to Europe to capture business that it has not been able to capture in New York, primarily because of regulatory impediments. Whether this business gambit will work out depends in part on the willingness of the SEC and European regulators to permit it to be successful.

In order for truly global stock exchanges to develop, however, it will be necessary to dismantle national regulatory barriers—in the United States, Europe and elsewhere—to securities listings and replace them with international standards. Furthermore, the regulation of markets will also have to be reviewed in order to achieve international convergence of standards.

224. *See id.* at 1231–32.

225. *See* Edward F. Greene, Daniel A. Braverman & Sebastian R. Sperber, *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 BUS. LAW. 413 (1995).

THE ESSENTIAL ROLE OF REGULATION IN PROMOTING EQUITY MARKET COMPETITION

Daniel M. Gray[*]

I. INTRODUCTION

November 2006 was a particularly good time for a symposium to evaluate equity market structure. In the United States, the equity markets were entering the final stages of implementation for Regulation NMS. Adopted in June 2005, Regulation NMS embodies changes to market structure that are designed to enhance and modernize the national market system adopted under section 11A of the Securities Exchange Act of 1934 (the '34 Act).[1] Regulation NMS includes a trade-through rule that generally prevents a market from executing trades at prices inferior to automated quotes that are displayed and immediately accessible at other markets.[2]

Over the last two years, the U.S. equity markets have been transformed. There are ten registered securities exchanges in the U.S., and nine of the ten have adopted new equity trading systems. Perhaps most notably, the New York Stock Exchange (NYSE), the largest equity market in the world, has fully automated its quote for the first time in its history. The exchanges brought their new trading systems into full operation on March 5, 2007.[3]

In Europe, as well, the state of competition among equity exchanges is in flux. As the economic boundaries between European countries have blurred, so have the boundaries between the traditional national stock exchanges. Several smaller exchanges have already merged, and there has been a continuing dance involving potential mergers among the "Big

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1. Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496 (June 29, 2005) (adopting release).

2. Regulation NMS Rule 611, 17 C.F.R. § 242.611 (2006). Rule 611 replaces an older trade-through rule that had applied to securities listed on exchanges other than Nasdaq. Rule 611 updates the old rule by extending trade-through protection only to automated quotes, in contrast to the old rule that protected both automated and manual quotes. In addition, Rule 611 applies to stocks listed on all exchanges, including Nasdaq. *See* Regulation NMS, 70 Fed. Reg. at 37,501–02.

3. Regulation NMS, Exchange Act Release No. 53,829, 71 Fed. Reg. 30,038, 30,039 (May 24, 2006) (setting compliance dates for Regulation NMS). *See also* Regulation NMS, Exchange Act Release No. 55,160, 72 Fed. Reg. 4202 (Jan. 30, 2007) (extending the Trading Phase Date until March 5, 2007).

Three" European exchanges—the London Stock Exchange (LSE), Deutsche Börse AG, and Euronext N.V.[4] More recently, of course, the U.S. exchanges have entered the mix with their own proposals for cross-Atlantic mergers.[5] In addition to this merger activity among existing exchanges, the scheduled implementation of the Markets in Financial Instruments Directive (MiFID) in November 2007 raises the potential that a transformed regulatory environment may create a more meaningful opportunity for new competitors to challenge the Big Three for market share in Europe. As a result, the next few years will offer up a wealth of new data for evaluating the effects of regulatory initiatives on competition in the equity markets.

The topic of the panel I spoke on at the *Brooklyn Journal of Corporate, Financial & Commercial Law* symposium was entitled: The Respective Roles of Government and Competition in Shaping and Developing the Markets. The panel discussed the extent to which competition rather than government regulation should shape the markets. I want to turn those statements around and suggest that, in the absence of a regulatory scheme specifically designed to promote competition among multiple equity markets, there is unlikely to be significant competition because of the economic forces that drive markets toward consolidation. Both economic theory and historical experience suggest that a single equity market will eventually dominate trading in its listed stocks. Regulations, therefore, should be viewed as playing an essential role in preserving and promoting equity market competition.

In examining this thesis, I will focus on three broad questions. First, given the powerful network effect that operates in the equity markets—best captured in the old maxim that liquidity attracts liquidity—is significant competition among equity markets for trading volume in the same stocks likely to exist in the absence of a regulatory scheme that makes such competition a primary objective?

Second, assuming that regulation does indeed play an essential role in promoting competition among equity markets, what regulatory tools are most effective in promoting competition, without losing the economic good that underlies the network effect (the best prices for investors)?

Finally, are regulatory efforts to promote competition among equity markets actually worth it? I will examine whether the benefits of such

4. U.K. COMPETITION COMMISSION, REPORT ON THE PROPOSED ACQUISITION OF LONDON STOCK EXCHANGE PLC BY DEUTSCHE BÖRSE AG OR EURONEXT NV, 3–4, 22–24, 44 (Nov. 2005) [hereinafter U.K. COMPETITION REPORT].

5. As this article goes to press, it appears that the proposed merger of the NYSE and Euronext will be completed, while Nasdaq's tender offer for the LSE has not been accepted by LSE shareholders. Press Release, NYSE Euronext to Commence Offer for Euronext Shares (Feb. 15, 2007), *available at* http://www.nyse.com/press/1171453128510.html (announcing commencement of offer for Euronext shares); Press Release, Nasdaq, Final Offers Lapsed (Feb. 10, 2007), *available at* http://www.nasdaq.com/newsroom/news/newsroomnewsHeadlines.aspx?year= (follow "Final Offers Lapsed") (announcing lapse of final offer for LSE shares).

competition exceed the costs of fragmenting the buying and selling interest in individual stocks, particularly by focusing on three historical events that offer empirical evidence to help assess this question.

II. IS REGULATION ESSENTIAL FOR EQUITY MARKET COMPETITION?

One of the primary statutory objectives for the Securities Exchange Commission (SEC) is to ensure fair competition among exchange markets, and between exchange markets and markets other than exchange markets.[6] Competition in this context refers to competition among multiple markets to attract trading volume in the same stocks. Markets compete in this way by offering better trading services to investors, such as low access fees, reliable systems, and innovative trading tools.[7] This type of competition is distinct from competition for listings, where the quality of trading services may be but one of many factors that influence an issuer's decision on where to list initially and whether to switch listings. In contrast, the quality of a market's trading services is more likely to be vitally important to actual traders and investors than it is to company management.

When evaluating the issue of equity market competition, the starting point is the principle that "liquidity attracts liquidity"—known in economic terms as a "network effect."[8] As a single market attracts more and more trading volume in a stock, each new participant in that market enhances the value of the market to both existing and prospective participants by adding liquidity and thereby enabling that market to offer better prices. After an initial period of potentially vigorous competition among multiple markets, liquidity can be expected to tip to a single market and stick there indefinitely. Because of this network effect, any market attempting to compete with the dominant market faces a tough challenge. Even if the new competitor offers better technology and lower fees, it may not attract trading volume because it cannot assure its participants that they will receive prices that match the quality of executions available on the dominant market. Moreover, the dominant market may respond to competitive challenges by reducing fees in the short-term until a competitor is driven off, or by adopting an improved technology that was developed and introduced by the competitor.

The consequences of the network effect can be seen today by assessing the equity markets throughout the world. The network effect appears to be alive and well. In countries other than the U.S., the major equity exchanges

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6. Exchange Act § 11A(a)(1)(C)(ii), 15 U.S.C. § 78k-1(a)(1)(C)(ii) (2000).

7. *See* Notice of Filing of Proposed Rule Change to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577, 10,582 (Feb. 28, 2000).

8. *See* LARRY HARRIS, TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 526, 535–36 (2003).

overwhelmingly dominate public trading in their listed stocks. Examples include the LSE in the United Kingdom; the Tokyo Stock Exchange in Japan; Deutsche Börse in Germany; Euronext in France, the Netherlands, Belgium, and Portugal; and the Toronto Stock Exchange in Canada.

In contrast, the U.S. equity markets currently are characterized by extremely vigorous competition among a variety of different types of markets for trading volume in the same stocks. For example, the NYSE floor, which historically has dominated trading in NYSE stocks, has seen its market share diminish in recent months. To counter the trend, the NYSE has adopted a Hybrid Market that offers fully automated access to its displayed quotes. Of course, the NYSE also has merged with the fully automated Archipelago Exchange, but the NYSE Group has decided to maintain both entities as separate exchanges that simultaneously trade NYSE stocks on different trading platforms.[9] Therefore, to some extent the two trading platforms operating under the NYSE Group umbrella will be competing with each other for volume in NYSE stocks.

For its part, Nasdaq has been approved as an exchange, has merged with two competitor ECNs, and has integrated the respective three trading systems into a single system with superior technology than its old system. Nasdaq has increased its share of trading in NYSE stocks by, among other things, offering low-cost routing to the NYSE floor for orders that check the Nasdaq order book first.[10]

The American Stock Exchange (Amex), like the NYSE, is transforming a manual floor-based market into a hybrid market with primarily automated trading.[11] The four traditionally "regional" exchanges—Chicago, Boston, Philadelphia, and National—have all received capital infusions from major securities firms wary of a potential NYSE/Nasdaq duopoly that would dominate trading in U.S. equities.[12] The regionals have adopted new, automated equity trading systems and believe that they have their best opportunity in many years to compete effectively for trading volume with the larger exchanges. Similarly, "[t]he two traditionally options exchanges—CBOE [the Chicago Board Options Exchange] and ISE [the

9. NYSE Group, Inc., Annual Report (Form 10-K), at 4–5 (2005).

10. Nasdaq Stock Market, Inc., Quarterly Report (Form 10-Q), at 22–26 (Nov. 8, 2006), *available at* http://excite.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?SessionID=dqUgjAWGR6-FQ1D&ID=4750663; Nasdaq Membership Frequently Asked Questions (Sept. 7, 2006), http://www.nasdaqtrader.com/trader/er/er_faqs.pdf.

11. Press Release, AMEX, American Stock Exchange's New Electronic Trading Platform Compliant With Regulation NMS (March 5, 2007), *available at* http://www.amex.com/?href=/atamex/news/press/sn_AEMIRegNMS_030507.htm.

12. Emily Lambert, *Could Small Mean Big? Why Regional Exchanges Are Heating Up*, FORBES.COM, July 3, 2006, http://members.forbes.com/forbes/2006/0703/054b.html.

International Securities Exchange]—have decided to expand into [trading] equities and . . . [have adopted] new, automated equity trading systems."[13]

Finally, in addition to the ten registered securities exchanges, a variety of alternative trading systems (ATSs) compete for trading volume in U.S. stocks. Three electronic communications networks (ECNs) publicly display their quotes through the National Association of Securities Dealers' (NASD's) Alternative Display Facility, and a large number of other ATSs operate "dark" pools of liquidity. These dark ATSs include crossing systems that facilitate block trading by institutional investors, as well as liquidity pools operated by broker-dealers that seek to match orders internally prior to any interaction with the transparent, public markets.[14]

The United States and other countries have contrasting expectations for a competitive equity market structure. While market participants in other countries have long accepted dominant exchanges, many in the U.S. have expressed great concern over the prospect of a duopoly with trading dominated by the NYSE Group and Nasdaq. This concern to maintain a competitive market structure reflects a fundamental policy choice of the U.S. regulatory scheme.[15] The Exchange Act directs the SEC to facilitate the establishment of a national market system (NMS).[16] The NMS is made up of multiple markets that simultaneously trade the same stocks. One of the primary NMS objectives is to ensure fair competition among broker-dealers, among exchange markets, and between exchange markets and non-exchange markets.[17]

This NMS approach to market structure is an attempt to have your cake and eat it too. On the one hand, investors in the United States want to have the benefits of competition among markets (such as innovative trading tools and low trading fees). But on the other hand, they want to minimize any adverse effects of "fragmentation"—when the buying and selling interest in individual stocks becomes so split up among multiple markets that it interferes with efficient pricing of those stocks.[18] In this respect, the NMS "incorporates two distinct types of competition—competition among

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13. Annette L. Nazareth, Comm'r, SEC, Remarks Before the STA Annual Conference (Oct. 13, 2006). *See also* John Authers & Norma Cohen, *Clearing the Floor: How a Regulatory Overhaul Is Helping Rivals to Close in on the Big Board*, FIN. TIMES, Sept. 14, 2006 (noting that ISE launched its equity trading service in the Fall of 2006, while CBOE planned to launch in 2007).

14. Daniel Safarik, *Illuminating the Dark*, ADVANCED TRADING, Sept. 26, 2006, at 26, 28; Nina Mehta, *Who's Afraid of the Dark?*, TRADERS MAGAZINE, May 2006, at 36, 40–41.

15. *See* Securities Exchange Act of 1934, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78nn (2000)).

16. Exchange Act § 11A(a)(2), 15 U.S.C. 78k-1(a)(2) (2000).

17. Exchange Act § 11A(a)(1)(C)(ii).

18. Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577, 10,577–78 (Feb. 28, 2000) (requesting comment on issues relating to market fragmentation).

individual markets and competition among [individual] orders."[19] The Commission's market structure challenge over the years has been to maintain an appropriate balance between these two forms of competition.[20]

III. WHICH REGULATORY TOOLS PROMOTE COMPETITION AND EFFICIENCY?

The SEC has balanced the two objectives of competition among markets and competition among orders by utilizing familiar regulatory tools. They include price transparency, non-discriminatory access to markets, non-discriminatory access to clearing and settlement systems, and the duty of best execution.

Mandatory price transparency helps non-dominant markets compete by enabling them to provide some assurance that their prices are as good as those offered by the dominant market. If the dominant market displays a quote to anyone, it is required to display that quote to the public.[21]

Mandatory fair and non-discriminatory access to markets prevents a dominant market from restricting its prices to favored customers.[22] Open access also prevents the dominant market from inhibiting traders from participating in other markets, such as through off-board trading restrictions.[23]

In addition, market participants in the United States have fair and non-discriminatory access to a national clearing and settlement system, no matter the particular market where a trade was executed. The extraordinary importance of this regulatory tool is apparent from the state of exchange competition in Europe, where individual markets own clearing and settlement systems as part of "vertical silos" in which trading services are effectively tied to clearance and settlement services.[24] Notably, when Congress ordered the creation of a national system for trading stocks in 1975, it also ordered the creation of a national system for clearing and settling trades.[25]

Finally, the duty of best execution plays a vital role in promoting competition by creating incentives for brokers to search for the best

19. *See* William H. Donaldson, Chairman, SEC, Testimony Concerning Recent Developments in the Equity Markets Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (May 19, 2005), *available at* http://www.sec.gov/news/testimony/ts051905whd.htm.

20. Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. at 37,498–99 (June 29, 2005) (adopting release).

21. *See* Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48,290 (Sept. 12, 1996).

22. Regulation NMS, 70 Fed. Reg. at 37,540.

23. Off-board trading restrictions prevent an exchange's members "from effecting transactions in [the exchange's] listed securities away from a national securities exchange." Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577 (Feb. 28, 2000) (proposing rescission of NYSE Rule 390).

24. U.K. COMPETITION REPORT, *supra* note 4, at 59, 67–70.

25. Exchange Act § 17A(a), 15 U.S.C. § 78q-1(a) (Supp. II 2002).

available markets.[26] In some cases, brokers may be committed to a dominant market because of financial considerations or other self-interests, or just through plain inertia. The duty of best execution helps focus brokers on the interests of their customers in trading on the best market. This focus expands the opportunity for smaller markets to compete with a dominant market by offering better prices or trading services that brokers are legally required to consider.

Many of these regulatory tools that promote competition also can minimize the adverse effects of fragmentation. For example, price transparency and open access help keep prices in line among all the different markets that trade a particular stock. If quoted prices diverge, the differences can immediately be arbitraged away. Public disclosure of order execution quality statistics by all markets is another important aspect of price transparency.[27] This specialized disclosure supplements real-time quote and trade transparency by honing in on the quality of executions actually provided at different markets for different types of orders that otherwise could not be seen by the public. Comparable statistics on order execution quality both help equalize the prices available across markets and enable markets to compete more directly on the quality of their order executions by making this factor visible to brokers and customers.[28]

IV. DO THE BENEFITS OF COMPETING EQUITY MARKETS OUTWEIGH THE COSTS OF REGULATION AND FRAGMENTATION?

Multiple markets trading the same stocks are necessary to have a competitive market structure. But the severity of any adverse effects of fragmentation may increase as the number of competing markets increases. The regulatory tools mentioned in Part III can help direct order flow to markets that offer the best prices. These tools thereby minimize the most obvious risk of fragmentation, which is that an investor's order will be executed at an inferior price in one market, while the best price was readily available in another market.

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26. Order Execution Obligations, 61 Fed. Reg. at 48,322 ("A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated both in SRO rules and, through judicial decisions, in the antifraud provisions of the federal securities laws.").

27. Regulation NMS Rule 605, 17 C.F.R. § 242.605 (2006).

28. *See generally* Ekkehart Boehmer, Robert Jennings & Li Wei, *Public Disclosure and Private Decisions: Equity Market Execution Quality and Order Routing*, 20 REV. FIN. STUD. 315 (2007) (examining whether public disclosure affects behavior and finding that it produces beneficial effects); Xin Zhao & Kee H. Chung, *Information Disclosure and Market Quality: The Effect of SEC Rule 11Ac1-5 on Trading Costs*, 42 J. FIN. QUANTITATIVE ANALYSIS (forthcoming 2007), *available at* http://ssrn.com/abstract=440429 (analyzing the impact of public disclosure and concluding that it encourages competition among market centers and reduces trading costs).

A deeper issue in evaluating a fragmented market structure, however, is whether its "best" prices are any good—particularly, whether the prices produced by a fragmented market structure are as good as the prices that would be produced by a more consolidated market structure. In other words, do the benefits of regulatory efforts to promote competition among multiple markets outweigh the excessive transaction costs that might be imposed on investors if fragmentation impaired price discovery for individual stocks?

As an initial matter, one should not fail to recognize, or underestimate, the costs of a fragmented market structure merely because investor transaction costs can be difficult to calculate precisely. Institutional investors experience this difficulty acutely because they trade in large size. Institutional investors, such as mutual funds and retirement plans, represent the financial interests of millions of individuals by enabling them to invest indirectly in the equity markets. For institutional investors alone, the implicit transaction costs associated with the prices at which their orders are executed has been estimated to be as high as 1% of the principal amount of their transactions.[29] Dollar cost estimates range from a conservative $30 billion to more than $100 billion annually. To provide a frame of reference, the total non-listing revenues of the NYSE Group and Nasdaq in 2005 were approximately $2.11 billion.[30] Consequently, the potential benefits of competition among markets in minimizing exchange fees are smaller by an order of magnitude than the potential costs to investors of impaired price discovery.

This issue of the trade-off between competition and fragmentation can be endlessly debated in theory, depending on one's views about optimal market structure. It is therefore interesting to look for relevant empirical data that might shed light on the issue. I will consider three historical periods that offer relevant natural experiments on the benefits and costs of competition among equity markets: first, in 1996, the entry of ECNs into the market for Nasdaq stocks following the Commission's adoption of the Order Handling Rules; second, in 2004, the LSE's initiation of the Dutch Trading Service (DTS) to compete with Euronext for trading in Dutch stocks; and third, also in 2004, the competition between the NYSE and Nasdaq to provide the most efficient market structure for trading their respective listed stocks.

Prior to the Order Handling Rules, trading in Nasdaq stocks was divided primarily between two markets: (1) the public dealer market operated

29. Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,533, 37,608 n.990 (June 29, 2005) (adopting release); Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Release No. 26,313, 68 Fed. Reg. 74,820, 74,822 (Dec. 24, 2003).

30. NYSE Group, Inc., Annual Report (Form 10-K), at 67, 69 (2006); Nasdaq Stock Market, Inc., Annual Report (Form 10-K), at 42 (2006).

by Nasdaq, and (2) the private agency market operated by a single ECN—Instinet. The public quotes for Nasdaq stocks generally reflected only market maker quotations. Instinet, in contrast, generally had better prices than the market maker quotes, but made these prices available only to Instinet subscribers and not to the public.

A natural experiment on the effect of increased equity market competition occurred when the SEC adopted rules to improve price transparency. The SEC required market makers to include in their quotes (or send to ECNs) customer limit orders that improved the market makers' published quotes. Market makers also were required to publicly display their best prices, either in their own quotes or through an ECN. The SEC believed the new rules would, among other things, address industry practices that had hindered competition among markets in Nasdaq stocks.[31]

The Order Handling Rules led to the creation of many new ECNs, which in turn transformed the market structure for Nasdaq stocks. The percentage of ECN trading in Nasdaq stocks rose from 9% in 1996 to 40% in 2003.[32] The entry of these new competitors improved both the quality of trading services and the quality of prices for Nasdaq stocks. For example, market access fees fell dramatically—by approximately 80%.[33] In addition, many economic studies found that investor transaction costs had declined significantly, with quoted and effective spreads declining by approximately 30%.[34] Importantly, a more competitive market structure also led to increased liquidity that benefited institutional investors in executing their large trades.[35] Thus, the Order Handling Rules provide a good example of a regulatory change that was a "win-win" for market structure—they led to both a significant increase in competition among markets and a significant reduction in transaction costs for investors.

When assessing the impact of the Order Handling Rules on market quality, one must recognize not only that there was an increased number of competing markets, but also that these competing markets were efficiently linked together through participation in a centralized, Nasdaq-operated trading system. The ECN quotes therefore were fully accessible to all participants in the dominant Nasdaq market, which allowed the ECNs to attract order flow both directly from subscribers and indirectly through

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31. Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48,290, 48,292 (Sept. 12, 1996).

32. U.S. GENERAL ACCOUNTABILITY OFFICE, SECURITIES MARKETS: DECIMAL PRICING HAS CONTRIBUTED TO LOWER TRADING COSTS AND A MORE CHALLENGING TRADING ENVIRONMENT 40 (2005), *available at* http://www.gao.gov/new.items/d05535.pdf [hereinafter GAO Report].

33. Letter from Edward J. Nicoll, CEO, Instinet Group Inc., to Jonathan G. Katz, Sec'y, SEC 5 (June 30, 2004), *available at* http://www.sec.gov/rules/proposed/s71004/igi063004.pdf (commenting on proposed Regulation NMS).

34. Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577, 10,584 (Feb. 28, 2000).

35. *Id.* at 10,585 n.53, 10,581–82.

Nasdaq.[36] As a result, competition increased, but within the context of an efficient linkage that helped minimize fragmentation.

The initiation of DTS by the LSE in 2004 provides a second natural experiment on the effect of increased equity market competition. The LSE decided to compete for trading volume in Dutch stocks in response to a request from Dutch trading firms for a new entrant to compete with the dominant Euronext exchange.[37] The Dutch firms were dissatisfied with Euronext for a variety of reasons, including high fees and unreliable trading systems.[38] Despite this seemingly promising opportunity for a new competitor, DTS was able to divert only a very low percentage of trading volume from Euronext.[39] One important factor that enabled Euronext to maintain its market share was its decision to lower trading fees by as much as 50% in response to the new competitor. This example of what a little competition can do for exchange fees is unlikely to have passed unnoticed in the U.S. when market participants considered the prospect of an NYSE-Nasdaq duopoly.

An economic study of the DTS experience made some interesting findings.[40] First, the study found that market quality appeared to improve significantly, despite the limited competitive success of DTS. While spreads stayed about the same, the consolidated displayed depth for the multiply-traded Dutch stocks increased by nearly 100% after the commencement of quoting on both DTS and Euronext.[41] Second, the study found that the ability of DTS to compete was hampered by an apparent failure of trading firms to use effective smart routers linked to DTS. For example, Euronext frequently traded through better-priced quotes on DTS. The study concluded that both the ability of DTS to compete, and the beneficial effect on market quality, would have been greater if more trading firms had used smart routers to access better-priced DTS quotes.[42] A stronger duty of best execution might have been helpful as a means to encourage brokers to route their orders to better prices that were immediately and automatically accessible on DTS, rather than executing their customers' orders at an inferior price on the dominant exchange.

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36. James McAndrews & Chris Stefanadis, *The Emergence of Electronic Communications Networks in the U.S. Equity Markets*, 6 CURRENT ISSUES IN ECON. AND FIN., Oct. 2000, at 2.

37. U.K. COMPETITION REPORT, *supra* note 4, at 49–50.

38. COMPETITION COMM'N, PROPOSED ACQUISITION OF LONDON STOCK EXCHANGE PLC BY DEUTSCHE BÖRSE AG OR EURONEXT NV, PROVISIONAL FINDINGS REPORT 76 (Aug. 3, 2005), http://www.mmc.gov.uk/inquiries/ref2005/lse/prov_find_report.pdf.

39. *Id.* at 50.

40. *See* Thierry Foucault & Albert J. Menkveld, *Competition for Order Flow and Smart Order Routing Systems*, (European Business Schools Librarians' Group, Working Paper No. 831, 2006), *available at* http://www.hec.fr/hec/fr/professeurs_recherche/upload/cahiers/CR831Foucault.pdf.

41. *Id*. at 28.

42. *Id.* at 32.

A third natural experiment on the costs and benefits of competition among markets is provided by comparing the market structures for NYSE stocks and Nasdaq stocks in early 2004. The two market structures provide an interesting natural experiment because of their contrasting levels of competition and consolidation. At that time, the NYSE floor retained approximately a 75% share of trading in its listed stocks, while still operating a manual trading mechanism that did not offer full automated access to displayed quotations.[43] In contrast, the market for Nasdaq stocks was automated, but seriously fragmented with trading volume split among many different markets, including Nasdaq, Inet, Arca, other ECNs, and market makers.[44] As a result, the respective market structures for NYSE and Nasdaq stocks in 2004 allow one to compare the market quality of, first, a centralized, manual market with little effective competition, and, second, a highly fragmented, automated market with vigorous competition.

As part of the Commission's review of market structure issues for Regulation NMS, the Commission staff examined comparative market quality for NYSE and Nasdaq stocks during the first part of 2004. Commentators opposed to the Regulation NMS proposals had asserted that trading in Nasdaq stocks was more efficient than trading in NYSE stocks, and that therefore there was no empirical basis for the Commission to adopt a trade-through rule for Nasdaq stocks.[45] To assess these comments, Commission staff analyzed a variety of indicators of market quality, including: short-term volatility; quoted, effective, and realized spreads; fill rates for marketable limit orders; and displayed depth.[46] The Commission found that the staff studies did not support the commentators' claim that trading in Nasdaq stocks was more efficient than trading in NYSE stocks. Rather, it concluded that both markets had weaknesses that could be addressed by updated and strengthened protection against trade-throughs.[47] Subsequently, the Government Accountability Office (GAO), as part of its report on the effect of decimal trading, studied trading in NYSE and Nasdaq stocks and made findings that are consistent with the Commission staff's studies.[48]

The staff and GAO studies offer useful data for evaluating the potential costs of fragmentation. The staff studies found, for example, that short-term volatility was significantly higher for Nasdaq stocks than for comparable NYSE stocks, particularly for stocks that fall outside the top tier of trading

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43. Regulation NMS, Exchange Act Release No. 49,325, 69 Fed. Reg. 11,126, 11,128 (Mar. 9, 2004) (proposing release); Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,517–18 (June 29, 2005) (adopting release).

44. Regulation NMS, 69 Fed. Reg. at 11,128 (proposing release).

45. Regulation NMS, 70 Fed. Reg. at 37,506 (adopting release).

46. *Id.* at 37,515, 37,600.

47. *Id*. at 37,512.

48. *See* GAO Report, *supra* note 32.

volume.[49] Consistent with this finding, the GAO study found that displayed depth for Nasdaq stocks was approximately one-half of the displayed depth for comparable NYSE stocks.[50] In addition, the GAO study found that, while spreads were comparable for the top tier of actively traded stocks, spreads in stocks with less trading volume generally were wider for Nasdaq stocks than NYSE stocks.[51] Finally, the GAO examined the transaction cost data for institutional investors generated by three private vendors of transaction cost analyses. Consistent with GAO's findings on displayed depth and spreads, the vendor data showed that institutional transaction costs were higher for Nasdaq stocks than NYSE stocks.[52]

These three experiments suggest varying conclusions on the benefits of market competition and the costs of market fragmentation. The Order Handling Rules and DTS examples suggest that a market structure with an overwhelmingly dominant market can be improved by the entry of new competitors. The DTS example particularly suggests that MiFID could prompt substantial improvements in the European equity markets if, as intended, it successfully enables new markets to challenge the dominant markets for trading share in their listed stocks. But the NYSE-Nasdaq example suggests caution. A highly fragmented market with superior technology may not, in fact, produce better prices for investors than a manual market with significantly consolidated order flow, particularly for investors in the thousands of smaller companies with stocks that fall outside the top tier of active trading. The severity of the adverse effects of fragmentation may well increase as trading volume decreases.

V. CONCLUSION

In adopting Regulation NMS, the Commission concluded that the market structure for both Nasdaq and NYSE stocks would be improved—though in different ways that reflect their current structural differences—by an updated and strengthened trade-through rule that protects only those displayed quotations that are immediately and automatically accessible.[53] The SEC noted that the new rule would promote competition by new or smaller markets with larger markets by assuring the markets that, if they display the best prices, they will attract order flow and cannot simply be ignored by participants in dominant markets.[54] The Commission also expected that the new rule would help promote greater depth and liquidity and reduce investor transaction costs.[55]

49. Regulation NMS, 70 Fed. Reg. at 37,515.
50. *See* GAO Report, *supra* note 32, at 33 fig.8.
51. *See id*. at 11–12 tbls.1&2.
52. *See id*. at 98–99 figs.17 & 18.
53. *See* Regulation NMS, 70 Fed. Reg. at 37,506.
54. *Id*. at 37,607.
55. *See id*. at 37,511–12, 37,537, 37,606–07.

Events since the adoption of Regulation NMS indicate that the prospect of strengthened trade-through protection has boosted the competitive opportunities of smaller markets. The effects of the new rule on market quality and investor transaction costs, however, remain to be seen. These effects will play out over the coming months as the new trade-through rule is fully implemented. It will be quite interesting to see the new data, generated by another natural experiment, on the effects of regulatory change on equity market competition and fragmentation.

SUGGESTIONS FOR PROCEDURAL REFORM IN SECURITIES MARKET REGULATION

Lanny A. Schwartz[*]

I. INTRODUCTION

The Securities and Exchange Commission must consider many complex market structure issues in the months and years to come, including overseeing the consolidation of self-regulators,[1] regulating cross-border activities of exchange markets,[2] creating a new paradigm for short sale regulation,[3] establishing clear guidelines for exchange ownership and governance,[4] and acting on perennial calls for reforming market data revenue distribution.[5] Whatever the SEC does in these areas, it will affect investor protection, the national economy, and the international position of markets and market participants. For each issue, the SEC will have to decide how much to intervene to promote specific policy goals, and how much to let the forces of competition dictate the shape of the solution.

The SEC's calculus concerning the role of competition is, to a significant degree, dictated by the Securities Exchange Act of 1934 (Exchange Act).[6] In designing the statutory framework for a national market system in the United States, Congress recognized that free and fair competition is essential to the achievement of preserving our securities

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1. *See, e.g.*, Press Release, NASD Member Firms Embrace Streamlined, More Efficient Regulation (Jan. 21, 2007), *available at* http://www.nasd.com/PressRoom/NewsReleases/2007NewsReleases/NASDW_018334.

2. *See, e.g.*, Christopher Cox, Chairman, SEC, Speech at Harvard Business School Global Leadership Forum: Cross-Border Exchange Mergers in the Context of Global Trade (June 22, 2006), *available at* http://www.sec.gov/news/speech/2006/spch062206cc.htm; Roel C. Campos, Comm'r, SEC, Remarks at NYU Stern: New Challenges in Regulating Financial Markets (Mar. 24, 2006), *available at* http://www.sec.gov/news/speech/spch032406rcc.htm.

3. *See* Exchange Act Release No. 54,891, 71 Fed. Reg. 75,068 (Dec. 13, 2006).

4. *See* Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 50,699, 84 SEC Docket 444 (proposed Dec. 8, 2004). Since the time of this proposal, not only has the New York Stock Exchange combined with Archipelago and the former Pacific Exchange, but many "regional exchanges" have formed alliances, including equity participation, with member organizations and other investors. *See, e.g.*, Aaron Lucchetti, *Wall Street Plays the Market*, WALL ST. J., Aug. 30, 2006, at C1.

5. *See, e.g.*, *Regulation NMS and Recent Market Developments: Hearing before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2005) (testimony of Mark E. Lackritz, President, Sec. Indus. Ass'n); Annette L. Nazareth, Dir., Div. of Mkt. Regulation, SEC, Opening Statement before the Open Meeting regarding Regulation NMS (Apr. 6, 2005), *available at* http://www.sec.gov/news/speech/spch040605aln.htm.

6. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2000 & Supp. IV 2004).

markets as a precious national resource.[7] When crafting the 1975 Amendments to the federal securities laws, Congress extensively debated the role of competition in shaping market structure.[8] There was concern that there might be areas in which competition would not act to create essential infrastructure for the markets and that regulation was therefore necessary to achieve Congress's goals.[9] However, the legislators were equally mindful that unnecessary regulation not impede market forces in shaping market structure,[10] and that the markets and their broker-dealer participants "not be forced into a single mold."[11] In the end, the amendments to the Exchange Act that flowed from those debates established a system that both promotes and significantly constrains competition between and among markets and market participants.[12]

The statute vests the SEC with extensive authority to influence market structure. Indeed, in certain respects, under the Exchange Act it is not enough for the SEC to merely fill in gaps left by competitive forces or correct the course of natural market development. Rather, the statute commands the SEC to be an activist regulator and to take affirmative action to achieve certain specific market structure objectives.[13] The SEC exercises this authority both in its formal actions, such as rulemaking and review of

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7. *See, e.g.*, Exchange Act § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C) (2000) ("It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets . . . ."); S. REP. NO. 94-75, at 8 (1975) ("The objective would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations of practices and services.").

8. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97.

9. *See* H.R. REP. NO. 94-229, at 92 (1975).

10. *See id*.

11. *See* S. REP. NO. 94-75, at 8 (1975). Congress also observed in the Senate Report that:

> In 1936, this Committee [on Banking, Housing and Urban Affairs] pointed out that a major responsibility of the SEC in the administration of the securities laws is to "create a fair field of competition." This responsibility continues today. . . . The objective would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services. It would obviously be contrary to this purpose to compel elimination of differences between types of markets or types of firms that might be competition enhancing.

Id. For a detailed analysis of the legislative history of section 11A, see Dale Oesterle, *Regulation NMS: Has the SEC Exceeded its Congressional Mandate to Facilitate a National Market System in Securities Trading,* 1 N.Y.U. J. L. & BUS. 613 (2005).

12. As discussed in Part II.C., *infra*, to the extent that Congress and SEC actions under the securities laws have not operated to explicitly displace them, other areas of law, including antitrust law and state law, also affect competitive activity in the securities markets and, therefore, market structure.

13. *See, e.g.*, Exchange Act §§ 11A(a)(2), (c)(1)(A)–(F), 15 U.S.C. § 78k-1(a)(2), (c)(1)(A)-(F).

self-regulatory organization (SRO) rules,[14] and also in its inspection, examination, enforcement, and other actions.[15] Indeed, in many instances, the SEC's power, even its *inaction*, significantly affects and shapes market structure and the landscape for competition.

In general, the Exchange Act's delegation of authority to a highly empowered expert body, such as the SEC, and the directions given to the SEC in the statute to weigh competitive effects against investor protection, maintenance of fair and orderly markets, capital formation and other policy considerations when shaping market structure, were choices and have worked reasonably well.[16] In the last decade alone, the SEC has implemented many successful market structure initiatives, which have proven the SEC's ability to advance the Exchange Act's policy objectives without squelching competition.[17]

Nonetheless, certain procedures outlined in the Exchange Act, as administered by the SEC, operate to impose effective restraints on innovation and other potentially salutary attributes of competition that may not be fully justified by countervailing policies. The present structure results in slow, conservative and opaque decision making. This paper examines certain procedural aspects of the SEC's role in shaping market structure and regulating competition under the Exchange Act—and, in particular, the SEC's regulation of securities exchanges, the National Association of Securities Dealers, Inc. (NASD), and other self-regulatory organizations.

Why does the *procedure* matter? First, securities markets compete with each other and establish the modalities by which their members can compete by establishing trading rules, introducing systems, and charging fees or otherwise affecting the cost of doing business. Each of these must be filed as a proposed rule change. Therefore, the SRO rule change process is the "critical path" of much new competition and in many instances the source of developments in market structure. Second, the clearer the Commission's processes for establishing and enforcing legal standards that impact the market are, the more possible it is for market participants to plan

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14. *See, e.g.*, SEC, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION, http://www.sec.gov/about/whatwedo.shtml (last visited Mar. 25, 2007) [hereinafter The Investor's Advocate].

15. *See id.*

16. *See, e.g.*, Exchange Act § 3(f), 15 U.S.C.S. § 78c(f) (LexisNexis 2006); Exchange Act § 23(a)(2), 15 U.S.C.S. § 78w(a)(2) (LexisNexis 2006); Exchange Act § 11A.

17. Naturally, each of these undertakings has had its detractors. In each major initiative, many commentators have argued that the SEC has either (a) gone too far in seeking to achieve through regulation what the forces of free competition would have handled just fine without government intervention, or (b) exceeded its statutory mandate. The SEC's proposal to adopt Regulation NMS alone attracted over 1500 comment letters—many addressing these precise issues. *See* Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,498 (June 29, 2005).

new initiatives and to attract capital for them. Thus, if the procedure does not work well, is too plodding, lacks transparency, or stifles innovation, then investors are denied freedom of choice with respect to many possible products, international competitiveness of U.S. financial institutions is hampered, and an appetite for "regulatory risk" becomes a key determinant of competitive advantage.[18]

This paper suggests a number of possible procedural reforms that might, if adopted, alleviate to some degree these concerns. Specifically, the SEC should:

- Establish new standards of conduct for market participants through the rulemaking process, rather than through informal staff policy determinations, examinations and inspections, and enforcement actions;
- Update the procedures for approval of SRO rule proposals in order to make more types of proposals eligible for "effective on filing" or other expedited processing in order to preserve valuable staff resources for proposals that truly raise competitive and investor protection issues;
- Establish by regulation (or request that Congress, through an amendment to section 19 of the Exchange Act, impose) a time limit for publishing SRO rule filings for public comment;

18. Of course, there is no blinding new insight here. The SEC and others have long been cognizant of this connection between procedure and competitive burden. Moreover, the Commission has successively (and often very productively) endeavored to address unnecessary procedural burdens. *See, e.g.*, Filings by Self-Regulatory Organizations of Proposed Rule Changes and Other Materials with the Commission, Exchange Act Release No. 15,838, 44 Fed. Reg. 30,924 (May 29, 1979); Filings by Self-Regulatory Organizations of Proposed Rule Changes and Other Materials with the Commission, Exchange Act Release No. 17,258, 45 Fed. Reg. 73,906 (Nov. 7, 1980); Proposed Rule Changes of Self-Regulatory Organizations: Annual Filing of Amendments to Registration Statements of National Securities Exchanges, Securities Associations, and Reports of the Municipal Securities Rulemaking Board, Exchange Act Release No. 34,140, 59 Fed. Reg. 29,393 (proposed June 1, 1994); Proposed Rule Changes of Self-Regulatory Organizations: Annual Filing of Amendments to Registration Statements of National Securities Exchanges, Securities Associations, and Reports of the Municipal Securities Rulemaking Board, Exchange Act Release No. 35,123, 59 Fed. Reg. 66,692 (Dec. 20, 1994); Proposed Amendment to Rule 19b-4, Under the Securities Exchange Act of 1934, Exchange Act Release No. 39,885, 63 Fed. Reg. 23,584 (proposed Apr. 29, 1998); Amendment to Rule Filing Requirements for Self-Regulatory Organizations Regarding New Derivative Securities Products, Exchange Act Release No. 40,761, 63 Fed. Reg. 70,952 (Dec. 22, 1998); Proposed Rule Changes of Self-Regulatory Organizations, Exchange Act Release No. 43,860, 66 Fed. Reg. 8912 (proposed Feb. 5, 2001); DIV. OF MKT. REGULATION, SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS, Study I, at 10 (Jan. 1994), *available at* http://www.sec.gov/divisions/marketreg/market2000.pdf [hereinafter *Market 2000*]. *See also* U.S. GEN ACCOUNTING OFFICE, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES, REP. NO. GAO-02-302, at 10–11 (Mar. 2002), *available at* http://www.gao.gov/new.items/d02302.pdf [hereinafter SEC OPERATIONS].

- Liberalize the use of no-action letters and exemptive relief in areas with a competitive impact, including new products and proposals—perhaps using more readily "generic" no-action letters, which can be relied upon by many industry participants, rather than just the applicant, and using temporary or pilot approvals to enable the Commission staff to study the impact of the approvals; and
- Explicitly seek to permit cross-border products and services where access to such products and services is not prohibited by law. In this regard, the SEC (or Congress) should develop a framework for weighing international competition and cross-border access in rulemaking and other official action.

In order to give context to these suggestions, Part II of this article describes the overall framework for market structure regulation utilized by the Exchange Act. The operation of the regulatory regime is evaluated in Part III of the article, which examines the strengths and weaknesses of the regulatory scheme. Part IV of the article contains a detailed discussion of the author's proposals for procedural reform.

II. THE CURRENT FRAMEWORK FOR MARKET STRUCTURE REGULATION

A. THE CONUNDRUM OF COMPETITION

The Exchange Act creates a dual system of securities market regulation. National securities exchanges, national securities associations, and other entities that function as SROs regulate their members and (if they operate markets) act as market regulators.[19] The SEC acts as an oversight regulator of the SROs, and it also promulgates its own rules and regulations and exercises enforcement authority over markets and market participants.[20] In addition, the SEC has extensive rulemaking authority to implement the Exchange Act's directives.[21]

Among the key areas that the Exchange Act directs the SEC and (somewhat indirectly) the SROs to consider when establishing rules is competition. Under the statute, the SEC is obliged (a) not to unnecessarily burden competition (or permit SROs subject to its purview to do so)[22] and (b) to promote fair and orderly markets by assuring, among other things,

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19. *See generally* Concept Release: Regulation of Exchanges, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485 (June 4, 1997) (discussing the system of self-regulation).

20. *See generally* The Investor's Advocate, *supra* note 14.

21. *See infra* notes 60-67 and accompanying text.

22. *See, e.g.*, Exchange Act § 6(b)(8), 15 U.S.C. § 78f (2000); Exchange Act § 19(b)(5)(ii), 15 U.S.C. § 78s (2000); Exchange Act § 3(f), 15 U.S.C.S. § 78c (LexisNexis 2006); Exchange Act § 23(a)(2), 15 U.S.C. § 78w (2000).

"fair competition" among and between market participants.[23] To understand the framework established by the Exchange Act in this area, and how it is administered in practice, it is helpful to observe that in designing a template for competition regulation, Congress essentially needed to reconcile several propositions that might appear on the surface to be mutually inconsistent:

Vigorous competition can be good. Competition can be an engine for innovation, which often benefits investors, such as when it spurs new technologies and trading methodologies.[24] Moreover, in the context of securities trading, competition, when coupled with price transparency and accessibility of trading interest, can result in economically efficient pricing mechanisms for investors and traders.[25]

Collaboration among competitors can be good and even necessary. Collaboration among competitors is a cardinal element of U.S. securities markets. Brokers and dealers participate jointly in the governance of securities exchanges, band together to form underwriting syndicates, agree upon the parameters for establishing opening prices for a market and respond collectively to a floor broker's request for a single price execution or resolving trading disputes. Securities markets also collaborate extensively to collect and disseminate consolidated quotation and last sale information,[26] develop and govern inter-market linkages,[27] allocate regulatory responsibilities for common members,[28] and coordinate

23. *See* Exchange Act § 11A(a)(1)(C)(ii), 15 U.S.C. 78k-1(a)(1)(C)(ii) (2000).

24. *See, e.g.*, *Reviewing U.S. Capital Market Structure—The New York Stock Exchange and Related Issues: Hearing before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003) (testimony of Meyer "Sandy" Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange), *available at* http://financialservices.house.gov/media/pdf/101603ml.pdf [hereinafter *Reviewing U.S. Capital Market Structure*].

25. *See., e.g.*, Cynthia A. Glassman & Paul S. Atkins, Comm'rs, SEC, Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS 29 (June 9, 2005), *available at* http://www.sec.gov/rules/final/34-51808-dissent.pdf [hereinafter *Regulation NMS Dissent*].

26. *See* OPRA, PLAN FOR REPORTING OF CONSOLIDATED OPTIONS LAST SALE REPORTS AND QUOTATION INFORMATION (Jan. 9, 2007), *available at* http://www.opradata.com/pdf/opra_plan.pdf; NYSE, Inc., Consolidated Tape Association Plan (Second Restatement) (June 16, 2006) (CTA Plan); NYSE, Inc., Consolidated Quotation Plan (Restatement) (June 16, 2006) (CQ Plan). Both the CTA Plan and the CQ Plan are *available at* http://www.nysedata.com/cta.

27. *See* PLAN FOR THE PURPOSE OF CREATING AND OPERATING AN INTERMARKET COMMUNICATIONS LINKAGE PURSUANT TO § 11A(3)(B) OF THE SECURITIES EXCHANGE ACT OF 1934 (2006), *available at* http://www.itsplan.com (follow "ITS Plan (pdf)" link); Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and International Securities Exchange LLC, Exchange Act Release No. 43,086, 65 Fed. Reg. 48,023 (Aug. 4, 2000).

28. *See* Exchange Act § 19(d), 15 U.S.C. § 78s(d) (2000); Exchange Act § 17(d), 15 U.S.C.S. § 78q(d) (LexisNexis 2006). For a discussion of allocation of regulatory responsibilities by SROs, see Program for Allocation of Regulatory Responsibilities Pursuant to Rule 17d-2, Exchange Act Release No. 54,136, 71 Fed. Reg. 40,759 (July 18, 2006).

surveillance efforts.[29] Without these numerous forms of collaboration among competitors that are directed by the Exchange Act or sanctioned by administrative action, we would not have many of the structures that we take for granted such as: firm quotes by dealers in the equities and options markets; a system of transparent consolidated quotations and last sale information; required display of most limit orders in equities and options; inter-market linkages (and inter-market order protection) in the equities and options markets; and orderly processes for clearance and settlement. Rather, we would have fragmented markets and trading, and non-uniform, non-fungible products without true transparency or inter-market competition. Thus, collaboration in some areas has created ground rules for fair competition that operate in the public interest.

Defining competition in the context of the securities markets is maddeningly complex. Even the definition of competition in the securities business is tricky because exchanges can compete with broker-dealers (and vice-versa)[30] and investors can compete with broker-dealers.[31] Apparently, many at the SEC believe that the proper type of competition to promote is not competition between market participants, so much as competition among orders.[32] In addition, the competing interests of "short-term" and "long-term" investors were a significant element in the policy debate concerning the adoption of Regulation NMS.[33] Exchange markets in

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29. See Amendment to Rule Filing Requirements for Self-Regulatory Organizations Regarding New Derivative Securities Products, Exchange Act Release No. 40,761, 63 Fed. Reg. 70,952, 70,959 (Dec. 22, 1998), for a discussion of Intermarket Surveillance Group. *See also* Request for Comment on Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities, Exchange Act Release No. 47,849, 68 Fed. Reg. 27,722, 27,723 (May 20, 2003).

30. *See, e.g.*, Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844, 70,910 (Dec. 22, 1998); *see also* Domestic Sec., Inc. v. SEC, 333 F.3d 239, 243–44 (D.C. Cir. 2003); Aaron Lucchetti, *Wall Street Firms Plan New Service for Block Trades*, WALL ST. J., Sept. 27, 2006, at C4.

31. *See, e.g.*, Notice of Filing of Amendments No. 2, 3, and 4 to Proposed Rule Change to Modify the Information Contained in a Directed Order on the Boston Options Exchange, Exchange Act Release No. 53,357, 71 Fed. Reg. 10,730, 10,730–32 (Mar. 2, 2006); Letter from Adam C. Cooper, Senior Managing Dir. & Gen. Counsel, Citadel Inv. Group, LLC, to Nancy Morris, Sec'y, SEC (Mar. 17, 2006), *available at* http://www.sec.gov/rules/sro/bse/bse200552.shtml; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change to Establish a Fee Per Contract Traded for Improvement Orders Submitted Into a Price Improvement Period by a Public Customer That Are not Submitted as Customer PIP Orders, Exchange Act Release No. 54,328, 71 Fed. Reg. 49,493 (Aug. 23, 2006); Letter from Adam C. Cooper, Senior Managing Dir. & Gen. Counsel, Citadel Inv. Group, LLC, to Nancy Morris, Sec'y, SEC (June 17, 2006), *available at* http://www.sec.gov/comments/sr-bse-2006-10/bse200610-1.pdf; *see also* Proposed Rule Change by International Securities Exchange, Concerning Professional Account Holders, SR-ISE-2006-26 (May 5, 2006), *available at* http://www.iseoptions.com/legal/pdf/proposed_rule_changes/SR-ISE-2006-26$Professional_AccountHolders$20060505.pdf.

32. *See, e.g.*, Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,498 (June 29, 2005).

33. *See Regulation NMS Dissent*, *supra* note 25, at 24–27.

equities, options, and derivatives compete with over-the-counter markets.[34] The extent to which international and cross-border issues should be considered by the SEC in evaluating competitive impacts of various initiatives is a question that has been raised repeatedly, but has not been fully developed in Exchange Act jurisprudence.[35] Therefore, the regulation of competition cannot be limited to focusing on specified "categories" of market participants and their competitive relations with one another.

Empowering competitors to establish standards, systems and rules is risky. Self-regulation has its benefits—particularly placing front line regulation in the hands of the people who best understand the business and also requiring industry participants to bear a large part of the cost of regulating themselves.[36] However, Congress well understood that, absent a proper system of oversight, the SRO structure would not be sound (though it took some years for an effective statutory oversight structure to be established).[37] For example, without oversight there would be continuous concerns that SROs would use their power to levy fees and impose discipline on members to benefit some members but not others, exchange systems would be designed to promote the interests of certain traders but not others (and certainly not investors), and standards would be developed (such as fixed commission schedules) that would discourage competition.[38] To ensure that the SROs do not use their statutory authority to the detriment of investors and the marketplace, and to ensure a proper balance of competition-related concerns and other policy objectives, the Exchange Act imposes several key controls, including: prescribing certain minimum standards for the content of SRO rules;[39] requiring significant policies and procedures of SROs (including systems and fees) to be filed with and (in

34. *See, e.g.*, Amendment to Rule Filing Requirements for Self-Regulatory Organizations Regarding New Derivative Securities Products, 63 Fed. Reg. at 70,965 (adopting Exchange Act Rule 19b-4(e)); *Examining the Commodity Futures Modernization Act of 2000 and Recent Market Developments: Hearing before the S. Comm. on Banking Housing and Urban Affairs*, 109th Cong. 2 (2005) (testimony of the Sec. Indus. Ass'n), *available at* http://www.sia.com/testimony/2005/mlackritz09-08-05.html [hereinafter *Commodity Futures Modernization Act of 2000 Hearing, SIA Testimony*].

35. *See, e.g.*, Letter from Jayda Dagdelen & Mara Tchalakov, Senior Task Force Comm'rs, Princeton University, Woodrow Wilson School of Public Policy, to Jonathan G. Katz, Sec'y, SEC (Jan. 14, 2005), *available at* http://www.sec.gov/rules/proposed/s71004/s71004-587.pdf.

36. *See generally* Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. REV. 475 (1984).

37. See generally *id.* at 480–87, for a history of self-regulation in the securities industry.

38. *See, e.g.*, Proposal to Adopt Securities Exchange Act Rule 19g2-1 to Relieve National Securities Exchanges and Registered Securities Associations from Certain Obligations, Exchange Act Release No. 12,483, 9 SEC Docket 731 (May 26, 1976); Enforcement Obligations of Exchanges and Associations, Exchange Act Release No. 12,994, 10 SEC Docket 998 (Nov. 18, 1976).

39. *See* Exchange Act § 6, 15 U.S.C. § 78f (2000); Exchange Act § 15A, 15 U.S.C. § 78*o*-3 (2000); Exchange Act § 17A, 15 U.S.C. § 78q-1 (Supp. II 2002).

most cases) approved by the SEC;[40] specifying procedures and standards for SEC review and approval of SRO rules and proposed rule changes;[41] imposing upon SROs a general legal obligation to enforce their rules and the federal securities laws;[42] conferring upon the SEC oversight and enforcement authority respecting SROs;[43] providing for a mechanism of appeal from certain SRO actions;[44] and establishing a mechanism for the SEC to amend SRO rules directly on its own initiative.[45]

Promotion of competition is but one policy objective. In order to be effective, a system of market regulation must take into account various alternative policy objectives—such as protecting investors and ensuring that there is adequate infrastructure for market operations and securities trading—that, in some cases, might point away from free competition.[46]

The operation of the Exchange Act in balancing these various considerations is briefly described in Section II.B, which follows immediately below. There are several points to note, however, in assessing the operations of this structure. First, the system is set up to ensure that certain *formal* actions of the SEC are required to be informed by particular policy objective, but not necessarily other actions. Second, in some cases, but not others, the marketplace is informed of the SEC's analysis and has an opportunity to comment upon it. Third, because of the procedures associated with SRO rule approval, the SEC can effectively exercise a "pocket veto" over potentially innovative and pro-competitive rule proposals. This allows the SEC to substantively influence rule proposals without subjecting the proposals to notice and public comment or explaining its rationale for doing so. Fourth, when the SEC does make rules and take other official actions, it is, to some extent, constrained by the policy guidance explicitly stated in the Exchange Act. Thus, the SEC is compelled to weigh certain policy objectives above others, which may be equally valid, or even more compelling, under the circumstances. The implications of these four points in evaluating the effectiveness of the system and determining if it strikes the proper balance in terms of allowing competitive forces—not regulatory mandates—shape market structure are discussed in Section IV, below.

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40. *See* Exchange Act § 19, 15 U.S.C. § 78s (2000).
41. *See id*.
42. *See* Exchange Act § 19(g).
43. *See* Exchange Act § 19(h).
44. *See* Exchange Act § 19(d), (f).
45. *See* Exchange Act § 19(c).
46. *See* SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, pt. 4, at 502–05, 576–79 (1963).

B. STATUTORY DIRECTIVES

1. Content of SRO Rules

In determining whether to allow an organization to register as a national securities exchange or a registered securities association, the SEC must determine whether the organization's rules meet certain specified standards. Among these are the criteria contained in sections 6(b)(8) (dealing with national securities exchanges) and 15A(b)(9) (dealing with registered securities associations) of the Exchange Act, which direct the SEC to ensure that the rules of the exchange or association "do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act. The Exchange Act also provides that the rules of the exchange or association must provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities, and be:

> [D]esigned to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange.[47]

2. SEC Consideration and Approval of SRO Rules

Section 19(b)(1) of the Exchange Act requires each SRO to file with the SEC any proposed rule or rule change, accompanied with a statement of the basis and purpose of the proposal. Such rules and rule proposals must be approved by the SEC in order to take effect,[48] unless the proposal falls within a list of prescribed categories that are "effective upon filing."[49] The SEC must publish notice of the proposal and give the public an opportunity to comment on it. Generally the comment period for a proposed rule change is twenty-one days, and comments often focus on competition issues.

47. Exchange Act § 6(b)(4), (5), 15 U.S.C. § 78f(b)(4), (5) (2000); *see also* Exchange Act § 15(a)(b)(5), (6), 15 U.S.C. § 78*o*(a)(b)(5), (6) (Supp. II 2002).

48. *See* Exchange Act § 19(b)(2).

49. See Exchange Act § 19(b)(3)(A), which provides that proposed SRO rules constituting a stated policy, practice, or interpretation regarding the meaning, administration, or enforcement of an existing rule, establishing or changing a due, fee, or other charge, or concerned solely with the administration of the self-regulatory organization are not the subject to SEC approval order, but are "effective on filing." *See also* Exchange Act Rule 19b-4(f), 17 C.F.R. § 240.19b-4(f) (2004).

According to section 19(b)(2), the SEC may only approve a proposed rule or rule change if it finds that the proposal is consistent with requirements of the Exchange Act.[50] For example, the SEC must determine whether the rule would impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The SEC must also consider the protection of investors and "whether the action will promote efficiency, competition, and capital formation."[51] Thus, the SEC is required to engage in a balancing of various factors along with competition.

In analyzing the effects of SRO proposals on competition, the SEC has observed that it "is not required to achieve its objectives in the least anticompetitive manner and is at most required to decide that any anticompetitive effects of its actions are necessary or appropriate to the achievement of its objectives."[52] In a matter involving the rules of a registered clearing organization (a type of SRO) the SEC stated that in assessing the anticompetitive effects of the proposed rules, the SEC "is required to balance the maintenance of fair competition with a number of other equally important express purposes of the Act such as the protection of investors and the safeguarding of securities and funds."[53] For example, in acting upon the application of the clearing organization to largely withdraw from the clearance and settlement of equity securities, the SEC effectively approved a monopoly on clearing of equity securities in the United States. The SEC observed that, despite the dominant market position of certain clearing organizations, the regulatory structure and nature of the depository industries were sufficient to avoid the negative effects of a monopoly, and therefore the proposed rules were not "an inappropriate or unnecessary burden upon competition."[54]

Although the Exchange Act contains many directives to the SEC concerning consideration of the implications of its actions on competition, it gives little guidance concerning how to analyze competition issues. As a result, the Commissioners and the staff are left to consider, with respect to each action, which type or measure of competition is the most significant. In rulemaking, the Commission generally explains its competitive impact analysis in detail and backs up that analysis with empirical data. Often, the Commission is flooded with adverse comment on its rulemaking proposals

50. *See* Exchange Act § 19(b)(2).

51. *See* Exchange Act § 3(f), 15 U.S.C. § 78c(f) (2000).

52. Order Granting Partial Permanent Approval and Partial Temporary Approval of Proposed Rule Changes Relating to a Decision by the Philadelphia Stock Exchange, Inc., Exchange Act Release No. 39,444, 62 Fed. Reg. 66,703, 66,705 (Dec. 19, 1997); Bradford Nat'l Clearing Corp. v. SEC, 590 F.2d 1085, 1105 (D.C. Cir. 1978).

53. Order Granting Partial Permanent Approval, 62 Fed. Reg. at 66,705.

54. *Id.*

urging it to adopt different approaches to its competition analysis.[55] However, by contrast, approvals of SRO rule changes generally do not contain extensive analysis of competitive impacts. Generally, statements regarding competition are conclusory and are rarely backed by extensive data.

Where the SEC is uncertain regarding the possible effects of a particular SRO rule, it frequently approves the rule on a temporary or "pilot" basis. In such cases, the SEC often requires the SRO to submit data regarding the effects of the rule so that it can evaluate whether the rule complies with statutory standards and should be approved on a permanent basis.[56]

Many SRO rules become effective by an SEC-issued order. Like other final orders of the Commission, aggrieved persons may request that such orders be reviewed by a federal court of appeals.[57]

In regard to filings that are "effective upon filing," there is no Commission approval order issued. However, the SEC may "abrogate" the filing, cause it to be refiled in the "ordinary way" (i.e., under section 19(b)(2)), and subject it to full notice and public comment and SEC review if the Commission believes that such action is necessary to protect investors or to further the purposes of the Exchange Act. In practice, the SEC abrogates "effective upon filing" SRO rule changes where the SEC considers that the proposal raises significant policy issues that should be

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55. *See, e.g.*, *Reviewing U.S. Capital Market Structure*, *supra* note 24. Interestingly, a former SEC Chairman and a former Secretary of the Commission have both recently called for greater economist involvement in policy setting at the SEC. *See* Harvey Pitt, *Over-Lawyered at the SEC*, WALL ST. J., July 26, 2006, at A15; Jonathan G. Katz, *Rules Are Not Sacred, Principles Are*, WALL ST. J., Aug. 8, 2006, at A11.

56. *See, e.g.*, Order Granting Accelerated Approval to Amendment No. 1 by the International Securities Exchange LLC Relating to Market Maker Allocations, Exchange Act Release No. 42,808, 65 Fed. Reg. 34,515, 34,517 (May 30, 2000) ("The Commission . . . intends to use the one-year pilot period to monitor the rule's impact on competition."); Order Granting Accelerated Approval to the Proposed Rule Change on a Temporary Basis Relating to Bond Mutual Fund Volatility Ratings, Exchange Act Release No. 42,476, 71 SEC Docket 1852 (Mar. 8, 2000) ("The proposed rule change would permit, for an 18-month trial period, the use of the mutual fund volatility ratings subject to certain limitations, and provided certain disclosures are made."); Order Granting Accelerated Approval of a Proposed Rule Change to Initiate a Pilot Program that Allows the Listing of Strike Prices at One-Point Intervals for Certain Stocks Trading under $20, Exchange Act Release No. 48,013, 68 Fed. Reg. 35,933, 35,936 (June 11, 2003) ("The Commission expects the Exchange to monitor the applicable equity options activity closely . . . . In addition, the Commission requests that the PHLX monitor the trading volume associated with the additional options series listed as a result of the Pilot Program . . . ."); Press Release, SEC Chairman Cox Urges Options Exchanges to Start Limited Penny Quoting (June 7, 2006), *available at* http://www.sec.gov/news/press/2006/ 2006-91.htm. For a discussion of pilot programs concerning the practice of "preferencing," see SEC, REPORT ON THE PRACTICE OF PREFERENCING, http://www.sec.gov/news/studies/prefrep.htm (last visited Feb. 21, 2007).

57. *See* Exchange Act § 25(a), 15 U.S.C. § 78y (2000).

commented upon by interested persons before the rule change becomes "permanently effective."

3. SEC Oversight

Section 19(g) of the Exchange Act requires every SRO to comply with (and, in general to cause its members to comply with) its own rules, the Exchange Act, and the rules and regulations promulgated thereunder. The SEC, under section 21 of the Exchange Act, may make investigations to determine whether any person has violated, is violating, or is about to violate any provision of the Act or any SRO rule. The SEC also has authority to institute cease and desist proceedings in the case of actual or prospective violations of the Exchange Act.[58] Within this context, the SEC may investigate those individuals participating in anticompetitive practices and take appropriate actions to eliminate such anticompetitive behavior. [59]

Finally, section 19(d) of the Exchange Act permits appeals by affected persons of certain SRO disciplinary sanctions, denials of access, and certain other (but not all) SRO actions.

4. SEC Rulemaking

An important source of SEC rulemaking authority and policy direction affecting market structure is section 11A of the Exchange Act, in which Congress directed the SEC to "facilitate the establishment of a national market system for securities."[60] In this regard, section 11A makes an important policy choice regarding the role of government in market structure development: it commands the SEC to take an activist role in rulemaking to promote those attributes that Congress determined were essential to the national market system which it envisioned.

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58. Exchange Act § 21C, 15 U.S.C. § 78u-3 (Supp. II 2002).

59. For example, in August 1996, as a result of a widely publicized economic study suggesting that NASD market makers colluded to maintain artificially wide inside spreads on Nasdaq by avoiding odd-eighth quotations in many stocks, the SEC issued a report in accordance with section 21(a) of the Exchange Act. *See* REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND NASDAQ MARKET, Exchange Act Release No. 37,542, 62 SEC Docket 1385 (Aug. 8, 1996). Other enforcement proceedings against securities markets have involved competition issues and have been directed, at least in part, at remedying anticompetitive practices. *See, e.g.*, In the Matter of Certain Activities of Options Exchanges, Exchange Act Release No. 43,268, 2000 SEC LEXIS 1881 (Sept. 11, 2000) (proceeding against The American Stock Exchange, The Chicago Board Options Exchange, The Pacific Exchange, and The Philadelphia Stock Exchange for engaging in anticompetitive activities and for failing to adequately enforce compliance with their own rules).

60. *See* Exchange Act § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2) (2000).

Congress stated that the following interests should be assured in regard to the national market system:

- Economically efficient execution of securities transactions;
- Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
- The availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities; [61]
- The practicability of brokers executing investors' orders in the best market; and
- An opportunity for investors' orders to be executed without the participation of a dealer.

In terms of its specific rulemaking authority in section 11A, the SEC is authorized to compel joint action by competitors in regard to the national market system.[62] Also, it is important to note that section 23 of the Exchange Act confers general rulemaking authority on the SEC.

When making rules pursuant to the Exchange Act, the SEC is required to consider, among other matters, the impact that rule or regulation would have on competition. The SEC is not permitted to adopt any rule or regulation "which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act. When the SEC adopts a rule, it must express in writing "the reasons for [its] determination that any burden on competition imposed by such rule or regulation is necessary or appropriate in furtherance of the purposes of" the Exchange Act.[63]

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61. *See* Exchange Act § 11A(1)(d) ("[An additional goal is] the linking of all markets for qualified securities through communication and data processing facilities, [which] will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.").

62. The SEC may "by rule or order, . . . authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under this title in planning, developing, operating, or regulating a national market system . . . ." Exchange Act § 11A(a)(3)(B). In addition to issuing orders directing SRO collaboration under section 11A, the SEC also approves "plans" submitted to the Commission by SROs to effectuate matters described in section 11A, such as inter-market linkages. *See, e.g.*, Regulation NMS, 70 Fed. Reg. 37,496, 37,624–30 (June 29, 2005) (defining rules 601(a)(3) and 608); *see generally* Oesterle, *supra* note 11, at 12–25 (discussing the history, operation, and procedural aspects of these plans). For a recent instance of such a plan proposal, see Notice of Filing of the NMS Linkage Plan by the American Stock Exchange LLC, Boston Stock Exchange, Inc., Chicago Board Options Exchange, Inc., Chicago Stock Exchange, Inc., The Nasdaq Stock Market LLC, National Stock Exchange, New York Stock Exchange LLC, and NYSE Arca, Inc., Exchange Act Release No. 54,239, 71 Fed. Reg. 44,328 (Aug. 4, 2006).

63. It is interesting to note that the other federal securities statute that is of most direct application to most securities markets and trading firms, the Securities Act of 1933 (Securities Act), which concerns the registration of securities offerings, deals somewhat differently with

Where the Commission is studying the effects of a rule, from time to time it adopts the rule (or a partial exemption from a rule) on a temporary or pilot basis. As with pilot approvals of SRO rules noted above, this permits the SEC to study the effects of the rule on competition and on market behavior. For example, there is currently a pilot program in effect which exempts certain "short sales" of equity securities from the SEC's and SRO restrictions.[64]

Commission rulemaking under certain sections of the Exchange Act are appealable to the federal circuit courts.[65] Although such appeals to Exchange Act rules are not common,[66] there has recently been a spate of successful challenges to SEC rulemakings under other statutory authority,[67] including the Administrative Procedure Act.[68]

5. Exemptive Authority and No-Action Letters

a. Exemptive Authority

Section 36 of the Exchange Act allows the SEC to conditionally or unconditionally exempt from the requirements of the Exchange Act "by rule, regulation, or order . . . any person, security, or transaction, or any class or classes of persons, securities, or transactions" so long as the exemption "is necessary or appropriate in the public interest, and is consistent with the protection of investors." Section 36 further gives the SEC authority to determine the procedures under which to grant exemptive authority. The SEC may exercise discretion and decline any application for an exemption. Various other provisions of the Exchange Act contain grants of exemptive authority and/or the authority to define terms used in the

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competition. Specifically, the provisions of the Securities Act that authorize the SEC to promulgate rules and regulations do not require the SEC to consider the effects on competition. *See* Securities Act § 19(a), 15 U.S.C. § 77s (Supp. II 2002).

64. On July 28, 2004, the Commission issued an order creating a one year pilot suspending the provisions of Rule 10a-1(a) under the Act and any short sale price test of any exchange or national securities association for short sales of certain securities. The pilot was created pursuant to Rule 202T of Regulation SHO, which established procedures to allow the Commission to temporarily suspend short sale price tests so that the Commission could study the effectiveness of short sale price tests.

Order Extending Term of Short Sale Pilot, Exchange Act Release No. 53,684, 71 Fed. Reg. 24,765, 24,765 (Apr. 26, 2006) (citations omitted). The pilot approval has since been extended.

65. Exchange Act § 25(b), 15 U.S.C. § 78y(b)(1) (2000).

66. *See, e.g.*, Ass'n of Inv. Brokers v. SEC, 676 F.2d 857 (D.C. Cir. 1982).

67. *See, e.g.*, Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006); U.S. Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005); Chamber of Commerce of the U.S. v. SEC, 443 F.3d 890 (D.C. Cir. 2006).

68. 5 U.S.C. § 551 (2000).

Exchange Act.[69] Frequently, when the SEC promulgates rules under the Exchange Act, it gives itself exemptive authority in respect of its own rule.[70]

b. No-Action Letters

The SEC also issues informal guidance, which takes the form (among others) of no-action letters. The SEC defines no-action letters as letters "in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated."[71] Although most no-action letters are addressed to a single applicant and are not intended to be relied upon by others, the staff sometimes issues "generic" no-action letters that, by their terms, permit reliance by all persons who meet the criteria specified in the letter.[72] No-action letters are not legally binding on the SEC and are not issued by the full authority of the Commission, but instead represent the views of the staff of the Division from which they are issued.[73] The SEC takes the position that the staff's responses to letters "are not rulings . . . on questions of law or fact" and that "such letters are not intended to affect the rights of private persons."[74] However, as a practical matter, despite the formal lack of precedential significance of no-action letters, market participants widely rely upon no-action letters as if they did represent an official legal position.

In some respects, no-action letters are an ideal tool for the SEC to test the waters by permitting new activities, which, while consistent with the

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69. *See, e.g.*, Exchange Act § 3(b), 15 U.S.C. § 78c (Supp. IV 2004) (defining terms); Exchange Act § 5(2), 15 U.S.C. § 78e(2) (2000) (limited volume exchanges); Exchange Act § 6(h)(4), 15 U.S.C. § 78h(4) (2000) (security futures); Exchange Act § 11(c), 15 U.S.C. § 78k(c) (2000) (certain exchange rules); Exchange Act § 15(a)(2), 15 U.S.C. § 78*o*(2) (Supp. II 2002) (registration of brokers and dealers); Exchange Act § 15B(a)(4), 15 U.S.C. § 78*o*-4(a)(4) (Supp. II 2002); Exchange Act § 17(h)(4), 15 U.S.C. § 78q(h)(4) (Supp. IV 2004); Exchange Act § 17B(c), 15 U.S.C. § 78q-2(c) (2000) (penny stock automated quotation systems); Exchange Act § 31(f), 15 U.S.C. § 78ee(f) (Supp. II 2002) (transaction fees). By contrast, section 28 of the Securities Act gives the SEC similar exemptive authority, but the SEC can only make exemptions by rule or regulation. *See* 15 U.S.C. § 77z-3 (2000). This means that the SEC has less flexibility to grant exemptive relief from the registration requirements of the Securities Act than it is from the requirements of the Exchange Act.

70. *See, e.g.*, 17 C.F.R. §§ 242.203(d), 242.301(a)(5), 240.3b-16 (2007).

71. Procedures Utilized by the Division of Corporation Finance for Rendering Informal Advice, Securities Act Release No. 6253, 45 Fed. Reg. 72,644, 72,644 (Nov. 3, 1980).

72. *See, e.g.*, Giovanni P. Prezioso, Cleary, Gottlieb, Steen & Hamilton, 1997 SEC No-Act. LEXIS 525 (Apr. 9, 1997) (concerning Exchange Act Rule 15a-6) [hereinafter *Nine Firm Letter*]; David C. Whitcomb, Jr., Chicago Stock Exchange, 2006 SEC No-Act. LEXIS 545 (July 20, 2006) (concerning Exchange Act Rule 10a-1).

73. 17 C.F.R. § 202.1(d) (2006).

74. Monthly Publication of List of Significant Letters Issued by the Division of Corporation Finance, Securities Act Release No. 5691, 41 Fed. Reg. 13,682 (Mar. 17, 1976).

relevant statutes,[75] may be novel or represent a step beyond the current state of agency rulemaking. Since the staff is not called upon to (and does not) concur in the applicant's legal analysis, the letter does not formally have precedential effect and cannot be relied upon by third-parties, and the letter can be withdrawn if (among other things) the staff's view of the law or policy changes. No-action letters are a low cost avenue to permit the limited introduction of new business models which enhance competition.

C. LURKING IN THE BACKGROUND: ANTITRUST LAW AND STATE LAW

1. Sherman Act and Doctrine of Implied Repeal

The principal federal statute governing competition in the securities markets is the Sherman Antitrust Act (Sherman Act).[76] Section 1 of the Sherman Act states that "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."[77] The central concern of this section is concerted action.[78] Section 2 of the Sherman Act[79] is mainly concerned with monopolization.[80] The goals of the Sherman Act are not as comprehensive as those of the SEC under the Exchange Act, which along with being concerned with competitive issues, is concerned with "the viability of sellers, the truthfulness of information, with sharp practices that may injure customers, and with the smooth functioning of trading institutions."[81] Often the regulatory scheme of the Exchange Act conflicts with the policy of the Sherman Act.[82] Although Congress did not expressly exempt securities market conduct from the Sherman Act, courts have historically utilized the doctrine of "implied repeal" to reconcile potential or actual conflicts between the securities laws, SEC actions, and SEC-approved SRO rules,[83] and the Sherman Act, and to decide whether an activity is immune from a Sherman Act challenge.[84]

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75. While no-action letters purport to be a statement of enforcement intention, rather than a statement of the law, the staff requires applicants to submit a legal opinion that the requested action is consistent with applicable legal standards.

76. Sherman Antitrust Act, 15 U.S.C. §§ 1–7 (2004).

77. Sherman Antitrust Act § 1.

78. *See* IRVING SCHER, ANTITRUST ADVISER § 1.3 (4th ed. 2005).

79. Sherman Antitrust Act § 2.

80. *See* SCHER, *supra* note 78, § 1.3.

81. Herbert Hovenkamp, *Antitrust Violations in Securities Markets*, 28 J. CORP. L. 607, 609 (2003).

82. *See* Russell L. Hewit, *Securities Exchanges and the Antitrust Laws*, 33 WASH. & LEE L. REV. 999, 999–1000 (1976).

83. *Id.* at 1000.

84. *Id*.

Courts utilize the "implied repeal" doctrine in two situations. First, courts will find implied repeal if Congress, via a specific statute, gave clear authority to the SEC to supervise a particular activity and the application of the antitrust laws would unduly interfere with the operation of the statute and subject those who are regulated under the statute to conflicting standards.[85] Second, courts will find implied repeal if the regulatory scheme established by Congress is so pervasive that applying the antitrust laws in the face of such specific standards and broad regulatory authority would subject the regulated entities to duplicative and inconsistent standards.[86]

Historically, the SEC's active intervention in market structure has been significant in preventing the application of inconsistent standards that might have prevailed if ordinary antitrust rules applied.[87]

2. State Law and Preemption

SEC regulation in many instances also, explicitly or implicitly, preempts state law. According to the Supremacy Clause of United States Constitution, the laws of Congress are "the supreme law of the land."[88] When Congress chooses to exercise its constitutionally delegated authority, state law must yield to it.[89] Although Congress, when enacting the Exchange Act, did not generally preempt state law,[90] state law has been explicitly overridden in certain instances by specific legislation. For example, the National Securities Markets Improvements Act of 1996 (NSMIA)[91] preempts state laws respecting capital, custody, margin, financial responsibility, recordkeeping, and other obligations of broker-dealers.[92]

In addition, courts imply congressional intent in instances where the legislative scheme is "so pervasive that it raises a reasonable inference that

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85. *See* Gordon v. N.Y. Stock Exch., 422 U.S. 659 (1975).

86. *See* United States v. Nat'l Ass'n of Sec. Dealers, 422 U.S. 694 (1975).

87. *See* Oesterle, *supra* note 11, at 18.

88. U.S. CONST. art. VI, cl. 2.

89. *See* Gibbons v. Ogden, 22 U.S. 1, 211 (1824). *See generally* Complaint, Sec. Indus. Ass'n v. Klein, No. 2:06 CV 00623 (D. Utah July 28, 2006), *available at* http://www.sia.com/utah_lawsuit/pdf/complaint.pdf (citing additional cases); Kenneth I. Denos, *Blue and Gray Skies: The National Securities Markets Improvement Act of 1996 Makes the Case for Uniformity in State Securities Law*, 1997 UTAH L. REV. 101, 131 n.202 (1997) (citing additional cases).

90. *See* Exchange Act § 28(a), 15 U.S.C. § 78bb(a) (2000) ("[T]he rights and remedies provided in this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.").

91. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416.

92. *See* Exchange Act § 15(h), 15 U.S.C. § 78*o*(h) (2006). NSMIA also amended section 18 of the Securities Act, preempting state registration and qualification requirements for certain "covered securities." *See* Brief for Plaintiff at 17, NASD Dispute Resolution, Inc. v. Judicial Council of California, 232 F. Supp. 2d 1055 (N.D. Cal. 2002) (No. C02 3486), *available at* http://www.sec.gov/litigation/briefs/nasddispute.htm.

Congress left no room for a state to supplant it," or where "compliance with both federal and state laws is an impossibility."[93] Where the SEC takes action within the scope of its delegated authority and pursuant to the Exchange Act, inconsistent state law must give way.[94] This is generally thought to extend to SEC orders approving SRO rules.[95]

Other areas of law, including intellectual property law, can also impact competition and even securities market structure.[96]

III. SOME STRENGTHS AND WEAKNESSES OF THE CURRENT STRUCTURE

A. STRENGTHS

The Exchange Act's statutory scheme has many positive attributes. Principally, it acknowledges that the success of the securities markets rests upon various factors, and that the competition is but one leg of the stool.

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93. *See* Shulick v. Painewebber, Inc., 722 A.2d 148, 150–51 (Pa. 1998) (finding that SEC regulation of broker disclosure requirements impliedly preempted state agency law requirements).

94. *Id.* There are, of course, limits to the SEC's jurisdictional authority to displace state law through rulemaking. *See* Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (holding that the SEC exceeded its authority under section 19(c) of the Exchange Act by promulgating certain rules affecting voting rights).

95. *See, e.g.*, Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119 (9th Cir. 2005); *see also* Carapico v. Philadelphia Stock Exch., 1994 U.S. Dist. LEXIS 1667 (E.D. Pa. Feb. 14, 1994). The full extent to which SRO rules preempt State law has been the subject of considerable debate, but has not yet been resolved fully in litigation.

96. Intellectual property law affects competition in the securities markets in various ways. Specifically, licensing arrangements with respect to "derivative" products that are based on indices or other measures of value have enabled exchanges to have the exclusive right to trade options based on the index—a large and increasing segment of securities products encompassing exchange traded securities products, such as exchange traded funds and options on them and equity index options. In many instances, intellectual property rights in respect of the use of indexes have been used as a basis for claiming exclusive trading rights in overlying securities products in situations where comparable non-derivative products would not have been permitted to trade on an exclusive basis as a matter of securities law. See Exchange Act § 12(f), 15 U.S.C. § 78*l* (Supp. IV 2004), with respect to unlisted trading privileges regarding exchange-listed securities, and Exchange Act Rule 19c-5, 17 C.F.R. § 240.19c-5 (2006), concerning options products. It has been asserted that exclusive intellectual property rights "directly affects investors." *See* Request for Rulemaking to Amend Rule 19c-5 Regarding Certain Options Exchange Licensing Arrangements, SEC Petition 4-469 (Nov. 1, 2002), *available at* http://www.sec.gov/rules/petitions/petn4-469.htm. Although claims of exclusivity and trading rights in specific products have been slowly resolved on a case-by-case basis in the courts, *see, e.g.*, Dow Jones v. Int'l Sec. Exch., Inc., 451 F.3d 295 (2d Cir. 2006), there are still many open questions, including exclusive rights to trade options based upon a security index. The extent to which the SEC can and should intervene in these issues is a fertile and timely one. *See generally* Annette L. Nazareth, Comm'r, SEC, Remarks before the STA Annual Conference: Competition & Regulation Balancing the National Market System (Oct. 7, 2005), *available at* http://www.sec.gov/news/speech/spch100705aln.htm (discussing current market issues and "broader regulatory challenges" that arise "as the financial landscape gets more sophisticated and multi-dimensional") [hereinafter *Competition & Regulation Balancing the National Market System*].

Congress's delegation to the SEC of oversight authority with respect to the SROs, as well as independent rulemaking authority, also recognizes an essential point; the economic, legal and technological underpinnings of the securities markets are constantly changing. Formulating policy in promoting the welfare of the securities markets will necessarily involve an assessment of the proper course in light of changing conditions. Thus, it was wise to vest an expert body with the authority and practical ability to balance these factors when formulating and implementing policy.

The doctrines of implied repeal and preemption also operate to the benefit of the markets by giving effect to the sound policy that the ordinary principles of competition law could operate at cross-purposes to the larger scheme of regulation developed by the SEC in aid of the national market system.

In effect, the system permits the SEC to leverage the benefits of cooperative efforts by industry participants, such as broker-dealers acting through national securities exchanges (or pursuant to their rules) and SROs acting through National Market System plans, while keeping a watchful eye on anti-competitive consequences.

In the last decade alone, the SEC has tackled many important market structure issues without crushing competition, including:

- Facilitating the almost total transition of member owned and dominated exchanges to shareholder ownership and control;[97]
- Approving the separation of The NASDAQ Stock Market, Inc. from the NASD, and overseeing many developments in that market;[98]
- Implementing decimalization of all of the securities markets and the inception of penny minimum price variations in the options market;[99]

97. *See, e.g.*, Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3, Exchange Act Release No. 49,098, 69 Fed. Reg. 3974 (Jan. 27, 2004); Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1, Exchange Act Release No. 49,718, 69 Fed. Reg. 29,611 (May 24, 2004); Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 by the Chicago Stock Exchange, Inc., Exchange Act Release No. 51,149, 70 Fed. Reg. 7531 (Feb. 14, 2005); Order Granting Approval of Proposed Rule Change and Amendment Nos. 1, 3, and 5 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 6 and 8, Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251 (Mar. 6, 2006); Order Approving Proposed Rule Change and Amendment Nos. 1 and 2, Exchange Act Release No. 53,963, 71 Fed. Reg. 34,660 (June 15, 2006).

98. *See* In the Matter of the Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550 (Jan. 23, 2006); *see also* Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1, Exchange Act Release No. 54,084, 71 Fed. Reg. 38,935 (July 10, 2006).

- Introducing a very flexible and highly successful method for exchange-like trading platforms to enter operation rapidly and without most of the extensive requirements applicable to registered national securities exchanges;[100]
- Fostering multiple trading, creating a linkage system, discouraging competitive practices, and approving new market entrants in listed options markets;[101]
- Establishing a new framework for intermarket order protection and open intermarket access in the listed equities market;[102]
- Casting a bright light on specialist practices at the NYSE through enforcement action;[103]
- Promulgating important order handling requirements[104] and extensive reporting of equity market execution quality in furtherance of best execution and investor protection goals;[105] and
- Reconsidering the framework for short sale regulation.[106]

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99. See U.S. GEN. ACCOUNTING OFFICE, SECURITIES MARKETS: DECIMAL PRICING HAS CONTRIBUTED TO LOWER TRADING COSTS AND A MORE CHALLENGING TRADING ENVIRONMENT, REP. NO. GAO-05-535 (May 2005) [hereinafter GAO DECIMALIZATION REPORT], for a full discussion of decimalization.

100. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844 (Dec. 22, 1998).

101. *See generally* Competitive Developments in the Options Markets, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124 (Feb. 9, 2004). *See also* Order Granting Approval to Proposed Rule Change and Amendment No. 3 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 4 Thereto by the Boston Stock Exchange, Inc., Exchange Act Release No. 49,068, 69 Fed. Reg. 2775 (Jan. 20, 2004); In the Matter of the Application of the International Securities Exchange LLC for Registration as a National Securities Exchange, Exchange Act Release No. 42,455, 65 Fed. Reg. 11,401 (Mar. 2, 2000).

102. *See* Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496 (June 29, 2005).

103. *See* In the Matter of New York Stock Exchange, Inc., Exchange Act Release No. 51,524, 2005 SEC LEXIS 814 (Apr. 12, 2005). *See also* In the Matter of Performance Specialist Group LLC, Exchange Act Release No. 50,075, 2004 SEC LEXIS 1564 (July 26, 2004); In the Matter of SIG Specialists, Inc., Exchange Act Release No. 50,076, 2004 SEC LEXIS 1563 (July 26, 2004); In the Matter of Bear Wagner Specialists LLC, Exchange Act Release No. 49,498, 2004 SEC LEXIS 743 (Mar. 30, 2004); In the Matter of Fleet Specialist, Inc., Exchange Act Release No. 49,499, 2004 SEC LEXIS 744 (Mar. 30, 2004); In the Matter of LaBranche & Co. LLC, Exchange Act Release No. 49,500, 2004 SEC LEXIS 749 (Mar. 30, 2004); In the Matter of Spear, Leeds & Kellogg Specialists LLC, Exchange Act Release No. 49,501, 2004 SEC LEXIS 742 (Mar. 30, 2004); In the Matter of Van der Moolen Specialists USA, LLC, Exchange Act Release No. 49,502, 2004 SEC LEXIS 2197 (Mar. 30, 2004).

104. *See* Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48,290 (Sept. 12, 1996) (adopting Exchange Act Rule 11Ac1-4 and amendments to 11Ac1-1).

105. *See* Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43,590, 65 Fed. Reg. 75,414 (Dec. 1, 2000) (adopting Exchange Act Rules 11Ac1-5 and 11Ac1-6).

106. *See supra* note 3. *See also* Short Sales, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008 (Aug. 6, 2004) (adopting Regulation SHO); Amendments to Regulation SHO, Exchange Act Release No. 54,154, 71 Fed. Reg. 41,710 (July 21, 2006) (proposing amendments to Regulation SHO); Order Granting Accelerated Approval of Proposed Rule Change to Exempt all

Critics of the SEC's most recent ambitious market structure initiative, Regulation NMS, were particularly concerned about dampening competition.[107] Yet, it is clear that, while some business models may be impacted, others are rising to take their place. It is worth noting that, since the adoption of Regulation NMS, not only have traditional markets, like the "regional" stock exchanges, submitted proposals to introduce new equity trading platforms, in some cases backed by fresh capital,[108] but also new competitors have emerged.[109] A newly reorganized Nasdaq promises to be a potent force in competing for trading volume in NYSE stocks.[110] Finally, the NYSE has broadly enhanced its own trading platform with the introduction of the Hybrid system.[111]

To be sure, Regulation NMS and other reforms will affect (sometimes fatally) particular business models.[112] And the SEC must be extremely vigilant that certain business models, including those of market makers and other liquidity providers, do not become unviable. Yet, at least in the case of the equities market, if recent signs of intent to compete are an indication, it seems unlikely that competition will perish, even if some business models suffer or even fade.

The options market seems to be extremely vibrant and competition has never been more intense, despite market structure reforms that many predicted would have dire consequences.[113] In addition, the velocity of

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Securities in the NASDAQ-100 Index From the Price Test Set Forth in NASDAQ Rule 3350(a), Exchange Act Release No. 54,435, 71 Fed. Reg. 55,042 (Sept. 20, 2006).

107. *See* Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,498–99 (June 29, 2005). Among other things, Regulation NMS requires trading centers to establish policies and procedures to prevent "trade throughs" and eliminates sub-penny quoting in most listed stocks.

108. *See* Lucchetti, *supra* note 4; Aaron Lucchetti, *Wall Street Firms to Control NSX*, WALL ST. J. Sept. 5, 2006, at C3 (describing investments by major financial institutions in the National Stock Exchange).

109. *See* Annette L. Nazareth, Comm'r, SEC, Speech at the Mutual Fund Directors Forum: Lifting The Veil—Investment Industry Trading Practices And Best Execution Workshop (June 7, 2006), *available at* http://www.sec.gov/news/speech/2006/spch060706aln.htm. *See, e.g.*, Order Granting Accelerated Approval to Amendment No. 2 Thereto to Establish Rules for a Screen-Based Trading System for Non-Option Securities, Exchange Act Release No. 54,422, 71 Fed. Reg. 54,537 (Sept. 15, 2006); Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to Establishing ISE Stock Exchange, LLC as a Facility of the International Securities Exchange, Inc., Exchange Act Release No. 54,399, 71 Fed. Reg. 53,728 (Sept. 12, 2006).

110. *See* NASDAQ Market Share Statistics, http://www.nasdaqtrader.com/trader/tradingservices/marketshare.stm (noting that for the month of August 2006, Nasdaq's total market share in NYSE securities was roughly twenty-eight percent). *See also Nasdaq Beats NYSE in August Market Share Grab*, WALL ST. LETTER, Sept. 18, 2006, at 4.

111. *See* News Release, New York Stock Exch., NYSE Completes Hybrid Market Phase III Activation (Jan. 24, 2007), *available at* http://www.nyse.com/marketinfo/hybmarket/1127349068564.html (follow "NYSE Completes Hybrid Market Phase III Activation" link).

112. *See* GAO DECIMALIZATION REPORT, *supra* note 99, at 8, 44.

113. *See, e.g.*, *id*. at 64–67. See generally Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and

introduction of significant new systems and modalities of listed options trading is staggering.[114]

Although the SEC has been less active in directly regulating the corporate bond market, those market structure innovations that the SEC has encouraged, particularly the NASD's TRACE system for transaction reporting,[115] have been successful in promoting transparency in that market without compromising competition.[116]

Thus, although past results cannot guarantee future performance, it is hard to say that the major market structure initiatives have fatally compromised competition overall or hurt the markets.

B. WEAKNESSES

Despite the strengths of the current market structure, the system also has a number of significant flaws. For example, the process for establishing standards lacks transparency and is slow, the SEC's staff is too cautious, and the Commission and its staff lack clear standards for considering the international implications of its actions.

1. The Process for Establishing Standards is Often Opaque

It is something of a paradox that the SEC exerts much of its market structure influence without any transparency. Although rulemaking and SRO rule approvals require a notice and public comment process,[117] in practice, much policy setting is not subjected to that discipline. There are several reasons for this lack of transparency.

International Securities Exchange LLC, Exchange Act Release No. 43,086, 65 Fed. Reg. 48,023 (Aug. 4, 2000), for a discussion of comments in opposition to options inter-market linkage.

114. *See, e.g.*, Order Granting Accelerated Approval to Amendments No. 1, 2, and 3 Thereto To Adopt a Simple Auction Liaison System to Auction Qualifying Marketable Orders for Potential Price Improvement, Exchange Act Release No. 54,229, 71 Fed. Reg. 44,058 (Aug. 3, 2006) (approving, on a pilot basis, CBOE's AIM system); Order Approving Proposed Rule Change and Amendments No. 1 and 2 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 Thereto Relating to the Establishment of the OX Trading Platform, Exchange Act Release No. 54,238, 71 Fed. Reg. 44,758 (Aug. 7, 2006) (approving NYSE Arca's OX Trading Platform). Nasdaq has also indicated recently its intention to enter the options market. *See* Jenny Anderson, *Nasdaq is Planning to Start Options Exchange in 2007*, N.Y. TIMES, Sept. 7, 2006, at C3.

115. *See* Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 4 to the Proposed Rule Change by the National Association of Securities Dealers, Inc., Exchange Act Release No. 43,873, 66 Fed. Reg. 8131 (Jan. 29, 2001).

116. *See, e.g.*, Annette L. Nazareth, Dir., Div. of Mkt. Regulation, SEC, Testimony before the United States Senate Committee on Banking, Housing and Urban Affairs, (June 17, 2004) *available at* http://www.sec.gov/news/testimony/ts061704aln.htm; Cynthia A. Glassman, Comm'r, SEC, Remarks at The Bond Market Association Legal & Compliance Conference in New York City, N.Y. (Feb. 3, 2004), *available at* http://www.bondmarkets.com/story.asp?id=440.

117. *See supra* notes 48–49 and accompanying text.

a. Rulemaking

Rulemaking is a resource intensive process, which requires the Commission to present elaborate analysis regarding the proposal and its impacts both under the Exchange Act[118] and under other legal regimes.[119] Thus, it is natural for the staff to seek other, less burdensome means to effect policy and carry out the agency's mission.[120]

Moreover, the Commission has been subjected to various successful challenges to its rulemaking,[121] which, no doubt, will tend to discourage and further deter the use of this avenue.[122]

Another factor that contributes to the opacity in the establishment of new behavioral norms is the SEC's organizational structure. The SEC is organized in a way that promotes standard setting other than through the rulemaking process. Since the Office of Compliance and Inspections and Examination (OCIE) and the Division of Enforcement (Enforcement) are effectively co-equals with the Division of Market Regulation, their agendas and legal interpretations are not necessarily aligned with those of the Division of Market Regulation. Increasingly, these units are establishing new modalities of behavior through the inspection process or through enforcement settlements that involve behavioral undertakings with industry-wide and market structure impacts.[123] OCIE and Enforcement often are tempted to (and do) fill regulatory gaps that should be addressed in formal SEC rules by establishing new standards of conduct through the examination and inspection process and not via rulemaking.[124] Naturally,

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118. *See supra* note 63 and accompanying text.

119. In addition to the requirements of the Exchange Act noted above, SEC rulemaking requires compliance with a variety of other technical requirements, such as the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, 110 Stat. 857 (codified as amended in scattered sections of 5 U.S.C. and 15 U.S.C., and as a note to 5 U.S.C. § 601), Regulatory Flexibility Act, 5 U.S.C. § 603 (1996), and the Paperwork Reduction Act, 44 U.S.C §§ 3501–3520 (1995).

120. *See* Richard H. Walker, Dir., Div. of Enforcement, SEC, Remarks at The Bond Market Association's 6th Annual Legal and Compliance Seminar: Regulation vs. Enforcement in an On-Line World (Oct. 25, 2000), *available at* http://www.sec.gov/news/speech/spch413.htm.

121. *See supra* note 67 and accompanying text.

122. *See Lawsuits, Regulatory Scrutiny Threaten SEC, Its Mission, Campos Says*, 8 Broker/Dealer Compliance Rep. (BNA) No. 34 (Aug. 23, 2006) (regarding the implications of this litigation on the mission of the SEC).

123. *See* Paul S. Atkins, Comm'r, SEC, Remarks before the IA Compliance Best Practices Summit 2006 (Feb. 28, 2006), *available at* http://www.sec.gov/news/speech/spch022806psa.htm ("An integrated structure could allow for improved interaction and exchange between the folks who write and interpret rules and those who are on the frontlines interacting with registrants and assessing their compliance with our rules.").

124. *See, e.g.*, Federal Court Approves Global Research Analyst Settlement, SEC Litigation Release No. 18,438, 2003 SEC LEXIS 2601 (Oct. 31, 2003); In the Matter of Certain Activities of Options Exchanges, Exchange Act Release No. 43,268, 73 SEC Docket 530 (Sept. 11, 2000); In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 37,538, 62 SEC Docket 1346 (Aug. 8, 1996); In the Matter of Certain Market Making Activities on

standards of conduct that are imposed in undertakings by regulated entities that are parties to enforcement settlements with "remedial" undertakings do not have the benefit of notice and public comment, nor are they subjected to the careful balancing of the factors, including competition, that the SEC is obliged to weigh in rulemaking and other official actions.[125] Moreover, settlements may not reflect actual legal standards, but rather the give and take of negotiation between the Enforcement staff and respondents/litigants. In these latter cases, the policy outcome is not structurally guaranteed to be informed by the formal and mandatory consideration and balancing of competitive effects and other factors that the SEC must engage in when promulgating rules. Therefore, the carefully crafted standards for weighing competition in the Exchange Act are effectively subverted.[126]

Perhaps because of the inherent difficulties in rulemaking and the other factors noted above, the SEC's stance on many significant matters affecting market structure are not clearly stated in final rules, but are the subject of unofficial general statements that the market place must use to read the tea leaves. For example, although the SEC has continuously stated its view that promoting best execution is a key aspect of its policymaking, and indeed, has taken many official actions to support and undergird best execution in the marketplace,[127] it has refused to give definition to this concept or to

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Nasdaq, Exchange Act Release No. 40,900, 68 SEC Docket 2693 (Jan 11, 1999); SEC v. Credit Suisse First Boston Corp., SEC Litigation Release No. 17,327 (Jan. 22, 2002); In the Matter of New York Stock Exchange, Inc., Exchange Act Release No. 41,574, 70 SEC Docket 106 (June 29, 1999). *See also* In the Matter of Canadian Imperial Holdings Inc. & CIBC World Markets Corp., Securities Act Release No. 8592, Exchange Act Release No. 52,063, Investment Advisors Act Release No. 2407, 2005 SEC LEXIS 1773 (July 20, 2005). A recent enforcement settlement in which the SEC concluded, without detailed analysis, that certain swaps were unlawful under the margin rules, a proposition that has caused much consternation, and possibly divergent practices in the world of equity swaps.

125. These concerns are not, of course, limited to the SEC, but arise in many areas of Administrative Law. *See, e.g.*, 1 C.F.R. § 305.91-5 (2006) (labor law); Phillip J. Kolczynsk, A Dangerous New Precedent in FAA Enforcement Law (Oct. 25, 2000), http://www.aviationlawcorp.com/content/dangerous.html (FAA law); Comments of Verizon Wireless, In the Matter of Petition for Rulemaking to Enhance Security and Authentication Standards For Access to Customer Proprietary Network Information, CC Docket No. 96-115, RM 11277 (Fed. Commc'ns Comm'n Oct. 31, 2005), *available at* http://www.epic.org/privacy/iei/sbc_comments.pdf.

126. See Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation By Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149 (1990), for a full discussion of various pitfalls relating to regulation by enforcement. *See also* Paul S. Atkins, Comm'r, SEC, Remarks before the National Association for Variable Annuities (June 28, 2005), *available at* http://www.sec.gov/news/speech/spch062805psa.htm.

127. *See* Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,508 (June 29, 2005) ("[O]ne of the primary benefits of the Order Protection Rule is to backstop a broker's duty of best execution. . . ."); Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43,590, 65 Fed. Reg. 75,414, 75,420 (Dec. 1, 2000); Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54,165, 71 Fed. Reg. 41,978, 41,978 (July 24, 2006) ("Fiduciary principles require money managers to seek the best execution for client trades . . . .").

articulate a standard regarding the implications of such related practices as payment for order flow and similar order flow routing arrangements, internalization, and (in the case of the options markets) seeking to have orders executed in "mini auctions" in evaluating compliance with best execution obligations.[128] Therefore, collectively, this inaction leaves market participants to decide for themselves and to be subject to inspections and examinations where unknown standards will apply to their performance. Options markets in particular have been offering arrangements similar to payment for order flow and/or that encourage order flow arrangements (sometimes called "directed orders") between firms and price improvement auction facilities. Market participants may be at a loss concerning the significance of these practices for evaluating their order flow costing arrangements. Therefore, the SEC's official silence on how these practices effect best execution analysis in options has itself become a significant market structure issue.

b. SRO Rule Proposals

Much of the SRO rule review process goes on behind the scenes, with the Commission staff commenting on successive drafts of filings that are not published for public comment until that unofficial review process is complete. The SROs have no effective means of causing the publication of their filings in order to trigger the notice and comment process. That is, the SEC must, within 35 days following the publication of a notice of filing of a proposed rule change, either approve a proposed rule change or institute proceedings to disapprove it (subject to the ability to extend this period of up to 90 days in certain circumstances).[129] However, there is no statutory provision contained in the SEC's rules that compels the staff to publish such a notice within a set time period.[130]

See also *Market 2000, supra* note 18, for a historical overview of the SEC's involvement in promoting best execution and reluctance to establish definitive global standards.

128. *See, e.g.*, SEC, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS & OFFICE OF ECONOMIC ANALYSIS, SPECIAL STUDY: PAYMENT FOR ORDER FLOW AND INTERNALIZATION IN THE OPTIONS MARKETS, (Dec. 2000), *available at* http://www.sec.gov/news/studies/ordpay.htm; Competitive Developments in the Options Markets, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124 (Feb. 9, 2004); Elizabeth K. King, Assoc. Dir., Div. of Mkt. Regulation, SEC, Remarks before the 2006 Options Industry Conference (May 5, 2006), *available at* http://www.sec.gov/news/speech/2006/spch050506ekk.htm; Elizabeth K. King, Assoc. Dir., Div. of Mkt. Regulation, SEC, Remarks before the 2003 Options Industry Conference (May 13, 2005), *available at* http://www.sec.gov/news/speech/spch051305ek.htm; OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC, REPORT CONCERNING EXAMINATIONS OF ORDER ROUTING AND EXECUTION, *available at* http://www.sec.gov/news/studies/2007/optionsroutingreport.pdf (last visited Mar. 8, 2007).

129. Exchange Act § 19(b)(2), 15 U.S.C. § 78s(b)(2) (2000).

130. The SEC has stated at various times in the past that it is mindful of the burdens of delays in publishing SRO rule proposals for public comment and expressed an intent to expedite the process. *See* Proposed Rule Changes of Self Regulatory Organizations; Annual Filing of

Thus, the staff has considerable power to cause an SRO to bow to the staff's "desk drawer" views of policy, since rule proposals can be held up indefinitely, sometimes for years, in this unpublished state. The Division of Market Regulation often imposes informal standards of conduct not contained in the Exchange Act or its own rules as a condition for publishing and later approving SRO initiatives.[131] As a consequence, despite the fact that SRO rule filings are subject to a notice and public comment process, this will not necessarily reveal the staff's thinking in imposing an unwritten standard upon the SRO. Moreover, even though the SEC's approval orders are subject to judicial review, an informal condition imposed on the SRO by the SEC in this manner would not necessarily be reviewable, since potential litigants would not necessarily be able to claim that they were aggrieved by that aspect of the Commission approval order.

A further defect in the SRO rule proposal process is that often the SEC does not expressly enunciate the basis on which it determined the impact, if any, on competition of the rule proposal, and whether such impact is justified. Rather, its statements are generally conclusory and its analysis is not described. The staff rarely institutes proceedings to disapprove rule filings, even where a proposal does not meet the staff's standards from a competition perspective. Rather, the staff either declines to notice the proposal for public comment or asks an SRO to voluntarily withdraw the proposal. This process makes it difficult for markets and market participants to form a view regarding the staff's analytical approach to competitive impact, which, in turn, makes planning extremely difficult. Moreover, the SEC is effectively not held accountable with regard to the consistency of its analysis and approach to competition as it relates to SRO rule filings.

Amendments to Registration Statements of National Securities Exchanges, Securities Associations, and Reports of the Municipal Securities Rulemaking Board, Exchange Act Release No. 35,123, 59 Fed. Reg. 66,692, 66,699 (proposed Dec. 20, 1994).

131. For example, in various national securities exchange demutualizations, the staff has indicated its policy to require certain limitations on ownership and voting by exchange shareholders. *See, e.g.*, Order Granting Approval of Proposed Rule Change Relating to the NYSE's Business Combination With Archipelago Holdings, Inc., Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251, 11,256–57 (Mar. 6, 2006); Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550, 3552 (Jan. 23, 2006). Although the SEC has proposed rulemaking that would codify these requirements, *see* Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 50,699, 84 SEC Docket 444 (proposed Dec. 8, 2004), they are not embedded in the Exchange Act or regulations. In effect, demutualizing SROs were forced to accept this unwritten policy as a condition to publication of their proposed post-demutualization rules. Similarly, in the options market, the staff has imposed an informal standard regarding the maximum that a specialist or equivalent market maker at parity, or a firm that facilitates an order, may receive on a guaranteed basis when executing an order. *See, e.g.*, Chicago Board Options Exchange Rules 6.45A & 6.74A; Philadelphia Stock Exchange Rules 1014(g) &1064 [hereinafter PHLX Rules]; International Securities Exchange Rule 713 (regarding enhanced split rules in options trading); NYSE Arca Rule 6.47 (regarding facilitation rules).

c. Summary

In the aggregate, an opaque process is bad because market participants are not uniformly aware of the SEC's true views of the state of the law and the rationale for those views. Market participants often operate in a zone of uncertainty regarding the legality of particular practices. Moreover, they cannot make rational business plans for introducing new products, systems, and methods, without clarity regarding the time frames in which their proposals (or the SEC's own) will be acted upon. All of this affects competition and market structure.

2. The Process is Slow

The Commission staff is very deliberative and careful, and the notice and public comment process extremely important in drawing out well informed views of investors and market professions likely to be affected. Moreover, it is inevitable that proposals (particularly those of SROs) may not be what they seem, and careful review is merited because of the technical complexity of many such proposals and the potential for burdening competition. However, in general, slow is bad. SEC rulemaking proposals and its consideration of SRO filings can take years to be finalized, often dying of their own weight.[132] First, market participants often do not know with certainty the legality of particular practices.[133] Second, they cannot make effective plans for introducing new products, systems and methods, without clarity regarding the time frames in which their proposals (or the SEC's own) will be acted upon.[134] This burdens competition because players with the greatest appetite for regulatory risk develop a competitive "first mover advantage," disadvantaging the most responsible market participants. Also, bureaucratic delay tends to entrench existing participants because it can be a barrier to entry for would-be entrants with new and innovative business models.

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132. The SEC reported that it received 959 SRO rule filings during its 2005 fiscal year, and that 80% (765) had been reviews by the staff and approved or disapproved within 60 days of receipt of the last amendment filed by the SRO. SEC, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 41 Ex.2.8 (Nov. 25, 2005), *available at* http://www.sec.gov/about/secpar/secpar2005.pdf. However, this performance statistic must be taken with a grain of salt, since many SRO rule filings are submitted initially in draft form and therefore not "filed" until the staff has advised the SRO that the draft filing is generally satisfactory to the staff. Moreover, the staff often requests multiple non-substantive amendments during the course of their processing a filing. Also, in many instances, filings are withdrawn (sometimes at the staff's request) and subsequently re-filed.

133. *See* Annette L. Nazareth, Comm'r, SEC, Remarks before the ICI Equity Markets Conference (Sept. 22, 2005), *available at* http://www.sec.gov/news/speech/spch092205aln.htm ("[M]arket participants need certainty and the rules of the road must be clear for them to function efficiently and compete effectively in a globally competitive marketplace.").

134. *Id*. *See also Competition & Regulation Balancing the National Market System*, *supra* note 96, at 2; SEC OPERATIONS, *supra* note 18, at 15–16.

3. The Staff is Cautious

Despite numerous sources of authority to grant exemptive relief, define terms, and issue no-action and similar guidance,[135] the staff is reluctant to grant such relief.[136] The process is generally very protracted.[137] Moreover, rulemaking cannot capture all permutations and scenarios. Where the SEC staff is requested to permit activity that does not raise the concerns addressed by the general rule, or to give clarity and definition to the application of rules, the staff should use its authority more liberally, particularly if the grants promote fair competition that do not threaten to compromise investor protection. Moreover, outside of the context of SRO rule approvals, the Commission's use of pilot programs and temporary rules to permit it to study the impact of specific actions is too infrequent. These would seem to be an ideal way for the Commission to validate whether its assumptions regarding competitive impact are appropriate.

In regard to SRO rule filings, the staff often does not permit filings that technically qualify for effective upon filing or similar treatment in accordance with the Exchange Act[138] and SEC rules. Instead, the staff often

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135. *See supra* Part II.B.5.

136. Between January 1, 2006 and August 31, 2006, the Division of Market Regulation issued only forty-four no-action letters that were thought to be of sufficient significance to publish on the SEC website. *See* Division of Market Regulation: Exemptive Orders and Exemptive, Interpretive, and No-Action Letters, Chronological List of No-Action Letters, http://www.sec.gov/divisions/marketreg/mr-noaction.shtml#chron (last visited Mar. 1, 2007). The SEC website also lists one interpretive statement, *see* SEC Interpretive Releases, http://www.sec.gov/rules/interp.shtml (last visited Mar. 1, 2007), and five section 36 orders, *see* Exemptive Orders, http://www.sec.gov/rules/exorders.shtml (last visited Mar. 1, 2007), involving market regulation issues. Outside of the context of SRO rule approvals, no new pilot programs affecting market regulation issues were introduced during this period.

137. *See* SEC OPERATIONS, *supra* note 18, at 14; *cf.* SEC 2005 PERFORMANCE AND ACCOUNTABILITY REPORT, *supra* note 132, at 41 Ex.2.7. The SEC reported that 85% of exemptive, no-action and interpretive requests (across all Divisions) in 2005 were issued within six months. *Id.* This performance statistic must be taken in context. Most requests for this type of relief are submitted and negotiated in draft form, and no formal request is made until the staff is satisfied. If the staff does not indicate that it is prepared to issue the relief requested, the request is often (but not always) withdrawn. Therefore, requests for relief that are ultimately granted are generally formally submitted (following negotiation with the staff) very close in time to when the staff is ready to issue the letter granting the relief. *See, e.g.*, Jeffrey M. Oakes, SEC No-Action Letter, 2007 SEC No-Act. LEXIS 300 (Mar. 2, 2007); William G. Farrar, SEC No-Action Letter, 2007 SEC No-Act. LEXIS 227 (Feb. 8, 2007).

138. The Exchange Act provides that a proposed rule change may take effect upon filing with the Commission if they fall within the following categories:

> (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization,
>
> (ii) establishing or changing a due, fee, or other charge imposed by the self-regulatory organization, or

prefers to handle SRO filings in the "ordinary way": subject to notice and public comment prior to effectiveness. The Commission rarely, if ever, relies upon its statutory authority to put a rule filing into effect summarily.[139] Given the Commission's ability to abrogate filings that have taken effect upon filing within 60 days and requiring them to be refiled in the ordinary way, this approach seems unnecessarily cautious. It also possibly burdens competition in two respects. First, it denies the SRO the ability to "test the waters" by quickly implementing a system or rule without subjecting it to extensive pre-approval public comment and waiting period.[140] Second, the handling of these proposals consumes valuable staff

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> (iii) concerned solely with the administration of the self-regulatory organization or other matters which the Commission, by rule, consistent with the public interest and the purposes of this subsection, may specify . . . [as being eligible for effective on filing treatment].

Exchange Act § 19(b)(3)(A), 15 U.S.C. § 78s(b)(3)(A) (2000).

Section 19(b)(3)(A) is implemented by Exchange Act Rule 19b-4(f), which incorporates verbatim the categories in clauses (i) and (ii) of § 19(b)(3)(A), reprinted above, as well as the category of rules that are concerned only with administration. *See* 17 C.F.R. § 240.19b-4 (2004). It also includes, among other things, that a proposed rule change may take effect upon filing with the Commission pursuant to § 19(b)(3) of the Act, if properly designated by the self-regulatory organization as:

> [(1)] Effecting a change in an existing order-entry or trading system of a self-regulatory organization that:
>
> (i) Does not significantly affect the protection of investors or the public interest;
>
> (ii) Does not impose any significant burden on competition, or have the effect of limiting the access to or availability of the system; or
>
> [(2)] Effecting a change that:
>
> (i) Does not significantly affect the protection of investors or the public interest;
>
> (ii) Does not impose any significant burden on competition, and
>
> (iii) By its terms, does not become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest.

Exchange Act § 19(b)(3). In this latter case, the SRO must give the SEC written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change. *Id.*

In 2001, The Commission proposed Rule 19b-6, which would have expanded the categories of proposed rule changes eligible for effective upon filing treatment. *See* Rule Changes by Self-Regulatory Organizations, Exchange Act Release No. 43,860, 66 Fed. Reg. 8912, 8912 (proposed Feb. 5, 2001). However, it never acted upon this proposal.

139. The authority is derived from Exchange Act § 19(b)(3)(B), 15 U.S.C. § 78s(b)(3)(B) (2000) ("[A] proposed rule change may be put into effect summarily if it appears to the Commission that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds.").

140. By contrast, "designated contract markets" (i.e., futures exchanges) regulated by the CFTC have the option of filing rules with the CFTC and "self-certif[ying]" that the rule complies with

resources that might be better utilized in processing proposals that have potentially larger policy ramifications.

4. There are No Standards for the SEC's Consideration of International Implications of its Actions Under the Exchange Act

The Commission and the staff are well aware of the implications of their actions on international competition.[141] The most well-publicized current ramification of this is the application of U.S. accounting and auditing standards and the provisions of the Sarbanes-Oxley Act of 2002 to foreign issuers.[142] There are, however, other less visible, but highly significant, cross-border issues such as the ability of U.S. residents to trade and purchase securities products traded on foreign securities markets, and the extent to which foreign financial institutions may access U.S. investors. The SEC does not ignore the significance of these issues, and takes cautious, but non-systematic, steps to address them.[143] By contrast, the

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the Commodity Exchange Act or seeking affirmative CFTC approval of such rules. *See* 17 C.F.R. §§ 38.4(b), 40.6 (2002).

141. *See, e.g.*, *Market 2000*, *supra* note 18, Study VII; Laura S. Unger, Comm'r, SEC, Speech at the Third National Securities Trading on the Internet Conference: The Global Marketplace, Ready or Not Here it Comes (Jan. 24, 2000), *available at* http://www.sec.gov/news/speech/spch344.htm. *See also* SEC OPERATIONS, *supra* note 18, at 10. For a discussion of the integral part that financial services plays in the global economy, see U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE CHAIRMAN, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, U.S. SENATE, FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE, REP. NO. GAO 05-61, at 44–46 (Oct. 2004).

142. *See, e.g.*, Paul S. Atkins, Comm'r, SEC, Speech at the University of Cologne, The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation (Feb. 5, 2003), *available at* http://www.sec.gov/news/speech/spch020503psa.htm; Aaron Lucchetti & Carrick Mollenkamp, *New York to Study Lack of IPOs*, WALL ST. J., Sept. 27, 2006, at C3. *See also* Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 55,005, 72 Fed. Reg. 1384 (proposed Dec. 22, 2006).

143. *See, e.g.*, Cleary, Gottlieb, Steen & Hamilton, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 138 (Jan. 30, 1996) (concerning Exchange Act Rule 15a-6); *Nine Firm Letter, supra* note 72 (concerning Exchange Act Rule 15a-6); Cleary, Gottlieb, Steen & Hamilton, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 662 (July 27, 2005) (concerning the sales of certain foreign options listed on Eurex) [hereinafter *Foreign Options on Eurex No-Action*]; Order Granting Limited Volume Exemption from Registration as an Exchange Under Section 5 of the Securities Exchange Act, Exchange Act Release No. 41,199, 64 Fed. Reg. 14,953 (Mar. 22, 1999); Morgan Stanley & Co., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 975 (Dec. 20, 1996) (granting no-action relief with respect to broker-dealer registration requirements due to Indian law restrictions applicable to transactions executed through local broker-dealers); Futures Industry Association, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 693 (Aug. 20, 2002); Macquarie Media Holdings Limited and Macquarie Media Trust, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 799 (Sept. 27, 2005); Supervised Investment Bank Holding Companies, Exchange Act Release No. 49,831, 69 Fed. Reg. 34,472 (June 21, 2004); Application of the Definition of Narrow-based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, Exchange Act Release No. 54,106, 71 Fed. Reg. 39,534 (July 13, 2006). *See also* Custody of

CFTC has a very liberal regime for permitting access by U.S. persons to foreign futures exchanges and foreign futures products without subjecting the markets, brokers and products to extensive U.S. regulation.[144]

One instance of the SEC's caution in balancing international competition and investor access concerns is in the area of exchange-traded derivative products. Although U.S. investors may freely invest in foreign shares and other securities,[145] and do in large quantities,[146] their access to risk management tools, such as options on indexes, single securities, exchange-traded funds (ETFs), security futures, and index futures based upon foreign stocks and foreign stock indexes, are often quite limited. These limitations are generally in the name of investor protection. The offering of these products in the United States is, in some cases, bounded by statute or other rules.[147] Yet, in many cases, where the SEC has discretion, it chooses to limit sales of these products very conservatively. For example, a foreign options exchange may not effectively permit access to its options products without submitting to a laborious no-action process, which to date has narrowly limited sales of such products to "qualified institutional buyers," as defined under Rule 144A under the Securities Act.[148] Also, U.S. options exchanges are effectively limited in their ability to list and trade index options with significant foreign stock components or options on ETFs

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Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176, 68 Fed. Reg. 56,692 (Oct. 1, 2003) (concerning foreign custodians); Investment Company Act Rules 17f-5 and 17f-7, 17 C.F.R. §§ 270.17f-5, 270.17f-7 (2000) (permitting certain international banks to act as custodians for certain assets owned by U.S. registered investment companies).

144. Commodity Futures Trading Comm'n, Foreign Futures and Options, http://www.cftc.gov/dea/deadcioforeignfuturesandoptions.htm?from=home&page=epforeignopscontent.html (last visited Feb. 4, 2007).

145. *See* DIV. OF CORP. FIN., SEC, INTERNATIONAL INVESTING: GET THE FACTS 2 (1999), http://www.sec.gov/pdf/ininvest.pdf. Even so, the offering of such securities into the United States is clearly subject to limitations under the Securities Act and, in many instances, state securities laws. Moreover, large numbers of U.S. shareholders can subject foreign issuers to registration under section 12(g) of the Exchange Act. *See* Exchange Act § 12, 15 U.S.C. § 781 (Supp. IV 2004). But the issuer may perfect an exemption under Exchange Act Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2(b) (2005).

146. *See, e.g.*, SEC OPERATIONS, *supra* note 18, at 10.

147. *See, e.g.*, Exchange Act § 6(h)(4)(A), 15 U.S.C. § 78f(h)(4)(A) (2000); *Examining the Commodity Futures Modernization Act of 2000 and Recent Market Developments: Hearing before the S. Comm. on Banking Housing and Urban Affairs*, 109th Cong. 11–12 (2005) (testimony of Robert L.D. Colby, Deputy Dir., Div. of Mkt. Regulation, SEC), *available at* http://www.sec.gov/news/testimony/ts090805rldc.htm [hereinafter *Commodity Futures Modernization Act of 2000 Hearing, Colby Testimony*]; Kevin M. Foley, *Foreign Products: Still Off-limits to U.S. Investors*, FUTURES INDUSTRY MAG. (Dec. 2001), *available at* http://www.futuresindustry.org/fimagazi-1929.asp?a=743 (noting that the equity option listing standard requires class of underlying stock to be registered under the Exchange Act). *See also* PHLX Rule 1009(a)(1).

148. *See, e.g.*, *Foreign Options on Eurex No-Action*, *supra* note 143.

and similar instruments.[149] Narrow-based index futures on foreign equities that are not registered under the Exchange Act are also restricted.[150] As a result, much hedging of foreign securities investments must be done in the over-the-counter markets, which lack transparency, have relatively high transaction costs and are limited to non-retail investors.[151]

The SEC has taken steps to address access and competition issues involving these types of products, such as promulgating joint rulemaking with the CFTC to permit narrow-based index options on foreign sovereign bonds[152] and announcing other initiatives.[153] However, there is no over-arching policy guidance directing the SEC's actions in this arena.

The SEC is also taking pains to balance investor protection concerns with respect to the ability of foreign broker-dealers, including those affiliated with U.S. financial institutions, to do business in the United States. The current framework, which has been in place since 1989, is awkward and in need of reconsideration.[154] Likewise, although there have been calls for greater access of U.S. investors and intermediaries to "screens" of foreign securities markets, direct access to foreign markets by U.S. investors has not been comprehensively revisited for almost a decade.[155]

The fault here, if there is one, does not rest principally with the agency. The SEC's formal actions, and institutional direction, must be guided by the

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149. *See, e.g.*, PHLX Rule 1009A(b)(9), (d)(10); PHLX Rule 1009 cmts. .03, .06(b), .07(b); Amendment to Rule Filing Requirements for Self-Regulatory Organizations Regarding New Derivative Securities Products, Exchange Act Release No. 40,761, 63 Fed. Reg. 70,952 (Dec. 22, 1998) (limiting percentage of underlying securities that may be of issuers in jurisdictions with which there is no surveillance agreement, and requiring absence of blocking statute and real time reporting).

150. *See Commodity Futures Modernization Act of 2000 Hearing, Colby Testimony*, *supra* note 147, at 11–12; *Commodity Futures Modernization Act of 2000 Hearing, SIA Testimony*, *supra* note 34, at 6.

151. *See* Commodity Exchange Act, 7 U.S.C. § 1a(12) (2000) (defining "eligible contract participant").

152. Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, Exchange Act Release No. 54,106, 71 Fed. Reg. 39,534 (July 13, 2006) (adopting CFTC Rule 41.15 and adding Exchange Act Rule 3a55-4).

153. *See Commodity Futures Modernization Act of 2000 Hearing, Colby Testimony*, *supra* note 147, at 11–12.

154. Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 27,017, 54 Fed. Reg. 30,013 (July 18, 1989) (adopting Exchange Act Rule 15a-6). Based upon a recent speech by SEC Director of Market Regulation, Eric R. Sirri, it seems possible that the SEC staff may currently support incremental liberalization of the limited safe harbor for foreign broker-dealers contained in Exchange Act Rule 15a-6. Eric R. Sirri, Dir., Div. of Mkt. Regulation, SEC, Speech in Boston, Massachusetts: Trading in Foreign Shares (Mar. 1, 2007), *available at* http://www.sec.gov/news/speech/2007/spch030107ers.htm [hereinafter *Trading in Foreign Shares*].

155. *See* Concept Release: Regulation of Exchanges, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485 (June 4, 1997). This issue does not seem likely to be resolved in the foreseeable future. *See Trading in Foreign Shares*, *supra* note 154, at 24, 27–28.

law. The SEC lacks a clear Congressional or other policy direction with respect to the roles of international cooperation, competitiveness of U.S. and non-U.S. financial institutions, and U.S. investor access in the calculus that it must make when making rules, issuing orders and taking other actions under the Exchange Act. Therefore, there may be no specific legal basis for according these factors much weight, and it is difficult for the staff to counterbalance these factors against other concerns that they are charged with, such as investor protection.

As our principal exchanges combine and affiliate with foreign markets,[156] there is likely to be accelerating pressure on the SEC to develop a more effective framework for U.S. investor access to foreign securities products and services, including access to foreign securities exchanges. Perhaps it is time for a larger reconsideration of whether the Commission should have more specific policy direction in regard to the role of international competition and investor access to foreign products and markets.[157]

IV. RECOMMENDATIONS FOR REFORM

A. ESTABLISH NEW STANDARDS OF CONDUCT FOR MARKET PARTICIPANTS THROUGH THE RULEMAKING PROCESS AND NOT IN THE CONTEXT OF INFORMAL STAFF POLICY DETERMINATIONS, EXAMINATIONS AND INSPECTIONS AND ENFORCEMENT ACTIONS

As outlined above, the Exchange Act carefully crafts administrative procedures for rulemaking, issuing orders, and approving SRO rule filings. These procedures (a) direct that certain factors, including competitive effects, be considered, (b) provide for notice and public comment, and (c) provide for an appeal process. All of this is subverted when the SEC effectively establishes new rules through industry enforcement settlements, offhand comments in settlements, remedial "recommendations" in OCIE inspection or examination reports, or unofficial statements in Commissioner or senior staff speeches. None of these processes require the same degree of balanced consideration and transparency as rulemaking does. These

156. *See, e.g.*, Press Release, New York Stock Exch., NYSE Euronext to Commence Offer for Euronext Shares (Feb. 15, 2007), *available at* http://www.nyse.com/press/1149157439121.html; Press Release, New York Stock Exch., NYSE Group to Purchase 5% Equity Interest in National Stock Exchange, India's Largest Financial Marketplace (Jan. 10, 2007), *available at* http://www.nyse.com/press/1168342114215.html; Press Release, N. Y. Stock Exch., NYSE Group and Tokyo Stock Exchange Enter Strategic Alliance (Jan. 31, 2007), *available at* http://www.nyse.com/press/1170156819950.html; Press Release, Nasdaq, Acquisition of Shares in LSE Group PLC (Feb. 10, 2007), *available at* http://www.nasdaq.com/newsroom/news/pr2007/ne_section07_014.stm.

157. *See Trading in Foreign Shares, supra* note 154.

informal standard setting processes also deny affected parties the possibility to voice their positions or present relevant data. Therefore, establishing industry standards by means other than rulemaking certainly burdens competition, and does not take into account the full scope of policy considerations which Congress intended.

Thus, despite the difficulties inherent in the process of rulemaking, the SEC should not give in to the temptation to "take the easy road" in establishing industry-wide standards of conduct through these other means. In addition, the Commission should seek to ensure that the legal positions of the Divisions of Market Regulation and Enforcement and OCIE are closely aligned, and that their inspection and examination process and rulemaking priorities are in synch.

B. Reform the Procedures for Approvals of SRO Rule Proposals in Order to Make More Types of Proposals Eligible for "Effective on Filing" or Other Expedited Processing

The staff of the Division of Market Regulation diligently and intelligently scrutinize SRO rule filings with a cautious eye for anti-competitive and discriminatory concerns. However, in many cases the benefits of such scrutiny do not outweigh the burdens on competition implied by delay. In some instances, the concerns raised in staff reviews are hypothetical or nonsubstantive. SROs, when functioning in their capacity as market operators, compete vigorously with each other for issuer and product listings, trading volume in multiple listed securities, market data revenues, and new member organizations (among other things). Delays in introducing new rules or trading systems directly burden that competition. Moreover, Commission review of all SRO filings, even those that are truly non-controversial, is an enormous drain on staff resources that could be better deployed in processing more significant filings and doing the leg work necessary for rulemaking.[158]

The SEC should take several actions. First, it should dust off and extend, its former proposed Rule 19b-6[159] so that fewer SRO rule filings would get full pre-effective reviews. The Exchange Act invites this in section 19(b)(3)(A), and the Commission should use this statutory authority to reduce procedural barriers to competition. Many elements of the 19b-6 proposal were sound, including the elimination of pre-filing submissions and pre-effective periods for "non-controversial" filings, and permitting

158. *See generally* SEC OPERATIONS, *supra* note 18, at 14–16.
159. *See* Rule Changes by Self-Regulatory Organizations, Exchange Act Release No. 43,860, 66 Fed. Reg. 8912 (proposed Feb. 5, 2001). *See also supra* note 138 and accompanying text.

certain trading rule changes to be effective on filing.[160] Beyond this, the SEC should give more definition and be liberal about which rule filings are eligible for the "systems change" category.[161] Moreover, now that most exchanges are demutualized and members are less involved in exchange governance than in the past, a more expansive view of which changes to an exchange's governance structure and governing documents should be eligible for effective on filing treatment (or should be excluded from the definition of "rule" and "proposed rule change" under the Exchange Act and Rule 19b-4 altogether). There is little risk that anticompetitive or discriminatory rule proposals will find their way into the permanent structure of the markets, since the Commission retains the power to summarily abrogate rule filings that are effective upon filing.[162] If necessary, the SEC could recommend that Congress extend the period during which it could summarily abrogate rule filings as a trade-off for expansion of effective upon filing treatment.[163]

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160. *Id.*

161. *See* Exchange Act Rule 19b-4(f)(5), 17 C.F.R. § 240.19b-4(f)(5) (2006).

162. *See* Exchange Act § 19(b)(3)(C), 15 U.S.C. § 78s(b)(3)(C) (2000).

163. One concern that is latent in the expansion of "effective upon filing" treatment is the extent to which SROs may assume that proposed rule changes which become effective under section 19(b)(3)(A) enjoy the benefits of preemption from state law and immunity from antitrust challenge under the doctrine of implied repeal, since there is no Commission order approving such rule changes. This uncertainty stems in part from the language of the statute, which provides that a rule change filed pursuant to section 19(b)(3)(A) becomes effective immediately and may be enforced by the SRO "to the extent it is not inconsistent with the provisions of this chapter, the rules and regulations thereunder, and applicable Federal and State law." *See* Exchange Act § 19(b)(3)(C). With regard to antitrust immunity, in its proposing release for Rule 19b-6, the SEC stated:

> Subsection (h) of Rule 19b-6 clarifies that where a proposed rule change becomes effective upon filing pursuant to section 19(b)(3)(A) of the Act, no inference may be made regarding whether the proposed rule change is in the public interest, including whether it has an impact on competition. Although the Commission intends to conduct a review of proposed rule changes that are effective on filing in order to determine whether they raise significant issues requiring abrogation of the filing, the Commission will not be taking final action unless it chooses to abrogate the proposed rule change and subsequently issues an order approving or disapproving the proposal pursuant to section 19(b)(2) of the Act. Therefore, the Commission will not necessarily have made a final determination on whether the proposed rule change is in the public interest, including whether it has an impact on competition, where the proposal has become effective upon filing pursuant to section 19(b)(3)(A) of the Exchange Act. Absent a Commission order approving the proposed SRO rule change pursuant to section 19(b)(2), a person may not necessarily draw conclusions about whether the proposed rule change is in the public interest, including whether it has an impact on competition.

Rule Changes by Self-Regulatory Organizations, Exchange Act Release No. 43,860, 66 Fed. Reg. 8912, 8917 (proposed Feb. 5, 2001). Because many SRO rules directly or indirectly authorize joint action among members, the absence of clear antitrust immunity could be a significant stumbling block. *See* Letter from Meyer S. Frucher, Chairman and CEO, Philadelphia Stock Exch., to Jonathan G. Katz, Sec'y, SEC (Apr. 6, 2001), *available at* http://www.sec.gov/ rules/proposed/ s70301/frucher1.htm (concerning proposed Rule 19b-6).

Second, the staff should curtail its current practice of reviewing each filing that is made pursuant to section 19(b)(3)(A) and holding over the SROs the threat of rejecting filings as incomplete or defective if the SRO implements the rule change.[164] The staff should allow the filings to become effective and use their power to abrogate more liberally. In that way, the true effects of the filing can be observed, and any required amendments can be made on a post-effective basis.

Third, with respect to those rule filings that truly raise competitive implications, the staff should include in the approval orders a detailed analysis of competitive effects and policy justification for competitive impacts that are determined to exist. It is doubtful that any one model of competition analysis is "the right one." However, it is certain that if the SEC adopts a different standard and approach to competition analysis in each of its official actions (or merely, as it does in the case of most SRO rule filing approvals, recites that it does not view the filing as having an adverse impact on competition), virtually any result can be justified.[165] A more detailed analysis would permit market participants to analyze prospectively how the Commission is likely to view the competitive impact of a given proposal while it is in the formulation stage. It would also, where appropriate, facilitate appeals.

There is a similar concern with preemptive effects on state law. *See* Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119, 1132 n.18 (9th Cir. 2005) (leaving open the question of whether SRO rules that have become effective upon filing under section 19(b)(3)(A) of the Exchange Act pre-empt inconsistent state law); Brief for the SEC, NASD Dispute Resolution v. Judicial Counsel of Cal., 232 F. Supp. 2d 1055, 1055 n.11 (N.D. Cal. 2002) (No. C 02 3486 SBA), *available at* http://www.sec.gov/litigation/briefs/nasddispute.htm.

However, to the extent that SROs are concerned about preemption and antitrust issues, they always have the option to submit a filing under section 19(b)(1), (2) and obtain a Commission order approving the filing. *See* Exchange Act § 19(b)(1), (2), 15 U.S.C. § 78s(b)(1), (2) (2000).

164. Naturally, there is some risk that an SRO rule change actually is technically or substantively defective. *See, e.g.*, Filings by Self-Regulatory Organizations of Proposed Rule Changes and Other Materials with the Commission, Exchange Act Release 15,838, 44 Fed. Reg. 30,924 (May 29, 1979) (containing a discussion of defective filings). However, a fatally defective filing that was inconsistent with the Act and the SEC's rules presumably could not be enforced by the SRO in any event.

165. This suggestion is not meant to suggest that a more coherent and explicit approach to competition analysis in its SRO rule filing approval order would make them more susceptible to court challenge. The standards that the SEC is charged with implementing are very general, and courts are extremely deferential to expert regulatory bodies, such as the SEC, in their analysis of the types of complex and technical issues that arise in such contexts as securities market competition. *See, e.g.*, Domestic Sec., Inc. v. SEC, 333 F.3d 239 (D.C. Cir. 2003); *see also* Oesterle, *supra* note 11, at 3.

C. ESTABLISH BY REGULATION (OR REQUEST THAT CONGRESS, THROUGH AN AMENDMENT TO SECTION 19 OF THE EXCHANGE ACT) A TIME LIMIT FOR PUBLISHING SRO RULE FILINGS FOR PUBLIC COMMENT

Although this will no doubt result in more actions to disapprove filings (which would be a regrettable burden on staff resources), there is no better way to improve the pace and transparency of the process overall. This proposal would eliminate the possibility of significant SRO actions which could promote competition from being stalled at the staff level, thereby acting as a barrier to new entrants to challenge the status quo, while the staff considers the filing. It would also force out earlier in the process the full range of comment by interested parties.

D. LIBERALIZE THE USE OF NO-ACTION AND EXEMPTIVE RELIEF IN AREAS WITH A COMPETITIVE IMPACT, INCLUDING NEW PRODUCTS AND PROPOSALS—PERHAPS USING MORE READILY "GENERIC" NO-ACTION LETTERS AND TEMPORARY OR PILOT APPROVALS TO ENABLE THE COMMISSION STAFF TO STUDY THE IMPACT OF THE APPROVALS

The rulemaking process is too blunt an instrument to capture all of the permutations and variations in businesses being regulated, and to adapt to unforeseen changes in technology and business methods. No-action letters, temporary rules and pilot programs are "escape valves" to permit legitimate activities that do not contravene the law or the spirit of regulation and are meant to be used. They do not commit the SEC to being stuck indefinitely with bad decisions.[166] If the principal constraint on these procedural vehicles is staffing, then the Commission should make it a priority to increase staffing for this purpose.[167] Perhaps a statement of policy by the Commission, giving direction to the Division Directors and the staff, would encourage the staff to be bolder in recommending or granting relief.

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166. No-action letters also can be granted on a temporary basis. *See, e.g.*, REDI System, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 444 (Mar. 29, 2002). They may also be withdrawn if facts or Commission policies change. *See, e.g.*, Domestic Securities, Inc., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 756 (Oct. 21, 2005); Dominion Resources, Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (Mar. 7, 2000).

167. *See* SEC OPERATIONS, *supra* note 18, at 14–16.

E. Recognizing that Markets are Increasingly International, Explicitly Seek to Permit Cross-Border Products and Services (or Consider Requesting Congress to Add to the Statutory Factors that the SEC Should Consider in Rulemaking and Other Official Action)

The SEC lacks a comprehensive framework for balancing international issues, including the competitive position of U.S. financial institutions and U.S. investor access to foreign markets and products, against other policy issues. As a result, such issues are given relatively little weight. International competitiveness and freedom of access should be considered as a matter of course when developing rulemaking and taking other official actions. Perhaps this can only be effected on a systematic basis by amending the Exchange Act.

V. CONCLUSION

Although the Exchange Act provides an appropriate mechanism for balancing the roles of the SEC and competitive forces in developing market structure in the context of *formal* SEC actions, such as rulemaking, there are several respects in which the system of regulation established under the Exchange Act operates in practice to burden competition unnecessarily. If the modest procedural reforms described in this article are adopted they should promote the general goals of the Exchange Act to alleviate a number of constraints on competition and innovation without compromising the Exchange Act's other policy objectives.

NOTE

THE TRIANGLE SHIRTWAIST FIRE AND THE MERRILL LYNCH ANALYST RATINGS SCANDAL: LEGISLATIVE AND PROSECUTORIAL RESPONSES TO CORPORATE MALFEASANCE

I. INTRODUCTION

The New York City of 1911 was very much the same as the New York City of 2001. Both boasted new economies churning out wealth for the nation on a massive scale. Both were mostly unregulated playgrounds filled with sharp dealing and corner cutting, and both systems were unsustainable.[1] Both eras were marked by scandal: the Triangle Shirtwaist Fire of 1911 and the Merrill Lynch analyst rating scandal of 2001. The fire and the analyst scandals were both major events in New York City's and the nation's histories, and these scandals put a face on growing economic threat to millions of Americans.

Transcending traditional governmental roles, New York State Assembly Majority Leader Al Smith and New York State Attorney General Eliot Spitzer attempted unique solutions within New York State in response to the problems that caused each tragedy. This Note will examine the different methods each used and evaluate the relative effectiveness of each method.

While Al Smith responded to the Triangle Fire with a series of legislative reforms, Spitzer pursued corporate malfeasance with ad hoc investments and media campaigns. Both solutions successfully prevented future malfeasance in the short term, yet the long term effects of a legislative solution provide a base for future reform and set a baseline of acceptable behavior. Investigations and widely publicized settlements may pillory the corporate bad actors, but they also seem to have few lasting effects and are deeply tied to the future office holders' decisions on how to use the assets of their office.

As New York State Assembly Majority Leader, Al Smith used the specially created Factory Investigating Commission as a tool to pass more than thirty-two new laws governing worker safety, most of which were signed into law.[2] All modern worker safety laws are built upon this

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1. *See* DAVID VON DREHLE, TRIANGLE: THE FIRE THAT CHANGED AMERICA 13 (2003) (citing the massive growth in New York City around the turn of the century).

2. *See* ROBERT A. SLAYTON, EMPIRE STATESMAN: THE RISE AND REDEMPTION OF AL SMITH 98 (2001).

legislative base.[3] In fact, Franklin Roosevelt once said of the New Deal: "Practically all the things we've done in the federal government are like things Al Smith did."[4] Smith is also praised today by opponents of federal power for using New York State as a laboratory of democracy to pass laws that, once they demonstrated their effectiveness, were passed by the federal government.[5]

Eliot Spitzer has used the Attorney General's office to pursue corporate reforms, but he has chosen to use the prosecutorial tools of his office, specifically the far ranging Martin Act,[6] to publicize corporate criminality, rather than trying to twin that with an attempt to affect systemic reform through codification.[7] The Martin Act was meant to fight fraud, and it allowed Spitzer to "subpoena witnesses, compel their attendance, examine them under oath . . . and require the production of any books or papers . . . deem[ed] relevant or material . . ." to his investigations.[8] The law does not require the attorney general to impose a judicial sanction or even to charge the subjects of these inquiries with a crime.[9] Spitzer used the power given to him under the Martin Act to compel disclosure of Merrill Lynch's internal e-mails, which he then disclosed to the press.[10] This tactic led to a public shaming of Merrill Lynch, as the e-mails disclosed that Merrill Lynch analysts and star technology analyst Henry Blodget were publicly touting stocks they privately derided.[11]

Al Smith used the publicity from his investigations to become the first Catholic Governor of New York State and later the first Catholic major party candidate for President.[12] Eliot Spitzer has also parlayed the publicity from his investigations into his election as Governor of New York State, and his national reputation raises the possibility that he too may run for

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3. *Id.* (dust jacket).

4. *Id.*

5. BROOKE A. MASTERS, SPOILING FOR A FIGHT: THE RISE OF ELIOT SPITZER 14 (2006). Smith's legislative program was, as Roosevelt said, the intellectual forbearer of the New Deal. It should be noted, however, that Smith later publicly broke with Roosevelt and claimed that Roosevelt's reforms went far beyond anything Smith had created while he was Governor and State Assembly Majority Leader in New York State.

6. N.Y. GEN. BUS. LAW art. 23-A, §§ 352 to 359-h (McKinney 2005).

7. *See id.* § 352. *See also* Nicholas Thompson, *The Sword of Spitzer*, LEGAL AFFAIRS MAGAZINE, May/June (2004), at 2; Ben White & Robert O'Harrow, Jr., *Wall Street Probe Puts Prosecutor in Spotlight*, WASH. POST, Apr. 24, 2002, at A1.

8. N.Y. GEN. BUS. LAW § 352.

9. *See id.*

10. CHARLES GASPARINO, BLOOD ON THE STREET: THE SENSATIONAL INSIDE STORY OF HOW WALL STREET ANALYSTS DUPED A GENERATION OF INVESTORS 246 (2005).

11. *Id.* at 246–47.

12. *See* SLAYTON, *supra* note 2, at 299, 321–22. Smith was elected Governor in 1918. After losing his re-election campaign in 1920, as a result of a Republican landslide, he was returned to office in 1922. Smith served as Governor until he ran for President in 1928 and lost to Herbert Hoover.

President someday.[13] Their differing responses to corporate malfeasance show two possible solutions state actors can employ to check quasi-criminal behavior, and these solutions should be an instructive lesson in government responses to future corporate scandals.

Americans became aware of the massive nature of corporate scandals through the very public failure of WorldCom and Enron. These failures and the ensuing stock market decline sparked the drive for corporate reform.[14] Spitzer's investigations fed the growing din for change, but they were neither the sole precursors nor the main impetus for reform.[15]

Focusing on Spitzer's first investigation of Merrill Lynch, it is possible to see how an abuse of the system could have been corrected by state, and later federal, legislation. By not using the momentum gained by the stunning disclosures of stock analysts' practices to support meaningful legislative change, this Note concludes that Eliot Spitzer lost a golden opportunity to either let New York State take the lead in regulating stock analysts or put forth proposals for legislation based on his unique experience and perspective regarding what had gone wrong at Merrill Lynch. By staying silent, Spitzer robbed legislators of the benefit of his experience and made an already difficult job even more impossible.

Part II of this Note examines the traditional roles of Tammany Hall, the political machine that spawned Al Smith, and the traditional roles played by Eliot Spitzer's predecessors as State Attorney General. In addition, this Part also examines New York's factory economy at the turn of the 20th century and its financial markets at the dawn of the 21st. Part III recounts the Triangle Shirtwaist Fire and the legislative path to reform. Part IV tells the story of the Merrill Lynch stock analyst ratings scandal and analyzes the effectiveness of Eliot Spitzer's reforms. Part V explains the criminal justice system's failure to serve a deterrent or retributive role for the corporate actors involved. Part VI examines Spitzer's preference for a prosecutorial or investigative solution and concludes that a legislative solution to corporate malfeasance, along the lines of Al Smith's Factory Investigating Commission, would have served the public far better than Eliot Spitzer's use of the Martin Act.

13. Many national publications have touted a potential Spitzer candidacy for President. Spitzer, for his part, has not claimed national ambitions, but by the same token he has done little to discourage these Presidential speculations. If Spitzer's public comments on running for Governor were any indication, a run for President may well be in the cards. *See* Raymond Hernandez, *Finding Fraud On Wall St. May Be Step to Higher Post*, N.Y. TIMES, April 29, 2003, at C4.

14. John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57 (2005).

15. *Id.* at 57–59 (discussing the scope of the Enron fraud).

II. BEGINNINGS

A. NEW YORK CITY AT THE TURN OF THE 20TH CENTURY

By the dawn of the 20th century, New York City's primary industry was manufacturing.[16] Factories hummed from dawn until well past dusk, churning out products that traveled across the country and the world. One of the major contributors was New York's garment industry.[17] In 1791, Alexander Hamilton had estimated that two-thirds to four-fifths of American clothing was home-spun, but by the 20th century almost all clothing was store bought.[18] This rapid change was a result of several factors. The increased movement of Americans to cities, combined with the specialization of farmers and the democratization of concepts like leisure time and fashion, brought a need for more and better quality clothes.[19] City dwellers bought their clothes in department stores while rural residents ordered theirs from mail-order catalogues. Technological innovations had made it easy to mass-produce garments, but these machines caused a massive demand for cheap labor, which the influx of eastern European immigrants around the turn of the 20th century rapidly met.[20] The means and scale of production had changed, as had the relationships among worker, manager, and owner, but the laws regulating factories and protecting workers were stuck in a much earlier age.[21]

According to a survey taken in the 1890s, the average work week for immigrant garment workers was eighty-four hours a week, which translated to twelve hours a day, seven days a week.[22] A dependent and impoverished class of workers cried out to muckraking journalists and social reformers for help, yet the New York State Legislature and the New York City Council voted down or buried legislation that would ameliorate their harsh working and living conditions.[23] Industrialists had created an alliance between business and urban political machines.[24] Immigrants from Ireland, Italy, Germany, and, to a lesser extent, Jews from Russia and Eastern Europe made up the predominant support for the machines.[25] The stalwart machine voters were often the most exploited workers, but it was not until the early 20th century that machine politicians and reformers formed an alliance to create worker protections.

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16. DREHLE, *supra* note 1, at 15.
17. *Id.* at 41.
18. *Id.* at 39.
19. *Id.* at 44.
20. *Id.* at 39.
21. *Id.* at 15.
22. *Id.* at 41.
23. *See* CHRISTOPHER M. FINAN & ALFRED E. SMITH: THE HAPPY WARRIOR 88–89 (2002).
24. *See id.* at 89.
25. OLIVER E. ALLEN, THE TIGER 145–46 (1993).

Machine leaders were initially reluctant to join forces with reformers. First, "reform" candidates routinely ran against machine candidates for office and, as a result, machine leaders saw reformers as their main enemy at the ballot box.[26] Second, political machines gained financial support from industry leaders.[27] In fact, many machine leaders were the very same businessmen who benefited from lax worker protections.[28] Most importantly, however, in the years before social welfare and the safety net, the political machine was the safety net, and replacing it with government protections would threaten the machine's ability to dole out benefits and reap the rewards on Election Day.[29]

In his book *Plunkitt of Tammany Hall*, William Riordon describes a day in the life of the esteemed Tammany Hall District Leader, and sometime State Senator, Alderman and City Councilman George Washington Plunkitt.[30] In the course of an average day, Plunkitt fed and sheltered fire victims, helped constituents obtain civil service jobs, represented local drunks before a judge and promised funding for a local church.[31] Plunkett also made time to attend the weddings, funerals, religious services, christenings, confirmations, bar-mitzvahs and picnics that a District Leader must attend in order to keep touch with his constituents.[32] For his constituents, George Washington Plunkitt was *the* social safety net, and it was for this reason that many voters tolerated the corruption and graft so endemic in the 19th Century urban political machine.[33]

The appeal of machine leaders was so intertwined with their ability to dole out favors that using government as a tool of social change struck at their success. It also threatened to break the lucrative ties machines held to industry leaders. It would be a machine Democrat, however, who would harness the power of Tammany Hall and create protections for factory workers throughout New York State.

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26. *See id.* at 226 (citing, as an example, a Tammany leader and a reform activist working together).

27. *See id.* at 201.

28. *Id.* at 210. "Silent" Charlie Murphy, the legendary boss of Tammany Hall, was considered one of the most honest members of Tammany, and it was his patronage and support which allowed Al Smith to organize the Factory Investigations Commission. However, even he was not above graft. One of Murphy's major sources of income was the New York Contracting and Trucking Company, which leased piers from the City of New York and turned a 5,000% profit. Conflicts of interest like this were endemic and were even rationalized by Tammany supporters as "honest" graft. *Id.*

29. *See id.*

30. WILLIAM L. RIORDAN, PLUNKITT OF TAMMANY HALL: A SERIES OF VERY PLAIN TALKS ON VERY PRACTICAL POLITICS 90 (Meridian 1991) (1963).

31. *Id.* at 91–93.

32. *Id.* at 90–98.

33. *See id.*

B. MARKETING AND FINANCIAL SERVICES IN NEW YORK CITY TODAY

Today, New York City is no longer a manufacturing city.[34] Instead, the financial services industry has taken over as a pillar of the tax base and as an employment provider.[35] Commensurate to its explosion in New York City, the financial services industry has also experienced a tremendous growth in scope and visibility throughout American life. Money is no longer solid, and each bill paid or check written is no longer like a slice or chip off the bi-monthly loaf with the remainder stored under the mattress or in a bank.[36] Instead, a wide variety of investment products have turned money into liquid flowing in and out of the ever expanding portfolio of investments and liabilities carried by the average investor.[37] Today over 60% of Americans own stock either personally or through their retirement or pension plans.[38] Money now flows from one perception to another at the push of a button, and as investment opportunities continue to grow and Americans derive more and more wealth from investments instead of wages, Americans' need for information about the financial markets grows.[39]

The growth of company pension funds, mutual funds, and investing as a pastime and hobby has meant that now, more than any other time in history, average Americans have a direct stake in the stock market.[40] As a result, financial news and planning is no longer merely the province of the wealthy. This explosion of interest in finance and the stock market has been a boon to New York City, and it has once again made New York the center of a growing engine of business. Rapid growth and change, however, have quickly outpaced regulatory changes. New York State has traditionally played a very small role in the actual enforcement of financial regulations.[41] Almost every major financial institution has its main presence in New York City. However, until Eliot Spitzer, the New York State Attorney General traditionally maintained a hands-off policy on regulating Wall Street.[42]

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34. *See* Steven Kurutz, *He Heart (Made In) New York*, N.Y. TIMES, Jan. 9, 2005, at 12.

35. Heather Timmons, *New York Isn't The World's Undisputed Financial Capital*, N.Y. TIMES, Oct. 27 2006, at C1.

36. *See* Grover Norquist, *The Democratic Party Is Toast*, WASH. MONTHLY, Sept. 1, 2004, at 27.

37. *See* GASPARINO, *supra* note 10, at 96–97.

38. Norquist, *supra* note 36.

39. *See* GASPARINO, *supra* note 10, at 97.

40. *See id.* (noting that at the height of the bull market in 2000, American households held $7.7 trillion dollars in assets in the stock market, an almost nine-fold increase from American household stock holdings in 1980).

41. *See* Phillip Weinberg, *Office of N.Y. Attorney General Sets Pace for Others Nationwide*, 76 N.Y. ST. B.J. 10 (2001) (discussing the powers and role of New York State's Attorney General).

42. *Id.*

C. THE ROLE OF THE NEW YORK STATE ATTORNEY GENERAL: THEN AND NOW

The position of New York State Attorney General is often considered the waiting room of New York State politics—in fact, it is said that the initials of the office stand for Almost Governor.[43] In the past half century, almost every single Attorney General has run for higher office, so it should come as no surprise that the position often attracts publicity seekers.[44] One of only four statewide elected offices, the office of Attorney General offers the possibility of statewide media exposure and the promise of a path to election as either Senator or Governor. In fact, New York State's third Attorney General was none other than the original publicity seeking politician: Aaron Burr.[45]

The modern history of New York State's Attorney General Office is dominated by two street fighting ethnic politicians from New York City, Louis Lefkowitz and Robert Abrams. Louis Lefkowitz was first appointed in 1957 to replace Jacob Javitz, who had been elected to the Senate.[46] Lefkowitz followed the mold of the fiscally moderate and socially liberal policies of Nelson Rockefeller, and his tenure was marked by his desire to drive the debate on civil rights legislation in New York and his aggressive consumer oriented prosecutions.[47] Lefkowitz prided himself on a political independence and often, like his successor Robert Abrams, declined to defend Governor's actions in the courts.[48]

Abrams was also a native of New York City and, like Lefkowitz, found a kindred ideological spirit in the Governor with whom he served. Although Lefkowitz and Abrams were from different political parties, their focus in office remained the same. They were committed to the liberal ideals of social justice, as well as with bread and butter issues like consumer fraud. From 1992–2000, New York State saw two short term, undistinguished Attorney Generals. However, Eliot Spitzer's election in November 2000 marked the broadening of the Attorney General's Office and a new role for the Attorney General himself.

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43. Kathleen Lucadamo, *Rudy Shaking the Money Tree for Pirro,* N.Y. DAILY NEWS, Aug. 28, 2006.

44. Weinberg, *supra* note 41.

45. *See* New York State, Complete List of the Previous New York State Attorneys General 1626–Current, http://www.oag.state.ny.us/previous_aglist.html (last visited Jan. 13, 2007).

46. Weinberg, *supra* note 41.

47. *Id.*

48. Wayne Barrett, *Why Did Spitzer Defend Pataki?*, VILLAGE VOICE, July 8, 2003, at 24.

III. FIRE! THE TRIANGLE SHIRTWAIST FIRE AND THE LEGISLATIVE SOLUTION

A. FIRE BREAKS OUT: THE TRIANGLE SHIRTWAIST FIRE

Near closing time on Saturday afternoon, March 25, 1911, a fire broke out[49] at the Triangle Shirtwaist Company, located on the eighth, ninth and tenth floors of the Asch Building in New York City's Greenwich Village.[50] It started in a pile of rags and spread rapidly.[51] On the ninth floor, as workers tried to rush down the fire escape to safety, they found the doors to the fire escape chained shut.[52] Rather than burn to death from the flames or be asphyxiated by the smoke, workers leapt from the building onto the street below.[53] William G. Shepard, a correspondent for United Press, described the sound: "Thud-dead, thud-dead, thud-dead, thud-dead. Sixty-two thud-deads. I call them that, because the sound and the thought of death came to me each time, at the same instant. There was plenty of chance to watch them as they came down. The height was eighty feet."[54] Shepard completed his story with this message:

> The floods of water from the fireman's hose that ran into the gutter were actually stained red with blood. I looked upon the heaps of dead bodies and I remembered these girls were the shirtwaist makers. I remembered their great strike of last year in which these same girls had demanded more sanitary conditions and more safety precautions in the shops. These dead bodies were the answer.[55]

In its account of the fire, *The New York Times* also led with a damning indictment of a system that had come to see workers as expendable. The article stated:

> The building is fireproof. It shows hardly any signs of the disaster that overtook it. The walls are as good as ever so are the floors, nothing is the worse for the fire except the furniture and 141 of the 600 men and girls that were employed in its upper three stories.[56]

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49. DREHLE, *supra* note 1, at 116–19.
50. *Id.* at 46–47, 117.
51. *Id.* at 119.
52. *Id.* at 123, 127, 267. Chaining the doors shut was common practice by employers to prevent workers from leaving their benches during the work day.
53. *Id.* at 155.
54. William G. Shepherd, *Eyewitness at the Triangle*, MILWAUKEE J., Mar. 27, 1911.
55. *Id.*
56. *141 Men and Girls Die in Waist Factory Fire; Trapped High Up in Washington Place Building; Street Strewn With Bodies; Piles of Dead Inside*, N.Y. TIMES, Mar. 26, 1911, at 1. Several months before the fire broke out, the Triangle Shirtwaist Factory had been the setting for one of the most acrimonious battles of the labor movement. Blanck and Harris hired prostitutes and gangsters to defeat organizers from the International Ladies Garment Workers Union and after several violent clashes, defeated a plan to unionize the shop. The use of prostitutes to assault female workers was a common industry practice. *See* DREHLE, *supra* note 1, at 6–12.

By the end of the day, 146 bodies had fallen to the street or had been consumed by the flames.[57]

The owners of the factory, Max Blanck and Isaac Harris, like most of the fire victims, were first generation Jewish immigrants from Russia.[58] They had immigrated to America with little but the clothes on their back, and like their employees had spent the early part of their lives in the back-breaking conditions of the sweatshop.[59] Blanck and Harris worked their way up the ladder from small contract manufacturers, and by 1911, they were the largest shirtwaist manufacturers in the country.[60] Their lives seemed to be straight out of a Horatio Alger story. Born into poverty, they were now chauffeured to work and lived in neighboring townhouses on the fashionable Upper West Side of Manhattan. Blanck and Harris boasted cooks, maids, laundresses, governesses and, for Max Blanck's newborn baby, a nurse.[61] They were perfect models for the ethos that preached that hard work would eventually lead to success.

They were neither the cruelest factory owners nor the kindest, and their factories were neither noteworthy nor notorious; but it was the mundane quality of their business practices that made the ensuing disaster of the Triangle fire so disturbing. The question could now be asked: If a fire this large and this deadly could happen to the "Shirtwaist Kings," where else could it happen, and how many more people would have to die before anything changed?[62]

B. MR. SMITH GOES TO ALBANY

Into the breach stepped a politically ambitious product of Tammany Hall. Al Smith was born on Oliver Street, far from Blanck's and Harris's townhouses on the Upper West Side, but just one mile south of the Asch Building.[63] When Smith was fourteen his father died, and Smith was forced to work to support his family.[64] He was always proud of his work as a truck

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57. DREHLE, *supra* note 1, at 3, 155.

58. *Id.* at 38.

59. *Id.* The term sweatshop is used today to connote any working conditions that may be considered substandard or poor. In the 19th and early 20th centuries, however, the term was a description of a very specific type of operation that lay at the bottom of the manufacturing ladder. Newly arrived immigrants, otherwise know as greenhorns, were snatched up by unscrupulous contractors. The contractors provided, according to one survey, over ninety percent of all the garments manufactured in the trade. They would use crowded tenement rooms, often their own living quarters, and cram in as many immigrants and sewing machines as they could. In these dim, dirty, and claustrophobic conditions, the contractors "sweated" their workers, aiming to undercut their competition. *Id.*

60. *Id.* at 37, 44. Shirtwaists would be known today as blouses and in late 19th and early 20th Century life were an essential part of a women's wardrobe. Blanck and Harris became so successful that they were dubbed "The Shirtwaist Kings." *Id.*

61. *Id.* at 36–37.

62. *Id.* at 37.

63. SLAYTON, *supra* note 2, at 3.

64. *Id.* at 36.

chaser, and in later years, at the Fulton Fish Market and throughout his career, he would contrast his background with the Ivy League educated colleagues with whom he served.[65] In a telling anecdote from his service in the State Assembly, Smith was on the floor of the Assembly when the results of a recent crew race were announced.[66] One by one, his colleagues took turns taking the floor to extol their alma mater, each reciting the race in which his university had won, saying, "I'm a Harvard man" or "I'm a Yale man."[67] When Smith took the floor, in an act that caused much confusion among his colleagues, he proudly proclaimed himself an "F.F.M. man,"[68] which he later explained stood for the initials of the Fulton Fish Market.[69]

Despite his modest background, or perhaps because of it, Smith was recognized as a rising star by Tammany Hall leaders, and he was elected to the State Assembly in 1903 when he was barely thirty years old.[70] After his election Smith read bills and books on parliamentary procedure during the evenings, nights and weekends and soon became a master of the legislative process.[71] When the Democrats re-took the Assembly in 1910, Smith became Majority Leader of the State Assembly.[72] In the wake of the Triangle Fire, newly minted Majority Leader Smith was also named the Co-Chair of the Factory Investigating Commission, along with State Senate Majority Leader, and future U.S. Senator, Robert Wagner.[73] Through this Commission, Smith turned the tables on corporate accountability and found a new role for the urban political machine.[74]

C. THE FACTORY INVESTIGATING COMMISSION, IF YOU BUILD IT REFORM WILL COME

The Factory Investigating Commission was both a bully pulpit for Smith and a tool to reform manufacturing corporations. While it might have been given a different name at the time, Smith's pursuits were the corollary to Spitzer's crusade. Investigators on Smith's Commission uncovered what today might be described as "corporate malfeasance" on a truly shocking scale.

65. FINAN, *supra* note 23, at 61.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.* at 47.
71. DREHLE, *supra* note 1, at 203–04. Smith had been forced to leave school after eighth grade, which put him at a significant disadvantage compared to his better-educated colleagues.
72. *Id.* at 213.
73. *Id.*
74. *See id.*

The idea to create a commission was originally Smith's.[75] Rich people, he explained to the trade unionists, were "always very busy, and you can't get their attention for very long."[76] Smith suggested a legislative commission with the power to craft legislation.[77] In that instant, Smith wedded the power to reach New Yorkers through the sensational campaigns, to which muckrakers were accustomed, with the legislative power to affect change and actually change conditions rather than just decry them.

It was rough going for the Factory Investigating Commission at first. The New York State legislature appropriated only a $10,000 budget (a little less than $200,000 in today's dollars)[78] to the Commission for staff and expenses. The enabling act further restricted investigations to the nine largest cities in the state, and the Commission received jurisdiction over fire safety. However, when the Commission decided to look under the rocks of modern industrialism, and the Commission's stories began appearing in papers across the state, its mandate grew. Soon, newspapers began to cover the Commission's investigations, and the stories that followed tugged at the hearts of all New Yorkers. Husbands and wives worked opposing shifts at a rope factory in Auburn and had time to kiss each other goodbye only as their shifts began and ended.[79] In canneries, children as young as three worked eighteen hour shifts.[80] One child expressed the hopelessness, despair, and cruelty of his fate when he responded to a question asking how long he had been working by saying, "Ever since I was."[81]

As revelations of working conditions kept coming, public pressure buoyed Smith's legislative efforts. Through the Commission's work, New York State passed legislation that laid the groundwork for modern labor laws. Before the Commission, the law required buildings to be fireproof, but the buildings' occupants received no protection.[82] Smith passed legislation that mandated fire drills and sprinklers.[83]

The Commission expanded its purview and took on legislation regulating all aspects of factory working conditions.[84] Under the new

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75. *Id.* at 212–13.

76. *Id.*

77. DREHLE, *supra* note 1, at 213.

78. *Id.* at 213–14. To calculate inflation, see The Inflation Calculator, http://www.westegg.com/inflation (last visited Apr. 3, 2007). For this calculation, $10,000 was entered for "amount of money," 1911 was entered for "initial year" and 2006 was entered for "final year."

79. SLAYTON, *supra* note 2, at 97. When using the term "rich people," Smith was referring to a group commonly known as the "go-gos." The go-gos, short hand for good government types, were often the leaders of reform movements. But they were usually dilettantes in their interest in politics and quickly flitted from one fashionable reform cause to another.

80. *Id.* at 94–95.

81. *Id.* at 97.

82. *Id.*

83. *Id.* at 97–98.

84. DREHLE, *supra* note 1, at 214.

legislation, "[w]omen could not be forced to work for four weeks after a pregnancy; clean facilities for washing, eating, and toilet functions were also mandatory . . . ."[85] This change not only brought dividends for workers, but was also a victory for public health.[86] Children under fourteen could no longer work in cannery sheds or tenements, a small step towards the eventual banning of child labor.[87] Factories had to provide seats with backs for women.[88] Work for women was limited in canneries, and their hours of night work were also curtailed.[89] Slowly chipping away at the hours women were forced to work created a time for recreation and rest, which for Smith were essential elements in maintaining the values of family.[90] Losing his father at fourteen, watching his mother struggle, and working to support his family made this a personal cause for Smith. When critics asked him if his limits on night work for women went too far, he responded, "You can't tell me. I've seen these women. I've seen their faces. I've seen them."[91]

The Factory Investigating Commission produced thirty-two bills, most of which were signed into law.[92] Following its lead, New York City passed thirty ordinances.[93] New York State's Labor Commissioner had the power to close down any establishment and label any product "unclean" if there was evidence of a contagious disease.[94] By 1912, New York State had conducted 132,601 fire inspections.[95] By 1920, it had 123 factory inspectors.[96]

The Factory Investigating Commission combined the best aspects of legislative power and investigative tools. A staff brimming with eager reformers brought to light abuses that cried out for change.[97] Their actions alone were not noteworthy. In fact, reformers had been bringing these abuses to light for years. But now, their efforts combined with legislators who were determined to change the law.

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85. SLAYTON, *supra* note 2, at 97.
86. *Id.* at 97 (noting that physical inspections of bakery employees showed that thirty-five percent were afflicted with respiratory diseases, which they would transmit to customers by spitting on or drying their hands with dough).
87. *See id.* at 98.
88. *Id.* at 98.
89. *Id.*
90. SLAYTON, *supra* note 2, at 97.
91. *Id.*
92. *Id.* at 98.
93. *Id.*
94. *Id.*
95. *Id.* at 99.
96. *Id.* at 98.
97. Among those eager reformers were two very accomplished women, Belle Moskowitz and Frances Perkins. Belle Moskowitz became Smith's shadow and closest political advisor; Frances Perkins served for over twelve years as the first female Secretary of Labor. *See* Joyce Purnick, *Guess Who's Not Coming to Dinner*, N.Y. TIMES, Sept. 20, 2004, at B1; Frank Tomaino, *This Week in Mohawk Valley History*, OBSERVER-DISPATCH, Jan. 29, 2006, at 2F.

The Commission was able to hold the public's interest through sustained dramatic revelations of factory conditions that shocked and appalled New York State. Unlike previous campaigns, which through books, speeches, pictures, and exhibitions reached only an audience already in sympathy with progressive campaigners, the Commission captured a state-wide audience and held it with continuing revelations and exposés. The constant media drumbeat served as the fuel for reform. Without a continued media spotlight, those whose interests had successfully beaten reformers countless times before would have undoubtedly buried, stalled or blocked the legislation.[98]

V. SCANDAL! THE MERRILL LYNCH ANALYST RATINGS SCANDAL AND THE PROSECUTORIAL RESPONSE

A. ENTER SPITZER

In June 2001, another politically ambitious Democrat sought to seize the mantle of reform. Eliot Spitzer's past was almost the polar opposite of Al Smith's. The scion of a wealthy family, Spitzer was educated in exclusive private schools: he graduated from Princeton and earned a law degree from Harvard.[99] Spitzer didn't work within the Democratic Party while waiting his turn to run for office, but instead, leveraged his family money and connections to eke out a close victory against a weak Republican incumbent.[100]

Like their backgrounds, their approaches to corporate malfeasance were also different. While Smith sought to reform corporate practice through legislation, Spitzer chose publicity and prosecution.

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98. NANCY JOAN WEISS & CHARLES FRANCIS MURPHY, 1858-1925: RESPECTABILITY AND RESPONSIBILITY IN TAMMANY POLITICS 87 (1968). Prior to Tammany Boss Charlie Murphy's conversion, he was a key ally of the bosses. In fact *the* key ally. When a reform bill came up in the State Legislature, one Tammany legislator explained reality to a reformer: "I had a talk with Murphy. The bill is not going to pass." The bill did not pass. DREHLE, *supra* note 1, at 212.

99. Thompson, *supra* note 7.

100. *See generally* MASTERS, *supra* note 5, at 42–45. Swept into power during the Republican landslide of 1994 against a weak general election opponent, Dennis Vacco, the Republican defeated by Spitzer, was often derided as inept. The Vacco-Spitzer battle was waged in the shadow of the titanic battle between incumbent Senator Alphonse D'Amato and Representative Charles Schumer, but was no less vitriolic. Spitzer prevailed by 25,286 votes out of over two million cast. Vacco appealed the election to the New York State Court of Appeals, but conceded six weeks after the election. *See* Joshua Chaffin, *Spitzer Glitz and a humbling of Harvey Pitt: Attorney General's Role in Pitt's Downfall*, FIN. TIMES, Nov. 7, 2002, at 10; Joseph P. Fried, *Following Up*, N.Y. TIMES, Aug. 18, 2002, at 33.

B. THE MARTIN ACT, FROM OUT OF THE BLUE CLEAR SKY COMES SPITZER'S ANSWER

Spitzer's authority to compel the disclosure of Merrill Lynch's e-mails was based on New York State's Martin Act, which passed in 1921 and, interestingly enough, was signed into law by then-Governor Smith.[101] The Act gave a prosecutor in New York State virtually unchecked power to pursue fiscal malfeasance.[102] The Martin Act has its origins in the "Blue Sky" laws of the early 20th Century. The original authors of the Act called it the "blue sky" law for their contention that the targets of these anti-fraud statutes would "[s]ell you the sky if they could."[103] However, one might make the point that a purchaser foolish enough to make such a bargain might indeed fall within the bounds of caveat emptor.

The prosecutorial bark of the Martin Act allows the investigator a wide ambit in calling for the production of documents and affords limited protections to witnesses.[104] The criminal bite of the statute, however, is limited to misdemeanor prosecutions.[105] The statute's main intent seems not to be to aid a prosecutorial strategy, but rather to allow prosecutors a vast array of discovery weapons with which they can build fraud cases against con-artists and other tricksters. Spitzer's strategy was to combine the power of the Martin Act with public exposure and leverage the damage that would be done with the volatile nature of the stock market.

Spitzer's investigations were wide ranging and encompassed almost every sector of Wall Street, from late trading to the insurance industry.[106] The Martin Act and the press conference were his sword and hammer. This prosecutorial technique has been hailed as a new way for states to intervene in what has been traditionally a federal area.[107] As Spitzer moves to higher office though, the question becomes: Have Spitzer's tactics improved industry practices concerning stock market analysts, and are they more effective than the methods used by Al Smith and his Factory Investigating Commission?

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101. Thompson, *supra* note 7.
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.*
107. *See id.* (writing about the "unspoken agreement" that allows the Martin Act to be used against small time criminals but not "against the big boys").

C. HENRY BLODGET & MERRILL LYNCH, THE SCANDAL UNFOLDS AND A SCHEME UNRAVELS

If the industrial revolution was about turning human labor and raw materials into a finished product, the information revolution was about using human intellect to distill and organize raw information into cognizable and understandable data. Thus, as the doors of the stock market were flung open, a ravenous need for information developed. Traditionally, this need had been met by stock market analysts who were considered experts in certain fields or sectors of the economy. Their work was highly valued, but in the 1990's they found themselves besieged on all sides by unethical temptations and pressures.[108]

The case study of Merrill Lynch technology analyst Henry Blodget provides an example of the temptations of the typical tech stock market analyst. Blodget's actions, like those of factory owners Blanck and Harris, were typical to those in his profession. A former fact-checker and journalist, Blodget stumbled into stock analysis and shot to fame by predicting that Amazon.com would reach $400 a share, a prediction that the stock quickly reached and surpassed.[109] Blodget was then hired by Merrill Lynch in a highly publicized move to be a star financial analyst and, in Merrill Lynch's words, a "rainmaker."[110] Blodget was already one of the most well known voices of the bull market, and at Merrill Lynch he continued to urge the purchase of technology stocks.[111] Merrill Lynch used Blodget as a way to build its investment banking business,[112] billing him as part of a package deal. The pitch roughly became: use us and our analysts—especially Henry Blodget—will tout your stock.[113]

Initially, Blodget was extremely accurate in his stock picks, but the run up of the stock market during the bullish 1990's could not last forever. In internal e-mails and to his peers, even Henry Blodget discussed what he saw to be the end of the Internet bubble and the worthlessness of some of his stock picks.[114] When Eliot Spitzer gained access to Merrill Lynch's e-mails, these e-mails from Blodget were the smoking gun.[115] What emerged was a duplicitous pattern where Blodget would publicly announce that a

108. Ralph Sieland, *Caveat Emptor! After All the Regulatory Hoopla, Security Analysts Remain Conflicted on Wall Street*, 2003 U. ILL. L. REV. 531, 536 (discussing the challenges faced by analysts trying to steer clear of conflicts of interest).

109. Ryan Underwood, *Relics of the New Economy: Where Are They Now?*, FAST COMPANY, Mar. 2004, at 61.

110. Mara Der Hovanesian, Louis Lavelle & Tom Lowry, *How Analysts' Pay Packets Got So Fat*, BUS. WK., May 13, 2002.

111. GASPARINO, *supra* note 10, at 41.

112. *Id.*

113. *See id.*

114. *Id.* at 246.

115. *Id.*

stock "presents an attractive investment," while he would privately e-mail a co-worker that he couldn't believe "what a POS [piece of sh-t]" the stock was.[116] In a particularly egregious example, Blodget publicly called Infospace.com "one of the best ways to play the wireless Internet."[117] Yet, privately, he referred to it as "a piece of junk."[118] On June 11, 2000, when Blodget made his predictions, Infospace.com's stock closed at $596.88, on a volume of 579,310 shares.[119] On March 18, 2007, Infospace.com closed at $25.14 a share, on about the same volume as June 11, 2000, a drop of over 96.5% in value.[120]

It is important to note that Infospace.com was a major Merrill Lynch investment banking customer, and Blodget's compensation, like that of many other analysts, was tied to investment banking profits.[121] The nature of the stock market thrust analysts like Blodget into highly public roles where their predictions affected billions of dollars in stock value, yet their activities as analysts generated few if any direct profits for investment banks.[122]

It is easy to concentrate on the eye popping amounts of stock value that were lost during the tech stock bust, but it is important to remember that these lost billions represented retirement and college funds, lost homes and broken families. The sudden drop in the stock market led many people to begin to cast around for blame. Stock analysts who had been feeding the boom with rosy predictions, which they broadcast on CNBC, magazine, newspapers, and websites, were the most obvious targets.[123]

One of those investors was Debasis Kanjilal.[124] Kanjilal had invested over $500,000 in two technology stocks, one of which was Infospace.com, on the advice of Henry Blodget's reports.[125] Kanjilal's lawyer alleged that conflict tainted Blodget's analysis—Infospace was seeking to acquire Go2Net, a Merrill investment banking client.[126] Although Spitzer had not

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116. Alan T. Saracevic, *Pulling Curtain Back on Hype-Master Blodget*, S.F. CHRON., Apr. 14, 2002.

117. Ron Insana, *The People v. Wall Street: New York's Attorney General Probes Analysts' Conflicts of Interest,* MONEY MAGAZINE, June 2002, at 71.

118. Joseph Nocera, *Led Into Temptation, Who Wasn't*, N.Y. TIMES, Sept. 2, 2005 at C1.

119. About Infospace@Investor Relations, Historical Price Lookup, http://investor.infospace inc.com/stockLookup.cfm (last visited Mar. 18, 2007).

120. This figure was calculated by dividing the March 18, 2007 close by the June 11, 2001 close. *Id.* Infospace is only one of the stocks touted by Blodget, however, almost all the other stocks cited in the Spitzer press release are either for companies who have been bought or have gone bankrupt.

121. *See* Sieland, *supra* note 108.

122. *Id.* The situation was so skewed that investment banks listed their analyst sectors an unmitigated liabilities on their balance sheets.

123. Marcia Vickers, Mike France, Emily Thornton, David Henry, Heather Timmons & Mike McNamee, *How Corrupt is Wall Street?*, BUS. WK., May 13, 2002, at 1.

124. GASPARINO, *supra* note 10, at 206.

125. *Id.* at 206–07.

126. *Id.* at 208.

filed any criminal charges against Merrill Lynch, he did have enough evidence to fulfill the Martin Act's requirement that Merrill Lynch's behavior was part of a "scheme or artifice." [127] As a result, Spitzer was able to launch an investigation.[128] In April 2001, the office subpoenaed all documentation from Merrill that concerned initial public offerings (IPOs), stock recommendations, and compensation for research analysts like Blodget.[129] After wading through e-mails, Spitzer's investigators struck gold in Blodget's comments.

D. SPITZER TO THE RESCUE! REFORMS AND RESPONSE TO THE SCANDAL

Spitzer immediately published the revelations in a stunning press release that distilled the over 100,000 pages of Merrill Lynch documents and e-mails into one clear message: Merrill Lynch analysts knew the stocks they were pushing were poor investment choices.[130] Forty-three days after Spitzer's press release, Merrill Lynch settled.[131] Merrill Lynch made no admission of guilt and paid only a $100 million fine, which, to put their penalty in perspective, is less than the volume of Infospace.com for two and one half hours after Henry Blodget's recommendation.[132] From Spitzer, Blodget received a pass and was not charged with any offense.[133] Only the NASD charged Blodget with securities fraud and forced him to pay a $4 million fine. At no point was Blodget required to admit any wrongdoing, but he was banned from any future stock market involvement.[134] Nevertheless, in a rejoinder to F. Scott Fitzgerald's contention that "there are no second acts to American lives,"[135] he currently writes a column for Slate.com and an investor-based blog.[136] In addition to Blodget, his

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127. N.Y. GEN. BUS. LAW § 352 (McKinney 2005).

128. *See* Roberta S. Karmel, *Do Financial Supermarkets Need Superregulators?*, 28 BROOK. J. INT'L L. 495, 520–21 (2003).

129. GASPARINO, *supra* note 10, at 217–18, 239.

130. Thompson, *supra* note 7.

131. Press Release, Office of N.Y. State Att'y Gen. Eliot Spitzer, Spitzer, Merrill Lynch Reach Unprecedented Agreement To Reform Investment Practices (May 21, 2002) [hereinafter Reform Investment Agreement].

132. Total calculated by multiplying the closing price by the total volume of the day and dividing by the number of hours the stock exchange operates. About Infospace@Investor Relations, Historical Price Lookup, http://investor.infospaceinc.com/stockLookup.cfm (last visited Mar. 24, 2007).

133. GASPARINO, *supra* note 10, at 260.

134. *Id.* at 308–09.

135. The Oxford Dictionary of Modern Quotations, http://www.koapp.narod.ru/english/diction/book7.htm (last visited Mar. 26, 2007).

136. Blodget's new role is that of an investor "watchdog" and his columns are filled with the conservative investment advice he once eschewed. In a recent column predicting that the now Justice Samuel Alito's stock portfolio qualifies him well to be a Supreme Court Justice Blodget writes, "The evidence that high costs, frequent trading, and tax-blind strategies reduce expected returns is in plain view, and there is a ton of it. This evidence, however, is often obscured or ignored by a vast cacophonous brokerage industrial complex (brokers, fund companies, amateur

supervisor, Jack Grubman, and other co-workers paid fines and made agreements similar to Blodget's.[137]

Spitzer did require, as a major portion of the settlement, that Merrill Lynch make reforms within its analyst department. Merrill Lynch made six substantive changes to its policies, which included prohibiting input from the investment department to analysts; severing the link between compensation for analysts and the investment banking department; creating a new investment committee to review analysts recommendations; creating a monitor for compliance; requiring that if research is discontinued for a company that Merrill Lynch's analysts previously covered, a report be issued on why this occurred; and finally, requiring disclosure in research reports if Merrill Lynch has received any compensation from a covered company in the past twelve months.[138]

"By adopting the reforms embodied in the settlement, Merrill Lynch is setting a new standard for the rest of the industry to follow."[139] Eliot Spitzer's comments in the wake of the settlement show his hope that the concessions he had wrung from Merrill Lynch would become standard.[140] From his statement, it seems that Spitzer viewed this settlement as a catalyst to force the industry to become self policing.[141] By creating an industry standard of the separation between analyst and investment banking functions, Spitzer would make it a viable option for other firms.[142]

An interesting analogy can be made to the noted labor leader Samuel Gompers and his position on Al Smith's factory reforms. Gompers was at the forefront of the movement to reform manufacturers but opposed government intervention because he believed that only a vibrant trade-union movement would make the manufacturing industry self-policing.[143] He felt that government intervention would not be effective and would handicap labor's ability to monitor management.[144] Gompers, like Spitzer, sought industry compliance without the force of legislation.

Buffetts, and personal-finance media) which, unlike the average investor *benefits* from trading fees, viewers, listeners, etc. The brokerage-industrial complex is so good at telling us what we want to hear…that its strategies have been accepted as conventional wisdom." Henry Blodget, *Sam Alito, Financial Whiz*, SLATE.COM, Nov. 3, 2005, *available at* http://www.slate.com/id/2129302/.

137. Editorial, *Finding Fraud on Wall Street*, N.Y. TIMES, Apr. 29, 2003, at A28.

138. Reform Investment Agreement, *supra* note 131.

139. *Id.*

140. *See id.*

141. *See id.*

142. *See id.*

143. Katerine Van Wezel Stone, *Rustic Justice: Community and Coercion Under the Federal Arbitration Act*, 77 N.C. L. REV., 931, 1010 n.516 (1999).

144. Howard D. Samuel, *Troubled Passage: The Labor Movement and the Fair Labor Standards Act*, MONTHLY LABOR REV., Dec. 1, 2000, at 32. Gompers protested statutes that would empower outsiders to decide any disputes which he felt should be kept between management and labor. At the 1913 American Federation of Labor Convention, Gompers was quoted as saying, "If it were proposed in this country to vest authority in any tribunal to fix by law

Congress's initial response to Spitzer's investigation of Merrill Lynch was a letter from Representative Richard Baker, Republican from Louisiana and Chairman of the Financial Services Subcommittee on Financial Markets, to the SEC and the forty-nine other state attorney generals asking them not to follow Spitzer's example and promising curbs on the powers from Congress if they did so.[145] Spitzer was not cowed by Baker's letter and continued to investigate the financial services industry.[146] Finally, the SEC did reach an agreement with Wall Street's major investment banks though the December 2002 "Global Settlement,"[147] which incorporated the benchmarks set in the settlement with Merrill Lynch. Eventually, many of these regulations would be grafted onto the Sarbanes-Oxley Act and adopted into law.[148]

E. AN ANALYSIS OF SPITZER'S EFFECTIVENESS

Investorside, a non-profit advocacy group created in the wake of the stock analyst scandals has been a tremendous beneficiary of Spitzer's actions, and the group invited him to speak at a recent conference.[149] Despite this relationship, by the group's own calculations, 95% of the top eighty-two firms on Wall Street have inherent conflicts of interests, the conflict being the basic existence of an investment banking department.[150] The numbers cast doubt on any claims that the system has changed.

Spitzer's investigations against stock analysts came to a final fruition when regulators forced the several structural reforms Spitzer had urged on Merrill Lynch on the brokerage industry as a whole.[151] In his speech to Investorside, Spitzer made the point that it may not be possible to measure the effectiveness of reforms "because market conditions change and there are too many variables."[152] That may well be true, and in this regard, the

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wages for men, labor would protest by every means in its power." *Id.* (quoting AFL Convention Proceedings 59 (1913)).

145. Jodi Schneider, *Keeping an Eye on the Funds, Low-key Congressman Watches out for "The Investor Class,"* U. S. NEWS & WORLD REP., Jan. 19, 2004, at 51.

146. Press Release, Office of N.Y. State Att'y Gen. Eliot Spitzer, Spitzer Responds to Rep. Richard Baker's Letter to the SEC (Apr. 30, 2005).

147. Press Release, Office of N.Y. State Att'y Gen. Eliot Spitzer, SEC, N.Y. Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices (Dec. 20, 2002).

148. *See* Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended at various sections of 11, 15, 18, 25, 28, and 29 U.S.C.).

149. Press Release, Investorside Research Association, Independents' Day 2005 Independent Research Conference (Apr. 13, 2005).

150. Scott Cleland, *Keep Feeding the Market's Best Watchdogs*, WALL ST. J., Jan. 9, 2004, at A11.

151. Janet Stewart Kidd, *With Analyst 'Sell' Signals Rare, Investors Need to be Alert,* BALTIMORE SUN, Sept. 10, 2006.

152. Eliot Spitzer, Att'y Gen. of the State of N.Y., Keynote Address at the Inverstorside Research Association's Independents' Day 2005 Conference (Apr. 13, 2005), *available at* http://www.investorside.org/conflogo/Transcript.pdf [hereinafter Spitzer Keynote Address].

evidence is very cloudy. Spitzer went on to claim success based on the fact that, "an analysis preformed by *U.S.A. Today*, given a hypothetical portfolio from brokerage analysts' recommendations, showed that the internal recommendations would have under-preformed industry benchmarks in '02, and in '03 and '04, they beat the S&P by 2.2 percentage points."[153] As Spitzer goes on to point out, this information is only a "relevant data point" and not the end of the conversation.[154] By that same token, a September 2006 analysis of analyst sell ratings showed a 32% drop in sell ratings from 10.4% in 2003 to 7.1% in September of 2006.[155] These two data points show the difficulty in determining whether or not reforms have changed the industry.[156]

The question of effectiveness is one that, especially in the context of this Note, should be examined with an eye to future effectiveness, not simply to short term changes in behavior. Spitzer did answer this question at the Investorside conference when he was asked whether there was a danger that the industry would revert back to its previous habits[157] Spitzer responded,

> [Y]es, very often there is a flow back, things do revert. The metaphor I've used is that what we've gone through is like watching someone else get a speeding ticket. Now your first response is, "I'm glad I'm not the one who was caught," your second response is to slow down for an exit or two on the thruway, and your third response is to put your foot on the gas pedal and say, "There won't be another trooper ahead."[158]

The important follow-up questions to ask, however, are whether watching another company get the equivalent of a speeding ticket will really alter behavior and whether there are, indeed, more troopers ahead.

VI. CRIME & PUNISHMENT, THE TRIAL OF BLANCK AND HARRIS AND THE TRIBULATIONS OF HENRY BLODGET

In both Smith's and Spitzer's situations, the criminal justice system was either unwilling or unable to punish those responsible. Although, in both men's defense, the bad actors were merely symptomatic of deeper problems within their respective industries, and the bad actors' behavior was no better or worse than their cohorts. It was only poor timing, and what Blanck, Harris, and Blodget might have claimed was bad luck that led to their becoming the public face for these societal ills.

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153. *Id.*
154. *Id.*
155. Kidd, *supra* note 151.
156. Spitzer Keynote Address, *supra* note 152.
157. *Id.*
158. *Id.*

Both situations also ended similarly. The trial of factory owners Blanck and Harris proved to be a great anti-climax, even though the men were set upon by grieving workers and relatives as they entered the courtroom and confronted by many witnesses who testified to the factory's failure to comply with the fire code.[159] Despite the overwhelming evidence, a Tammany judge and a exceptionally skilled defense lawyer, Max Steuer, combined to help acquit both owners of murder.[160] Blodget and his co-workers paid fines and agreed never again to tout stock, but none of the analysts responsible at Merrill Lynch were sent to jail or even tried in a court of law. Spitzer has spoken about his prosecutorial philosophy in many interviews but has never articulated a clear rationale for not charging Blodget.[161] The surprising fact about Spitzer's decision is that a spokesman for the Attorney General's Office commented on Spitzer's decision not to bring charges against analyst Jack Grubman by saying that because the Attorney General's Office could not find that "Grubman's public and private views were divergent."[162] Blodget's e-mails obviously fit the criteria for divergence on public and private views, yet the only action filed against him was by the NASD.[163]

For Spitzer, it seems that a white collar prosecution of all stock analysts was not feasible because of the cost and sheer magnitude of such prosecutions. Smith saw with Blanck's and Harris's acquittals that societal forces would simply not allow the imprisonment or execution of such prominent businessmen. In the face of a criminal justice failure, both Spitzer and Smith had to search for alternate solutions to remedy the endemic flaws in respectively, the financial services industry and the manufacturing industry.

VII. CONCLUSION: LEGISLATION V. PROSECUTION

As Attorney General, Eliot Spitzer was not shy in calling on the Congress and the New York State legislature to pass legislation on a variety of topics. In fact, scarcely weeks before he issued a press release on Merrill Lynch, Spitzer called on Congress to pass a prescription drug benefit and tied it to his decision to file a $100 million lawsuit against Aventis and Andrx for keeping cheaper generic drugs off the market.[164] The year before, Spitzer introduced what he called "Comprehensive Gun Legislation" and advocated that it be passed by the legislature.[165] The office of the Attorney

159. DREHLE, *supra* note 1, at 258.
160. People v. Harris, 74 Misc. 353 (N.Y. Ct. Gen. Sess. 1911).
161. GASPARINO, *supra* note 10, at 260.
162. *Id.* at 311.
163. *Id.* at 308–09.
164. Press Release, Office of N.Y. State Att'y Gen. Eliot Spitzer, Spitzer Announces Syracuse Areas Top Three Health Care Concerns and Outlines Agenda to Address Them (Mar. 8, 2002).
165. Press Release, Office of N.Y. State Att'y Gen. Eliot Spitzer, Spitzer Introduces Comprehensive Gun Legislation (Feb. 28, 2001).

General, unlike Al Smith's position as Majority Leader of the State Assembly, is not intrinsically legislative; thus, it lends itself to non-legislative solutions. Therefore, the case can be made that the investigations were a result of Spitzer's desire to combat corporate misbehavior any way he could. However, what at first glance seemed to be the result of policy expediency has turned into a tactical and legislative choice. As Spitzer's fame, acclaim, and clout have grown he has shown little desire to translate this popular support into codified laws. At some point, Spitzer's behavior has to be seen less as a result of his position and more as a policy to pursue change through prosecution and investigation instead of through litigation.

Taking a victory lap after the successful conclusion of his investigation, Spitzer testified before the Senate Commerce, Science and Technology's Subcommittee on Consumer Affairs, Foreign Commerce and Tourism.[166] Spitzer's testimony primarily focused on his argument that federal law should not prevent state prosecutions like his Merrill Lynch investigation. As to legislative remedies, Spitzer limited his comments to a few statements: "Rebuild the wall between research analysts and investment bankers for more favorable research reports . . . ensure that analyst compensation is not based on investment banking revenue . . . provide greater disclosure to the public . . . (and) every firm should have an independent committee that reviews all research recommendations."[167]

Within Spitzer's testimony and statements on the settlement, there was never an attempt to spell out how these reforms would be accomplished, and Spitzer only referred to these reforms by saying that any reform in this area should include these effects. He never stated whether he thought other reforms were needed.[168] Spitzer never used his position to advocate for legislation the way he advocated for gun control, and he never used his investigations to set the stage for legislation the way he did with the prescription drug benefit or, as in his legislative program, for an area like strengthened DWI laws.[169]

Spitzer has never claimed that the settlement he made with Merrill Lynch was the endgame to analyst regulation. In fact, despite not making it part of his settlement with Merrill Lynch, Spitzer did believe that the best solution was a total separation between investment bankers and analysts.[170]

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166. *Hearing on Corporate Governance: Hearing Before the Subcomm. on Consumer Affairs, Foreign Commerce and Tourism of the S. Comm. on Commerce, Science and Tech.*, 108th Cong. (2002) (statement of N.Y. State Att'y Gen. Eliot Spitzer), *available at* http://www.oag.state.ny.us/press/2002/jun/testimony7.pdf.

167. *Id.*

168. *See id.*

169. Press Release, Office of N.Y. State Att'y Gen. Eliot Spitzer, State Urged to Adopt Stronger DWI Laws (Aug. 25, 2000) (calling on the New York State legislature to pass a comprehensive package of DWI proposals).

170. *See Hearing on Corporate Governance: Hearing Before the Subcomm. on Consumer Affairs, Foreign Commerce and Tourism of the S. Comm. on Commerce, Science and Tech.*,

From this notion, it is possible to assume that perhaps this was Spitzer's eventual goal and something he hoped that voluntary compliance would accomplish. If that was indeed Spitzer's goal, for the moment it has not been accomplished.

To understand the magnitude of the opportunity lost by Spitzer's decision not to seek codification of his feelings toward investment banks and their analysts, it is important to consider what the public could have gained had Spitzer decided to form a commission similar to Al Smith's Factory Investigating Commission. Through the Martin Act, Spitzer would have had the necessary investigative power to force investment banks to divulge their private e-mail and correspondence.[171] While we can only speculate what might have been discovered, it stands to reason that a commission would have uncovered abuses at least as galling as Henry Blodget's. Like the abuses at the rope factory in Auburn, or the tales of children in canneries, these stories would have served to ratchet up the pressure of public officials to find ways to end these abuses.[172] Instead of having to settle for piece-meal compliance with a watered down standard, a commission could have built momentum for a thorough overhaul of the industry by the New York State legislature. There is, of course, no guarantee that this legislative plan would have become law. However, it does seem that even in failure, an investigative commission would have at least raised awareness about the problems in the financial services industry and softened up the ground for future legislative attempts at reform.

Had Al Smith merely relied on voluntary compliance, the results of the Triangle fire might well have been different. Assuming, as was the case with Merrill Lynch, that the Triangle Shirtwaist Company was publicly traded, and, as a result of the fire and the criminal prosecutions of Blanck and Harris, its stock had dropped precipitously, Triangle would have sought to settle with the State of New York and accepted certain voluntary constraints on its relations with workers. Smith might have proposed a watered down version of the legislation he passed, perhaps sprinkler systems, fire drills and adequate fire escapes. These reforms would have had a positive effect, but they would not have solved the deeper problems of worker abuse within the manufacturing industry. Fortunately, Smith took the more effective route, and, by striking at the heart of these abuses, he was able to hasten the end of worker exploitation. In contrast, by not seeking to systematically overhaul the research industry, Spitzer tolerated the continually cozy relationship between stock analysts, the companies they cover, and investment banks.

108th Cong. (2002) (statement of N.Y. State Att'y Gen. Eliot Spitzer), *available at* http://www.oag.state.ny.us/press/2002/jun/testimony7.pdf; Reform Investment Agreement, *supra* note 131.

171. Thompson, *supra* note 7.

172. SLAYTON, *supra* note 2, at 97.

Al Smith's decision to use the Triangle fire as a catalyst for a program of systematic reform can be judged as an unqualified success because it embraced the concept that reforms should be codified. Spitzer made three major decisions that contrast Smith's approach. First, he settled with Merrill Lynch rather than continuing the prosecution. This approach can be justified in light of the reforms he wrung from the company, but considering the freefall of the stock, Spitzer could have wrung more concessions from the industry by waiting.[173] His next decision was to choose voluntary compliance, rather than statutory enforcement through legislation in the New York State legislature.[174] While there are pros and cons to both choices, it is important to note that Spitzer saw his settlement with Merrill Lynch as a first step towards greater reforms, although it will take more time to determine the true effectiveness of his choice.[175] The independent analyst industry is still rather small, and it takes time and distance before one can judge the true import of reforms.

Foreclosing a chance for legislative reform at the state level, Spitzer did provide the broad strokes of reform in his testimony before Congress. An interesting coda to his testimony is that legislation was indeed offered in the House of Representatives by Spitzer's former critic, Representative Baker.[176] While not previously known as an investor advocate and not necessarily known as a fan of Eliot Spitzer, Representative Baker's bill contained many of the same elements of Spitzer's settlement with Merrill Lynch.[177] For a Republican controlled Congress, which did not appear receptive to any investor reforms, it was quite a surprise, yet Spitzer was not fully supportive. The most Representative Baker could coax from Spitzer at a hearing in front of the House of Representatives Financial Services Committee's Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises was that the bill was "a good start."[178] Even the fact that leading Democrats like Massachusetts Congressman and Financial Services Ranking Member Barney Frank and California

173. Thompson, *supra* note 7.

174. *Id.*

175. *Id.* This assertion is contingent on interpreting his statements in the press release settlement in that light. However, taking into account his pro-investor posture and his boosting of independent research, it does seem plausible, though some may argue that he seeks reform through the industry rather than forcing change through legislation.

176. *See* Mutual Funds Integrity and Fee Transparency Act of 2003, H.R. 2420, 108th Cong. (1st Sess. 2003) ("Baker Bill").

177. *Id.* In a 2006 interview, Baker did say that he was "generally supportive" of Spitzer's actions though he cited some particular disagreements with Spitzer's positions. Shelley A. Lee, *Full Plate, Firm Hand,* FSI VOICE, Aug. 16, 2006, at 12.

178. *Mutual Funds: Who's Looking Out For Investors?: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 15–41 (2003) (statement of Hon. Eliot Spitzer, Att'y Gen., State of N.Y.).

Congresswoman Maxine Waters co-sponsored the legislation[179] could not persuade Spitzer to wholeheartedly support it.[180] Without the high profile support from potential backers like Spitzer, the bill eventually died in the Senate without a vote.[181] While partisan politics or the desire to thwart an old enemy may have played a role, it does seem that when it comes to corporate malfeasance, Spitzer has placed his beliefs firmly in the corner of prosecution ending in voluntary settlement, even though it is made under duress reforms instead of legislation.

For an argument against the efficacy of relying on prosecution, look no further than Spitzer's predecessor and his successor. Spitzer's predecessor and electoral victim, Dennis Vacco, built his career in Buffalo on child pornography prosecutions.[182] These prosecutions made him visible and popular, and they were a perfect launching pad to statewide office, but they bore no relation to Spitzer's current role in regulating business. New Attorney General Andrew Cuomo often pledged to model his administration after Spitzer's, but his first actions in office show a wide difference in priorities. Shortly after taking office, Cuomo announced that his staff would examine the over 6,000 member items passed by Albany, looking for waste, fraud and mismanagement.[183] While pursuing official corruption and child pornography are laudable goals, they bring to light the difficulty of pursuing compliance mainly through prosecution. It is unlikely that an Attorney General in the mold of Dennis Vacco would be nearly as aggressive as Eliot Spitzer had been, and just days into the post-Spitzer era, the prosecutorial priorities of the New York State Attorney General's Office are no longer the same.

Here is concrete evidence that an uncodified standard for future enforcement revolves almost entirely around the views of a single elected official. If Spitzer's successors had been in the same mold as the "Lantern Jawed Crime Fighter," as the New York Post called Spitzer, there may well be continued Wall Street investigations.[184] But if his successors are mere

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179. Summary of H.R.2420, http://thomas.loc.gov/cgi-bin/bdquery/z?d108:HR02420:@@@L&summ2=m& [hereinafter Summary of H.R. 2420].

180. *See* MASTERS, *supra* note 5, at 130–32.

181. Summary of H.R.2420, *supra* note 179.

182. Tim Knauss & James T. Mulder, *E-Mail Led to Dreamscape Seizure the Attorney General's Office Sent a Note That Led to Confiscation of the Internet Provider's Server,* POST STANDARD, Oct. 29, 1998. Vacco became known for targeting internet ISP providers through which child pornography sites flowed.
Terry Pristin, *The 1998 Campaign: Attorney General*, N.Y. TIMES, Oct. 23, 1998, at B4.

183. Nicholas Confessore, *Cuomo to Review Spending on State Lawmakers' Pet Projects,* N.Y. TIMES, Jan. 5, 2007, at B1 [hereinafter *Cuomo to Review*].

184. Brad Hamilton & Stefan C. Friedman, *Here's the "Spitz" Take, Gov Fave Eliot Weighs In*, N.Y. POST, Feb. 27, 2005, at 21.

mortals, there is nothing preventing future Attorney Generals from returning to Vacco's, Abram's, or Lefkowitz's traditional functions.[185]

Eliot Spitzer's campaign to clean up Wall Street started with a bang, but just five years later Attorney General Andrew Cuomo's pronouncement of a new focus on public corruption ended that campaign with a whimper.[186] No protests issued forth from the newly elected Governor, no howls of discontent from any highly placed sources. The only news from the Governor's mansion was a list of priorities for the coming legislative session, none of which related to corporate governance.[187] In his previously mentioned speech to Investorside, Spitzer placed a great deal of importance on making sure that there is always "another trooper" up ahead, even going so far as to say, "[W]e in the prosecutorial community have to keep our eye out more aggressively . . . and the burden is on us to do that.[188] Spitzer may now feel that federal regulators have been awoken, but considering his feelings on their previous failures,[189] beyond the headlines and effusive praise his investigations have garnered, the most important question to ask about Eliot Spitzer is: Why? Why pursue such a strategy and why turn your back on issue formerly of such concern and importance?

To illustrate the utilitarian nature of Spitzer's actions are two of his statements regarding the S.E.C. and its actions during his investigations. On November 4, 2003, Eliot Spitzer closed his testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House of Representatives Committee on Financial Services with the unsolicited comment: "The S.E.C. enforcement staff does a terrific job. They are aggressive, tough [and] smart prosecutors. I remain committed to working together with them and others as we continue our investigations and think about solutions."[190] This seemingly laudatory comment flew directly in the face of a comment Spitzer made less than four months later at a meeting with the *U.S.A. Today* editorial board: "[T]he S.E.C. had become like every other lumbering bureaucracy: so big, so segmented . . . . How could they have missed the market timing, the late trading? They got lazy. They simply failed to be as aggressive as they should have been."[191] The only explanation for the two contradictory

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185. *Id.* It would almost make sense for successors to try not to emulate Spitzer's success but rather to carve out a unique legacy for themselves.

186. *See Cuomo to Review*, *supra* note 183.

187. Tom Precious, *Spitzer Maps Route to Revival; Calls for Reforms, Property Tax Cuts*, BUFFALO NEWS, Jan. 4, 2007, at A1.

188. Spitzer Keynote Address, *supra* note 152.

189. Editorial, *Spitzer: Right Wing's 'Power to States' Just a Façade*, U.S.A. TODAY, Feb. 24, 2004 [hereinafter *Spitzer: Right Wing*].

190. *Mutual Funds: Who's Looking Out For Investors?: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 15–41 (2003) (statement of Hon. Eliot Spitzer, Att'y Gen., State of N.Y.).

191. *Spitzer: Right Wing*, *supra* note 189.

positions is that, like Las Vegas, what happens in the House of Representatives Subcommittee meetings, often stays there. The same can not be said of an editorial meeting at the nation's largest newspaper.

Later in the interview, Spitzer's comments in response to a question on what was the best means of enforcement show his differing positions: "Fines don't do it. Fines get passed through and disappear into the ether. Prison sentences and shame, that's the answer."[192] These bellicose quotes fly right in the face of Eliot Spitzer's actions. The subhead of the Attorney General's Office press release was the size of Merrill Lynch's fine and in an interview with *Money Magazine*, Spitzer's reply to a question concerning Henry Blodget's future was, "I think we have to understand whether the structures we have in place work and function—and we have to try to do so without vilifying individuals, which is not a productive thing to do. . . ."[193] Again, the specialized nature of subscribers of *Money Magazine* conflicts with the general nature of those of *U.S.A. Today*, and thus the answers given are different.

Currently, with executive, and now legislative, tools at his disposal, Eliot Spitzer's quest to tame Albany may yet be assured whether through fines, agreements, prison sentences, or even outright electoral victory. He may indeed enjoy a brief sojourn in Albany and then on to Washington, D.C., but the question again is: Why? What lasting effects will his tenure have had, what markers will he have left behind him, and whose lives will his policies have changed aside from the greater glory of Eliot Spitzer?

Al Smith was defeated in his first re-election campaign for Governor and lost by a landslide when he ran for President, but his ideas endured. By codifying his beliefs, he gave them an opportunity to speak for themselves outside of his shortcomings as a candidate. Legislation, even if it is compromised or watered down, sets a baseline of acceptable conduct. Abuses may continue to occur but they will only fuel the drive for reform. Seeking change through legislative reforms may not garner the same headlines or public praise as giving a publicly traded company a good public pillorying, but what it will do is protect the factory workers and the investors who come long after the commission has packed up and gone home and the press conference has ended.

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192. *Id.*

193. *See* Reform Investment Agreement, *supra* note 131; Ron Insana, *supra* note 117, at 71.

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