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Securities Markets Regulation

Time to Move to a Market-Based Approach

by Dale Arthur Oesterle

Executive Summary

The 1934 Securities and Exchange Act and subsequent amendments required securities exchanges to operate as self-regulatory organizations (SROs) that police themselves under the supervision of the Securities and Exchange Commission. But over the decades the SEC has grown more intrusive as SROs have failed to meet their responsibilities. And as cycles of scandals suggest, the system has not grown more honest and efficient. Worse, SRO rules are often used by exchanges to stifle competition. Two new developments suggest that the old SRO system has outlived whatever usefulness it may have once had.

First, in recent years electronic trading systems, usually known as electronic communications networks (ECNs), have been taking business from the established over-the-counter stock market, the NASDAQ, and threatening the preeminence of established stock exchanges such as the New York Stock Exchange. The SEC is requiring ECNs to create their own SROs or to become subject to the SRO subsidiary of the National Association of Securities Dealers, which runs the NASDAQ. Neither option makes sense. ECNs that automatically match trades by means of specialized computer software do not face the same regulatory challenges as do stock exchanges with physical trading floors. And subjecting ECNs to a competitor's SRO has obvious conflict-of-interest problems that will require excessive SEC oversight.

Second, competition is pressuring NASDAQ and NYSE officials to propose that their respective exchanges change from private, member-operated associations to public, for-profit companies that would sell stock to the public and thus would be owned and controlled by shareholders. That sound initiative is encountering resistance from exchange members. Shareholders would place the interests of the NYSE ahead of its members' interests and would likely insist on a move to an efficient electronic exchange. But a for-profit NYSE and NASDAQ, especially with electronic exchanges, would be fundamentally inconsistent with a government delegation of self-regulation through an SRO.

The SEC currently is considering a variety of approaches to future securities regulation. What system should replace the current SROs? Even without SROs, individual stock markets and exchanges have a strong self-interest in monitoring internally the honesty and integrity of their traders. Indeed, without SROs, the exchanges would compete with one another to offer the most efficient, honest trading system. If the SRO regime is abandoned, policymakers will need to redefine the SEC's role and decide what functions it might perform to ensure honest, open exchanges.

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The Origin and Justification of the SRO Regime

> We are at a unique moment in our markets' history, . . .
>
> —Arthur Levitt[1]

Before 1934 there were 21 securities exchanges in the United States. Those exchanges were member-controlled organizations, usually not-for-profit corporations or unincorporated associations, that ran physical trading floors on which members, and only members, could trade designated securities with one another. The exchanges offered accurate and current market prices for members. Each exchange, to generate a favorable reputation among stock traders and encourage those traders to use the services of exchange members, maintained some kind of internal disciplinary apparatus. Members who misbehaved were sanctioned. Stock in corporations that defrauded their stockholders was banished from the floor ("delisted").

In May 1934 Congress passed a heavily watered down version of the Fletcher-Rayburn bill regulating securities exchanges.[2] Known as the Securities and Exchange Act, that law was the product of a bruising political struggle that pitted the members of securities exchanges against crusading New Deal politicians, who blamed the industry for the stock market crash of 1929 and the ensuing Great Depression.[3] As part of a political compromise, Wall Street accepted federal oversight of the exchanges' right to police themselves.

Initially, the Securities and Exchange Commission, created by the act, was not to replace but, rather, to oversee the self-disciplinary apparatus of the existing exchanges. Exchanges were labeled self-regulatory organizations (SROs). The 1938 Maloney Act extended the self-regulation regime to the then-small, but growing, over-the-counter securities market. That market consisted, at the time, of an informal network of broker-dealers who traded stocks with each other. Most of the stocks traded were not listed on the national exchanges. Under the authority granted by the Maloney Act, the National Association of Securities Dealers was organized. Because NASD is the only professional association for securities traders, the law in effect requires that every broker-dealer in the United States who conducts securities business be a member. (Today NASD's wholly owned subsidiary, the National Association of Securities Dealers Regulation Inc., or NASDR, is the largest SRO in the world for the securities industry; it regulates 5,600 firms and 600,000 professionals.)

An often-quoted description of the SRO regime by the second SEC chairman and future Supreme Court justice, William O. Douglas, gives the flavor of the system:

> [T]he exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned and ready for use but with the hope it would never have to be used.[4]

The most ardent advocates of the present SRO system echo that justification today. For example, Richard Grasso, the current chairman and chief executive officer of the country's largest exchange, the New York Stock Exchange, in testimony before Congress maintained, first, that the sophistication of the markets puts market regulation beyond the expertise of government officials.[5] Individuals who design and actually run the markets are in the best position to recognize and address abuses.[6] As Grasso is fond of saying, SRO personnel are the "cops on the beat." Second, he maintained that an independent government regulatory agency would largely duplicate exchange monitoring systems already in place and thus be both costly and unnecessary. And, third, he suggested that there is substantial symbiotic value in having regulatory personnel involved in exchange operations and governance. Regulatory personnel who understand the inner workings of an exchange are invaluable in the development of modern trading and information systems that ensure and enhance the integrity of the market.

As proof of his contentions, Grasso, like his predecessors, extols the "success of the NYSE's strong regulatory system" and proclaims that "our securities regulatory system is the envy of the world, and self-regulation lies at its centerpiece [*sic*]."[7] At the core of the argument is the claim that the success of the NYSE, the "world's pre-eminent capital market," validates the regulatory system. In practice, the performance of the SRO regime has not been nearly as rosy as Grasso claims.

The Evolution of the SRO Regime

Although the U.S. securities markets are the world's largest and most liquid, it does not follow that the regulatory system has been an unqualified success. Strong economic fundamentals have created and sustained financial markets, not NYSE policing of its floor traders. Nor does it follow that the current system will be able to meet the future competitive challenges posed by the expansion of electronic trading companies. A fairer assessment is that the SRO regime has proved to be barely adequate at best. History shows that the SRO system has steadily evolved away from the pure form rooted in the 1934 act toward a system of more overt SEC intervention. Periodic public scandals in the trading markets have been the ostensible causes of the steps in that evolution. But as the failures of the original SRO concept brought more overt SEC regulation, the system itself actually removed incentives for stock exchanges to strictly police themselves in order to maintain maximum credibility with their customers.

In 1934 the newly created SEC could only, on written request from an interested party, "alter or supplement" 13 specific categories of the rules and practices of any stock exchange's SRO. Thus, under the original compromise, exchanges maintained certain rules that the SEC was not allowed to alter, and the SROs had the exclusive right to initiate certain kinds of rules. Moreover, new SRO rules over which the SEC did have some jurisdiction would take effect automatically unless the SEC acted to stop them, and SEC actions were limited to alterations or additions.

In 1975 Congress amended the 1934 act to require explicit SEC approval of all new SRO rules. Further, and more significant, the SEC now is allowed on its *own initiative* to "abrogate, add to and delete from" *any* SRO rules already in place "as the Commission deems necessary or appropriate to insure the fair administration of the [SRO]."[8] The SEC now has the power to write, at its discretion, SRO rules. The SEC, by merely threatening to use this initiative power, can induce SROs to pass rules desired by the SEC. The shotgun is no longer behind the door.[9]

The last major legislative change affecting SROs came in 1996 when Congress gave the SEC broad authority to exempt any party from any of the provisions of the 1934 act, including the provisions on the registration of exchanges, and to impose appropriate conditions on the operations of those parties.[10] The SEC used its new authority in 1998 to exempt electronic trading systems, usually known as electronic communications networks (ECNs) or alternative trading systems (ATSs), from the rules that governed other exchanges and to fashion alternative regulations for firms operating such systems.

In summary, the SRO regime has evolved away from SRO autonomy to more SEC intervention. Indeed, the current SEC chairman, Arthur Levitt, has recently referred to the SRO history as "years of battles fought, obstacles overcome and lessons learned."[11]

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SROs in Practice: A Cycle of Scandals

Growing government control over SROs resulted from the need perceived by the SEC

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and Congress to break a cyclical pattern of scandals in trading markets. But those scandals resulted from the hybrid nature of the SRO system, an odd mixture of agency authority and business incentives that tends to encourage both too little and too much SEC action. During quiet periods, the SEC largely relies on SROs to police trading floors, and it routinely approves SRO rules and disciplinary decisions. In other words, the SEC during such periods tends to be lazy and complacent.

When a scandal breaks in a trading market, there is embarrassment and handwringing over why the exchange involved was not more vigilant in disciplining its members. The exchange contritely proposes minor rule modifications, often at the SEC's insistence, leaving the exchange's functions and membership largely intact. The SEC approves the changes and, with some fanfare, the regulators and the regulated hail the virtues of the SRO system—until the next scandal. In recent years the SEC has not been able to resist the temptation to tinker too much with the rules of the exchanges. But the illusion that the SEC is guaranteeing the integrity of exchanges removes an incentive for the exchanges themselves to exercise diligence, lest they lose their customers. And customers are lulled into a false sense of security, believing the SEC is closely policing the day-to-day activities of the exchanges.

Examples of scandals are numerous and well-known. In 1937 then–SEC chairman Douglas was encouraging the NYSE to reorganize along more democratic lines. NYSE president Richard Whitney stymied those efforts at every turn, leading Douglas to denounce the NYSE as a "private club." Whitney was soon thereafter exposed as a crook; his firm had been insolvent for more than 3 years, and he had been embezzling customer funds for more than 11 years. Many NYSE members had known of the thefts but had done nothing. Once the scandal broke, an embarrassed NYSE adopted a new constitution and reorganized. The president became a paid nonmember, elected by the members of the exchange. The SEC said the problems with the NYSE had been fixed, and, with the rule changes, questions about the SRO system itself were submerged—for a while.

In 1961 the second largest specialist firm on the American Stock Exchange, the Re brothers, was found to be engaging in insider trading, distributing false information (touting), distributing fraudulent shares, and otherwise manipulating trading. In the late 1960s the "back-office" scandal saw an unprecedented number of failures of broker-dealer firms due, among other things, to shoddy and questionable back-office bookkeeping practices. The New York City police estimated that from 1966 to 1970 more than $100 million in securities was either stolen or otherwise disappeared.

One recent example of a seeming SRO lapse concerned price fixing on the NASDAQ. In 1994 two university professors studying surprising patterns on the NASDAQ in bid and ask prices, the spread, suggested that market makers' "collusion" may have been a cause. The NASDAQ's biggest trading firms were soon embroiled in charges of price fixing. The responsible SRO, the NASD, came under criticism for failing to adequately police its trading market, the NASDAQ. Two years later the Justice Department abandoned its investigation of the scandal after NASD instituted trading reforms negotiated with the SEC. The civil actions were settled for close to $1.03 billion.

One of the resulting reforms was the separation of the disciplinary function of the trading market from its operating function. NASD became a holding company with two separate divisions—one its regulatory body (NASDR), the other its trading market (NASDAQ). Another reform was that the NASDAQ market makers were required to fill or disclose within 30 seconds customer limit orders equal to or better than current quoted prices (the Order Handling Rules of 1997).[12] Just recently, however, the SEC found that many brokers were not complying with the new Order Handling Rules.[13]

The year 1998 saw a floor broker trading scandal on the NYSE. Floor brokers, when trading clients' stock, are barred by NYSE rules from trading for their own accounts. That prohibition precludes profit-sharing agreements with favored clients. A broker trading for his own account could do so to the disadvantage of his clients. For example, if a broker, asked to purchase shares of a certain stock for a client, first purchases some of that stock for himself (or for a client with whom the broker has a profit-sharing agreement), he could drive up the price of that stock, which will then cost more when he places the order for the client. Of course, the client order could drive the price of the stock still higher, allowing the broker to profit from his earlier, personal purchase. In 1998 prosecutors charged 10 floor brokers with abusing their positions by falsifying trades with clients to cover trading for their personal accounts. Nine brokers, all with Oakford Corporation, pled guilty, and the SEC investigated charges that the NYSE's SRO system had systematically failed to detect or curb illegal trading by many of its floor brokers. The NYSE promised to clean up its act and the SEC ended its investigation in June 1999.[14]

But the NYSE and now the SEC are confronted with claims by the Oakford nine, attempting to mitigate their sentences, that NYSE officials knew of and, by tacit assent, allowed their practices, which were ubiquitous on the floor. Oakford president William S. Killeen, frustrated in his attempts to put information on the practices of the NYSE before federal prosecutors, has gone public with claims that over a six-year period he "did business" with more than 150 floor brokers and that there are more than 60 different broker-dealer firms that do what he did "day in and day out."[15] Specifically, he charged that Spear Leeds, the largest specialist operation on the NYSE; major brokerage outfits such as Goldman Sachs; and NYSE chairman Grasso gave their tacit assent to such practices. Spear Leads, Goldman Sachs, and Grasso deny the charges. Further, before a federal district court judge in New York, the defendants produced a parade of corroborating witnesses, ranging from floor brokers to a top NYSE official.[16] Witnesses described, under oath, an exchange that, for years, failed to stop illegal trading on its floor. At one point, a witness claimed the tacit assent of the NYSE's vice-chairman. The NYSE now claims that in the early 1990s floor brokers could legally share in their customers' profits under some circumstances but claims that the Oakford nine "went too far."[17]

Historical Weaknesses in the SRO Regime

Those scandals are the tip of the iceberg. The SRO regime does not comport with common sense about basic human incentives in economic markets. We should, therefore, expect troubles until the regulatory regime gets in line with reality.

To begin with, securities exchanges are not government agencies or public utilities that operate in the spirit or under the legal requirement of public obligation and service. Some people think of exchanges as analogous to farmers' markets that anyone is free to enter to buy or sell as he wishes. But exchanges are private, closed trade associations furthering the business interests of their members. Exchanges seek to maximize the income of their members and should not be expected to serve the "public interest" in the way that charities do, or that government agencies or public utilities at least are chartered to do. To say this is not necessarily a criticism of exchanges. Exchanges, pursuing profits for members, do act in the public interest, just as do grocery stores. Privately run securities exchanges are an important part of America's flourishing economy.

At the same time, securities exchanges, as trade associations, have a business interest in creating trading systems that are honest and efficient in order to attract clients. Members of exchanges will impose a variety of obligations on themselves and on the firms whose stock they trade in order to ensure that their exchanges minimize total trading costs and

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are free of fraud and other forms of manipulative behavior. Otherwise customers of members, and eventually members themselves, will go elsewhere. Stock exchanges with the best rules will have a competitive advantage and attract more listings, more traders, and more capital.

Since 1792 the NYSE has dominated trading in some stocks, and since 1971 the NASDAQ has dominated trading in others, although electronic exchanges have been making major inroads in trading NASDAQ securities. The dominant position of an exchange or market in a stock can give rise to two factors that can lead to market inefficiencies and scandals. The first is the temptation for exchange members to bend their own rules, creating a difference between the rules as advertised and the rules as enforced. The actual practice of trading on a floor may, over time, differ considerably from what one would expect from reading an exchange's rules and policies. The second is the temptation for exchanges, which are, after all, trade associations of an elite group of otherwise independent agents, to act like cartels and attempt to stifle competition from other trading markets.[18]

The SRO Enforcement Problem

An exchange operates under constant tension. The personal interests of its members, specialists, and floor brokers and the personal interests of the members' clients can cause those groups to have different ideas about just how the exchange should understand its own rules and how strictly it should enforce them. Since the members control the exchange, the exchange's interests mirror the *members'* interests, not the investor-clients' interests. An optimal system from the point of view of an exchange member may be one in which the market has an image of honesty and efficiency but operates at some accepted distance from that image. The positive image keeps client confidence and trust high, encouraging clients to trade, and the sloppy enforcement maximizes the personal profits of the members. This is a delicate balance—too much slop and the image suffers; clients stay away and profits fall. Too little slop and members absorb more market risk in their inventories and trades; the profits of members fall.

One example of the difference between the exchange rules as written and as enforced is continued trading on an exchange floor after the bell signals the close of trading. In practice, there is an acceptable period of time for deals to be done "at close" after the bell. It can be seconds, but that is enough time for members to enjoy an additional strategic benefit. Another example of flexible rules is NYSE's Oakford nine scandal. Although NYSE rules prohibit discretionary trading by floor brokers for their own accounts, the defendants argued that there were times when such trading was allowed and condoned.

The enforcement problem arises in part from the secrecy in which the true operation and profits of exchange members are shrouded. Until 1999 there was little public information about how much money NYSE specialists made or their actual trading practices. When the parent corporation of an NYSE specialist firm went public in an initial public offering (IPO) that year, the parent had to disclose the profits of its specialist operation. The NYSE has successfully claimed over the years that the information is proprietary. The closed nature of the system makes it difficult for customers to monitor whether brokers are acting in an honest manner and giving customers the best prices and service.

If an exchange faces stiff market competition, the deviation between rules and practice can disappear. In a tough, competitive market, any one competitor has an incentive to honestly reveal its costs and methods of operation, as a means of showing that it offers a better deal than its competitors and thereby attracting customers.

Absent incentives for honesty generated in a strongly competitive market, the SEC relies on other approaches. The SEC chairman has taken to appealing "to public directors" on the NYSE board to "jealously guard . . . the standards of the markets they oversee."[19] He seems to expect the public directors to be whistle blowers or gatekeepers of the public interest, and his efforts do have a surface appeal, since those directors are not allowed to be associated with members of the exchange or with any broker-dealers.[20] But the public directors are nominated by an NYSE nominating committee and elected by the membership of the NYSE, just as directors of other enterprises are elected by stockholders.[21] The public directors thus have the *members'* interests at heart. Indeed, the nominating committee will not renominate public directors who get out of line. Granted, the members' interests do include the careful nurturing of an image of honesty to increase confidence in the exchange. However, if the NYSE is riding high—if volume and prices are up—despite questionable practices on the floor, the public directors cannot be expected to be and have never been whistle blowers.

The Cartel Problem

All trade associations since the beginning of mercantile economies have posed the risk of being vehicles for anti-competitive behavior. Members of trade associations invariably are tempted to use their market-dominant positions to the disadvantage of nonmembers. And often such associations defend their practices in public as attempts at reasonable self-regulation and the maintenance of quality standards.

Trading markets fit this familiar pattern. Prime examples of exchange rules that adversely affect those who are not members of particular exchanges are the various rules that the NYSE has had in place or requested over the years in its attempts to consolidate order flows on its floor. Today, with more alternative trading venues, including electronic ones, brokers, particularly those handling NASDAQ stocks, must shop around for their clients in order to obtain the best price. NYSE officials, worried that the NASDAQ situation will soon be replicated for NYSE-listed stocks, argue that consolidating orders on the floor of the exchange ensures the best single price for customers in listed stocks. But in fact such rules consolidate markets, that is, limit competition in the name of efficiency. NYSE's rules consolidating order flow on its trading floor allow its members to make commissions as intermediaries and to retard the development of alternative electronic trading systems.[22]

The optimal system for the NYSE, assuming it has the lion's share of trading in its listed stocks, is one in which all stock quotes and all trades are available only to exchange members or exchange licensees. One would have to pay an exchange member, directly or indirectly, for access to the best and most current stock prices. Members could charge clients a premium for the exclusivity of their access to the best prices.

Gradually, the SEC has nibbled away at the exclusivity of that exchange.[23] The NYSE fought and will continue to fight each change. Stock quotes and trading information, for example, are now publicly disseminated,[24] and the NYSE is a member of a consolidated quote and trading system.[25] Fixed commissions established by exchanges for their brokers were finally eliminated by the SEC in 1975. Two years ago the SEC forced the NYSE to drop Rule 500 that made it extremely difficult for firms to delist their stock.[26] The use of eighths of a percentage point for stock spreads was only recently abandoned in favor of sixteenths and thirty-seconds. Next year spreads will be quoted in pennies (decimalization). The NYSE has, under pressure from the SEC, proposed the elimination of its Rule 390, which stops its members from acting as dealers off the exchanges for old-line NYSE-listed securities.[27] (Securities listed on the NYSE after 1979 can be traded on other exchanges.) Most of these changes are 20 to 30 years late.

The SEC is also, slowly, attempting to change other rules that keep NASDAQ dealers and ECNs from trading stocks listed on the NYSE through the Intermarket Trading

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System.[28] One of the reasons the new electronic exchanges have not made significant inroads in the trading in NYSE-listed securities (most of their volume is in NASDAQ securities) is that the ECNs, as brokers and not exchanges, do not have access to the ITS system that connects those venues that trade NYSE-listed stocks. The SEC has also proposed a rule change that will allow regional exchanges to trade NYSE-listed IPOs on the first day of the offering rather than on the second day. Most of the SEC initiatives on ECNs are at least 10 years late.

But the most subtle forms of anti-competitive behavior by exchanges, in fact, may be made possible by their internal disciplinary mechanisms. The SEC mandates that exchanges have those mechanisms, enforces the penalties meted out by those mechanisms, and only very loosely monitors the prosecutorial discretion inherent in those mechanisms. For example, exchanges worried that their members could attempt to engage in activities that might be legal and permissible but that would in essence compete with the exchange can use threats of SRO disciplinary actions to deter members from engaging in such activities.[29] No member's books are perfect, and a fishing expedition or disciplinary inquiry is always costly and potentially embarrassing for a member.

Not surprising, in the name of efficiency, exchanges argue for the rationality of SRO rules that in fact give them market and pricing advantages. The NYSE argues, for example, that SRO rules that consolidate order flow are necessary to prevent the "fragmentation" of trading markets. It also argues that rules that protect the position of its members as intermediaries in large trades (and that limit the scope of electronic trading systems) give clients "price improvements" that electronic trading systems cannot offer. But the sophistication of telecommunications and computer technology is causing well-informed parties to be justifiably skeptical of both claims.

The NYSE continues to fight against erosion of its dominant market position, primarily through the government regulatory process. The NYSE's major focus at the moment is on curtailing the ability of competitors to divert stock trades from the exchange by matching the exchange price spreads, often with cheaper execution fees. Further, NYSE leaders have attacked their competitors' practice of diverting order flow to in-house market makers in other markets (internalization) or to market makers who will pay inducements for the orders (payment for order flow).[30] The NYSE has asked the SEC to ban that practice.[31] Thus far, the SEC has responded by requiring brokers who accept payment for order flow to disclose the practice to customers.[32] NYSE officials have also asked that the SEC to force competitors to reveal their orders to NYSE traders before the orders are executed (an order exposure rule).[33] Most recently, the NYSE asked the SEC to prohibit competitors from trading as principals with client orders unless the trade is executed at better than the current national best market prices.[34] A firm that trades as a principal with a client order buys from clients that place orders to sell and sells to clients that place orders to buy. Many of those rule proposals are still on the table.

A large, integrated market might look like a monopoly, but there is an important distinction between market power and barriers to market entry that are facilitated by government regulations. The primary lesson of these disputes is that it is the SEC, not the exchanges, that creates the conditions that allow cartels and monopolies in trading markets to arise and flourish. The exchanges need and use the SEC to ratify and enforce any anti-competitive rules that have bite and effect.

SROs and Electronic Trading Systems

In the past decade entrepreneurs with expertise in telecommunications and computers have developed a variety of alternative securities trading systems that are becoming substitutes for traditional securities exchanges. These computerized trading systems now handle close to 30 percent of the orders in securities listed on the NASDAQ and almost 8 percent of the orders for all exchange-listed securities.[35] Instinet Corp. (owned by Reuters Group PLC) is the largest ECN, with 50 percent of the total ECN volume; Island ECN (owned largely by Datek Online Holdings) and Archipelago Holding (owned by the large Wall Street brokerage houses) have 20 and 8 percent of the volume, respectively. Archipelago has recently announced a partnership with the Pacific Stock Exchange to create a new, fully computerized stock market.[36]

The SEC has struggled with the problem of how to regulate the new ECNs. After releasing three major series of rules, each more than 100 pages of arcane prose, the SEC settled on rules that became effective on April 21, 1999.[37] In essence ECNs have two options. First, an ECN can choose to register as a national securities exchange and meet the licensing requirements of Section 6 of the Securities Exchange Act. One registration requirement is that the ENC maintain an SRO. Two ECNs have so far applied to be exchanges. Second, an ECN can choose to register as a broker-dealer and comply with the special licensing requirements of a new Regulation ATS. If an ECN chooses that alternative, it will fall under the jurisdiction of the NASD's huge SRO, the NASDR, that covers all broker-dealers in the securities industry. Most of the existing ECNs will opt for Regulation ATS status, but the SRO portion of neither option makes sense for ECNs.

Consider the operations of a basic ECN. The owner of a large-capacity computer writes software to match buyers and sellers, software that the owner believes will appeal to a large number of traders. Traders, both buyers and sellers, subscribe, pay a fee, log on, and place bid and ask orders. The computer matches the trades that it can in a preestablished format. The traders are then notified of the matches. Unmatched traders are either cancelled after a set period of time or forwarded to other markets. The software programs can and, without SEC involvement, would differ from one another in many respects: the type of trader that the program allows to log on; the types of display of the size and price of and the identity of participants in any pending trades; the types of access nonsubscribers have to price quotes; the publication of the size and price of and the identity of participants in any successfully matched trade; and the mechanics of the matching process.

There are many kinds of matching processes that might be used to attract traders. For example, a software program could run a call auction at set times (the Arizona Stock Exchange), a continuous matching system with first-in-time priority (Instinet, Island), or a crossing system that matches unpriced orders at a single price established in another market (Posit). One of the more innovative systems that began with much fanfare is the OptiMark system that allows traders to post orders for different amounts of securities at different prices.[38]

If an ECN chooses to register as an exchange, it must develop an SRO. Consider what this entails: The SRO must include an internal compliance system for its owners and subscribers. The compliance system must include a "fair procedure" for any disciplinary actions. The SRO would have to develop a package of rules designed, among other things, to prevent fraudulent and manipulative practices, to allocate fees for access to the ECN, and to regulate trading by owners and employees.

But why should the SEC require the owner of such a system to form an SRO? There is no traditional exchange membership to discipline. The ECN sells its services to subscribers and should be allowed to terminate subscribers at will or under other conditions set forth in the subscriber contracts. There are far fewer insiders to monitor. Floor brokers and specialists are replaced by a machine and individual technicians. There are minimal listing requirements for the stock traded. The drastic reduction in manpower at the point of trade in an ECN

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suggests that there need be only laws that require an ECN to operate free from fraud. Such a law might require that any ECN be honestly advertised to subscribers and deliver on its promises. There is no longer a need for complex monitoring and compliance systems for each trading system. If each ECN creates an SRO, there will be, at minimum, excessive duplication among the various regulatory bodies of each ECN and an unnecessary cost burden that must be passed on to subscribers in the form of higher fees.

If an ECN attempts to avoid the burdens of creating and maintaining an SRO by not registering as an exchange, it must register as a broker-dealer and be subject to the SRO subsidiary of NASD, the NASDR. Yet NASD runs two competing markets, the NASDAQ and the AMEX. To eliminate potential conflicts of interest, the NASD has taken pains to separate, by means of a holding company structure, the operation of its trading markets from the operation of its disciplinary arm. Yet the parent corporation is still run by securities professionals who may have interests in one or more of the trading markets. (The logic of the separation of the divisions is obvious and ought to mature into a total separation of the two functions. NASD ought not to run the NASDR.)

Further, an ECN that is subject to an SRO that it does not run itself still faces many of the problems it would face if it did run the SRO. For example, the SRO still would have to determine how to regulate a market in which trading occurs in a computer with software that automatically matches certain kinds of trades rather than on a physical floor with human brokers.

Moreover, there is much potential mischief in the SEC's role as monitor of the SRO rules either of the individual ECNs registered as exchanges or of the NASDR for ECNs registered under Regulation ATS. The SEC cannot resist the temptation to tinker with the operating characteristics of ECNs—all in the name of consumer welfare, of course. For example, in a classic misstep, the SEC has required all ECNs registered under Regulation ATS to publicly display the full size of their best buy and sell orders if the ECN volume in a security is 5 percent or more of the security's total volume. Thus, if OptiMark grows significantly, processing a higher volume of orders, it will have to alter its operating system to allow for such display. But that would undermine one of the system's benefits for many subscribers, the ability to post single large orders in a way that does not immediately come to the attention of other dealers. Knowledge of the size of the order or of who is placing it would adversely affect the price. The SEC has also required Regulation ATS ECNs to afford nonsubscribers access to ECN quotes and "fair fees." But an ECN's control over its subscriber base is a crucial aspect of its overall business strategy.

The SEC has an underpaid, high-turnover staff of lawyers and economists who are not entrepreneurs and have a hard enough time trying to regulate traditional markets. Allowing that agency greater control over the new electronic trading systems would harm those systems, most likely to the advantage of traditional exchanges.

If the NYSE and NASDAQ "Go Public"

The NYSE and the NASD, both worried by the growing strength of the ECNs, have sought to develop their own sophisticated electronic operations. However, they have had only limited success.[39] Their own members have balked at the changes because the member-owned structure of the trading markets creates a conflict of interest.[40] The new technology would reduce or eliminate many of the members' traditional trading functions. The conflict between the welfare of a trading market and the welfare of its individual members has grown severe enough to put the health of the traditional trading markets in jeopardy.[41]

Thus the NYSE has been unable to establish an after-hours computer trading network. Only small orders are executed without human intervention. Investors are able to get automatic execution on orders of 1,000 or fewer shares, but such orders constitute less than 20 percent of the exchange's volume. James Brinkley, chairman of the Securities Industry Association, a trade association of brokerage houses, calls the incremental changes "pathetic."[42]

Of course, the incentives would be drastically changed if the NYSE and the NASD were to separated ownership of trading markets from the use of trading market services, that is to say, if they were to act on proposals before the members of both organizations to change from not-for-profit associations into private, for-profit companies, and to sell stock to the public.[43] The members would receive some of the stock and cash that the trading markets would raise from IPOs of common stock. A new class of owners, the stockholders, would run the exchanges to make a profit. The personal interests of the floor traders of an exchange would no longer dominate the exchange's decisions to take advantage of new technological innovations. A for-profit exchange would be likely to use some of the capital raised in an IPO, for example, to purchase and run its own ECN. Members might see this as being in their long-term interest. (As of now, however, members of the NYSE, NASD, and a number of other exchanges have successfully stalled these conversions.)[44] A for-profit corporation would offer the added benefit of enabling an exchange to use its own stock as consideration in such acquisitions.

With the advent of a for-profit exchange, the old SRO rhetoric that served the exchanges and the SEC for so many years would becomes intolerable. A for-profit corporation cannot be a partner with the government as a disciplinary regulator. The NYSE's efforts to go public have SEC chairman Levitt worried about "conflicts of interest." He notes, "We simply cannot allow the mandate of self-regulation to take a back seat to the exigencies of short-term profit." He has asked for a "strict corporate separation of the self-regulatory role from the marketplace it regulates."[45]

Of course, the SEC chairman's concern over conflicts of interest comes a bit late. There currently are conflicts created by the SRO system, for example, the use of SRO rules by exchanges to stifle competition, which conflicts with the goal of an open market system. And in any case, the NYSE currently is not some sort of public utility and certainly will not be one if it becomes a for-profit operation. A for-profit NYSE would mean that stockholders and not just members would have an interest in the exchange's welfare. NYSE chairman Grasso is probably right when he answers SEC chairman Levitt's concerns with the remark that "converting to for-profit status will strengthen our resolve to maintain the highest standards of self-regulation."[46] In any case, the SEC might well face the challenge of applying an already problematic SRO regime not only to ECNs but to exchanges that become shareholder-owned enterprises.

The Problematic "National Market System"

Adding to the problem of applying the SRO regime to ECNs is a 1975 amendment to the Securities Exchange Act that requires the SEC to work toward a "national market system." But does that requirement give the SEC license to structure trading markets? The SEC cites that directive as justification for most of its rules relating to the trading market structure.[47] Yet one of the true innovators of the ECN, Steve Wunsch, president of the computerized Arizona Stock Exchange, defined the issue well in an October 29, 1999, letter to the *Wall Street Journal*. Even though the SEC has discretionary powers it can use against Wunsch's operation, Wunsch dared to criticize that agency for "playing God."[48]

> In pursuit of such nebulous concepts as "transparency," "efficiency" and "fairness," the SEC and its academic advisers have relentlessly intervened to redesign the market structure. But, just as it is difficult to design a better eye or grain, attempts to turn the

The SEC cannot resist the temptation to tinker with the operating characteristics of ECNs—all in the name of consumer welfare.

Given the speed of changes in the market, the SEC may find itself constantly tinkering with the market structure in a struggle to keep up to date and eliminate past regulatory blunders.

> stock market into a "level playing field" . . . have produced only a slew of unintended consequences. . . . Why not let the market structure result from competition rather than mandates from on high? [49]

It is indeed amazing what rules the SEC justifies in the name of promoting a "national market system." In 1998 in new regulations for the ECNs, it took upon itself the responsibility of crafting a "balance" between the benefits of a centralized market—an integrated, deep, liquid market—and the benefits of competition among trading markets.

In practice, the "national market system" directive has meant that the SEC has crafted a plethora of regulations on the operation of markets, especially of ECNs. There are regulations on, among other things, member and subscriber access, price quote and trade display practices, listing requirements, a consolidated quotation and tape system, execution fee schedules, intermarket linkages, best execution obligations of brokers, order routing practices, and limit order procedures—in short, regulations on much of the essence of the market structure. Given the speed of changes in the market, the SEC may find itself constantly tinkering with the market structure in a struggle to keep up to date and eliminate past regulatory blunders.

The SEC's market-structure-by-mandate satisfies few in the industry. Unfortunately, many critics favor an even more centralized market on which all stock of any issuer can be traded.[50] Those who advocate centralization bemoan the dangers of "market fragmentation." They argue that only a centralized market will be orderly, liquid, and deep, with narrow price spreads. Moreover, only in a single market will traders know with certainty that they have received the best executions of their orders and that no one else offers a better price.

Advocates of centralized markets tend to favor one of three arrangements. First, there are advocates of the "black-box" approach. Devotees of that approach envision the single market as one all-encompassing computer trading system (sometimes referred to as a time-priority central limit order book, or CLOB).[51] Second, there are those who favor an overarching ITS.[52] (The ITS system historically has connected only the national exchanges, the NYSE and the AMEX, with the regional exchanges on exchange-listed securities.) Enthusiasts argue that time priority can also be imposed on competing markets by forcing all trading through a computerized message switch that monitors the timing of quote updates and routes orders accordingly. And third, those in current positions of superior market power, principally the NYSE, urge the SEC to consolidate order flows in their markets. The NYSE, in an effort to consolidate order flow on the floor, has urged the SEC to terminate the ITS system.[53] The new SEC Concept Release asks for comments on strengthening the ITS in ways that could divert order flow through the system from the NYSE to other markets. Rather than debate details, the NYSE wants to eliminate the system.

The approaches share a common problem. A central market would be a monopoly captured by a few to maximize their returns, and it would be resistant to innovation. Such a monopoly would be inherently unstable since markets overseas will develop that offer more attractive venues and prices. At best, the SEC does not have the foresight to create a market that would be superior to one created by the competitive process. Nobody knows currently which, if any, of the recent trading market systems will prove best. The SEC is likely to pick the wrong system, and trading will be less efficient than if selection of a system had been left to market forces.[54] At worst, the SEC will be captured and corrupted by the interests behind whatever market manages to establish itself as the only game in town.

The second alternative, an overarching, modified ITS, has a certain appeal. The ITS system has connected the national exchanges with the regional exchanges, and the SEC has recently moved to open up the ITS system to enable NASD dealers to trade NYSE-listed securities.[55] The SEC chairman wants the ECNs to be included as well, but, at the moment, technical problems are stalling the effort. Thus it might seem a simple step to convert the ITS into the single trading market.

The ITS system shares many of the problems of the SRO regime. The ITS is itself a combination of otherwise independent trading markets.[56] If all exchanges were required to belong to the ITS, and the ITS maintained exclusive rules for membership and a dominant market position, that system could easily become an anti-competitive combination of otherwise independent competitors. One can make a good case for the proposition that in the past the ITS system has been a major tool used by the national exchanges to stifled competition in exchange-listed securities. When the SEC recently announced an initiative to give NASD dealers full access to trading NYSE-listed securities over the ITS, the SEC chairman commented that the change was "long overdue and, frankly, should have been accomplished some time ago through the voluntary efforts" of the ITS membership.[57] Such a suggestion for "voluntary efforts" sounds like an invitation to collusion.

The ITS system is the trading market that bears the closest resemblance to a public utility. With an all-inclusive, market-dominant ITS would go an SEC that would act like a state public utility commission regulating water or electric service, in this case approving membership criteria, fees and basic operational structure, and procedures. The SEC already is moving the ITS in that direction. The SEC has announced an initiative to open up the ITS to ECNs, which makes sense unless it comes with heavy-handed corollary obligations. As members, ECNs may lose control over the fees they can charge to access their quotes. But the SEC has now, in a recent Concept Release on Market Fragmentation,[58] asked for comments on how to structure the ITS itself.

It is questionable whether an SEC micromanaging the operating characteristics of a super-ITS system will make the right technical decisions. For example, the overarching ITS system would have the same quote display problems that so bedeviled the SEC in its efforts to promulgate Regulation ATS. But could participants quote different prices for different amounts? Would traders be required to display their entire position, or could they dribble out their sales? Would all brokers have ITS access? Should strict time/price priority be enforced through an ITS (option six in the SEC's Concept Release on Market Fragmentation)?[59] Should an order exposure rule be applied through an ITS (option three in the SEC's Concept Release on Market Fragmentation)?[60] If the answers do not accord with the desires of large traders, those traders will go elsewhere unless the ITS system has overwhelming market power, that is, a monopoly maintained through government regulations.

What is the best ITS system? Surely the SEC ought not to be the final arbitrator of these critical operation issues (as is threatened by the Concept Release on Market Fragmentation), nor should a trade association of all the old-line exchanges (as is currently the case).

Centralizing trading through a time-priority message switch, that is, a modified ITS, raises all the issues that does centralizing trading in a central limit order book, the CLOB version of the "black-box" approach. It requires expensive new infrastructure and bureaucracy, precludes competition and innovation, and leaves the market dependent on a government-imposed technology. Moreover, a time-priority rule does not take into account other attributes of the participating markets that are relevant to execution choice. Another concern with time priority is that it prevents competition on factors other than price. In other words, the trading market that is first in line gets the order, regardless of whether other markets offer enhanced liquidity, faster or more reliable systems, lower rates of failed trades, or better credit, to name a few of the many factors on which markets compete today. Under a time-priority rule, the better markets will pressure the SEC to mandate

The problems of designing an all-inclusive ITS demonstrate why it would be better to have competition not only among trading markets but also among intermarket trading networks.

Trading markets are no different from any other service market: the more competition the better, the less government intervention the better.

rules that either "shape up" or eliminate the sloppier markets—a sure recipe for ever more intrusive SEC microregulation of the market.

The problems of designing an all-inclusive ITS demonstrate why it would be better to have competition not only among trading markets for traders but also among intermarket trading networks for the participation of trading markets. An SEC-mandated ITC would eliminate two kinds of competition: first, in the way competitors use any given intermarket trading system and, second, in the ways competing intermarket trading systems evolve.

Evidence of the strength of the first form of competition in the market is seen in Archipelago's recent purchase of the Pacific Stock Exchange's stock trading business. When Archipelago takes over, it will have access to the current ITS system. Members of the current system can execute in-house all incoming orders as long as the members match the best price in the system; they do not have to route orders to the market that first displayed the best price. The Archipelago program will automatically route incoming orders to whichever market has first posted an opposite order at the best price. That is, Archipelago will voluntarily offer "time priority" in an effort to woo customers.[61] The SEC did not need to legislate the practice.

Evidence of the strength of the second form of competition in the market comes from Internet businesses that interconnect various retail markets to offer customers the best price alternatives. The travel market, consisting of airline tickets, hotels, rental cars, and tourist event tickets, is the best example. Anyone can log on to one of those popular Internet sites and compare prices from a variety of businesses. The securities trading markets can and will develop competing market linkage sites that will include not only American markets but also markets abroad (London, for example) that trade American stocks. The SEC should not retard the development of either of these two forms of competition.

The SEC, despite its rhetoric, has not created a national market system in which regional exchanges can survive, nor, for that matter, has it created one in which many of the new ECNs can survive. Regional exchanges are merging in an effort to remain profitable, viable entities. A recent article in the *Wall Street Journal* notes that many of the nine ECNs are not generating sufficient revenue to survive.[62] After a "shakeout" only one or two ECNs might survive. The NYSE and NASDAQ will no doubt attempt to buy one of the successful ECNs when those exchanges succeed in going public. It would be very easy for the trading markets to consolidate further, not fragment, given the state of the SEC's regulation.

Trading markets are no different from any other service market: the more competition the better, the less government intervention the better. The majority of the critics have it upside down. The SEC already is too intrusive and trying to micromanage markets too much.

The Optimal Goal? A More Market-Based System of Regulation

In light of the problems with the current SRO regime, what kind of regulatory system would be appropriate for the future? SEC chairman Levitt is correct when he maintains that a for-profit NYSE should not run an SRO as it has been mandated to do in the past. Further, NYSE chairman Grasso is correct when he maintains that his exchange cannot currently be expected to run like some sort of public utility and, if it is sold to shareholders, most certainly will not be run like anything but a for-profit enterprise. The major problem with an SRO is its bizarre hybrid nature. An SRO is an odd mixture of agency authority and private business incentive.

Grasso also is correct that the NYSE should have internal rules to foster investor confidence in the exchange's activities and that, if it did not act as an SRO under law, the NYSE would still maintain and advertise a private disciplinary system. Before the 1934 act, all the exchanges had internal disciplinary systems in place. The NYSE has always had a business incentive to foster investor confidence, just as, say, a pharmaceutical company would have a business incentive to foster user confidence in its testing procedures even in the absence of the Food and Drug Administration. If Congress were to abolish SROs, this incentive would not disappear. Individual trading markets would still have private, internal compliance. Indeed, the various trading markets would compete partially on price and partially on the quality of their service. The quality of their service would depend on systems that guaranteed the integrity of trades and the absence of conflicts of interest.

What is lost with the SRO system? An SRO system retards competition among markets on the quality of their internal systems. The SEC tends to drive all the markets into a single format for their disciplinary systems. An SRO encourages both too little SEC action and too much. The SEC has a tendency to meddle too much in the formal, written operational mechanics of the systems regulated by the SRO and a tendency to rely too much on the SRO for the policing of floor trading practices. The SEC has to approve the written rules of SROs and, as a result, cannot resist a tendency to tinker with the mechanics of the operation of the trading markets.

The SEC buys into the "cop on the beat" theory of SROs that leaves to the SROs the policing of everyday trading practices. Trading practices are extraordinarily complex, given today's multitude of instruments, markets, and players. Insiders who know the system can best take advantage of it and use methods that are obscure to even sophisticated clients and traders. Under the theory that it takes a crook to catch a crook, the SROs are left to regulate this complex web of day-to-day trading practices. And periodically someone, usually outside the system, in neither an SRO nor the SEC, catches and publicizes wrongdoing, and a scandal ensues. With the SRO in place, the SEC is less accountable; it can blame the SRO for lack of enforcement.[63] The SRO disciplines someone and, after some negotiation with the SEC, changes its rules a bit. Without the SRO crutch, the SEC itself would have to either gain the expertise necessary to regulate the trading business or close up shop.

Given the inadequacies of the SRO regime, what sort of regulatory system would be best in the emerging age of electronic trading? Levitt has found "intriguing" a suggestion that one super-SRO regulate all the markets to "alleviate conflicts and reduce redundancy, paperwork, and operational costs."[64] NASD, if it were to spin off NASDAQ as a for-profit corporation while retaining NASDR as a division of the not-for-profit NASD, would be making a bold move to push NASDR as the single regulatory unit for all the trading markets and all the securities professionals.[65]

In any case, in light of the emergence of ECNs and the probability that exchanges will go public, the SEC's role will need to be redefined so that market discipline on exchanges is facilitated and the past problems of SEC micromanagement of exchange rules are avoided. In the future the SEC should, first, be limited to enforcing the full and accurate disclosure of the mechanics of exchanges and the compliance systems under which they operate. Second, the SEC should continue its independent investigations and prosecutions of various forms of fraud that historically have been attempted by those operating trading markets—false touting, back-dated trades, wash sales, unauthorized front running, and the like. To aid in the prevention of fraud, trading markets will need to maintain audit trails of quotes and trades. And third, the SEC should ensure that markets are open and competitive.

The exact details of the SEC's role vis-à-vis these needs are open to discussion. Unfortunately, the SEC seems poised to move in the direction of more regulation rather than less. For example, one proposal on the table at the SEC is for a government-operated and government-controlled computer system in which all market makers in the United States would be forced to participate.

In any case the SEC's role will need to be redefined so that market discipline on exchanges is facilitated and the past problems of SEC micro-management of exchange rules are avoided.

Securities markets are indispensable for a prosperous free-market economy.

The core of capitalism is the accumulation and use of capital by private individuals. Securities markets are indispensable for a prosperous free-market economy. That is what is at stake in the discussion of the future of SEC regulations, and that is why a system is needed that fosters competition between exchanges over safeguards while allowing the flexibility that the current regime lacks.

Notes

1. Arthur Levitt, chairman of the Securities and Exchange Commission, "Dynamic Markets, Timeless Principles," Speech delivered at Columbia Law School, September 23, 1999, p. 1. The speech continues: "a point of passage between what they have been and what they will become. In the next few years, they will undergo a transformation like we have never witnessed before. And, it is these changes that will define the marketplace for the 21st century." www.sec.gov/news/speeches/spch295.htm.

2. For a detailed history of the Securities Exchange Act, see Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Boston: Houghton Mifflin, 1982).

3. Hearings before the Senate Committee on Banking and Currency on the 1929 crash (remembered as the Pecora Hearings, after the committee's counsel, Ferdinand Pecora) exposed a myriad of stock price manipulations in the 1920s that hadn't raised objections as long as prices continued to rise. S. Rpt. no. 1455, 73d Cong., 2d sess., 1934 (report on the hearings).

4. W. O. Douglas, *Democracy and Finance* (New Haven, Conn.: Yale University Press, 1940), p. 82. The quote is a current favorite of Richard A. Grasso, chairman and chief executive officer of the NYSE. See, for example, Richard A. Grasso, Testimony at Hearing on Public Ownership of the U.S. Stock Markets before the Senate Committee on Banking, Housing, and Urban Affairs, 106th Cong., 1st sess. September 28, 1999, p. 7, www.senate.gov/~banking/92_09hrg/092899/grasso.htm.

5. See ibid., pp. 7–8.

6. Douglas would add that some things are "too minute for satisfactory control . . . lying beyond the periphery of the law in the realm of ethics and morality." William O. Douglas, Address before the Bond Club of Hartford, January 7, 1938, in Douglas, *Democracy and Finance,* p. 90.

7. Grasso, p. 7.

8. Securities Exchange Act of 1934, as amended § 19(b), (c), 15 U.S.C. § 78s (b) , (c) (1988).

9. The SEC has proposed five rules under the new section, adopted four, and lost one to judicial decision. A federal circuit court invalidated Rule 19c-4, the SEC's one-share, one-vote rule for listed securities, in *Business Roundtable v. SEC,* 905 F.2d 406, 409 (D.C. Cir. 1990), as not in "furtherance of the purposes of the Exchange Act." The real power behind the rule is the SEC's threat to act. On such a threat, most exchanges negotiate with the SEC and amend their own rules in accordance with a negotiated compromise.

10. Sec. 36 of the Securities Exchange Act of 1934, enacted as part of the National Securities Markets Improvement Act of 1996, 15 U.S.C. § 78mm (1999).

11. Levitt, p. 6 n. 1.

12. "Order Handling Rules Release," Securities Exchange Act Release No. 37619A, *Federal Register* 61 (September 6, 1996): 48290. Levitt has recently complained that the SEC has found "an alarming failure" of securities firms to abide by the rules. Quoted in Michael Schroeder, "SEC Studies Brokers' Failure to Disclose Stock 'Limit Orders,'" *Wall Street Journal,* March 17, 2000, p. C16.

13. On one regional exchange, one of six limit orders was mishandled. Ibid.

14. The SEC and the NYSE negotiated a settlement that included the filing and termination of an SEC complaint on the same day. In the complaint the SEC alleged that the NYSE's "failure to police . . . was a material inadequacy of its regulatory program."

15. Quoted in Gary Weiss, "A Street Scandal That May Not Die," *Business Week,* August 9, 1999, p. 76.

16. Gary Weiss, "Can the Big Board Police Itself?" *Business Week,* November 8, 1999, p. 154.

17. See Gregg Ip, "NYSE Seeks Dismissal of Suit by Stockbroker," *Wall Street Journal,* February 10, 2000, p. 22.

18. ECNs are making significant inroads into the NASDAQ market share, however. Moreover, there is a growing threat that some of the hypermodern international trading markets will erode both the NYSE and the NASDAQ market share.

19. Levitt, p. 6.

20. Securities Exchange Act of 1934 § 6(b)(3).

21. The nominating committee is a self-perpetuating body that functions independent of the board of directors.

22. However, one could have rules effecting monopolistic pricing without rules that consolidate order flow if an exchange acquired market power by being the most efficient (offering the lowest transaction cost on trades).

23. The Supreme Court, in a case that I believe was wrongly decided, vested exclusive antitrust authority over SROs in the SEC and divested the Department of Justice and the federal judiciary of the jurisdiction over SROs that they had had under long-standing federal antitrust statutes (the Sherman Act of 1890, for example). See *Gordon v. NYSE*, 422 U.S. 659 (1975).

24. See, for example, Exchange Act Rule 11Ac1-1, 17 C.F.R. 240.11Ac1-1 (2000); Exchange Act Rule 11Ac1-4, 17 C.F.R. 240.11Ac1-4 (2000); NASD Rule 4613; and NYSE Rule 60. Those rules require dissemination of stock quotes and trading information.

25. The market centers provide quote and trade information through central processors that are responsible for collecting and disseminating the market information on different types of securities. The processors consolidate the information of individual market centers, determine the national best bid and best offer (NBBO) for each security, and disseminate the information to broker-dealers and information vendors. See Marshall Blume, Jeremy Siegel, and Dan Rottenberg, *Revolution on Wall Street* (New York: W. W. Norton, 1993), pp. 166–70. The consolidated tape system started in 1975, the composite quote system and consolidated trading system in 1978.

26. The rule required that any firm attempting to delist secure a vote of two-thirds of its outstanding shareholders, usually an impossible task.

27. In 1977 the SEC proposed a rule to eliminate the practice but let the rule die. This year the chairman of the SEC again asked the NYSE to rescind the rule and the NYSE complied. Greg Ip, "NYSE Scraps Limit on Member Trades in Other Venues, But Seeks SEC Rule," *Wall Street Journal*, December 3, 1999, p. C18. The history of Rule 390 shows the NYSE's resistance to efforts to eliminate that rule. The agreement among brokers in 1792 that was the forerunner of the NYSE had at its core an agreement not to trade with anyone not signing the agreement. The NYSE first formally implemented the exclusive trading rule under a different title in 1896. Over time, responding to pressure, the NYSE incrementally relaxed the rule. First, the exchange loosened the rule to permit members to trade listed stocks on other exchanges. This kept some of the regional exchanges alive as NYSE member firms would send NYSE-listed company stocks to their own specialists on regional exchanges to internalize (take both sides of) major trades. Then, the NYSE, under pressure, amended the rule to allow members to trade listed stocks over the counter if the stock was listed after April of 1979. The amended rule, at the time the NYSE announced its rescission, covered 27 percent of the listed companies, accounting for 48 percent of the NYSE volume. The death of the rule may have been caused by its effect on NYSE member firms' experiments with ECNs. If an NYSE member firm posted a quote on an ECN and one of the firm's customer orders was executed against the quote, the firm violated the rule.

28. The NYSE has successfully resisted SEC efforts to open up the Consolidated Quotation Sytem, Consolidated Tape System, and Intermarket Trading System, electronic systems that link the NYSE, AMEX, and regional exchanges by transmitting quote and transaction data and routing orders. The CTS and CQS are operated by the eight national securities exchanges and NASD. To become a member of the ITS a subscriber must comply with an "ITS Plan." The ITS Plan rules in force prohibit NASDAQ market makers and ECNs that do not register as exchanges from joining. The SEC will soon move to loosen the rules.

29. The SRO of the NYSE, for example, regulates members that are also NASDAQ's major market makers. Other NYSE members have made major investments in ECNs. The conflicts and tensions have caused the NYSE to create a disciplinary process that attempts to look like a traditional judicial adjudication. There are numerous due process protections built into the system. As anyone familiar with a judicial system knows, however, the process does not offer complete protection. The threat of being sued, at the prosecutor's discretion, is itself a huge blow to one's business.

30. Internalization is the routing of order flow by a broker to a market maker that is an affiliate of the broker. An integrated broker-dealer, for example, internalizes orders by routing them to the firm's market-making desk for execution. An example of payment for order flow might be the behavior of a market maker who pays brokers an agreed-upon amount per share or enters into explicit profit-sharing arrangements with brokers.

31. The NYSE has also attacked the related practice of "preferencing," the practice of brokers' routing orders to a regional exchange in preference to the NYSE. The regional market makers may be members of the brokers' firms. See SEC, "Report on the

Practice of Preferencing," April 11, 1997.

32. SEC Rule 10b-10(a)(2)(C), 17 C.F.R. 240.10b-10(a)(2)(C) (2000). The SEC is considering whether it should broaden the disclosure obligation.

33. One example of acceptable exposure would be an order exposed to order flow in another trading market that had provided price improvement to a specified percentage of previous orders over a specified period of time. Another example of acceptable exposure would be a market maker who, before executing an order as principal in a security whose quoted spread was greater than one minimum variation, published for a specified length of time a bid or offer that was one minimum variation better than the NBBO. The commission proposed such a rule for public comment in 1995 at the time it proposed the Order Handling Rules but has delayed adoption. Securities Exchange Act Release No. 36310 60 *Federal Register* 60 (October 6, 1995): 52792 (proposed Rule 11Ac1-5—Price Improvement for Customer Market Orders).

34. Securities and Exchange Commission, "Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation," Release No. 34-42450, February 23, 2000 (NYSE requesting that competitors trade with clients only inside the spread). Cited hereafter as Concept Release on Market Fragmentation. An execution inside the spread refers to an execution at the national best offer price (in the case of a sell order) or an execution at the national best bid price (in the case of a buy order), or an execution between the NBBO prices.

35. This number will increase substantially once the SEC puts its new ITS rules in place.

36. Archipelago, one of the fast-growing screen-based trading systems, will acquire the struggling Pacific Stock Exchange's stock trading business.

37. Securities Exchange Act Release No. 43-40760, *Commerce Clearinghouse* 68 (December 8, 1998), SEC Doc. at 2045.

38. The system has foundered, however, because traders have found it too complex.

39. See generally Jeffrey E. Garten, "How to Keep NYSE's Stock High," *Wall Street Journal*, September 13, 1999, p. A44. See also Frank G. Zarb, chairman and chief executive officer of NASD, Testimony at Hearing on Public Ownership of the U.S. Stock Markets before the Senate Committee on Banking, Housing, and Urban Affairs, 106th Cong., 1st sess., September 28, 1999 (describing a proposal to spin off NASDAQ into a for-profit corporation), www.senate.gov/~banking/99_09hrg/092899/Zarb.htm.

40. See "A Home-Grown Revolutionary," *The Economist*, July 31, 1999, p. 60 (describing Grasso's attempts to deal with the NYSE membership on technology-related issues).

41. Grasso sums up the conflict this ways:

> Under the current ownership structure, NYSE members are only able to realize economic value from their right to trade on the NYSE floor. This fact skews the interests of member-owners toward the value of the floor trading privilege, since they currently have no ability to profit from initiatives that may serve the interests of the institution, but may not beneficially impact the floor trading privilege. The problem is exacerbated by the fact that even among NYSE members, there are diverging interests depending on the nature and structure of each member's business. Some firms market to the retail investor; others have an institutional investor base; some concentrate on "upstairs" trading; others concentrate on the floor; some offer full service to their customers; others focus exclusively on discount brokerage. Our firms compete with each other; they also compete with us as market makers in listed securities trading over-the-counter.

Grasso, p. 43.

42. Quoted in Gregg Ip and Randall Smith, "Big Board's Members Face Off on the Issue of Automated Trading," *Wall Street Journal*, November 15, 1999, p. A8.

43. See Dale Oesterle, Donald Winslow, and Seth Anderson, "The New York Stock Exchange and Its Out-Moded Specialist System: Can the Exchange Innovate to Survive?" *Journal of Corporate Law* 17 (1992): 223, for an argument in favor.

44. See, for example, Michael Schroeder and Terzah Ewing, "Broker-Dealer Association May Disrupt Sale of Nasdaq Unless It's Put on Hold," *Wall Street Journal*, March 6, 2000, p. C17; and Peter McKay, "For-Profit Plans by Exchanges Hit a Big Wall: Member Firms," *Wall Street Journal*, February 3, 2000, p. C1.

45. Levitt, p. 6.

46. Grasso, p. 50.

47. See, for example, Securities Exchange Act of 1934, Release No. 34-407060, *Commerce Clearinghouse* 68 (December 8, 1998), SEC Doc. at 2048-49.

48. The Arizona Stock Exchange has had for years a special exemption from Section 6 regulation. That exemption allows the Arizona exchange to do business without abiding by the many SEC regulations that apply to other stock exchanges.

49. Steven Wunsch, Letter to the editor, *Wall Street Journal*, October 29, 1999, p. A19.

50. If one reads the full letter from Steve Wunsch noted above, he seems also to be complaining about the SEC's not centralizing the market. This makes his letter odd indeed for it is only through laws that a market will be centralized. Left on its own, the market for trading systems will have numerous participants.

51. The most mature of the proposals comes from J. W. Peake, professor of finance at the University of Northern Colorado. In his proposal, an issuer would have the exclusive right to determine, for five-year periods, a single exchange for the trading of its securities. Peake has powerful allies. Recently, a managing partner in Goldman Sachs gave a public address calling for an "electronically driven central market." Henry Paulson, chief executive officer of Goldman Sachs Group, quoted in Ip and Smith, p. A8.

52. Professor Jeremy J. Siegel of the Wharton School of Business argues that the SEC should establish an intermarket trading system on which the highest bid and lowest offer for every stock, no matter where they originate, should be displayed on a screen available to all investors around the clock. Jeremy J. Siegel, "The SEC Prepares for a New World of Stock Trading," *Wall Street Journal,* September 27, 1999, p. A34.

53. Greg Ip, "NYSE, in a Break with Heavyweights, Calls for End to System Linking Markets," *Wall Street Journal,* April 7, 2000, p. C1.

54. A new entrant in the market, for example, is Primex Trading NA LLC. Primex has developed an electronic system that mimics the NYSE's own auction market process. When an order is sent to Primex, participants bid for it by attempting to better the best price then prevailing in any other market. Primex's major shareholders are several of the largest brokerage houses on Wall Street.

55. Greg Ip, "Dispute Hinders Electronic Networks in Competition to Trade NYSE Stocks," *Wall Street Journal,* December 9, 1999, p. C13.

56. Under the rules governing the ITS, each exchange has a veto over all ITS rule changes.

57. Quoted in Ip, "Dispute Hinders Electronic Networks in Competition to Trade NYSE Stocks."

58. Securities and Exchange Commission, Concept Release on Market Fragmentation.

59. To ensure a high level of interaction of trading interest, the SEC could order the establishment of a national market linkage system that would provide price/time priority for all displayed trading interests. Under this option, the orders and quotations of all market centers would be displayed in the national linkage system (NLS). All NLS orders and quotations would be fully transparent to all market participants and the public. Orders and quotations displayed in the NLS would be accorded strict price/time priority. Market makers could execute transactions as principals only if they provided price improvement over the trading interest reflected in the NLS. Trading interest in the NLS could be executed automatically; however, the NLS would not be a market center itself: executions would continue to occur at the level of individual market centers. Public access to the NLS would be provided through self-regulatory organizations, alternative trading systems, and broker-dealers. The NLS could be administered and operated by a governing board made up of representatives from the public and relevant parts of the securities industry. Securities and Exchange Commission, Concept Release on Market Fragmentation, IV.C.2.F.

60. To enhance the interaction of trading interests, the SEC could require that all market centers expose their market and marketable limit orders in an acceptable way to price competition. As one example of acceptable exposure, an order could be exposed in a system that provided price improvement to a specified percentage of similar orders over a specified period of time. As another example of acceptable exposure, a market maker, before executing an order as principal in a security whose quoted spread is greater than one minimum variation, could publish for a specified length of time a bid or offer that was one minimum variation better than the NBBO. Securities and Exchange Commission, Concept Release on Market Fragmentation, IV.C.2.c.

61. The exchange risks losing brokerage clients that want payments for order flow but hopes to draw customers by increases in execution speed, decreases in cost, and an increase in execution quality.

62. Greg Ip, "Electronic-Trading Firms Generate Buzz and Backers but, For Many, Few Bucks," *Wall Street Journal,* December 2, 1999, p. C1.

63. See, for example, Scot J. Paltrow, Greg Ip, and Michael Schroeder, "As Huge Changes Roil the Market, Some Ask: Where Is the SEC?" *Wall Street Journal*, October 11, 1999, p. A1.

64. Levitt, p. 6. See also Jeffrery E. Garten, "How to Keep NYSE's Stock High," *Wall Street Journal*, September 13, 1999. Garten, who is dean of the Yale School of Management, argues for one new independent national self-regulating body.

65. See Zarb, p. 6 n. 1.