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Available at: https://scholarship.richmond.edu/lawreview/vol39/iss4/3
DEMYTHOLOGIZING THE STOCK EXCHANGE: RECONCILING SELF-REGULATION AND THE NATIONAL MARKET SYSTEM

Onnig H. Dombalagian *

In recent years, stock exchanges have been squeezed between the two fundamental principles of exchange regulation advanced by the Securities Exchange Act of 1934 (the "Exchange Act"): competition and self-regulation. As venues for trading securities, they have been challenged by alternative trading systems ("ATSs") and increasingly automated market maker and brokerage firms, who have unrelentingly demanded a more level regulatory playing field. As quasi-regulators, the adequacy of their efforts to discharge their self-regulatory responsibilities has been called into question by recent corporate governance scandals and instances of misconduct on exchange trading floors.  

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Congress gave little guidance to the U.S. Securities and Exchange Commission (the "SEC" or "Commission") in amending the Exchange Act in 1975 (the "1975 Amendments") regarding how to balance the dual role that exchanges play in the securities market. The 1975 Amendments advanced the principle that primary exchanges must use their self-regulatory power to regulate issuers and broker-dealers. The Commission's mandate to create a national market system, adopted within the same Amendments, proceeded from the premise that monopoly power of the primary stock exchanges should be restrained to promote greater competition among markets. These competing principles have forced the Commission to take very nuanced—if not irreconcilable—positions in various recent market structure initiatives, such as exchange registration, best execution, and exchange governance.

It may yet be a mistake, however, to dismiss the "myth" that the primary responsibility for market regulation should rest with market professionals themselves. Self-regulation creates a special relationship between the Commission and the self-regulatory bodies with the power to dictate norms for public companies, broker-dealers, and other market participants. This Article proposes


a modified regulatory framework for the securities marketplace that seeks to preserve the unique benefits of self-regulation by reallocating certain, but not all, self-regulatory responsibilities from exchanges to a more representative set of market participants. "Demythologizing" the exchange, without abandoning self-regulation, may ease the transition from the "exchange"-centered regulatory regime of the Exchange Act to the market of the twenty-first century.

Part I of this Article provides a brief summary of the history of stock exchange regulation. Part II provides an overview of the general framework for exchange self-regulation, including the premises for and the ambit of exchange self-regulation. Part III discusses the challenges faced by exchanges as competing market centers in the securities marketplace. Part IV explores some of the issues that the Commission has faced in reconciling these two objectives under the Exchange Act, and Part V outlines a modified framework for resolving this tension consistent with the competing goals outlined by Congress, the Commission, and the securities industry.

I. HISTORY OF STOCK EXCHANGE REGULATION

A. Origins

The history of the formation and regulation of stock exchanges is well-documented. Stock exchanges were formed as professional associations of securities brokers seeking to profit from the economic expansion and industrialization of the nineteenth century. Brokers and dealers—the intermediaries who execute securities transactions for investors—sought to enhance their stature and


9. The enthusiasm generated by the expansion of business enterprises, coupled with the use of "limited liability" to facilitate the transferability of ownership, led to significant public investment in corporate stock in Britain and the United States during the nineteenth century. See generally JOHN MICKLEWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA (2003).
profitability by centralizing trading activity in stocks and other securities of local interest.\textsuperscript{10} Exchanges were developed largely to enforce agreements among brokers to deal exclusively with one another in certain "listed" securities and to fix commission schedules for transactions with nonmember brokers and the investing public.\textsuperscript{11}

Despite the exclusive access to liquidity\textsuperscript{12} and trading information\textsuperscript{13} that exchange members enjoyed, competitors managed to attract significant trading interest in exchange-listed securities. Many off-exchange dealers provided liquidity by "making markets" in listed securities—i.e., buying and selling for their own account on a continuous basis—based on prices disseminated to the


\textsuperscript{11} See infra note 57 (discussing the rescission or elimination of such rules).

\textsuperscript{12} See Jonathan Macey & Hideki Kanda, The Stock Exchange As a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges, 75 CORNELL L. REV. 1007, 1012 (1990) (defining the liquidity of a market generally as the ability to buy or sell a stock promptly, at a price rationally related to the market's existing estimation of the firm's earnings prospects, and with information on stock prices produced and disseminated at low cost). The liquidity of a market may be measured, among other things, by the difference—or "spread"—between the published buy and sell quotations of a market, the number of shares available at quoted prices—or "depth"—the turnaround time for execution, and the ability of the market to absorb temporary imbalances in order flow. See Lawrence E. Harris, Liquidity, Trading Rules, and Electronic Trading Systems, in MONOGRAPH SERIES IN FINANCE AND ECONOMICS 1990-4, at 3 (1991).

\textsuperscript{13} Members had preferential access to information regarding trading on the exchange, whether through their direct observation of trading activity on the floor or through the exclusive receipt of real-time information about recent trades and other brokers' current buying and selling interest—"quotes." Specialists enjoyed a further advantage over other market participants because they controlled the "book," infra note 17, and the associated information about depth of trading interest and market trends. As a result, specialists and members might profit considerably by using such information to trade ahead of public customers. The conflicts of interest resulting from this arrangement naturally engendered significant criticism of the specialist model. Oesterle et al., supra note 8, at 241–43.
public by the exchange. Because such “market makers” were not bound by exchange rules, they could entice customers with comparatively cheaper commissions. Exchanges sought to protect themselves from such competitors, among other means, by successfully asserting an exclusive property right in their market data to prevent such “derivative” pricing. Exchanges also developed mechanisms—such as exchange “specialists”—to provide investors greater assurance that their orders would be executed promptly and at a price reasonably reflecting prevailing supply and demand for the subject security.

Exchanges and their members were also confronted by the prospect of state and federal regulation of listed companies and broker-dealers. The investment banking community sought to curb onerous and inconsistent state “blue sky” legislation throughout the United States, without inviting federal regulation of public companies. The New York Stock Exchange (the “NYSE”) and its membership likewise sought to avoid more intrusive regulation of exchange operations and investment banking firms within New York. To address these developments, the

14. See infra note 22.

15. Some of these markets developed into exchanges in their own right, such as the AMEX, while others disappeared or merged into established exchanges. See Oesterle et al., supra note 8, at 237–39 (describing the merger of the Open Board and the NYSE and resulting innovations to the NYSE’s trading system).


17. The specialist differs from other dealers in that it maintains a central book that reflects buying and selling interest at various prices and volumes in each security. Historically, a stock could have more than one specialist, but the practice of maintaining competing specialists for a single security died out on exchanges such as the NYSE as specialists were pressured to take greater financial risk (and thus commit more proprietary capital) to “stabilize” supply and demand in the market. H.R. Doc. No. 88-95, pt. 2, at 64 (1963) [hereinafter Special Study]. But see Oesterle et al., supra note 8, at 241–51 (suggesting that the decline in competing specialists may be attributable to specialists’ desire to consolidate their monopolistic role).

18. Exchanges sought to consolidate trading at designated times, through one or more “calls,” or auctions, to determine the price at which stocks could be bought or sold. See infra note 165 (discussing auction markets). Eventually, mechanisms were developed to facilitate continuous auction trading and to disseminate current trading prices to member firms and to the public.

19. PARRISH, supra note 8, at 21–23 (describing the Investment Banking Association’s efforts to develop uniform standards for securities offerings and limit the amount of required disclosure); SELIGMAN, supra note 8, at 45–46.

20. PARRISH, supra note 8, at 21–23. New York’s securities fraud statute, the Martin Act, was virtually unopposed by the securities industry or the exchanges, allegedly be-
NYSE and other exchanges promulgated financial disclosure and governance standards for their listed companies as an alternative form of "self-regulation."²¹

Because stock exchanges were at the epicenter of the manipulative and speculative activity that led to the Crash of 1929 and its economic fallout,²² the hearings leading up to the adoption of federal securities legislation largely focused on trading activity in stock exchanges.²³ The Exchange Act²⁴ sought to ensure that stock exchanges were no longer run as "private clubs to be conducted only in accordance with the interests of their members," but as public utilities or "public institutions which the public is invited to use for the purchase and sale of securities listed

cause of its focus on prosecuting fraud without adopting any prophylactic measures such as licensure of dealers or registration of securities issues. Id. at 22–23.

²¹. On the NYSE, listing contracts were initially negotiated individually with each issuer. In 1869, the NYSE Committee on Stock List was formed to evaluate companies for listing based on the degree of national interest, their standing, the market for their products, and their stability and future prospects. Roberta S. Karmel, The Future of Corporate Governance Listing Requirements, 54 S.M.U. L. REV. 325, 326–27 (2001). While firms initially resisted the NYSE's efforts to publish financial information, the threat of federal and state legislation encouraged issuers to comply with the NYSE's disclosure requirements. See SELIGMAN, supra note 8, at 44–46 (describing emerging state "blue sky" securities regulation). The NYSE also adopted corporate governance standards for its listed companies to protect shareholders against abuses of corporate power. These included the distribution of annual reports to shareholders, the requirement of an annual stockholders' meeting, notification of changes to shareholders' rights, and a "one-share, one-vote" standard. See Karmel, supra, at 325; ABA Market Structure Study, supra note 2, at 1498–99.

²². The public's increasing reliance on trade prices disseminated by exchanges created opportunities for market manipulation and fraudulent trading activity. "Bucket shops" entered into off-exchange contracts with customers based on price movements in listed stocks without ever purchasing or selling the underlying stock. Paul G. Mahoney, The Exchange as Regulator, 83 VA. L. REV. 1453, 1484 (1997); J. Harold Mulherin et al., Prices Are Property: The Organization of Financial Exchanges from a Transaction Cost Perspective, 34 J. L. & ECON. 591, 605–06. Members would engage in prearranged trades to create the semblance of active trading interest and escalating prices in stocks—"painting the tape." Short sellers were accused of engaging in "bear raids" in order to profit from artificial troughs in stock prices.

²³. See Securities Act: Hearings Before the Senate Comm. on Banking and Currency on S. 875, 73rd Cong. (1933), reprinted in 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973). The first of the federal securities laws adopted as part of the New Deal financial legislation, however, was the Securities Act of 1933, enacted "to provide full and fair disclosure of the character of securities sold" in initial public offerings, "and to prevent frauds in the sale thereof." Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74. The complex issues raised by regulation of the secondary market were deferred to the following year.

thereon." Congress specifically expressed concern over the manipulation and control of quotes and trade information disseminated by the exchanges and over-the-counter markets, as well as the impact of excessive speculation in securities on interstate commerce. The Exchange Act contained provisions designed to prevent known manipulative practices in the exchange and over-the-counter markets, as well as to regulate exchange members' trading activity and conflicts of interest. In addition, the Exchange Act also sought to regulate the obligations of issuers of exchange-listed securities traded in the secondary market.

The centerpiece of the Exchange Act was the registration of and associated obligations imposed on exchanges. A registered national securities exchange was required, among other things: (i) to agree to comply and to enforce, so far as is within its powers, compliance by its members with the provisions of the Act and rules thereunder, (ii) to furnish certain data regarding its organization, rules of procedure, and membership, as well as its organic documents and the rules of the exchange (and amendments thereto), and (iii) to provide for the expulsion, suspension, or disciplining of members for willful violations of federal securities laws and regulations or for conduct inconsistent with "just and equitable principles of trade."

To avoid the "impracticality of a burgeoning bureaucracy" that would be "in danger of breaking down under its own weight and

26. For example, section 9 of the Exchange Act prohibits wash sales, painting the tape, rumor-mongering, and other activity designed to produce artificial fluctuations in securities prices on stock exchanges. 15 U.S.C. § 78i (2000). Section 10(a) gives the Commission the authority to promulgate rules governing short sales in exchange-listed securities, and section 10(b) prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any listed or unlisted security. Id. § 78j(a)(1), (b). Section 11 regulates members' floor trading and specialist dealings, among other matters. Id. § 78k(a)-(b).
27. Id. § 78f(f). Such an issuer is required to register listed classes of securities with the Commission, and to provide the Commission with information about itself and its affiliates, the organization, financial structure and nature of its business, its securities, management and compensation, major shareholders, financial information, and any other matter required by Commission rules and regulations. Id. § 78(b). The Exchange Act also imposes requirements on communications with shareholders in connection with proxy solicitations. Id. § 78n(a)-(e).
28. Id. § 78f(1).
29. Id. § 78(f)
30. Id. § 78(b)(5). Approximately nineteen exchanges were exempted from registration under section 5(b) of the Exchange Acts. Id. § 78e(2).
proving ineffective," Congress settled upon a self-regulatory framework for regulating the activities of stock exchange members. 31 Under this framework, members of a registered national stock exchange would be responsible for collectively governing their activities; governmental regulation would be used only "to supplement and supervise what in the first instance was self-regulation of the exchanges." 32 The Act imposed no requirements on the governance structure of the exchange, on its membership, or its purposes, 33 although the SEC did seek voluntary governance reforms at the NYSE over the next few years, largely to diminish the dominance of specialists over the exchange's management. 34

Over the next few years, Congress, the Commission, and the brokerage industry took significant steps to establish a regulatory regime for over-the-counter brokers and dealers. 35 In 1938, Congress amended the Exchange Act to create a framework for voluntary self-regulation of broker-dealers that were not members of a national securities exchange through "national securities associa-


32. Id.

33. See Securities Exchange Act of 1934, ch. 404, § 6(c), 48 Stat. 881, 886 (1934) ("Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located.").

34. SEC, ANNUAL REPORT 89-90 (1938); Joel Seligman, Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission, 59 BUS. LAWYER 1347, 1356-57, 1360 (2004).

35. The Exchange Act only tangentially addressed regulation of the over-the-counter market. Many stocks, whether listed or unlisted, as well as virtually all bonds and government securities, traded in the "over-the-counter" market, an unorganized network of dealers—or "market makers," in the case of regularly traded instruments—and other market professionals. SELIGMAN, supra note 8, at 140-41. After studying the conflicts of interest that over-the-counter firms faced in acting simultaneously as brokers and dealers, the Commission determined not to seek outright segregation of brokerage and dealing activities, in part due to the willingness of exchanges to adopt basic rules for the protection of investors. SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER 110-14 (1936) [hereinafter SEGREGATION REPORT]. Rather, the Commission sought and obtained authority in 1936 to regulate broker-dealers for record keeping and financial responsibility and to prohibit fraudulent activity in the over-the-counter market. See generally 15 U.S.C. §78o (2000). In deference to self-regulation, the Commission exempted members of a stock exchange from certain of these requirements if they were subject to more stringent requirements under the rules of the exchange. This deference was eliminated in 1975.
tions," such as the National Association of Securities Dealers (the "NASD").\textsuperscript{36} Although membership in the NASD was voluntary,\textsuperscript{37} Congress gave broker-dealers a powerful anticompetitive incentive to join: NASD members were permitted to deal on preferential terms with one another in securities distributions and other transactions, but prohibited from dealing with nonmember broker-dealers except on the same terms as are accorded to the general public.\textsuperscript{38}

The proposed framework for regulating a national securities association and the national stock exchanges differed significantly in that the scope of the NASD's self-regulatory responsibilities was narrowly defined by statute, and the Commission had greater authority to oversee the NASD's disciplinary and enforcement processes. The NASD's mandate was limited to adopting rules "designed to prevent fraudulent and manipulative acts and practices," to provide safeguards against unreasonable profits, "to promote just and equitable principles of trade," "to protect investors and the public interest," and "to remove impediments to and perfect the mechanism of a free and open market."\textsuperscript{39} The NASD was expressly prohibited from engaging in certain anti-competitive practices characteristic of exchanges (other than exclusive dealing), such as imposing a schedule of prices or fixing minimum commissions.\textsuperscript{40}

\textsuperscript{36} Maloney Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938). Unlike the Exchange Act, the Maloney Act was adopted with the endorsement of several key securities industry associations—including the Investment Bankers Committee, a voluntary industry organization that promulgated best practices—as a preferable alternative to direct Commission regulation. S. REP. NO. 75-1455, at 5 (1938); Concept Release, supra note 6, at 71,257. The NASD is the only national securities association registered under section 15A of the Exchange Act. See id. at 71,257 n.26.

\textsuperscript{37} In 1983, Congress amended the Exchange Act to require each broker-dealer to become a member of the NASD, unless its business is confined solely to an exchange of which it is a member. 15 U.S.C. § 78o(b)(8) (2000).

\textsuperscript{38} Id. § 78o-3(e).

\textsuperscript{39} Id. § 78o-3(b)(6).

\textsuperscript{40} Id. Throughout the 1940s, the Commission and the NASD jointly developed inspection programs and prohibitions against fraudulent and unethical practices, which were enforced through administrative and disciplinary proceedings. Special Study, supra note 17, pt. 2, at 541.
B. The Special Studies and the 1975 Amendments

The number of securities issued and the volume of securities traded in the United States increased significantly during the rapid economic expansion following World War II.\textsuperscript{41} Securities listings became concentrated in exchanges such as the NYSE and the American Stock Exchange (the "AMEX"), which emerged as the "primary" U.S. stock exchanges due to their national reputation and the breadth of their information distribution networks.\textsuperscript{42} The NYSE sought to encourage public participation in securities trading through a number of additional corporate governance initiatives designed to improve investor confidence in listed stocks, such as minimum quorum rules and voting rights, antidilution rules, standards for the independence of directors, and more rigorous accounting and auditing requirements.\textsuperscript{43} The AMEX, by contrast, courted listings from issuers that could not satisfy the NYSE's listing standards by imposing more lenient standards.\textsuperscript{44}

The bull market of the 1950s eventually led to a rise in securities fraud, as the understaffed Commission failed to keep up with the growth of the securities markets and diverted resources away from the surveillance and enforcement of stock exchanges and the NASD.\textsuperscript{45} Despite advances in technology, exchanges and over-the-counter market makers had little incentive to improve their surveillance efforts, trading facilities, or the dissemination of market information. Commission investigations into the operation of the self-regulatory organizations ("SROs") and various floor trading scandals on the AMEX, for example, led to a major reorganization of its governance structure in 1962 to check the dominance of its specialists.\textsuperscript{46}

\begin{itemize}
\item \textsuperscript{41} Special Study, supra note 17, pt. 1, at 21.
\item \textsuperscript{42} E.g., id. pt. 2, at 811 (discussing the prestige of the NYSE and noting that national distribution capabilities can induce issuers to list on an exchange); id. pt. 2, at 915–18, 922–23 (discussing the decline of regional exchanges and noting that the "principal" exchanges were the New York exchanges).
\item \textsuperscript{43} See Karmel, supra note 21, at 329; ABA Market Structure Study, supra note 2, at 1500. See generally NYSE, LISTED COMPANY MANUAL §§ 303.00, 303A.06–07, 310.00, 313.00 (2005).
\item \textsuperscript{44} Douglas C. Michael, Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act, 47 BUS. LAW. 1461, 1463 n.12, 1464 n.15 (1992); ABA Market Structure Study, supra note 2, at 1500–02.
\item \textsuperscript{45} SELIGMAN, supra note 8, at 277.
\item \textsuperscript{46} Id. at 305–10; Seligman, supra note 34, at 1362. The securities industry also ex-
The crisis of investor confidence prompted Congress to commission a special study of the securities markets by the Commission staff. The Special Study, completed in 1963, covered a broad range of matters relating to the operation of exchanges and over-the-counter markets, as well as the effectiveness of stock exchanges and the NASD in carrying out their regulatory responsibilities.\textsuperscript{47} In addition to examining the efficacy of self-regulation, the Special Study produced one of the most comprehensive descriptions of the processes by which exchanges and over-the-counter markets operated. During the ensuing years, Congress and the Commission took a number of steps to implement the recommendations of the Special Study with respect to over-the-counter securities, the financial responsibility of broker-dealers, and the consolidation of market information.\textsuperscript{48} These efforts culminated in the Securities Acts Amendments of 1975.

On the one hand, the 1975 Amendments imposed greater limitations and obligations on exchanges under the Exchange Act's self-regulatory framework, to address the "common and serious misunderstanding" that the exchanges were not subject to Commission oversight as well as the "serious deficiencies" in self-regulation and the unfairness and inefficiencies in certain aspects of exchange operations.\textsuperscript{49} The amendments were to "clarify" SROs statutory responsibilities, to regulate the rule making and disciplinary processes of exchanges more closely, and to increase the Commission's authority to oversee SROs.\textsuperscript{50} On the other hand, the

\begin{itemize}
  \item \textsuperscript{47}See generally Special Study, supra note 17.
  \item \textsuperscript{48}15 U.S.C. § 78aaa-78lll (2000) (registration of over-the-counter securities); id. § 78ccc-eee (insolvency insurance for broker-dealers with public customers).
  \item \textsuperscript{49}1975 Amendments Legislative History, supra note 46, at 24. See generally Special Study, supra note 17.
  \item \textsuperscript{50}Special Study, supra note 17, pt. 5, at 13.
\end{itemize}
amendments gave the Commission greater authority to eliminate "unnecessary or inappropriate burdens on competition"—such as fixed commissions—and to apply new technology to improving the accessibility and transparency of primary exchanges under the rubric of a "national market system."  

1. Strengthening Self-Regulation

One of the principal changes to the framework for exchange self-regulation was to impose greater limitations on the exercise of rule making and disciplinary authority by exchanges. Unlike the NASD, whose rule-making authority was limited, exchanges had the authority to adopt any rule "not inconsistent" with the Exchange Act in addition to the minimum areas of exchange rule making enumerated in the statute. Commission approval of new exchange and NASD rules also was relatively informal, and Commission approval was not necessary for changes to or repeal of such rules.

The 1975 Amendments significantly changed the framework for exchanges by importing many of the features of the NASD model. Exchanges were subjected to substantive limitations on their rule-making authority to reflect their mission as quasi-public organizations. Exchanges and the NASD were required to publish both proposed new rules and proposed rule changes, as well as a "concise general statement of the basis and purpose" thereof, for public notice and comment, and the Commission was required to publish its reasons for approval thereof. Congress further granted the Commission the authority to amend or mod-

51. 1975 Amendments Legislative History, supra note 46, at 2. One contemporary has suggested that the reason for the two directives was legislative compromise: the House of Representatives favored increased SEC authority over SROs, whereas the Senate favored a national market system. Panel Discussion: Celebrating Thirty Years of Market Regulation, 9 FORDHAM J. CORP. & FIN. L. 295, 309 (2003) (comments of Andrew Klein, Director of the Division of Market Regulation, 1977-1979).

52. See supra note 33.

53. See Concept Release, supra note 6, at 71,257 (noting that federal regulations governing exchanges were not adopted until after 1934).


56. Id. § 78w(a)(3).
ify exchange and NASD rules, as well as to require exchanges or the NASD to adopt new rules.\footnote{57} The 1975 Amendments also granted the Commission additional oversight authority over SROs in making membership decisions or in the exercise of their disciplinary and enforcement duties. The amendments required exchanges to provide the same fundamental standards of due process\footnote{58} as the NASD in admission and disciplinary proceedings against its members,\footnote{59} including notice of adverse actions to the Commission and the availability of Commission review.\footnote{60} The amendments gave the Commission additional flexibility to impose intermediate sanctions on exchanges for failure to carry out their enforcement responsibilities.\footnote{61} The Special Study also prompted the Commission to prod the exchanges to heighten their corporate governance standards for public companies.\footnote{62} The NASD had already begun to develop listing standards, including corporate governance requirements, for companies whose securities were quoted through its automated quotation facility, NASDAQ,\footnote{63} to enable them to qualify for ex-
emption from state blue sky securities laws.64 Throughout the 1970s and 1980s, the Commission pressured the NYSE, NASDAQ, and AMEX—the three primary listing markets—to heighten their corporate governance standards.65 The Commission's ability to press for further reform was constrained, however, by the limitations of the antifraud provisions of the Exchange Act66 and the Commission's lack of express authority to pursue corporate governance reforms directly through its rule-making authority.67

2. Building a National Market System

The 1975 Amendments also gave the SEC new authority to promote greater competition in securities trading. The Special Study documented the significant changes in trading patterns in listed and unlisted securities since the adoption of the Exchange Act. First, the Special Study noted the growth in trading of unlisted securities. From the 1930s through the 1960s, the market for over-the-counter securities had grown sufficiently in size that many issuers opted not to list to avoid complying with exchange listing requirements, even if they otherwise qualified under the primary exchanges' standards.68 Because trading in

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64. See supra note 19 and accompanying text. The Securities Act of 1933 was amended in 1996 to preempt state laws requiring registration or qualification of securities "listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed, or authorized for listing, on the National Market System of the Nasdaq Stock Market (or any successor to such entities)." 15 U.S.C. § 77r(b)(1)(A) (2000).

65. See Karmel, supra note 21, at 340-43. One key success was the requirement that listed firms maintain independent audit committees. See id. The Commission further strengthened the independence requirement for audit committees in 2000 as part of a Blue Ribbon study of accounting and auditing practices for public companies. 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, 1063, 1072-73 (1999).


68. See Special Study, supra note 17, pt. 2, at 811. In 1964, Congress extended the Exchange Act's registration requirement, as recommended in the Special Study, to unlisted securities with 500 shareholders and $1 million in assets. 15 U.S.C. § 78l(g)
unlisted securities was fragmented across multiple dealers, brokers—particularly retail brokers—had to "shop around" from market maker to market maker for the best prices. Second, the Special Study noted the migration of segregated volume in listed securities of the primary "lofty" exchange. As regional listings declined, regional exchanges refocused their business model to competing for orders in multiply listed securities, with regional specialists and market makers dealing at the prices disseminated by the primary exchange. Institutional investors, for example, increasingly found it advantageous to send orders to regional exchanges and the over-the-counter markets, among other reasons, to obtain better execution of large orders and to avoid the fixed commission structure of the NYSE.

From the Commission's perspective, the rise in over-the-counter trading and increased "fragmentation" of listed securities trading raised several concerns. First, the diversion of order

(2000); see Special Study, supra note 17, pt. 2, at 55–56; see also 17 C.F.R. § 240.12g-1 (raising the asset threshold to $10 million).

69. Special Study, supra note 17, pt. 2, at 833.

70. Regional companies that had not migrated to, or were consolidated into companies listed on, the NYSE and the AMEX sought to avoid the onerous disclosure obligations required of listed companies under the Exchange Act and to opt for the increasingly automated over-the-counter market. See Special Study, supra note 17, pt. 2, at 924; Karmel, supra note 21, at 334; Walter Werner, The SEC as a Market Regulator, 70 VA. L. REV. 755, 762 (1984). By the time of the Special Study, the number of regional exchanges had declined from over 100 to fourteen, of which four were low volume exchanges exempt from registration and three were western mining exchanges. See Special Study, supra note 17, pt. 5, at 144. As of the time of this writing, there are five registered securities exchanges other than the NYSE and the AMEX that deal in stocks.

71. Congress and the Commission have taken a number of steps to shelter the regional exchanges from these trends since the inception of the Exchange Act. See infra notes 268–69 and accompanying text.


73. Maynard, supra note 72, at 859. Institutions and broker-dealers entered into a number of other arrangements to avoid the NYSE's fixed commission schedule, such as various reciprocal and "give-up" arrangements and various forms of nonprice competition, such as the use of "soft dollars" to pay for investment research. SELIGMAN, supra note 8, at 302–03.

74. Several scholars have criticized the Commission's preoccupation with the problem of fragmentation in the absence of evidence to suggest that price discovery was impaired by trading on multiple markets. See, e.g., Mark Klock, The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence, 51
flow from the primary exchanges reduced the flow of retail orders to the primary exchange. This was thought to impair the ability of primary exchanges to discover the market’s valuation of securities prices. In addition, the Commission was skeptical that individual trades executed in the over-the-counter market were executed at the best available prices. Despite NASD business conduct rules, trading practices in the over-the-counter market were governed by informal codes of conduct, and limited information was available to the public about quotes and trade prices for over-the-counter securities.

Throughout the early 1970s, the SEC sought to consolidate reporting of transactions in listed securities from exchange and over-the-counter markets, so that all investors would have access to all exchange and over-the-counter transaction reports on equivalent terms. With respect to over-the-counter securities, the Commission encouraged the NASD to develop an automated quotation system that would collect and disseminate firm bid-and-ask quotations from market makers. These efforts led to the creation of NASDAQ in 1971. With respect to exchange-listed securities, in 1974, the Commission sought to mandate real-time dissemination to the public of all completed trade information in exchange-listed securities collected from all exchanges and over-the-counter market makers in a “Consolidated Tape,” based on the NYSE and AMEX’s ticker tape for transactions effected on their exchange floors.

The NYSE initially resisted Commission efforts to regulate data dissemination, as it would have limited the ability of the exchanges to exploit the value of their market data vis-à-vis the

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75. See infra note 90 (discussing price discovery).
76. See generally Special Study, supra note 17, pt. 5, at 115.
77. SELIGMAN, supra note 8, at 490–97.
78. Id. at 490.
79. Id. at 505. The Securities Industry Automation Corporation (the “SIAC”) is the exclusive “securities information processor” for listed securities, as is the NASDAQ Stock Market for over-the-counter securities. The SEC’s advisory committee on market information recently issued a report considering, among other alternatives, the possibility of competing consolidators for market information. REPORT OF THE ADVISORY COMMITTEE ON MARKET INFORMATION: A BLUEPRINT FOR RESPONSIBLE CHANGE § V.B.7 (Sept. 14, 2001), at http://www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm (last visited Mar. 26, 2005).
over-the-counter market. In response, Congress gave the Commission the express authority to create a national market system for securities trading. The purpose of this mandate was to advance the goals of economic efficiency, fair competition, transparency, best execution, and the opportunity to trade without dealer intermediation. Among other things, the national market system legislation gave the Commission the authority to authorize or require SROs, acting jointly, to develop and operate communications and data processing facilities for linking markets for "qualified securities." At the same time, the amendments gave the SEC the authority to eliminate certain key anticompetitive practices—such as fixed commissions—that restricted competition among exchanges and the over-the-counter market.

Over the past thirty years, the exchanges and the NASD have, at the Commission's behest, developed additional intermarket mechanisms under a series of plans negotiated by the exchanges and the NASD and approved by the Commission. Real-time quotations and transaction reports in exchange-listed securities are collected from the primary and regional exchanges and the over-the-counter market, consolidated and disseminated to the public under the "Consolidated Quotation" or "CQ" Plan and the "Consolidated Tape Association" or "CTA" Plan, respectively. Quotations and transaction reports in over-the-counter securities qualifying as "national market" securities under the NASD's rules are

82. Id. § 78k-1(a)(1)(C).
83. Id. § 78k-1(a)(3).
84. See generally SELIGMAN, supra note 8, at 473–86. It is frequently noted that such authority was politically feasible largely because institutional investors already and member firms had already developed methods to circumvent minimum commission schedules, such as regional exchange memberships, give-up arrangements, and soft brokerage. Id. Many exchange members also came to believe that greater competition would be beneficial to the exchanges and their members by recapturing order flow that had migrated to regional exchanges and the over-the-counter market. Id.
86. Proposed Regulation NMS, supra note 5, at 11,130–32 (describing the history and terms of the "CQ" Plan, the "CTA" Plan, and the NASDAQ-UTP Plan).
collected, consolidated, and disseminated under the "NASDAQ-UPT" Plan. The access to the best quotes in listed securities published by competing exchanges and market makers was made possible, if not practicable, through the Intermarket Trading System. The Commission also sought to spur further technological evolution of the over-the-counter market, through mechanisms improving accessibility and reliability of NASDAQ market maker quotes—particularly for smaller retail orders.

C. The Impact of Automation on the U.S. Securities Markets

While the SEC charted the expansion of the national market system, a number of private sector alternatives to traditional exchanges were under development. Institutional investors organized private trading systems in which they could trade directly with one another to avoid the conflicts of interest in trading with exchange specialists, members, and market makers. These systems sought to avoid registration as national securities exchanges on the grounds that they provided an automated brokerage function. The Commission, after due consideration, ultimately chose

87. Id.
88. The Intermarket Trading System established linkages among exchanges and over-the-counter market makers (through NASDAQ's Computer Assisted Execution Service), protocols for ITS participants to access each other's quotes, and remedial measures for "trading through" the price published by another participant without first attempting to access such participant's published quote. See id.; infra Part IV.B.2 (discussing the "trade through" rule).
to regulate such systems as broker-dealers, subject to additional
conditions negotiated with the Commission staff.92

The volume on such private trading systems increased during
the 1990s after several systems relaxed their admissions criteria
to include market makers.93 In 1995, following academic studies
and Commission and DOJ investigations, it was discovered that
market makers were essentially able to trade with each other at
prices that were more competitive than the prices they quoted in
NASDAQ. This allowed market makers to profit from the spread
between the two market segments: the competitive market cre-
ated by institutional trading, and a public retail market at which
market makers could collude to maintain artificially wide
spreads.94 In addition to imposing sanctions, the Commission
forced market makers to publish their hidden orders, either by
updating their quotes or by requiring alternative trading sys-
tems, then called "electronic communications networks" or
"ECNs," to publish their best-priced market maker orders in the
NASDAQ montage.95

As the number of alternative trading systems increased during
the 1990s,96 the Commission became more concerned that such

(adopting former Rule 17a-23, which established record-keeping and reporting require-
ments for brokers and dealers that operate automated trading systems); see also Regulation
of Exchanges, supra note 4, at 70,900-01 (stating a history of proposed Rule 15c2-10
for proprietary trading systems).

93. In 1997, the Commission estimated that alternative trading systems accounted for
twenty percent of the orders in over-the-counter stocks and four percent of the orders in
30,485, 30,486 (June 4, 1997) (codified at 17 C.F.R. pt. 240) [hereinafter Request for Com-
ments]. Today, alternative trading systems account for more than fifty percent of trading
in NASDAQ stocks. Moreover, as a result of competition from alternative trading systems
and other market participants, the NYSE and the AMEX only account for approximately
seventy-five percent and twenty-seven percent of trading in their respective listed stocks.
Proposed Regulation NMS, supra note 5, at 11,128.

94. SEC, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT
[hereinafter NASDAQ 21(A) REPORT], available at http://www.sec.gov/litigation/investreport/

95. See 17 C.F.R. §§ 240.11Ac1-1(c)(5), 240.11Ac1-4 (2004) (requiring market makers
to publish customer orders at or better than their public quote, either in NASDAQ or
through an alternative trading system integrated into an exchange or NASDAQ quote
montage).

96. Moreover, firms were rapidly developing trading systems for other instruments,
such as government and federal agency securities, municipal securities, corporate debt,
systems remained outside the scope of formal regulation. In particular, the Commission expressed concern that institutional orders placed in such systems remained invisible to the public and were not afforded an opportunity to interact with retail orders. Because participants in these systems were largely broker-dealers and institutions, there was no requirement that they do business with all members of the public on reasonable terms. Moreover, after the market break of October 1987, the Commission became apprehensive of the capacity, integrity, and security of such systems as well.97

In 1998, the Commission adopted Regulation ATS, which stopped short of imposing full exchange regulation on such systems and instead imposed additional requirements to improve access to and oversight of such systems.98 In particular, Regulation ATS sought to enable retail investors to access orders in alternative trading systems by requiring such systems to publish their best-priced customer orders in the national market system through a SRO.99 Alternative trading systems resisted these efforts, however, because they viewed exchanges and NASDAQ as competing markets.100 The Commission, after extended public notice and comment, ultimately resolved the impasse only by requiring the NASD to develop an entirely separate "alternative

97. See Regulation of Exchanges, supra note 4, at 70,875 (describing the automation review program for self-regulatory organizations and its application to alternative trading systems and other broker-dealers).

98. See id. at 70,845.

99. See 17 C.F.R. § 242.303(b)(3) (requiring public display of and access to an alternative trading system's best-priced, internally displayed orders equivalent to that provided to the members of an SRO); id. § 242.301(b)(5) (requiring systems to maintain neutral, nondiscriminatory standards for fair access); id. § 242.301(b)(6) (imposing requirements relating to capacity, integrity, and security of alternative trading systems); id. § 242.301(b)(7) (requiring cooperation with Commission inspections, examinations, and investigations); id. § 242.301(b)(8)–(9) (imposing audit trail and reporting requirements); id. § 242.301(b)(10) (imposing requirements with respect to the use of confidential customer information).

100. Until recently, the only entity capable of sponsoring such access was the NASDAQ market, and accordingly a series of disputes arose over the fairness and adequacy of the access it offered alternative trading systems within its quotation montage and execution facilities. See Notice of Amendment No. 8, Exchange Act Release No. 43,514, 65 Fed. Reg. 69,084 (Nov. 15, 2000); Notice of Amendment Nos. 5, 6, & 7, Exchange Act Release No. 43,133, 65 Fed. Reg. 49,842 (Aug. 15, 2000); Notice of Amendment No. 4, Exchange Act Release No. 42,573, 65 Fed. Reg. 16,981 (Mar. 30, 2000) [hereinafter Notice of Amendment No. 4]; Notice of Proposed Rule Change, Exchange Act Release No. 42,166, 64 Fed. Reg. 68,125 (Dec. 6, 1999) (giving notice of and soliciting comments on proposed rule changes and numerous amendments thereto relating to SuperMontage); see also infra Part IV.B.
display facility" for alternative trading systems and market makers to fulfill their regulatory obligations under Regulation ATS.\(^\text{101}\)

Regulation ATS did, however, offer alternative trading systems the opportunity to avoid integration into NASDAQ or another exchange by registering as national securities exchanges and participating in the national market system directly. Although the Commission attempted to address issues relating to governance requirements and self-regulatory obligations for new registrants, few alternative trading systems responded. Those that did apply to register as exchanges, moreover, were put on hold as the Commission attempted to apply the self-regulatory requirements of the Exchange Act to entities that did not resemble traditional exchanges.\(^\text{102}\) As a result, some alternative trading systems have recently chosen to partner with regional exchanges to compete more effectively within the national market system.\(^\text{103}\)

II. THE STOCK EXCHANGE AS REGULATOR

National securities exchanges are subject to a regulatory framework under various sections of the Exchange Act described as "self-regulation."\(^\text{104}\) Essentially, self-regulation gives members of a self-regulatory organization license to set collectively the ground rules for carrying out their business, subject to public no-

\(^{101}\) Order Approving Proposed Rule Changes, Exchange Act Release No. 43,863, 66 Fed. Reg. 8020, 8053–54 (Jan. 26, 2001) [hereinafter Order Approving Proposed Rule Changes] (conditioning approval on the simultaneous implementation by the NASD of a quote and trade reporting alternative satisfying the regulatory obligations of ATSs, ECNs, and market makers, and the dissemination of such NASD quotes through NASDAQ on an attributed basis, such that participation in SuperMontage would be entirely voluntary). A challenge to the adequacy of the alternative display facility was rejected in Domestic Securities v. SEC, 333 F.3d 239, 249 (D.C. Cir. 2003).

\(^{102}\) See, e.g., 2003 House Hearings, supra note 1, at 131 (prepared statement of Robert Greifeld, CEO and President, NASDAQ Stock Market).


Self-regulation is intended to strike a balance between “the limitation and dangers of permitting the securities industry to regulate itself” and “the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale.” The source of an exchange’s self-regulatory power, the premises for granting exchanges self-regulatory authority, and the ambit of exchange self-regulation are discussed in turn.

A. Source of Self-Regulatory Power

Self-regulation is most effective when the self-regulatory organization has the power to set baseline standards of conduct or other standard terms of dealing for all persons involved in a particular line of business—e.g., lawyers, doctors, accountants, and other professionals. Failure to comply with the rules and regulations of the self-regulatory organization may result in a suspension, revocation, or other limitations on the right to exercise one’s profession. In the realm of securities markets, the Exchange Act has created numerous self-regulatory organizations with exclusive authority to perform certain activities, such as clearance and settlement of publicly traded securities, providing insolvency insurance for broker-dealers, and drafting rules for municipal securities transactions.

105. Self-regulation differs in this respect from the internal controls and audit function that publicly held corporations and regulated entities are required to adopt for the protection of their shareholders or customers. See Miller, supra note 7, at 859 (suggesting that “cooperative regulation” is a more accurate description of the current regulatory framework for securities markets).

106. 1975 Amendments Legislative History, supra note 46, at 22.


108. 15 U.S.C. § 78ccc (creating the Securities Investor Protection Corporation as a self-regulatory organization to insure market participants against the failure to maintain sufficient funds or securities for the benefit of a broker-dealer's customers in the event of insolvency).

109. Id. § 78o-4(b) (creating the Municipal Securities Rulemaking Board).
In the context of stock exchanges, the grant of self-regulatory authority was premised on the ability of the exchange to exercise dominant market power in specific securities or geographic areas. Exchanges may come to acquire dominant market power because the aggregation of liquidity creates a natural monopoly or because members naturally benefit from economies of scale or standardization of terms. Self-regulatory organizations enforce their rules and the federal securities laws using the sanctions available to them—denial of membership and its privileges. While such powers carry with them the threat of anticompetitive behavior, it is the exchange’s monopoly power that also gives it the ability to carry out its self-regulatory mission.

The Exchange Act does not specifically define the term “exchange” by reference to the potential for exercising dominant market power. Nevertheless, the Commission has acknowledged that a market’s ability to restrict access or to condition access on compliance with rules restricting the activities of its members may compel exchange registration. One purpose of heightened regulation of securities exchanges would be to ensure that markets exercise their power to adopt uniform rules judiciously and in the public interest. If this were the only goal of self-
regulation, however, the same result might be obtained by granting each exchange the flexibility to negotiate trading rules and enforcement authority by contract and to address abuses of market power through specific Commission regulation or antitrust law.\textsuperscript{115}

The self-regulatory framework of the Exchange Act, as enhanced by the 1975 Amendments, is designed aggressively to exploit the dominant market power of exchanges to advance the goals of the federal securities laws.\textsuperscript{116} The heightened regulatory obligations imposed on exchanges and national securities associations therefore carry with them an implied antitrust immunity conferred by the Exchange Act.\textsuperscript{117} To prevent abuses of exchange authority, both Congress and the courts have recognized immunity from the antitrust laws "only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary."\textsuperscript{118}

There is a significant question as to whether the current system of exchange regulation is an effective means of regulating the exercise of dominant market power; for this reason, among others, it is often suggested that self-regulation be replaced with ei-
ther direct SEC oversight or unregulated competition.\textsuperscript{119} While the Commission has the power to block undesirable exchange rules, such authority hampers the ability of exchanges to compete effectively by requiring all significant business decisions to be subject to public notice and comment.\textsuperscript{120} Moreover, such authority only prevents efforts to exercise market power through changes in exchange rules, practices, and procedures: the section 19 process provides no assurance that self-regulatory organizations will act to prevent informal collusion among their members.\textsuperscript{121}

B. Premises for Granting Exchanges Self-Regulatory Authority

In large part, Congress's decision to grant self-regulatory authority to the securities exchanges appears to be the result of historical accident and political expediency. Congress needed to address misconduct on securities exchanges, and since securities exchanges already had an infrastructure in place for regulating issuers and broker-dealers, it was convenient for legislators to build the federal securities regulatory framework on this regime. Nevertheless, regulators and commentators have articulated numerous arguments why our "path-dependent" system of exchange self-regulation remains preferable to alternative frameworks—such as a single governmental regulator or a single self-regulatory organization for the entire securities marketplace.\textsuperscript{122} These arguments and their merits are discussed in turn.

\textsuperscript{119} Mahoney, supra note 22, at 1456.

\textsuperscript{120} The SEC has the power, under section 19 of the Exchange Act, to approve or disapprove of every "rule change of a self-regulatory organization," as well as the power to amend or delete exchange rules unilaterally to ensure the fair administration of the exchange or in furtherance of the purposes of the Exchange Act. 15 U.S.C. § 78s(b) (2000); see Request for Comments, supra note 93, at 30,492 (describing attempts by the AMEX to block competing brokers from using its order routing systems and by the NYSE to prohibit the use of phone lines on the exchange floor to transmit market information off-board); Notice of Amendment No. 4, supra note 100, at 16,981 (describing competitive concerns regarding NASDAQ's proposal to downgrade the execution priority of competing alternative trading systems in its proposed order display facility based on order execution methodology).

\textsuperscript{121} NASDAQ 21(A) REPORT, supra note 94, at 38.

1. Operational Familiarity and Reputation Interest

Because an exchange has an interest in ensuring that its customers are satisfied that trading through its facilities occurs in a fair manner, it is often argued that entrusting the regulation of exchange members to the exchange, subject to regulatory oversight, is the most effective means of regulating securities trading. Exchanges and their members and customers developed contractual arrangements for dealing with the costs of monitoring members and listed companies trading prior to the enactment of the Exchange Act, and exchange rules often impose obligations beyond those required under the Exchange Act.

Since exchange personnel have much greater technical expertise with the operations of an exchange—e.g., specialist dealings and floor trading—they are in theory better able to enforce exchange rules and federal securities law than an outside regulator. Some regulatory requirements, for example, may need to be heightened or relaxed as market conditions dictate, or adjusted as exchanges observe new trading patterns, concentration of positions, or other activity gleaned from market surveillance. Administrative process or judicial decision making may be too cumbersome to address such problems.

Exchange members also have a significant interest in enforcing certain rules against one another. Broker-dealers, like other professionals, will naturally seek to weed out the most egregiously incompetent or dishonest firms and individuals from their ranks. Regulation may also serve an important anticompetitive purpose: raising the stakes for participation in certain exchange transactions—such as higher minimum net capital requirements or other restrictions on the leverage members and their customers may

124. See, e.g., Mahoney, supra note 22, at 1458 (arguing that exchanges, through competition, will develop optimal standards).
126. See infra note 366.
employ in various lines of business—ensures that only a limited number of members are able to effect such transactions.\footnote{127}

Many areas of exchange regulation do not require particular operational expertise.\footnote{128} As discussed below, there does not appear to be any nexus between corporate governance standards, handling of customer accounts, and intermarket surveillance, and the operations of particular exchanges. All securities exchanges other than the NYSE have delegated enforcement of their business conduct rules to either the NASD or the NYSE with respect to their dual members.\footnote{129} Other areas of market surveillance that require monitoring all market activity—e.g., insider trading and manipulative market practices—may benefit more from centralized regulation than self-regulation.\footnote{130}

Moreover, there is considerable doubt as to whether exchange self-regulation motivated by reputational interest has succeeded in inspiring investor confidence. As commentators have noted, exchanges are best at punishing isolated misconduct by a “few bad apples;” it is considerably more difficult, however, for an exchange to punish systemic fraud\footnote{131} or to prosecute aggressively questionable market practices that are of vital economic significance to members.\footnote{132} The Special Study further recognized that an exchange might often be “excessively concerned with defending its members from public criticism and insufficiently concerned with governing their conduct in a public market as the Exchange Act requires it to do.”\footnote{133}

\footnote{127. See infra note 196 (implicating higher specialist net capital requirements in the decline of competing specialists).}
\footnote{128. Miller, supra note 7, at 862–63.}
\footnote{129. See infra note 216. Exchanges, of course, remain responsible for regulating their market operations.}
\footnote{130. As a result, exchanges and prominent industry associations have called upon Congress and the Commission to distinguish between self-regulation of “markets” and self-regulation of “members,” and to consolidate regulation of the latter task into a single entity—such as a governmental regulator or a single self-regulatory body—to eliminate inefficiencies. See infra note 360.}
\footnote{131. Marcel Kahan, Some Problems with Stock Exchange-Based Securities Regulation, 83 VA. L. REV. 1509, 1517 (1997).}
\footnote{132. LEE, supra note 110, at 191.}
\footnote{133. Special Study, supra note 17, pt. 5, at 177–78.}
2. Financial Ability

Self-regulation allows the government to shift the financial burden of regulating markets and market intermediaries onto the securities markets.\textsuperscript{134} If securities trading were regulated solely by the Commission or a single industry-wide SRO, such regulation would presumably be funded either through assessments against broker-dealers or from other dedicated sources of revenue administered by federal law.\textsuperscript{135} Self-regulation allows regulators to bundle industry regulation with the other services and expenses in an exchange's income statement, thus "[sparing the federal government much of the burden of securities regulation"] while obscuring the actual cost to the private sector.\textsuperscript{136}

The resources allocated by exchanges at the NASD to self-regulation, vis-à-vis other exchange services, are difficult to determine. Exchanges and the NASD derive revenues from four principal sources: (i) regulatory fees and assessments paid by members; (ii) transaction fees paid by persons entering into securities transactions in a given market; (iii) listing fees paid by corporate issuers; and (iv) market information fees paid by consumers of market information.\textsuperscript{137} Exchanges are currently not required to disclose how such revenues are allocated among self-regulatory functions, such as regulation of market operations, listing and member regulation, and their operating activities.\textsuperscript{138}

\begin{itemize}
  \item \textsuperscript{134} 2003 House Hearings, supra note 1, at 85–86 (prepared statement of Professor John Coffee); Smythe, supra note 117, at 475–77.
  \item \textsuperscript{135} See SIA White Paper, supra note 2, at 48–61. For example, the Public Company Accounting Oversight Board ("PCAOB"), which oversees the auditors of public companies, is funded by "accounting support fees" paid by registered issuers. Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201, 7211, 7219 (Supp. II 2003). From 1965 to 1983, the Commission experimented with direct regulation of broker-dealers that were not members of an SRO, a project that was ultimately abandoned due to its cost and diversion of SEC staff resources. Concept Release, supra note 6, at 71,267.
  \item \textsuperscript{136} Regulation of Market Information Release, supra note 80, at 70,624.
  \item \textsuperscript{137} The Market Data Concept Release notes that, on average, regulatory fees accounted for nineteen percent of an exchange's revenue, transaction fees accounted for thirty percent, listing fees accounted for twenty-three percent, and market data fees accounted for twenty-one percent in 1999. Id. at 70,625. That year, the regional exchanges obtained most of their funding from transaction fees—forty-five percent to seventy-one percent—and sale of market information—fourteen percent to forty-five percent. Id. The NYSE, the NASD, and the AMEX, by contrast, were funded from a more balanced combination of these sources. Id.
  \item \textsuperscript{138} Id. at 70,625–26. As a result of the reorganization of the NASD's regulatory functions (NASD Regulation) and market operations (NASDAQ), the NASD does provide such
\end{itemize}
Allowing the industry to fund self-regulation from exchange revenues creates significant conflicts of interest since the quality of exchange self-regulation may become compromised by commercial considerations. Members could threaten to shift transactions away from an exchange, and thus deprive the exchange of revenue, if the exchange threatens burdensome regulation. \(^{139}\) Issuers could threaten to delist if corporate governance standards are too onerous. \(^{140}\) Investors could seek to consume less market information—or, if permitted, purchase subsets of market information—if data fees become too high. \(^{141}\)

More generally, self-funding raises concerns when revenues otherwise attributable to the commercial activities of exchanges and nonexchange markets become the subject of Commission pricing and allocation. For example, while market information is

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\(^{139}\) Prior to 1976, various exchange rules prohibited members from effecting transactions in a listed security off the floor of an exchange ("off-board trading"). See infra note 267 and accompanying text.

\(^{140}\) See infra note 292 and accompanying text (discussing efforts to eliminate restrictions on voluntary delistings).

a by-product—or product, depending on one's point of view—of an exchange's market operations, the Commission has, through its national market system authority, regulated not only the price at which data may be sold but also the allocation of those revenues exclusively to SROs in the name of funding self-regulation. This creates incentives for exchanges and SROs to use such dedicated sources of revenue for commercial purposes, to the detriment of markets that do not purport to engage in self-regulation.

3. Voluntariness of Regulation

Imposing regulation through a self-regulatory exchange is also thought to be politically advantageous because it has fostered the perception that broker-dealers and issuers assume heightened regulatory obligations voluntarily. As discussed below, self-regulatory organizations are thought to be better able to adopt and enforce ethical norms of business conduct with respect to their members than a government agency. Expansion of Commission authority to proscribe "unethical" conduct would require a "minute, detailed, and rigid regulation of business conduct by law" that would not keep pace with evolving practices in the mar-

142. Exchanges could in theory compete not only on the basis of trades but also based on the value of their market data. See, e.g., Mulherin et al., supra note 22, at 594, 643–44. The Commission has long expressed concern, however, that allowing exchanges to set different prices for their market data may lead exchanges to price their data anticompetitively to deny or restrict access to information. But see supra notes 16–18 and accompanying text (providing description of data products offered by individual exchanges). The Commission has recently proposed a formula for allocating market data fees that takes into account the “aggressiveness” of an exchange's public quotes. Proposed Regulation NMS, supra note 5, at 11,134–35. This raises the question whether the Commission can do better than market forces in determining the appropriate value of market information.

143. For example, all exchanges and the NASD are entitled to share in market data revenues in proportion to their trading activity, but alternative trading systems, market makers, and broker-dealers are not, even though they generate a substantial portion of the data captured and disseminated by market data systems. See Regulation of Market Information Release, supra note 80, at 70,625. In 2003, net revenues from the sale of market data across all national market system securities totaled $386 million. Proposed Regulation NMS, supra note 5, at 11,179. While the Commission has proposed to modify the allocation formulae to reflect the value of the information provided, there is no plan to distribute such revenues directly to non-SRO systems that generate quotation information. Id. at 11,180.

144. This may be done by “sharing” market data revenues with members based on the volume of orders or transactions they bring to the exchange for execution. See Proposed Regulation NMS, supra note 5, at 11,156–57 (describing various exchange revenue sharing arrangements).
Since exchanges depend on SEC approvals to implement their own commercial and regulatory initiatives, exchanges may seek to adopt rules upon a "suggestion" or "raised eyebrow" from the SEC, thus eliminating the need for federal intervention.

The Exchange Act offers issuers and broker-dealers the option to list on or become members of an exchange and comply with its standards of conduct as a means to differentiate themselves from their competitors. This facilitates tiering of market participants without the need for the Commission to establish multiple listing or broker-dealer standards. It also removes more controversial corporate governance or business conduct proposals out of the political area in which Congress and the Commission operate until the effectiveness of implementing and enforcing such rules can be demonstrated on a subset of companies or broker-dealers that "voluntarily" undertake them.

For example, despite the lack of general Commission authority to adopt corporate governance rules for listed companies, the Commission has enjoyed some success as discussed above in

145. Regulation of Over-the-Counter Markets, S. Rep. No. 75-1455, at 3 (1938). The SEC has, however, considered standards-based regulation for SROs in certain circumstances. See, e.g., Request for Comments, supra note 93, at 30,494–95; Lipton, supra note 125, at 537–40.

146. See infra note 338 (describing the SuperMontage controversy).

147. Lipton, supra note 125, at 536; Donald E. Schwartz, Federalism and Corporate Governance, 45 Ohio St. L.J. 545, 571 (1984).


149. See, e.g., ABA Market Structure Study, supra note 2, at 1503; Poser, supra note 72, at 901–15 (describing the failed attempt at developing tiered standards for national market system securities).

150. For example, the U.S. House of Representatives has passed a bill that would preempt a recent accounting principle regarding stock option expensing promulgated by the Financial Accounting Standards Board. Stock Option Accounting Reform Act, H.R. 3574, 108th Cong. (2004); see also Floyd Norris, When Politicians Write Accounting Rules, Reality Can Be Forgotten, N.Y. Times, July 23, 2004, at C1.
prodding exchanges to adopt and enforce listing standards in specific areas without the need for rule making or legislation.\textsuperscript{151} The existence of multiple SROs has also proven to be helpful in developing best practices for brokerage firms, particularly in the area of financial responsibility. While many trade associations may perform the same functions, only an SRO has the ability to enforce compliance with such practices.\textsuperscript{152}

4. Industry Accountability

Exchanges also serve as publicly accountable representatives of the securities industry. As associations of broker-dealers with the power to bind their members, exchanges serve as a useful foil with which regulators and legislators can publicly negotiate for reforms in the securities industry. The NYSE, as the self-regulatory authority for the preeminent investment houses on Wall Street, occupies a unique place in these discussions. The NYSE and its personnel are regularly represented in many major public policy discussions on securities market reform, in no small part because the exchange has the ability to negotiate voluntarily remedial measures on behalf of major firms in lieu of individually negotiated settlements or tailored injunctions.

C. Ambit of Stock Exchange Self-Regulation

To prevent abuse of the exchange's implied antitrust immunity, the scope of each exchange's self-regulatory power and responsibility must be defined.\textsuperscript{153} Unlike the pre-1975 regime, the Ex-

\begin{itemize}
\item[\textsuperscript{151}] See supra note 150 and accompanying text. With the passage of the Sarbanes-Oxley Act, Congress and the Commission have renewed their reliance on exchange and NASDAQ listing standards to improve corporate governance practices.
\item[\textsuperscript{153}] Even in the case of SROs that ostensibly have a statutory monopoly on a particular market service, the Commission must be careful to ensure that the SRO does not use its monopoly power to establish a competitive edge in the provision of related services through "tie-in" arrangements. See, e.g., 2003 House Hearings, supra note 1, pt. 2, at 24 (statement of Rep. David Scott) (referring to a proposed rule change of the National Securities Clearing Corporation ("NSCC") that would allow the NSCC to provide certain messaging services provided by private sector participants); Notice of Filing of Amendment Nos. 2 and 3 to Proposed Rule Changes by National Association of Securities Dealers, Exchange Act Release No. 43,616, 65 Fed. Reg. 71,174 (Nov. 29, 2000) (eliminating, in light of
change Act provides that the rules of a national securities exchange may not extend to matters "not related to the purposes of [the Exchange Act] or the administration of the exchange." Naturally, exchanges have developed rules and regulations relating to the core business services they provide, such as standardized terms of trading, clearance and settlement, dispute resolution, and liquidity provision. Substantive exchange rules of regulatory concern may be generally grouped into three categories: (i) rules regulating exchange transactions; (ii) rules governing listing of public companies; and (iii) rules governing members' handling of public customer business.

1. Regulating Exchange Transactions

The regulation of exchange transactions was one of the key reasons for the promulgation of the Exchange Act in 1934. To the extent that exchanges such as the NYSE exercised dominant power with respect to both the volume of transactions effected as well as the price discovery process that established market prices, legislators and regulators saw great potential for abuse of power by exchange members. Thus, regulators took particular interest in the manner in which trades were executed, the right of specialists to intervene in the execution of trades, and the right of other members to profit from their privileged position in the market. Regulators also sought to ensure that exchanges took responsibility for monitoring abusive practices and taking appropriate action to restore the integrity of markets.

As exchanges become more competitive with other markets, the justification for regulatory oversight of these processes becomes increasingly less important. In particular, the struggle to articulate the obligations of exchange members and specialists with respect to customer orders has both failed to resolve the essential conflicts of interest on an exchange floor and have hindered, to some degree, the ability of exchanges to compete. Moreover, the

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existence of multiple markets has long called into question the ability of exchanges to monitor unusual market activity or to detect improper trading patterns. Each of these aspects of exchange regulation is discussed in turn.

a. Trading Rules

Exchanges facilitate execution of securities transactions by bringing together the orders of buyers and sellers of securities. According to the SEC's most recent interpretation of the statutory definition, the hallmark of an exchange is that execution takes place through some established, nondiscretionary means that allows orders to interact directly. Assuming that prices are best "discovered" by the interaction of buying and selling interest,

157. The Exchange Act definition does not provide much additional guidance:

The term "exchange" means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

15 U.S.C. § 78c(a)(1) (2000). The "plasticity" of Congress's definition reflects the contemporaneous view that the term was "self-explanatory" and that a narrowly tailored definition might encourage exchanges to evade regulation. See Bd. of Trade v. SEC, 883 F.2d 525, 535 (7th Cir. 1989); 1975 Amendments Legislative History, supra note 46, at 211. Colloquially, an exchange may be defined as a place for organized trading of stocks or other financial instruments and the performance of ancillary services that are associated with stock exchanges. See Lee, supra note 110, at 322–23; Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 604 (3d ed. 1995) ("The hallmark of a stock exchange historically has been the centralization of trading on an exchange floor.").

158. For example, assume customer A submits an order to buy 1000 shares at $10.10 per share and customer B submits an order to sell 1000 shares at $10.05 per share. In the over-the-counter market, two different market makers might handle A's order and B's order, such that A gets an execution price of $10.10 per share and B gets an execution price of $10.05 per share. In an exchange market, A and B theoretically have an opportunity to interact—assuming their orders arrive contemporaneously, see infra notes 191–92—such that one or both will receive a better price: A might be able to purchase from B at $10.05 per share, or B might be able to sell to A at $10.10 per share.

159. Lawrence Harris, Trading and Exchanges § 5.3.2, at 94–95 (2003). Essentially, prices are discovered on an exchange through the interaction of orders submitted by buyers and sellers. Buyers who are willing to "bid" up the price of a security and sellers prepared to "offer" lower prices to prospective purchasers telegraph to the broader marketplace their estimate of the value of a security. The aggregation of such bids and offers produces the exchange "quote." The more bids and offers submitted to a market, the more accurately the quote reflects the market's valuation of a security. A market consisting solely of dealers also engages in price discovery, see id. § 13.6.1, at 284–85, although such a market cannot produce a single bid and offer without establishing a means for consoli-
exchange rules should therefore be designed in a manner that maximizes the "opportunity . . . for investors' orders to be executed without the participation of a dealer."\textsuperscript{160}

One purpose of regulating the trading processes of exchanges would thus be to ensure that exchanges do not compromise their trading rules.\textsuperscript{161} Defining exchanges in this manner preserves the "stamp of reputability" that investors associate with an exchange execution, insofar as the rules of an exchange minimize opportunities for exchange intermediaries to extract profits from exchange trades.\textsuperscript{162} Thus the Commission has taken great care to reserve the right to designate who may call itself an exchange\textsuperscript{163} and has required broker-dealers to advise their customers whether they have obtained an exchange execution in connection with each transaction.\textsuperscript{164}

Designation of exchange markets is thought to benefit not just the exchange and its customers, but the marketplace as a whole. Exchange rules are designed to encourage informed investors to
dating bids and offers and resolving quotes that "lock" or "cross" one another. \textit{See, e.g.}, NASD Rule 4613(e).

160. 15 U.S.C. § 78k-1(a)(1)(C)(v); \textit{see, e.g.}, LTV Fed. Credit Union v. UMIC Gov't Sec., 523 F. Supp. 819, 834–35 (N.D. Tex. 1981) (holding that UMIC was not an exchange because it interposed itself in transactions and did not allow direct order interaction).

161. In connection with Congress's grant of exchange trading privileges to unlisted securities, it was noted that "[t]he protections inherent in exchange-type trading should be afforded to investors in all securities with suitable characteristics and should not be dependent upon the decision of corporate management to 'list.'" 1975 Amendments Legislative History, \textit{supra} note 46, at 19.


163. A trading venue may not call itself an "exchange"—even if it performs an auction-type execution and otherwise fits within the definition of an exchange—if that venue is not registered as a national securities exchange. 17 C.F.R. § 242.301(b)(11) (2004) ("The alternative trading system shall not use in its name the word 'exchange,' or derivations of the word 'exchange,' such as the term 'stock market.'"). It is not clear, however, whether using the letter "X" prominently would violate this rule. \textit{See, e.g.}, http://www.nexttrade.com (last visited Mar. 26, 2005).

164. For example, customer confirmations must disclose whether a trade is executed on an exchange or by a "dealer" in the over-the-counter market, but not, for example, whether a trade actually interacted with other orders or with a specialist or market maker's book. 17 C.F.R. § 240.10b-10 (2004).
reveal the maximum or minimum price at which they are willing to buy or sell by guaranteeing that their "limit" orders will be granted priority of execution within its facilities. Designation of a market as an exchange signals that other markets—such as the over-the-counter market, the options and futures markets, or the market for negotiated derivative transactions—may reasonably rely on the prices generated by the exchange.

While both traditional floor-based exchanges and modern alternative trading systems rely on priority rules to govern the interaction of orders, different markets may provide different sets of priority rules and permit greater discretion for market intermediaries to trade within the parameters set by those priority rules. Despite some objections, both Congress and the SEC have rejected the notion that all securities trades should be processed in a single market, or subject to a single algorithm.

165. In a pure auction market, the bid-ask spread represents the best buy and sell orders with associated prices ("limit orders"). Price discovery takes place as either (i) additional limit orders that either improve the bid or asked price or the size of the quote at the bid or asked price, or (ii) market orders or marketable limit orders are executed against the prevailing bid or asked price, thus "moving the market" to the next highest bid or next lowest ask price.


167. For example, customers may wish to attach detailed instructions to orders regarding visibility to the public, duration of the order, the conditions under which the order is to be executed, canceled or modified, or parameters for negotiation of the final trade price with other market participants. Different exchanges and trading systems have different order types reflecting these options. Exchanges must naturally strike a balance between affording customers too many order types (which would inhibit development of sufficient trading volume) and too few (which would discourage investors from submitting orders that are sensitive to market developments). See Harris, supra note 12, at 17–19 (noting that exchange rules typically entail a composition of priorities based on price, display status, time, and size).

168. Mahoney, supra note 22, at 1458. For example, the SEC appears to have classified NASDAQ's Level 2 quote montage as an "exchange" in so far as market makers are required to display quotes and accept executions at those quotes pursuant to established rules. See Regulation of Exchanges, supra note 4.

Though consolidation of all trading into a single "central limit order book" would ensure identical treatment of all orders and theoretically improve price discovery, the Commission has recognized that different classes of investors may prefer different permutations of these priority rules. Similarly, investors may demand that exchanges differentiate among pools of liquidity with different characteristics.

For example, many successful trading systems offer very strict priority rules for executing customer orders for institutions and other "informed" investors trading on the basis of proprietary analysis of stock values. These systems succeed partly because of their ability to hide portions of their trading interest from public view, thus eliminating the adverse selection problem posed by public limit orders on an exchange. Others have sought to relax
their priority rules to respond to growing competition from market makers in the over-the-counter market. These modifications allow exchange members to cross or internalize customer orders expeditiously with the imprimatur of the exchange.

b. Regulating Members' Informational Advantages

The Exchange Act contains certain provisions designed to ensure that exchange members do not profit from the information gained from their special access to the exchange floor. These provisions exist because exchanges may offer their members a superior opportunity to observe trading conditions and to use the information obtained from such observations to anticipate and influence market movements. For example, the Exchange Act prohibits members who engage in public business from executing a member's order ahead of any public investor's order, unless certain steps are taken to eliminate certain informational advan-

“work” the order in pieces without signaling the investor’s trading interest to other participants. Today, trading venues have developed various technological tools to accomplish the same task. Amihud & Mendelson, supra note 169, at 1451–53 (2004).

175. Consistent with their best execution obligations, market makers must at a minimum ensure that their customers' market orders are executed at the publicly quoted price. It has been suggested that market makers should either be required to improve upon a quoting market's public quote or route the customer's order to the quoting market, on the theory that (i) a customer order might receive a price better than the exchange's quote if the order were sent to the quoting market and (ii) as between an execution on a primary exchange and in the over-the-counter market, it is preferable to execute the order against the exchange's quote to encourage placement of public limit orders to the primary exchange. Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577, 10,584 (Feb. 28, 2000). Some market makers have adopted such policies. See, e.g., MADOFF'S GUIDE TO BEST EXECUTION, at http://www.madoff.com/dis/display.asp (last visited Mar. 26, 2005) (providing automatic price improvement for many retail orders executable at current market prices).

176. It has been alleged, however, that these modifications appear to be motivated by the desire to inflate exchange volume by "printing" pre-arranged transactions. See Proposed Regulation NMS, supra note 5, at 11,171.

177. The SEGREGATION REPORT suggests that these prohibitions were intended to reduce market volatility by preventing members from engaging in excessive trading activity for their own accounts, as well as to eliminate members' cost advantage resulting from the exchange's fixed commission schedule and capital requirements. SEGREGATION REPORT, supra note 35, at 15–17.

178. Id.

179. This excludes market makers, odd-lot dealers, arbitrageurs, and transactions where a member is acting as an underwriter to stabilize market prices under the terms permitted in section 11(a) of the Exchange Act.
The relevance of such prohibitions has declined as technology has eliminated the informational advantages of members and as exchanges have allowed members to trade in the over-the-counter market where no such prohibitions exist.\(^{181}\)

The regulation of exchange specialists poses more significant problems, since the conduct of specialists is routinely cited as one of the most egregious abuses of exchange market power.\(^{182}\) Exchanges have historically enhanced liquidity and reduced volatility by engaging certain market intermediaries—such as specialists or market makers—to deal in certain securities through their facilities.\(^{183}\) Specialists (acting as agents) represent market and limit orders submitted by other members to them while simultaneously trading with customers and other participants (acting as a dealer) as necessary to maintain “a fair and orderly market[].”\(^{184}\) In U.S. markets, specialists and other such intermediaries may be compensated by fees for handling certain orders as

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182. See, e.g., 2004 House Hearings, supra note 1, at 10–11.

183. See, e.g., id. at 106–16 (prepared statement of Frank G. Sullivan, CEO, RPM International, Inc.) (describing benefits of NYSE specialist intermediation, particularly in the event of significant imbalances in buying and selling interest at the opening of trading).

184. Id. at 111.
well as profits on the spread between the prices at which they
purchase and sell securities (the "bid-ask spread").

This dual role creates a significant conflict of interest, in that
the specialist has the discretion to intervene in the direct interac-
tion of public orders when it is not to the advantage of the ex-
change's customer. Many exchange floor trading scandals in-
volve situations in which a specialist is believed to have profited
from unnecessary interventions in exchange trading. Recent
examples include specialists who trade ahead of customer orders
at a negligibly superior price ("trading ahead"), who "interpose"
themselves between two orders that might otherwise meet within
a reasonable period of time, or who "freeze" automatic execution
systems to prevent electronically routed order flow from interact-
ing with orders represented on the floor.

What distinguishes specialists from larger over-the-counter
market makers, who increasingly perform similar services for the
same compensation, is perhaps an expectation that specialists are
subject to more stringent obligations with respect to their trading
activity due to their monopoly position on the exchange. In par-

185. Id. at 106–16.
able at 2004 SEC LEXIS 1563; Performance Specialist Group LLC, Exchange Act Release
No. 50,075 (July 26, 2004), available at 2004 SEC LEXIS 1564 (calculating fines based on
profits from interpositioning and lost execution opportunities due to "trading ahead" or
unexecuted limit orders).
188. The minimum price increment on the stock exchanges is currently $0.01. Thus, for
example, if an institutional customer wishes to purchase 100,000 shares of XYZ stock at
$10 for $1 million, the specialist could trade ahead of that customer by placing a bid at
$10.01, which would be an additional cost of $1,000, and executing the order before the
institution has a chance to respond. The specialist benefits from the institution's valuation
of XYZ stock without executing the institution's order. See Special Study, supra note 17,
pt. 2, at 144.

Some alternative trading systems permit, and NASDAQ has recently proposed to allow,
trading in fractions of a penny. The Commission has suggested, however, that subpenny
trading is largely employed to trade ahead of other customers and accordingly has pro-
posed to ban the practice. See Proposed Regulation NMS, supra note 5, at 11, 163.
189. For example, if customer A submits an order to buy XYZ at $10.10 per share at
12:05:00 p.m., and customer B submits an order to sell at $10.00 per share at 12:06:00
p.m., the specialist could sell XYZ to customer A at 12:05:20 p.m. and buy from customer B
at 12:06:20 p.m., making a profit of $0.10 per share. Alternatively, the specialist could
hold customer A's order in the expectation that an order to sell might be forthcoming, in
which case the $0.10 differential would go either to customer A or B.
190. Although some exchanges continue to maintain competing specialists, there are no
competing specialists on the NYSE as discussed supra note 17.
ticular, the Commission has recognized that customers who submit a limit order effectively give the exchange specialist or market-maker a "free option" to either execute the order or advertise the order to the market. There may be a greater expectation that a specialist will execute such an order for its own account when there is no trading interest on the opposite side of the market to minimize this implicit cost of submitting limit orders.

Establishing a distinction between specialists and other liquidity providers by law or regulation has proven to be an exceedingly difficult task. While the Commission has considered segregating the brokerage and dealing functions of specialists by law, exchanges have maintained that the combination of an auction market and a specialist to regulate order flow produces a system that provides the best price available for listed securities. Accordingly, the Commission has attempted to define—or to require exchanges to define—the circumstances in which specialists should be required to deal ("affirmative obligations") and should be required not to deal ("negative obligations") in compliance with the statutory requirement that specialists should trade as reasonably "necessary . . . to maintain fair and orderly markets".

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191. A customer submitting a public limit order writes a "free option" to the extent that the customer is committing itself to trade at a particular price, e.g., $10 to sell 1000 shares until the order is canceled, regardless of whether the market suddenly changes direction. Thus, if the specialist believes the value of XYZ will decrease, the specialist may ignore the limit order and sell for its own account to other customers at a lower price, e.g., $9.95. If the specialist believes the price of XYZ will increase, the specialist may execute the customer's order by buying the customer's 1000 shares for its own account and subsequently reselling them at a higher price.

192. Some trading systems have developed schemes to "reward" this free option by paying a "liquidity" rebate to customers placing limit orders. See Proposed Regulation NMS, supra note 5, at 11,168–69.


196. 15 U.S.C. § 78k(b) (2000). In 1937, the Division of Trading and Exchanges interpreted the statutory qualification to mean transactions that enhance price continuity and minimize the effects of imbalances between supply and demand. Exchange Act Release No. 1117, 1937 WL 31449 (Mar. 30, 1937). In 1964, the Commission adopted Rule 11b-1 setting forth various areas in which exchanges were required to adopt rules for specialists, including net capital requirements and "affirmative" and "negative" trading obligations. 17 C.F.R. § 240.11b-1(a)(2)(ii); see NYSE Rule 104 (implementing the standards articulated in the Saperstein interpretation). Section 11(b) was amended in 1975 to eliminate
It is difficult to apply such affirmative and negative obligations in practice. With respect to for-profit entities, it is unreasonable to expect specialists to court insolvency by absorbing investor orders at a loss when affirmatively required without being able to liquidate them for a profit when trading is unnecessary. Regulators and commentators thus focus on whether exchange specialists derive unreasonable profits from their privileged position in the exchange. Exchanges, in turn, have developed quantitative tests to assess the performance of their specialists. Given the handful of specialist firms that handle all specialist activity on the NYSE, it may be difficult to restrict specialist activities without further reducing the number of specialist firms. Thus, underperformance appears to be addressed primarily in the allocation of new stocks, or more infrequently, reallocation of existing stocks, rather than fines or other disciplinary action.

the express requirement that Commission rules restrict an exchange specialist's dealings when not "reasonably necessary to permit him to maintain a fair and orderly market." See Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, 110-111 (1975). Although the amendment was intended to "provide the SEC with greater flexibility in prescribing a specialist's obligations in a national market system," the "negative obligation" remains in Commission Rule 11b-1 and exchange rules. 1975 Amendments Legislative History, supra note 46, at 100.

197. See Maureen O'Hara, MARKET MICROSTRUCTURE THEORY 25-29 (1995); Harris, supra note 12, at 8 ("Efforts to compel dealers to offer more liquidity must somehow increase their profits or lower their perceived risk. Otherwise the dealers will simply quit.").

198. 2003 House Hearings, supra note 1, at 236-37 (draft report of Brian Becker) (finding that specialist firms earned pre-tax profits of thirty-five percent to sixty percent in contrast to the 9.7% return enjoyed by market making firms, with respect to stocks in various industry classifications). In the recent enforcement actions against two specialist firms, there was some disagreement among regulators and the specialists under investigation as to the manner in which the fines were calculated, notably with respect to the time frames used to determine whether specialist intervention was appropriate. See Landon Thomas, Jr., S.E.C. Steps In as Fines Are Planned on 5 Firms, N.Y. TIMES, Oct. 17, 2003, at C1 (noting that the NYSE increased the size of the fines assessed for improper specialist intervention after "narrow[ing] the time frame [for determining the backlog of executable customer orders from sixty seconds to ten seconds] pursuant to discussions with the S.E.C.," and thus determining that "more customer orders were in a backlog when the questionable trading occurred").

199. 2003 House Hearings, supra note 1, at 232-33 (draft presentation of Brian Becker) (noting that seven specialist firms make markets in approximately 2557 listed securities, of which LaBranche & Co. LLC, Spear Leeds & Kellogg Specialists, and Fleet Specialist, Inc, together account for approximately seventy percent of share and dollar volume); Thomas, supra note 195, at C10 (noting concern that there are only seven specialist firms left).

200. NYSE Rule 103A (reallocation proceedings for specialty stocks); see Oesterle et al., supra note 8, at 267-82. The Commission has also developed its own metrics for assessing execution quality across markets generally. See 17 C.F.R. § 240.11Aa1-5 (2004).
It would seem that the only effective constraints on specialist activities are those created by exchanges' commercial and reputational interests. In response to competitive pressures and technological opportunities, some specialists on competing markets have developed algorithms to perform their market-making task more efficiently.\footnote{201} As more trading systems offer investors the alternative of a "pure" auction in listed securities, exchanges may develop further restrictions on specialist conduct, or replace them with purely automated trading systems, to retain primacy as price discovery markets.\footnote{202} Given that exchanges must rely on sophisticated institutional order flow to assure the integrity of their price-setting function, it is not unreasonable to assume that exchanges will increasingly face commercial pressure to address perceived abuses of specialist power as other venues attract liquidity in listed securities.

c. Coordinating Intermarket Regulation

Perhaps the weakest area for relying upon self-regulation is the oversight of trading activity by members and nonmembers. For example, exchanges are called upon to determine whether unusual imbalances in trading activity or the dissemination of rumors or recent news require temporary halts in trading. Exchanges are also required to monitor trading in their markets for possible manipulative activity or insider trading. Such regulation historically was premised upon the concentration of liquidity in publicly traded securities on a single exchange or market.

In some cases, an exchange that has entered into a listing agreement with a public company might be the appropriate market participant to take the lead in coordinating intermarket action.\footnote{203} As the regulatory authority responsible for monitoring an issuer’s compliance with corporate governance standards and fed-
eral securities law, an exchange may initiate a dialogue with the issuer to recommend action to quell or confirm rumors or disclose additional information to the marketplace to restore market stability. There is a significant commonality of interest between markets and issuers in maintaining orderly trading activity that delegating this task to a primary market seems reasonable.

Trading practices that are designed to elude regulatory oversight—illegal short selling, insider trading, and market manipulation—may benefit more from a uniform order audit trail system, maintained by a single regulator. Such activity may be designed to take place across multiple markets in order to escape the notice of the primary exchange, or may exploit differences in trading rules applicable in different markets. For listed securities, monitoring for manipulative or insider trading activity today entails coordinating the audit trails and enforcement efforts of multiple SROs. Because the types of information captured un-


205. Mahoney, supra note 22, at 1499. For example, the Commission's efforts to prosecute recent specialist trading scandals relied heavily on the NYSE's detailed order audit trail to determine whether specialists improperly intervened in trading. See supra note 198 and accompanying text.

206. For example, after years of differential standards in the listed and over-the-counter markets for short selling in listed securities, the SEC recently proposed revisions to its short sale rule to promote greater consistency. Short Sales, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008 (Aug. 6, 2004) (adopting final rule instituting a new uniform bid test allowing short sales to be effected at a price one cent above the consolidated best bid with respect to all exchange-listed securities and NASDAQ National Market System Securities, wherever traded).

207. Market surveillance in the listed securities market is coordinated by the Intermarket Surveillance Group, whose members include all registered U.S. stock and options exchanges, the NASD, and several major futures exchanges. Prior to 1988, the Commission and the ISG members collected information about suspicious trading activity from broker-dealers through the use of “blue sheet” questionnaires, later replaced by an “electronic blue sheet” (“EBS”) system. See Electronic Submission of Securities Transaction Information by Exchange Members, Brokers, and Dealers, Exchange Act Release No. 44,494, 66 Fed. Reg. 35,836, 35,840 (July 9, 2001) (adopting final rule relating to electronic submission of securities transaction information). EBS inquiries are aggregated by SIAC, see supra note 79, and forwarded to the requesting entity. Until the adoption of Rule 17a-25, record-keeping and transmission requirements for the EBS system were established by individual SRO rules. See, e.g., NYSE Rule 410A; AMEX Rule 153A; NASD Rule 8211.

The EBS system does not collect information about the handling of customer orders; as a result, the maintenance of adequate order audit trails is governed by individual SRO rules. In the NASDAQ Stock Market, broker-dealers trading in NASDAQ securities are required to maintain an audit trail under the NASD's Order Audit Trail System. NASD Rule 6950. As unlisted trading in NASDAQ securities on exchanges increases, cracks in
order various exchange rules are inconsistent, and because individual orders may be shuttled among numerous broker-dealers before reaching an execution facility, it is very difficult to piece together a complete sequence of order routing instructions—from creation to execution—for an individual order in such a regime. Thus, commentators have called on the SEC to standardize rules across markets for surveilling for and enforcing against such practices.\textsuperscript{208}

2. Regulating Issuer Quality

An exchange's listing standards serve various purposes. Listing standards ensure that an exchange can sustain an expectation of reasonable liquidity in a continuous auction environment without undue specialist involvement.\textsuperscript{209} Thus, virtually all exchanges require issuers to meet certain quantitative criteria regarding the size of the issue, the volume of shares traded, the number of public shareholders, the aggregate market value of shares, and profitability.\textsuperscript{210} Listing rules also include mandatory disclosure requirements, corporate governance standards, and other factors designed to identify companies whose securities are likely to generate long-term confidence and thus sustainable trading interest by the public.\textsuperscript{211}


Moreover, the primary exchanges generally remain responsible for detecting anomalous order routing or trading activity, which may then lead to a request for submission of electronic order routing or transaction data by broker-dealers or consultation with the issuer. \textit{See, e.g., LCM, supra note 204, § 202.04. As trading fragments across multiple markets, it will become increasingly difficult for SROs to detect the type of activity warranting further investigation without a central market surveillance system.}

\textsuperscript{208} STA REPORT, \textit{supra} note 207, at 7–8.

\textsuperscript{209} Macey & Kanda, \textit{supra} note 12, at 1025–34; \textit{see also} Bus. Roundtable v. SEC, 905 F.2d 406, 408–09 (D.C. Cir. 1990).

\textsuperscript{210} Special Study, \textit{supra} note 17, pt. 2, at 828; see, \textit{e.g., LCM, supra note 207, § 102; NASD Rule 4310 (NASDAQ Stock Market criteria); NASD Rule 4420 (NASDAQ National Market criteria).}

\textsuperscript{211} \textit{See Michael, supra} note 44, at 1477. There may be good reason to subject other products, \textit{e.g., stock index funds and derivative contracts}, to some heightened degree of regulation in light of the particular function exchanges play in standardizing those contracts. Since the rights and privileges of securities are defined by state law, and since all
From the issuer's perspective, the listing contract serves largely as a method of attracting broad retail interest in, and thus conditioning a favorable market for subsequent issues of, its equity and debt securities. Shareholders of listed companies have access to the exchange's trading facilities and a commitment to liquidity, as well as access to current information about trading activity in their listed companies. Despite the emergence of rating agencies and other groups that perform a similar evaluation function with respect to publicly traded securities, exchange monitoring of an issuer's corporate governance standards is still generally considered vital to promoting investor confidence. Moreover, listing on the NYSE, the AMEX, or NASDAQ is generally necessary to claim an exemption from state blue sky registration and to permit securities to be purchased on margin.

As public attention periodically focuses on corporate wrongdoing, Congress and the Commission have put greater pressure on exchanges to raise listing standards, rather than federalize such standards for all registered public companies or to establish tiers of federal regulation. Particularly in light of the limitations on Commission authority pronounced in *Business Roundtable v. SEC*, the Commission has pressured exchanges to adopt standards for a range of issues to supplement state corporation law. More recently in the Sarbanes-Oxley Act of 2002, Congress required the Commission to adopt rules requiring that exchange contracts for the sale of stock are largely fungible as a result of the centralization of the clearance and settlement process, these considerations should not effect the development of exchange listing rules.

212. See Amihud & Mendelson, supra note 169, at 1426–33 (noting the impact of exchange listing or switching of listings on stock value).


214. But see Macey & O'Hara, supra note 155, at 40 (noting the declining value of the listing function).

215. 12 C.F.R. § 220.2 (2004) (defining margin security to include any security registered or having unlisted trading privileges on a national securities exchange or any security listed on the NASDAQ Stock Market); see supra note 21.

216. Michael, supra note 44, at 1476–77 (describing the Commission's efforts to develop corporate governance listing standards in the 1950s and 1970s); Poser, supra note 72, at 957–58 (describing the Commission's failed efforts to establish quantitative standards for national market system securities).


218. These include dual-class recapitalizations, expensing of stock options, composition and authority of audit committees and other independent board committees, executive compensation, and other matters historically left to state law. *Id.* at 409–10.
and NASDAQ-listed companies comply with certain heightened corporate governance standards.\textsuperscript{219}

Listing is, however, a contractual relationship. While the Exchange Act requires registration of issuers of publicly traded securities, it does not require listing of publicly traded securities. Issuers are free not to seek listing of their securities on any exchange, and as discussed below, are generally free to delist or relist their securities on another exchange. Moreover, an exchange listing is not required for investors to trade a particular issue on an exchange, if the exchange is able to trade the security on an unlisted basis.\textsuperscript{220} For many public issuers, the benefits of listing on the NYSE, the AMEX, or NASDAQ far outweigh the regulatory burdens, and accordingly issuers have tolerated—and in many cases embraced—such heightened regulation as the price of encouraging investor confidence.\textsuperscript{221}

If exchanges have been successful at imposing listing standards, it is far less certain that they have been able to enforce those standards or to take appropriate remedial action. Because the listing relationship is contractual, the only practical remedy for violation of exchange rules is the stigma of reprimand or delisting. Given the increasing competition for listings, it is unclear whether exchanges are willing to absorb the reputational loss of fewer listings or trades or the financial losses due to declining in listing, trading, and market data fees resulting from delistings.\textsuperscript{222} The Commission's efforts to facilitate "voluntary" delisting of public companies further removes an exchange's leverage to enforced their listing standards by allowing issuers to avoid the stigma of an exchange reprimand or other sanction.\textsuperscript{223}

\textsuperscript{220} See supra notes 209–11.
\textsuperscript{221} Approximately 13,500 registered public companies submitted reports to the Commission in fiscal year 2002. By comparison, the Commission reported that, as of December 31, 2002, there were 2102 issues of common stock listed on the NYSE and 657 issues of common stock listed on the AMEX. SEC, ANNUAL REPORT 139 (2003) [hereinafter SEC ANNUAL REPORT], available at http://www.sec.gov/about/annrep03.shtml (last visited Mar. 26, 2005). NASDAQ reported that there were approximately 3600 issues listed for trading on its facilities. NASDAQ, ANNUAL REPORT 2002.
\textsuperscript{222} See supra note 140 and accompanying text; infra Part III.B.
\textsuperscript{223} See infra note 291–92 and accompanying text (voluntary delisting).
3. Regulating Member Business Conduct

The Exchange Act requires national securities exchanges and associations to supervise their member firms with respect to a wide range of matters apart from their trading activities on an exchange or in the over-the-counter market. Exchanges historically have behaved very much like professional associations for broker-dealers, and professional associations have traditionally been granted enormous deference by legislators in drafting industry codes of conduct and disciplining their membership.\(^2\)\(^2\)\(^4\) As described above, the NASD was similarly designed to serve as a professional association for broker-dealers not a member of an exchange.\(^2\)\(^2\)\(^5\)

While there is no statutory obstacle to the formation of multiple SROs for the purpose of setting or enforcing standards of conduct, no new SROs appear to have been created for this express purpose, other than those established by Congress for specific segments of the securities market. As broker-dealers are limited in their choice of designated examining authority and the bundle of business conduct rules applicable to their public activities, it can be expected that exchanges and the NASD have significantly more leverage to oversee and discipline their members than their listed issuers.\(^2\)\(^2\)\(^6\)

a. Setting Standards of Conduct

One important function performed by the exchanges and the NASD is to establish rules for the regulation of broker-dealers' relationship with their public customers.\(^2\)\(^2\)\(^7\) The Exchange Act requires exchanges and the NASD to adopt rules designed, among other things, "to promote just and equitable principles of trade" and "to protect investors and the public interest."\(^2\)\(^2\)\(^8\) The ex-


\(^{225}\) See supra note 37 and accompanying text.

\(^{226}\) Of course, in light of the relatively small number of NYSE specialists, see supra note 199, it may become increasingly difficult for the NYSE to threaten them with disciplinary sanctions.

\(^{227}\) Such rules include a variety of matters, such as financial responsibility, fraud or manipulation, record keeping, reporting, sales practices for, advertising of, or standards of training, experience, competence, or other qualifications.

changes and the NASD have adopted rules relating to such matters as qualification examinations, registration and training of broker-dealer personnel, NASD Rules 1020–1070; NYSE Rules 304A, 345, 345A.

229. NASD Rule 2210.

230. NASD Rule 2210.

231. NASD Rule 2210.; NYSE Rule 405 (the "know-your-customer" rule).

232. NASD Rule 2340; NYSE Rule 409.

233. NASD Rule 2510; NYSE Rule 408.

234. NASD Rule 2520; NYSE Rule 431.

235. NASD Rule 2340; NYSE Rule 409.

236. NASD Rule 2510; NYSE Rule 408.

237. See generally LCM, supra note 204, § 301.00 to 315.00.


239. Mahoney, supra note 22, at 1457–59. The Maloney Act anticipated that multiple national securities associations could develop, subject to the requirement that they be drawn from a broad geographic base. See supra notes 36–38 and accompanying text.

240. Kahan, supra note 131, at 1516–17. The Commission has acknowledged, for example, that alternative trading systems are free to form their own self-regulatory organization if they believe that regulation by existing SROs is prone to conflicts of interest. Regulation of Exchanges, supra note 4, at 70,863.
standards.\textsuperscript{241} For example, with respect to the carrying and clearing of customer accounts, the NYSE regulatory staff has historically imposed high standards of financial responsibility\textsuperscript{242} and is often at the forefront of developing stringent financial responsibility requirements that are later incorporated into industry-wide rules.\textsuperscript{243}

There are also elements of member regulation that are directly affected by, or related to, market conditions such that they are an essential element of exchange operations. The ability to adjust capital requirements for members of an exchange or margin requirements for members' customers has traditionally been an important component of exchanges' regulatory power insofar as relaxation or tightening of standards or relief in individual cases may be necessary to avoid adverse consequences for a marketplace.\textsuperscript{244} Rules regarding the aggregation of short positions and customer debit and credit balances might provide markets with information about future demands on liquidity.\textsuperscript{245} Changes in trading patterns on individual markets may also prompt changes in exchange rules, policies, and practices.

b. Enforcing Securities Laws and SRO Rules

Two self-regulatory organizations, the NYSE and the NASD, predominate enforcement of securities laws and SRO rules.\textsuperscript{246} The Commission has authorized the securities exchanges and the NASD to allocate regulatory responsibility for monitoring and en-

\textsuperscript{241} See, e.g., Snyder, supra note 224, at 442-44.
\textsuperscript{242} Karmel, supra note 21, at 355; Mahoney, supra note 22, at 1461 (detailing the actions of the NYSE).
\textsuperscript{243} See Special Study, supra note 17, pt. 1, at 75-79.
\textsuperscript{244} See Jerry W. Markham, Federal Regulation of Margin in the Commodity Futures Industry—History and Theory, 64 TEMP. L. REV. 59, 99-111, 117-24, 130-32 (1991) (discussing the stock exchanges' use of discretionary authority to raise or lower margin requirements during adverse market conditions, and the argument for exchange control over margins as a self-protective measure). For example, the SRO serving as a broker-dealer's designated examining authority has the discretion to grant extensions for compliance with customer margin calls or payment for cash transactions under the rules of the Federal Reserve Board and the SEC. 12 C.F.R. §§ 220.4(c)(3)(ii), 220.8(d) (2004); SEC Rule 15c3-3(n); see NYSE Rule 434.
\textsuperscript{245} See, e.g., NYSE Rule 421.
\textsuperscript{246} The NYSE is the designated examining authority for approximately 280 of its member firms. The NASD regulates approximately 5100 firms. NASD, About NASD, at http://www.nasd.com (last visited Mar. 26, 2005).
forcing compliance with federal securities laws and SRO rules.\textsuperscript{247} The Commission also assigns each broker-dealer that conducts public business a "designated examining authority" to monitor compliance with applicable financial responsibility rules.\textsuperscript{248} The NYSE and the NASD have entered into contractual arrangements with other national securities exchanges for regulation of their dual members with respect to enforcement of their business conduct rules and self-regulatory responsibilities other than the operation of their markets.\textsuperscript{249}

As described above, self-regulatory enforcement of business conduct rules is thought to be preferable to SEC enforcement because self-regulatory organizations are thought to be better able to adopt and enforce ethical norms of business conduct with respect to their members than a government agency. Industry members may often be the best judge of the appropriate penalties for business practices that may be unethical, but not fraudulent.\textsuperscript{250} Likewise, the ability to distinguish "technical" violations from "serious" violations or to assess an individual firm's "commitment" to robust compliance programs when weighing enforcement options are said to involve value judgments that cannot be effectively codified into a regulation or enforced through a judicial proceeding.\textsuperscript{251}

The concerns raised by conferring regulatory responsibility to individual exchanges in enforcing business conduct standards and the federal securities laws are apparent. First, there is a per-

\textsuperscript{248} 17 C.F.R. § 240.17d-1 (2004).
\textsuperscript{249} The NYSE and the NASD have done so pursuant to 17 C.F.R. § 240.17d-2. See Request for Comments, supra note 93, at 30,519 n.211 (listing the existing agreements under Exchange Act Rule 17d-2 between various exchanges, the NYSE, and the NASD).
\textsuperscript{250} One example of this is the NASD's rule against excessive markup on securities in dealer transactions. NASD Rule 2440; NASD IM-2440. The SEC has tried to establish through judicial and administrative proceedings the threshold beyond which a mark-up is "fraudulent." See, e.g., SEC, SEC Settles Yield Burning Case Against Dain Rauscher, Inc., Litigation Release No. 16,505 (Apr. 6, 2000), at http://www.sec.gov/litigation/litreleases/lrl16505.htm (last visited Mar. 26, 2005). The NASD rule, by contrast, acknowledges that "no interpretation" of what is a "fair" price or commission "can be all-inclusive for the obvious reason that what might be considered fair in one transaction could be unfair in another transaction because of different circumstances," such as the prevailing market for the security, the type of security required, or the effort expended by the broker-dealer in acquiring the security. NASD IM-2440(a).
\textsuperscript{251} Kip Betz, NYSE's Ketchum Calls for Review, Not Replacement of Self-Regulatory Model, SEC. L. DAILY (BNA) (Nov. 12, 2004).
ception that exchanges may not have an incentive to reform rules having a significant impact on the most influential members, or to impose meaningful sanctions on firms in violation of those rules or the federal securities laws. There is also a perceived threat that exchanges may use their disciplinary authority to further the commercial interests of the exchange, rather than the interests of the public. As a result, there are periodic allegations that the NYSE, and to a lesser extent the NASD, fail to carry out their enforcement responsibilities as rigorously as possible.

This partly reflects the SEC's limited ability to require exchanges and other SROs to live up to their statutory responsibility to enforce federal securities laws and SRO rules in an even-handed manner. It is unclear what significant steps the SEC can take against a SRO for failing to comply with its regulatory duties without disrupting the securities marketplace, apart from assessing fines and seeking prospective injunctive relief to modify exchange governance. As a result, many enforcement actions proceed against broker-dealers directly for violations of federal

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252. For example, it has been suggested that the NYSE is more inclined to seek remedial measures—e.g., consultants and independent directors—than to impose punitive fines on its members. A Primer on the Regulation of U.S. Stock Markets, at http://pages.stern.nyu.edu/~adamodar/New_Home_Page/articles/whoregulates.htm (last visited Mar. 26, 2005).

253. For example, it has been alleged that primary exchanges might question the quality of executions in listed securities effected off the exchange. See 2003 House Hearings, supra note 1, at 42 (testimony of Gerald Putnam, CEO, Archipelago); Lipton, supra note 125, at 557 (noting that the NYSE and the AMEX oppose a best execution rule because they benefit from the order flow). As another example, some have questioned the propriety of the NASD's practice of depositing fines assessed in a general regulatory fund that is used, among other things, to pay regulatory officials. Laurie P. Cohen & Kate Kelly, NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?, WALL ST. J., Dec. 31, 2003, at Al; see also supra note 197 (pressuring specialists to provide more liquidity to certain firms).

254. See, e.g., Gretchen Morgenson, Big Board Is Far From Forefront When It Comes to Policing, N.Y. TIMES, Sept. 22, 2003, at C1. Following the market maker scandal of 1995, the NASD was enjoined to separate its regulatory operations and market operations into two segregated subsidiaries, NASD Regulation, Inc. and the NASDAQ Stock Market. See NASDAQ 21(A) REPORT, supra note 94, at 50–54.

255. Deregistration of an exchange is a rare event. See Karessa Cain, New Efforts to Strengthen Corporate Governance: Why Use SRO Listing Standards?, 2003 COLUM. BUS. L. REV. 619, 652–58 (2003). Sections 19(g) and (h) of the Exchange Act, 15 U.S.C. § 78s(g)–(h) (2000), added as a result of 1975 Amendments, grant the SEC authority to take more targeted action with respect to self-regulatory organizations and their associated persons—e.g., suspension of registration, censure, or limitation on the activities, functions, and operations. While the SEC has exercised this authority to limit certain types of trading—e.g., a moratorium on multiple listing of options contracts—it would be difficult to suspend trading on a major market for a significant period of time.
securities law, including unethical behavior deemed to violate the antifraud provisions thereof. 256

It is also difficult to determine whether exchange, or even a wholly independent SRO, could effectively discipline members even if management were aggressively willing to root out problems. Because the SRO relationship is contractual, SROs lack the law enforcement tools possessed by government regulators 257 and the sanctions available to SROs are limited—reprimand, imposition of fines, limitations on activities, 258 and expulsion or suspension from membership. 259 To the extent that SROs are representative of the industry, moreover, there will always be concern that the conduct of larger firms with greater trading volumes or greater influence over SRO governance, or systemic practices prevalent throughout the industry, will go unnoticed. 260

256. See, e.g., In re SIG Specialists, Inc., Exchange Act Release No. 50,076 (July 26, 2004), available at 2004 SEC LEXIS 1563; In re Performance Specialist Group LLC, Exchange Act Release No. 50,075 (July 26, 2004), available at 2004 SEC LEXIS 1564 (holding NYSE specialist firms liable under Rule 10b-5 for violating their implied representations to public customers that they were limiting dealer transactions to those reasonably necessary to maintain a fair and orderly market as required by SEC and NYSE rules). The SEC has long devoted a significant portion of its own resources to monitoring and enforcing compliance by broker-dealers with federal securities laws, often in cooperation with the NYSE and the NASD. See SEC ANNUAL REPORT, supra note 221, at 68, 72–74 (stating that Commission staff inspected 626 broker-dealers and noted deficiencies in areas such as record keeping, net capital computation, suitability, inadequate supervisory procedures); id. at 9–10 (noting significant enforcement cases against broker-dealers).

In such proceedings, the Commission has employed the "shingle theory" of broker-dealer antifraud liability to establish minimum standards of business conduct in areas such as churning of customer accounts and excessive commissions and markups, as well as traditional securities fraud. Roberta S. Karmel, Is the Single Theory Dead?, 52 WASH. & LEE L. REV. 1271 (1995).


258. The NYSE's regulatory arm is, according to a recent report, comprehensively reviewing its current penalty structure to tackle the problem of recidivist conduct—principally by replacing monetary fines with suspension of lines of business. Kip Betz, New York Stock Exchange: Comprehensive Penalty Review Underway at NYSE Regulation, Official Says, SEC. L. DAILY (BNA) (Dec. 3, 2004).

259. Kahan, supra note 131, at 1517. Some have suggested that the appropriate response is to give self-regulatory authorities greater powers to investigate and discipline their members. Adam C. Pritchard, Self-Regulation and Securities Markets, 26 REGULATION 32, 39 (2003).

260. Indeed, the Commission has been faulted for failing to target abuses by larger firms during periods that its enforcement resources have been strapped. 2003 House Hearings, supra note 1, pt. 2, at 31 (noting the SEC's failure to detect practices with respect to research analysts and mutual funds discovered by the New York Attorney General's office); SELIGMAN, supra note 8, at 268–69.
Other attempts at enforcement are equally problematic. Private rights of action, while an important component of regulating compliance with federal securities law, are not expressly authorized by the Exchange Act with respect to SRO rules. Thus, investors cannot generally seek to enforce exchange rules against member firms in court, or to sue an SRO for failing to follow its own rules or to enforce rules against its members. Mandatory arbitration clauses in customer agreements permitted by SRO rules effectively preclude litigation of many customer disputes in court.

III. THE EXCHANGE AS COMPETITOR

Despite the self-regulatory functions performed by securities exchanges such as the NYSE and the AMEX, Congress and the Commission have remained wary of allowing them to maintain a monopoly over securities trading. Thus the 1975 Amendments require the Commission both to review exchange rules for their impact on competition as well as to actively promote competition among exchanges and over-the-counter market makers by tearing down unnecessary barriers to competition for transactions and listings. The Commission's efforts in this area have had significant implications for the commercial interests of exchanges and their members, with the result that many exchanges have explored the possibility of abandoning the "cooperative" structure that makes self-regulation possible.

261. Courts have generally been averse to recognizing an implied private right of action by investors against members of an exchange or the NASD solely for a violation of the SRO's rules. See, e.g., Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 183 (2d Cir. 1966); see also 9 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4440–43 (3d ed. 2000). But see Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, 410 F.2d 135 (7th Cir. 1969). Violations of an SRO rule may nevertheless be adduced to establish a private right of action under common law or the antifraud provisions of the federal securities laws. See generally Eunice A. Eichelberger, Annotation, Private Federal Right of Action Against Brokerage Firm for Violation of Exchange or Dealer Association Rule, 54 A.L.R. FED. 11 (1981).

262. MM&S Fin., Inc. v. NASD, 364 F.3d 908, 911 (8th Cir. 2004).

263. FSP, Inc. v. Société Générale, 350 F.3d 27 (2d Cir. 2003). See generally Gretchen Morgenson, Why Investors May Find Arbitrators on Their Side, N.Y. TIMES, Aug. 19, 2001, at C1 (suggesting arbitration may be preferable for investors to the extent that arbitrators do not require customers to establish proof of intent to defraud in securities disputes predicated on violations of just and equitable principles of trade).
A. Competition for Transactions

As discussed above, exchanges faced competitive pressure from other markets long before the adoption of the Exchange Act. Historically, exchanges' primary competition has been the unorganized, over-the-counter market, where intermediaries offer to execute customer orders at prices set by reference to exchange prices—in particular, orders of uninformed and unsophisticated retail investors. Specialists on regional exchanges and market makers attracted such order flow by offering lower commissions, better trading mechanisms, and other ancillary services to attract customers from the primary exchanges.264

The Commission has expended considerable effort to make regional exchanges competitive with primary exchanges. Since many listed issuers on regional exchanges could not meet the Exchange Act's initial registration requirements, Congress permitted exchanges to trade unlisted securities pursuant to "unlisted trading privileges."265 In 1941, the Commission ordered the NYSE to "clarify" its rules to permit NYSE members to trade in NYSE-listed securities on other exchanges, so that NYSE specialists could make markets on regional exchanges.266 The Commission's rules under the national market system provisions of the Exchange Act effectively required the NYSE and the AMEX to open their market data distribution mechanisms to, and share the revenue generated by the sale of market data with, regional exchanges to keep them competitive.

The Commission has also taken significant steps to make over-the-counter market makers in listed securities competitive with the primary exchanges. Most significantly, Congress and the

264. Mahoney, supra note 22, at 1463. Regional exchanges and other markets have also historically used financial incentives to attract order flow. Some such incentives—e.g., guaranteed price improvement—benefit customers directly; others—e.g., payments to retail brokers for order flow—only benefit the customer to the extent his or her broker-dealer passes such payments along in the form of lower commissions.

265. 15 U.S.C. § 78l(f)(2) (2000). Not only were issuers permitted to list securities on multiple exchanges, but exchanges could also initiate unlisted trading in securities without issuer consent, with Commission approval.

Commission engaged in a prolonged battle with the exchanges, and principally the NYSE, to eliminate restrictions on trading by members in the over-the-counter market. In 1976, the Commission eliminated exchange prohibitions against off-board trading with respect to all public companies listed thereafter. 267 In May 2000, after significant pressure from the Commission and substantial evasion of the rule through after-hours trading, the NYSE rescinded Rule 390, despite its protestations that the rule was necessary to help concentrate order flow and thus promote price discovery for its listed securities. 268

While exchanges have sought to shield their price discovery process from free riding by other market participants, it is difficult to argue that competition from the regional exchanges and over-the-counter market makers posed a serious threat to the primacy, if not profitability, of stock exchanges. These markets did not attempt to engage in price discovery, but left to the primary exchanges the difficult task of managing quotes to reflect informed buying and selling pressure. 269 It is arguable that, until the development of more efficient order transmissions systems, it was not practicable to send smaller retail orders to an exchange floor for execution at all. 270 Indeed, it was the Commission’s concern about the lack of competition in the securities marketplace that formed the basis for many of its initial efforts to shape market structure. 271

The source of competition more troubling for exchanges in recent years has been the automation of trading by alternative trading systems and subsequently by NASDAQ, which now seeks to become an exchange. As described above, the Commission sought to protect these systems from the self-regulatory regime for exchanges through no-action relief in order to encourage private sector technological innovation. To do so, the Commission is-

269. There is some evidence that cream-skimming may have a negative impact on public spreads by discouraging submission of limit orders to the primary market. See Macey & O’Hara, supra note 155, at 31 n.26.
270. Seligman, supra note 193, at 106 (noting that regional exchanges were most effective at competing for marketable orders by offering low-cost executions).
271. 1975 Amendments Legislative History, supra note 46, at 1; Maynard, supra note 72, at 857.
sued an interpretation of the definition of the term "exchange" to exclude all similarly situated systems from regulation, provided that they were not "designed . . . to centralize trading and provide . . . quotations on a regular or continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations." 272

Unlike systems that engage in derivative pricing, however, some alternative trading systems have come to pose a more realistic—if as yet remote—competitive threat to the primary exchanges because they seek to supplant the exchanges' traditional price discovery function. 273 Such systems operate a limit order book that offers similar opportunities for direct order interaction, but without the ability of a specialist to intervene in trading on discretionary terms. 274 Many such systems promise to offer enhanced order types and order matching features at greater speed, all of which tend to increase the probability of execution at a favorable price. Some are even willing to disseminate their order books for free over the Internet to advertise the depth of their liquidity in certain securities. 275 It is conceivable that, over time,

272. Delta Release, supra note 10, at 1895. The Commission suggested in the Delta Release that the use of a continuous auction or consolidated limit order book might create such an expectation, while the Seventh Circuit, in affirming the Commission's order, highlighted the lack of a specialist or market maker providing continuous quotes as undermining the expectation of liquidity on such trading systems. As a result of the growing prominence of exchanges, however, the Commission has revised its definition of an exchange. See infra note 320 and accompanying text.


274. While electronic systems cannot replicate the negotiation of floor brokers and specialists in "working" a particularly large or sensitive order, many electronic systems offer subscribers negotiation features and enhanced order types, e.g. Instinet, at http://www.instinet.com (last visited Mar. 26, 2005), exposure of market orders to crowd participation, e.g. NASD's Primex, NASD Notice to Members 00-65, (Sept. 2000), at http://www.nasd.com (last visited Mar. 26, 2005), or the ability to enter matrices describing their trading interest under various market conditions, e.g. Optimark, OptiMark Holdings, Inc. Co. Profile, at http://biz.yahoo.com (last visited Mar. 26, 2005).

275. See, e.g., Bookviesuer, supra note 141. The Commission's Regulation NMS, as re-proposed, requires public dissemination of all limit orders. See Proposed Regulation NMS, supra note 5.
issuers may choose to designate such markets as the primary trading venue for their securities.\textsuperscript{276}

A related potential source of competition is foreign markets. In particular, European stock markets have undergone a series of consolidations over the past several years, through which traditional floor-based national stock exchanges have been replaced by a few, highly automated execution platforms.\textsuperscript{277} Unlike U.S. exchanges, which are limited to U.S. registered broker-dealer members, European stock exchanges are permitted to offer remote access to firms authorized in other jurisdictions, including the United States.\textsuperscript{278} For several years, foreign exchanges have lobbied Congress and the Commission to provide U.S. broker-dealers and investors with direct access to their trading systems.\textsuperscript{279}

While the Commission has enumerated a number of options for regulating access to foreign markets, it has resisted granting such relief generally,\textsuperscript{280} mostly because such markets are incapable of providing the SRO function U.S. exchanges provide without significant disruptions to their business model.\textsuperscript{281} The unfortunate impact of this regulatory impasse is that U.S. investors do not have the opportunity to interact with order flow in foreign markets, except through private linkages intermediated by U.S. broker-dealers and their foreign affiliates.\textsuperscript{282} To the extent that U.S. institutions and investment firms have used offshore markets to

\textsuperscript{276} See generally Macey & Kanda, supra note 12.
\textsuperscript{277} Deutsche Börse AG and Euronext NV, the two largest stock markets in Europe by market value, have each grown through a series of mergers with smaller European national exchanges over the past decade. Deutsche Börse AG recently confirmed the reopening of merger negotiations with the London Stock Exchange PLC, the third largest European stock market. Silvia Ascarelli, A Market Marriage in Europe?, WALL ST. J., Dec. 14, 2004, at C18.
\textsuperscript{279} Nevertheless, pressure from European exchanges and regulators continues to bear on the SEC. See Floyd Norris, U.S. and European Securities Officials Vow Cooperation, N.Y. TIMES, June 5, 2004, at C3. By contrast, the Commodity Futures Trading Commission has permitted foreign exchanges to provide electronic terminals to U.S. futures commission merchants.
\textsuperscript{281} See Concept Release, supra note 6, at 71,131.
\textsuperscript{282} See Request for Comments, supra note 93, at 30,521–22.
avoid certain trading restrictions in the United States, the inability of retail investors to interact with such markets is not entirely insignificant.283

Exchanges have modernized their trading facilities to deal with the threats posed by competing trading systems.284 One of the major obstacles to more substantive changes is the requirement that the Commission approve exchange rule changes after public notice and comment.285 Exchanges have long complained that their modernization efforts have been hampered by the public notice and comment process, which can in some cases take several years as Commission staff seek to address the issues raised in public comments—often propounded by rival exchanges, trading systems and broker-dealers.286 Despite its efforts, the Commission has yet to develop a workable scheme for exchange rule approval that balances the need for competitive flexibility and public accountability.287

B. Competition for Listings

As competition between exchanges and alternative trading systems increases, exchanges such as the NYSE, the AMEX, and NASDAQ have come under significant commercial pressure to compete with respect to their listing standards. Exchanges must balance their reputational interest in listing only companies exhibiting the potential for liquid trading and high standards of corporate governance against the need to retain or attract additional listings. Many markets in the United States and abroad began aggressively developing new market segments in the 1990s

283. See, e.g., 17 C.F.R. § 240.15a-6 (2004) (requiring U.S. broker-dealer intermediation of transactions between U.S. customers and unregistered broker-dealers outside of the United States). The significant volume of trades effected after-hours outside of the United States to avoid the application of NYSE Rule 390 prompted the NYSE to require reporting of offshore transactions in Rule 410-B. See supra note 91 and accompanying text.


287. Mendelson & Peake, supra note 169, at 462.
to attract, for example, new start-up companies that would not otherwise qualify for the most stringent listing requirements.288

The Commission has worked over the past thirty years to eliminate various exchange rules that, albeit anticompetitive, had the effect of encouraging continued listing. The partial repeal and eventual rescission of the prohibition against off-board trading, discussed above, eliminates the regulatory guarantee that exchange members will provide their customers an exchange execution.289 Without the ability to prohibit off-board trading by their members, exchanges must look to other tools at their disposal to encourage members to bring orders to the exchange floor in order to make good on the promise of liquidity for which listed issuers pay.290

At the same time, the Commission has sought the repeal of exchange rules that restrict "voluntary" delisting by issuers to enhance competition among markets for listings. Several exchanges, for example, once had rules prohibiting an issuer from delisting its securities unless a supermajority of its shareholders approved the delisting and there was no objection to the delisting by a significant minority of its shareholders.291 The ostensible purpose of these rules was to protect shareholders from a decline in the


290. Exchanges, unlike market makers or broker-dealers, can charge for listings. NASD Rule 2460 (prohibiting market makers from accepting compensation from issuers to make markets in their stock). In one recently publicized incident, former NYSE CEO Richard Grasso was alleged to have pressured the specialist in American International Group Inc. to supply greater liquidity to its shares after a complaint from AIG's CEO, who happened to sit on the NYSE's board of directors and compensation committee. Kate Kelly & Susanne Craig, At Behest of AIG Chief, Grasso Pushed NYSE Firm to Buy Stock, WALL ST. J., Oct. 3, 2003, at A1.

291. See, e.g., NYSE Rule 500.
value of their shares as a result of the perceived loss in liquidity from delisting. Under significant pressure from the Commission, these rules have been revised to permit corporate officers and directors to delist securities without a shareholder vote.292

The passage of the Sarbanes-Oxley Act of 2002 may also make the exchanges’ task of recruiting new domestic and foreign listings much harder. Traditionally, foreign listings have been exempt from many of the corporate governance requirements applicable to U.S. companies, both under exchange rules and federal securities law.293 For several years, the NYSE and other markets have actively solicited listings by foreign companies interested in tapping U.S. capital markets.294 Many foreign companies have elected to list on U.S. exchanges in part because of the positive signal conveyed to investors by the issuer’s willingness to comply with fuller disclosure requirements and greater protection for minority investors.295 Because the Sarbanes-Oxley Act applies across the board to all SEC-registered companies, there is growing concern that more foreign and U.S. companies will seek to “go private” or otherwise reduce the number of U.S. shareholders to avoid the Act’s corporate governance requirements.296


295. Coffee, supra note 294, at 1780.

One possible consequence of these efforts is that primary exchanges such as the NYSE and the AMEX, as well as NASDAQ, have been content to tolerate noncompliance with listing standards. The AMEX and NASDAQ, for example, have reserved the discretion to list companies that do not meet their quantitative standards for listing.297 There have also been concerns about the laxity of exchanges' enforcement with maintenance standards for listing.298 In light of these trends, the ABA's Market Structure Study has recommended that mandatory disclosure of noncompliance with best practices, rather than enforcement of listing standards through the delisting process, might be a better way to monitor corporate governance of public issuers.299

Another possibility is that exchanges will seek to expand trading in products other than listed securities. For example, the NYSE has in recent years considered unlisted trading in NASDAQ stocks, AMEX exchange-traded funds, and even derivative products to boost trading revenue.300 Regional exchanges have sought to boost the volume of NASDAQ-listed securities traded through their facilities.301 Exchanges may also seek to con-

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298. Id. at 3 (noting that twenty-two percent of new AMEX listings between Sept. 1, 1999, and Nov. 13, 2000, did not meet AMEX's initial listing standards).

299. ABA Market Structure Study, supra note 2, at 1490. Disclosure of noncompliance, for example, may be effected through the use of a modified listing symbol. See SECURITIES REGULATION, supra note 297, at 13.

300. See, e.g., Beyond Equities, THE ECONOMIST, Nov. 20, 2004, at 79 (reporting that the NYSE is considering whether to sponsor trading in additional ETFs, convertible bonds, and derivative products based on its listed companies); Big Board to Trade Amex-Listed Funds, N.Y. TIMES, April 6, 2001, at C5.

301. As a result of pairings between regional exchanges and alternative trading systems, regional exchanges are able to take credit for the latter's trading activity. See supra...
dition certain benefits—such as inclusion in proprietary market indices—on continued or exclusive listing.  

C. Impact of Competition on the Value of Membership

In addition to the problems faced by exchanges with respect to external competition, exchanges must also deal with the problems inherent in governing an association of broker-dealers. Traditionally, exchanges were organized along a "not-for-profit" or "cooperative" model, under which the exchange's purpose was to provide facilities for the benefit of its members. As a result, exchange decisions were made by weighing competing interests of multiple constituencies, rather than by reference to the impact on the exchange's bottom line. With the increase in competition among exchanges, the interests of exchange management have become much more focused on maximizing trading volume and fee revenues to remain viable. As exchanges develop the ability to automate execution of trades without the intermediation of specialists, floor brokers, and market makers, the interest of exchange management and its intermediaries become more divergent.

Meanwhile, the Commission's efforts to remove the anticompetitive restrictions imposed by exchanges on their members have had the effect of reducing the advantages of exchange membership. From a nonmember's perspective, the abolition of off-board trading restrictions, the public dissemination of exchange quotes and depth-of-book, and enhanced access to trading opportunities on exchange floors through intermarket linkages reduce the incentive to become an exchange member and pay exchange transaction or regulatory fees. From a member's perspective, the in-

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302. See, e.g., 2004 House Hearings, supra note 1, at 89 (prepared statement of Gerald Putnam, CEO, Archipelago Holdings, L.L.C.) (contending that NASDAQ's rule limiting the NASDAQ-100 and the associated "QQQ" exchange-traded fund to companies exclusively listed on NASDAQ is intended to create a disincentive to dual listing on other exchanges).

303. See LEE, supra note 110, at 57.

304. One historically significant division was between the specialists and floor brokers who execute trades and the public broker-dealers who bring in the customers. See generally Special Study, supra note 17, pt. 1, at 243.

ability to collectively benefit from restrictive rules significantly diminishes the value of an exchange seat.\textsuperscript{306}

These developments have prompted exchanges to take steps to demutualize and become "for-profit" entities. Demutualization would in theory allow exchange management to adopt rules and new technologies without soliciting member approval and to maximize revenue—such as by eliminating the intermediation of its members in exchange transactions.\textsuperscript{307} Demutualization also, in theory, would allow exchanges to pursue strategic alliances with other markets or to raise capital in equity markets to finance development of joint trading platforms and associated services.\textsuperscript{308} More cynically, it would allow exchange members to extract a premium for their exclusive access to exchange facilities before exclusivity is gradually regulated out of existence.\textsuperscript{309}

The Commission has signaled its willingness to relax the fair representation requirement and has already done so for a number of automated exchanges.\textsuperscript{310} Moreover, the Commission has effectively identified many of the key regulatory requirements one might impose on a "for-profit" exchange in the context of Regulation ATS and subsequent no-action and exemptive relief to those exchanges that have aggressively pursued for-profit status.\textsuperscript{311} Unsettled questions remain, however, about the extent of the Commission's regulatory authority over exchanges in light of demutualization. To the extent that exchanges are expected to act in the public interest—and that the fair representation requirement is

\textsuperscript{306} See id. at 410.
\textsuperscript{307} Fair Administration and Governance Release, supra note 6, at 71,132.
\textsuperscript{308} Id.
\textsuperscript{309} Big Board Seat Price Rises, N.Y. TIMES, Mar. 2, 2005, at C5 (noting the significant decline in NYSE seat prices since August 1999).
\textsuperscript{311} PCX/Arca recently hired a former SEC Chairman at a salary of $600,000 a year to advise it on governance issues. Miles Weiss, Archipelago Hires Ex-SEC Chief Breeden as $600-K-a-Year Advisor, BLOOMBERG NEWS, June 10, 2004.
the only guarantor of that expectation—it is difficult for the Commission to yield completely to the demutualization movement.312

IV. THE COMMISSION'S EFFORTS TO RECONCILE SELF-REGULATION AND THE NATIONAL MARKET SYSTEM

The Exchange Act thus requires exchanges to use their market power to advance the regulatory goals of the federal securities laws and to yield their market power by granting their competitors greater access to their market information and trading systems. It is too early to speculate whether such competitive forces313 will undermine the self-regulatory mission of dominant markets such as the NYSE.314 Nevertheless, the inherent contradiction in relying on market power for regulation while undermining market power in the name of competition may, to some degree, explain why neither self-regulation nor the national market system has appeared to be effective at accomplishing its intended objectives.

Three recent Commission initiatives illustrate the regulatory impasse created by the conflicting principles of self-regulation and the national market system. First, the Commission has encountered significant difficulty in integrating new entrants into the national market system. Second, the Commission has faced hurdles in improving accessibility and transparency of orders without infringing upon the autonomy of self-regulatory organizations. Third, the Commission has struggled to improve the fairness and quality of self-regulation without sacrificing the benefits of the current competitive framework. Each of these is discussed in turn.

312. Cf. NASD Rule 1017 (requiring application for approval of change in ownership, control, or business of NASD member firms); NYSE Rule 304(b) (requiring approval of persons who control a member or member organization). For example, it is unclear whether the Commission would permit control of a registered national securities exchange to pass to unregulated entities such as a nonbroker-dealer or foreign exchange. More problematically, the Commission might reserve the discretion to register “for-profit” private entities as exchanges based not on neutral, nondiscriminatory criteria, but on subjective assessment of the entity’s willingness to abide by the “spirit” of the Exchange Act.

313. See supra Part III.

314. See supra Part II.
A. Integrating New Entrants into the National Market System

The national market system was intended to reduce the monopoly power of exchanges within a controlled environment. Congress and the Commission historically looked to the AMEX (with respect to listings) and regional exchanges (with respect to trading) as the primary sources of competition to limit the NYSE's market power; accordingly, they structured the national market system mandate and mechanisms to improve regional exchanges' access to information about current quotes and trades as well as to provide regional exchanges with an opportunity to access the NYSE.\(^{315}\) As a result, regional exchanges and over-the-counter market makers through NASDAQ could "free ride" off the NYSE's price discovery and, to a lesser extent, its liquidity at the best published prices.

Congress and the Commission nevertheless sought to ensure that self-regulatory objectives would not be compromised for the sake of commercial advancement.\(^{316}\) While SROs were called upon to engage in "rivalrous" competition within the national market system, the only recognized competitors within the national market system were SROs. National market system "plans" were thus designed to replicate the anticompetitive power of exchanges on a national level by creating a committee of self-regulatory organizations to make market structure decisions, not unlike the way that broker-dealers were envisioned as collectively regulating themselves through individual self-regulatory organizations.\(^{317}\) Because the primary exchanges, the regional exchanges,


\(^{316}\) One consequence is that national market system mechanisms have been structured in a manner that allows the primary markets to limit access to its facilities by other markets, lest nonmembers obtain the benefits of the NYSE's liquidity without the intermediation of a NYSE member. For example, the NYSE succeeded in restricting the ability of the Pacific Exchange to integrate its proposed application of the Optimark system into national market system mechanisms by placing a ceiling on the volume of orders PCX was permitted to route to the NYSE specialist through ITS, relative to PCX's volume. Intermarket Trading System, Exchange Act Release No. 41,668, 64 Fed. Reg. 42,734, 42,735 (Aug. 5, 1999) (approving amendment to the Restated ITS Plan Linking the Pacific Exchange's Application of the OptiMark System to the Intermarket Trading System).

\(^{317}\) Karmel, supra note 305, at 397 (contrasting the SEC's abolition of fixed commissions with the SEC's market data consortium); see also Mahoney, supra note 22, at 1491. In particular, national market system mechanisms are established through "plans," which the Commission has the power to approve or amend to the same extent as the rules of in-
and the NASD jointly dictate national market mechanisms, their self-regulatory power is pooled into a regulatory cartel that sets the ground rules for competition among themselves. 318

Unfortunately, this structure has allowed established exchanges to shut new entrants out of the national market system by denying them a seat at the table in designing national market system mechanisms. 319 As a result, the Commission has struggled to integrate new competitors—such as alternative trading systems—into a system run by the entities they are competing against. The only way to eliminate such conflicts of interest, under the Commission's current policy, is to permit—or, in some cases, require—new challengers to register as national securities exchanges.

In Regulation ATS, the Commission revised its definition of an “exchange” to include the alternative trading systems that, in its view, are able to pose a significant competitive challenge to established exchanges. 320 The SEC's broadened definition covers any entity that “[u]ses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.” 321

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318. A useful analogy here is the manner in which options markets are regulated. Because there is no over-the-counter market in options, all securities options contracts must be executed on a national securities exchange. As a result, the Commission is able to regulate competition among a closed universe of trading venues.

319. Recent cases suggest that the conduct of national securities exchanges and the NASD under the aegis of national market system plans approved by the Commission will be immune from antitrust liability, regardless of whether the Commission takes express action to prevent such conduct or believes antitrust immunity is appropriate, as long as it has the authority under the Exchange Act to regulate such conduct. In re Stock Exchs. Options Trading Antitrust Litig., 317 F.3d 134, 150 (2d Cir. 2003); Friedman v. Salomon/Smith Barney, Inc., 313 F.3d 796, 800–01 (2d Cir. 2002); see supra Part II.A.

320. 17 C.F.R. § 240.3b-16 (2004). Oddly, the Commission achieved this result not through an interpretation of the term “exchange,” but rather through an interpretation, in Rule 3b-16, of the phrase “a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange,” which appears in the statutory definition of the term “exchange.” Id. § 240.3b-16(a). This circumlocution was presumably necessary to allow the Commission to use its exemptive authority under section 36 of the Exchange Act, 15 U.S.C. § 78jj (2000), to exclude alternative trading systems that comply with Regulation ATS from the definition of an exchange, and not just the registration requirement for national securities exchanges.

321. 17 C.F.R. § 240.3b-16(a)(2) (2004). This definition is intended to cover alternative
Those markets that wish to register as exchanges and take up the heavy burden of self-regulation may pull up a seat at the national market system table. Those that do not are deemed to elect "voluntarily" to comply with the rules set out by the self-regulatory organizations of which they are members.

There are a few problems with this approach. First, it is not clear whether many existing exchanges would meet such a definition of "exchange," applied literally, given the substantial blurring of auction and dealer functions in many markets. The trend among exchanges, as described above, is to promote greater internalization of orders through their facilities without sacrificing price priority, rather than to employ stricter trading rules to improve price discovery. At best, exchanges preserve an expectation of direct order interaction today only in the sense that other exchange members may not trade at an inferior price without accepting their order first. By modifying the definition of exchange in this manner, the Commission invites inquiry into whether existing exchanges may modify their trading rules without sacrificing their regulatory status.

More generally, such efforts threaten to reduce "self-regulation" to a series of formalistic arrangements necessary to gain entrée into the national market system. It is unrealistic for the Commission to define "exchange" retroactively by reference to their order interaction processes, when such systems lack the membership structure, internal enforcement mechanisms, and market power to carry out the self-regulatory mandate of section 6 of the Exchange Act. Indeed, the Commission does not even anticipate that new exchanges would perform any of those mandates—as with the regional exchanges, they would be expected to

trading systems with price discovery mechanisms that were formerly excluded from the statutory definition of exchange under the Delta Release and the corresponding no-action relief issued by the Commission. See generally Delta Release, supra note 10.

322. But see Findings and Opinion of Commission, supra note 310, at 11,388 (approving the ISE as an exchange for trading securities options).

323. See Regulation of Exchanges, supra note 4, at 70,847.

324. Maynard, supra note 72, at 848-50. To illustrate the application of its interpretation, the Commission provided descriptions of twenty trading systems together with a brief analysis as to whether they would or would not be considered an exchange. Regulation of Exchanges, supra note 4, at 70,854-56.

325. See, e.g., 2003 House Hearings, supra note 1, at 9 (testimony of William Donaldson, Chairman, SEC) ("I suspect that customers generally expect their better-priced orders to be protected within an exchange.").
outsource such obligations through regulatory delegation agreements. There is also little sense in imposing special "fair representation" and "public interest" requirements on electronic trading systems, when the trend is for exchanges to demutualize and go public.

The marketplace, to some extent, has already illustrated this problem. As described above, some alternative trading systems have begun to explore strategic alliances with regional exchanges to obtain the benefits of exchange status without registering themselves. Such developments partly address some of the inequities of the current structure—e.g., by allowing for more rational sharing of market structure fees. But they also threaten to reduce the regulatory status of regional exchanges to a transferable regulatory license—akin to a New York City taxicab "medallion"—that provides a portal into the national market system, confers the imprimatur of an exchange execution, and entitles the purchaser to a share of market data revenue.

Going forward, it will become increasingly difficult to justify excluding market makers and high-volume broker-dealers from national market system mechanisms as they increase the volume of their securities trading and provide greater opportunities for order interaction among their customers. Historically, the NASD has relied on market makers to generate liquidity in its NASDAQ-quoted securities, but as NASDAQ has developed its own order execution technology, its interests have also diverged.

326. Regulation of Exchanges, supra note 4, at 70,882.
327. Karmel, supra note 21, at 370–84.
328. For example, as a result of the commercial relationships developed between Instinet (an alternative trading system) and the National Stock Exchange ("NSX"), and between Archipelago (an alternative trading system) and the Pacific Exchange ("PCX"), both the NSX and the PCX have experienced a significant increase in market data revenues with respect to NASDAQ stocks. See Proposed Regulation NMS, supra note 5, at 11,179 (noting that NSX receives approximately $32.3 million in market data revenue, or eight percent of net market revenues allocated among the SROs, and PCX receives approximately $38.8 million, or ten percent of net allocated market revenues); Fair Administration and Governance Release, supra note 6, at 71,131.
329. See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 39,884, 63 Fed. Reg. 23,504, 23,504 (Apr. 29, 1998) (codified at 17 C.F.R. pts. 202, 240, 242, 249) [hereinafter Regulation of Exchanges and ATS Proposing Release]; Regulation of Exchanges, supra note 4, at 70,880. Such an exchange would presumably retain its governance structure and remain subject to the requirement to file rule changes and ensure fair access and fair representation; to the extent that the exchange would be entirely dependent on its strategic partner for survival, the exchange would likely lack the power to exercise any self-regulatory responsibility with respect to its marketplace.
from those of its market making members. As a result, larger market makers may seek greater freedom to offer quotes directly to the public through national market system facilities, rather than through the facilities created by NASDAQ. It is difficult to conceive of a further redefinition of the term "exchange" that would achieve this result.

B. Best Execution and Individual Market Access

The Commission has also found it exceedingly difficult to promote the national market system goals of transparency and access across markets without infringing upon the autonomy conferred on self-regulatory organizations by the Exchange Act. On the one hand, the Commission has used its rule-making and enforcement authority to require broker-dealers and alternative trading systems to improve their order handling practices—i.e., the routing, display, and execution of orders—consistent with the national market system mandate. On the other hand, the Commission has been unwilling to pressure exchanges and self-regulating markets such as NASDAQ to make the corresponding accommodations to facilitate efficient access to their market systems. The result is a series of Commission rules imposed on


331. Trading systems operated by broker-dealers and registered market makers are excluded from exchange registration, provided that matching or crossing of orders is incidental to their order routing, dealing, or market making activities. See, e.g., Regulation of Exchanges, supra note 4, at 70,884. It is not clear, however, whether the Commission could defend an interpretation of the term exchange that would encompass such systems, e.g., if a market maker opted for direct Commission regulation as an exchange instead of joining a self-regulatory organization, given that Congress clearly did not intend to regulate over-the-counter market makers as exchanges at the time the Exchange Act was adopted.


333. The Commission's use of its rule-making authority to establish national market system mechanisms is also subject to statutory challenge—in the same manner that Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990), circumscribed the Commission's authority to adopt exchange rules establishing corporate governance standards—to the extent that the Commission is merely directed to "facilitate" the mechanisms of a national
members of self-regulatory organizations without the correspond-
ing access to self-regulatory facilities necessary to carry them out.

1. NASDAQ and ATS Order Display

One example is the impact of the Commission's order handling rules on NASDAQ's ability to modernize its marketplace. NASDAQ, after much prompting from the Commission, sought throughout the 1980s and 1990s to improve automatic execution systems for market makers to compete more effectively with primary markets. The Commission, during the same period, adopted minimum standards for the display and accessibility of certain best-priced orders held by alternative trading systems. In addition to providing its orders to a national securities exchange or association for inclusion in its published quotation data, the alternative trading system was required to provide access "[e]quivalent to the ability of [any] broker-dealer to effect a transaction with other orders displayed on the exchange or by the association." As a result, alternative trading systems either had to cease their operations or to integrate their execution systems with those of a self-regulatory organization. For NASDAQ-listed securities, the only SRO system through which such integration was possible was NASDAQ.

The Commission's rule did not, however, require any self-regulatory organization to make reasonable accommodation for displaying its members' quotes, consistent with the principle that self-regulatory organizations should enjoy a free hand in designing their trading systems. As a result, NASDAQ's efforts to

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337. NASDAQ generally had a free hand in designing and implementing the national market system plan for over-the-counter NASDAQ-traded securities since trading in NASDAQ-listed securities by regional exchanges was historically limited. Request for
modernize its quotation collection and execution facilities were hampered by several rounds of public notice and comment, as alternative trading systems sought to ensure that they would be able to use NASDAQ to stay in business without drastic changes to their business model. The Commission eventually chose to require the NASD to create an alternative display facility and develop "direct access" rules, rather than require NASDAQ or any other marketplace to make all changes perceived as necessary by the Commission.

2. Trade-Through Rules

Similar issues have arisen with respect to the tension between broker-dealers' duty of best execution and the technological capabilities of primary exchanges. Broker-dealers have a duty, under the Commission's antifraud rules and SRO rules, to obtain the best terms for customer transactions reasonably available under


Two such technical issues that created significant problems in the negotiation of NASDAQ SuperMontage facility were automated execution and access fees. NASDAQ sought to require market makers to provide automatic execution at their quoted prices—i.e., if a market maker's NASDAQ quote indicates that it is willing to buy 1000 shares at $10, NASDAQ would automatically execute an incoming NASDAQ order to sell 1000 shares against the market maker's quote, even if the market maker simultaneously received and executed an order for 1000 shares from its own customer. The market maker is thus required to execute a total of 2000 shares at the quoted price, even though it had only advertised a willingness to buy 1000 shares. Because many alternative trading systems do not trade for their proprietary accounts, however, they cannot generally take on such risk.

With respect to access fees, market makers have not been permitted to charge a fee for execution against their public quotes, since they have traditionally profited from the bid-ask spread. Since alternative trading systems operate on a commission basis, the inability to charge an access fee would require them either to charge a separate fee for quote access through NASDAQ or to modify their customer orders to reflect a fee. The ability to charge an additional fee through NASDAQ, however, raises concerns insofar as the net cost of trading with an alternative trading system may be higher than its quoted price would suggest. See supra note 101 and accompanying text (discussing amendments to SuperMontage to accommodate order-delivery to alternative trading systems and discussions of access fees). In response to significant complaints from the securities industry, the Commission is proposing to cap access fees. See Proposed Regulation NMS, supra note 5, at 11,158–59.

See Order Approving Proposed Rule Changes, supra note 101, at 8024–30 (describing the alternative display facility).
the circumstances ("best execution"). In the context of a national market system, brokers must theoretically route orders to an exchange or market that either matches or improves upon the best price quoted in the "national best bid and offer," or reroutes such orders to the market quoting the superior price. To do so, the prices of markets quoting superior prices must in theory be "accessible" by such broker-dealers, even if they are not members of the relevant market.

The only mechanism that allows such access for exchange-listed securities is the Intermarket Trading System ("ITS"). The Commission has long sought to develop a system by which broker-dealers could access all quotes and orders in the marketplace, in order to provide public limit orders with a better chance of execution. Though such a system has been disregarded as not "feasible," the ITS allows regional exchanges to access the quote of a primary exchange specialist—and vice versa—in the event a regional specialist or market maker does not want to match the quote currently offered by the primary exchange. "Trading through" the quote of an ITS participant (i.e., dealing with a customer at an inferior price) contravenes the obligations of ITS participants under the ITS Plan.

340. Proposed Regulation NMS, supra note 5, at 11,137; NASD Rule 2320. The SEC has further indicated its belief that "best execution" for most investors means "best price."

341. Many alternative trading systems and market makers will route orders to another market, rather than match them internally, when the other market offers a superior price. 2003 House Hearings, supra note 1, pt. 1, at 164 (preprepared statement of Ed Nicoll, CEO, Instinet Group) (analogizing this strategy to the strategy employed by Macy's Kris Kringle in Miracle on 34th Street). In part, this is necessary to comply with best-execution requirements. It also allows the trading system to market itself as a system capable of order routing decisions, thus giving it "first crack" at orders that would otherwise be routed to another market for execution. There is, however, little incentive for a market with dominant power to route an order to competing markets.

342. While the SEC's recently proposed trade-through rules would apply to NASDAQ-listed securities as well, the NASDAQ market and participating market makers and ATSs are accessible through automated access. Proposed Regulation NMS, supra note 5, at 11,134.

343. Id. at 11,132–36.

344. A "trade through" under the ITS Plan is not, however, a violation of Commission rules; the rule is enforceable solely at the discretion of the market whose quote is "traded through." Thus, if Market Y is quoting a bid for 100 shares at $10, and Market X trades through Market Y's quote by executing a sale of 100 shares for Customer A at $9.95, Customer A does not have an actionable claim for the additional $5 he would have received had his order been executed against Market Y's quote. Market Y, however, may seek to recover the difference between its quote and the execution price on Market X ($5) to protect its quoted price.
As both regional exchanges and third market participants began to automate their execution capabilities, the protocols for ITS have become increasingly cumbersome. In particular, automated markets have argued that, for many customers, the certainty of obtaining an immediate execution at a marginally inferior price is preferable to the possibility of obtaining an execution at the superior price offered by a nonautomated market—e.g., a specialist-intermediated exchange such as the NYSE or the AMEX. Opponents of the trade-through rule have further accused the exchanges of using ITS as a tool to preserve their anticompetitive power. As a result, automated markets have sought the right to "trade through" the quotes of nonautomated markets since their ability to access the price quoted by the nonautomated market through ITS within a specified period of time is sufficiently questionable.

To resolve this tension successfully, the Commission could either (i) establish uniform access criteria for all markets and mandate order interaction or (ii) eliminate the trade-through rule altogether and allow market participants to access the market center of their choice. Uniform access criteria would make real the promise of best execution by requiring exchanges to modernize their facilities immediately. Eliminating the trade-through rule could similarly accomplish the longstanding goal of pressuring the NYSE and the AMEX to automate or to eliminate specialists altogether by raising the competitive stakes for the exchanges, but at the risk of creating a two-tiered market for listed securities for the foreseeable future. The Commission has nevertheless sought to have it both ways: its proposed solutions to date purport to uphold the principles of best execution and intermarket price protection while riddling the ITS trade-through rule


346. For example, ITS protocols traditionally allowed the market receiving a request to trade at its quoted price a specific period of time for the receiving specialist or market maker to execute the order or to reject the order and update its quote. With the automation of trading systems, markets offering instantaneous executions do not believe it is appropriate to be required to route orders to markets where execution remains subject to human discretion, since the allowed time delay effectively gives the receiving specialist or market maker a "free option" to execute or reject the order. Proposed Regulation NMS, supra note 5, at 11,134.
with exceptions that make it inapplicable to many transactions that trade through the NYSE and AMEX quotes. 347

The Commission's proposed Regulation NMS, as reproposed in December 2004, seems designed to strengthen, rather than undermine, the trade-through rule. The reproposed rule would require market centers to display most trading interest to the public and extend the trade-through prohibition to all publicly displayed orders in a market center's book rather than the best price. 348 Markets with significant liquidity but slow trading systems (such as the NYSE and the AMEX) would benefit significantly from such a rule, at the expense of markets with "fast" trading systems but sparse liquidity. Without any corresponding requirement that the exchanges comply with a minimum standard of access that reflects modern technological capabilities, it is difficult to see how the proposal would advance market structure. 349

C. Exchange Governance

Recent scandals and growing industry concern about the fairness of self-regulation has prompted the Commission and the securities industry to reform the current self-regulatory structure. 350 Many of the Commission's proposals to date are designed to improve the transparency of exchange decision making and remove conflicts of interest involving particular executives. Not


349. As a result, the proposal has been criticized as a sop to the NYSE. See, e.g., SEC Loves NYSE, WALL ST. J., Dec. 6, 2004, at A14.

350. See LEE, supra note 110, at 297–300 (discussing alternative regulatory structures).
surprisingly, these responses borrow heavily from the corporate governance rule-making initiatives promulgated pursuant to the Sarbanes-Oxley Act. Industry proposals, by contrast, target industry's growing concern with the conflicts inherent in markets regulating their members when their financial interests diverge. Among these initiatives are consolidation of certain SRO responsibilities in a single self-regulatory organization, segmentation of the self-regulatory arm of existing exchanges, or even direct regulation of broker-dealer activities by the Commission.  

D. Commission Initiatives

While the political impetus behind the Commission's efforts to address SRO governance appears to be the NYSE's recent executive compensation and specialist trading scandals, the proposals address other long-standing concerns about existing exchanges' operational and financial condition as well as the governance of new entrants and demutualized exchanges. Proposed governance rules would make exchange boards more independent and heighten their oversight role with respect to exchange management, segregate market and regulatory operations, and check the influence of individual member/owners of demutualized exchanges over exchange governance.  

351. Seligman, supra note 34, at 1384–87 (suggesting a PCAOB-like regulator).

352. For example, the Securities Industry Association's Ad Hoc Committee on the Regulatory Implications of Demutualization has proposed five alternative models for the future regulation of the securities industry, including: (i) multiple exchanges with separate boards and information barriers, as is the case with the NASD and NASDAQ, (ii) multiple SROs with firms designated to a single SRO for examination purposes (the "DEA Model"), (iii) a hybrid model, in which member regulation is effected by a single SRO, and individual markets regulate their own trading, (iv) a single SRO for all purposes, and (v) SEC regulation. See SIA White Paper, supra note 2. The Commission published these alternatives for public comment in a recent concept release concerning self-regulation. Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256 (Dec. 8, 2004) (codified at 17 C.F.R. pt. 240).

353. The NYSE took a number of steps to address these developments, including reorganization of and allocation of operational and regulatory responsibilities among the board of directors, a board of executives, and various exchange committees, and an agreement to separate the functions of chairman and chief executive officer. One commentator has questioned whether such reforms address the fundamental governance problems inherent in self-regulation. Seligman, supra note 34, at 1373–77.

sure rules would provide greater disclosure regarding financial information including revenue sources, surveillance efforts, and the adequacy of regulatory efforts and internal controls.\textsuperscript{355}

E. Industry Initiatives

Industry proposals to reform self-regulation, by contrast, seek further steps to eliminate the conflicts of interest in regulation by multiple, competing SROs rather than to improve the integrity of the current self-regulatory system. From the industry's perspective, the loss of dominant power by a self-regulatory exchange affects regulation in two ways. First, the exchange will be tempted to abuse its self-regulatory authority to deter competition from systems that pose a threat—however inchoate—to their market power. Second, the exchange will have a heightened incentive to relax enforcement of their listing and business conduct standards to preserve their loyal customer base, since these are the least critical to the exchange's competitive mission. Industry proposals accordingly seek further segregation of self-regulatory authority from exchange operations—particularly with respect to enforcement of business conduct standards that directly affect a member's discretion to trade on the exchange.\textsuperscript{356}

The result of proposal reform would be to phase out member-oriented self-regulation.\textsuperscript{357} The potential drawback of this approach is that the SEC would lose significant leverage over exchange listing and trading rules with respect to which it has no rule-making authority or appetite. If individual exchanges are relieved of the obligation to exercise self-regulatory responsibility,

\textsuperscript{355} Id. at 71,155–67 (describing Revised Exchange Act Form 1, Proposed Exchange Act Form 2, and Proposed Exchange Act Rules 15Aa-1 and 17a-26).

\textsuperscript{356} For example, proposals to consolidate order flow effectively alleviate retail broker-dealers from any duty to obtain best execution for their customers, since there would be only one pipeline for routing orders.

\textsuperscript{357} The implication of the governance releases is that the Commission would allow SROs greater freedom to modify trading practices and listing rules—including with respect to the activities of their specialists and market makers. For example, the Commission's proposed SRO governance rules address the problem of adequate oversight of affiliated companies of an SRO that propose to list on the SRO's market. See Fair Administration and Governance Release, supra note 6, at 71,150–53 (describing proposed Regulation AL). Perhaps the most prominent example of this phenomenon in the United States is NASDAQ's proposal to list its shares on the NASDAQ National Market. See, e.g., NASDAQ Files to Sell Up to $100 Million, WALL ST. J., Dec. 15, 2004, at A1.
the Commission cannot seek voluntary improvements in market structure without elaborate rule making because the bargaining chip of member-oriented self-regulation will no longer be on the table.\textsuperscript{358}

Proposals for self-regulatory reform that seek to maintain the status quo focus on facilitating greater cooperation among exchanges, rather than outright consolidation of exchange authority. In its \textit{Market Structure Study}, the Committee on Market Structure of the American Bar Association proposed requiring the NYSE, the AMEX, and NASDAQ to work in concert to develop best practices for public companies.\textsuperscript{359} In theory, as the sole listing authorities capable of granting access to national market system mechanisms, among other things, this troika could develop uniform standards for their listed companies. Because individual markets are likely to avoid delisting issuers, however, the proposal falls short of recommending that the three SROs enforce compliance with those standards. The principal benefit of such a proposal would be disclosure of compliance or noncompliance.

\textbf{V. DISPERSING SELF-REGULATORY RESPONSIBILITIES ACROSS A NATIONAL MARKET SYSTEM}

To the extent that the principle of self-regulation and the goals of the national market system are inherently at odds, policy alternatives to the current regulatory framework are often presented as a choice between consolidated regulation and unregulated competition. Another approach to addressing the conundrum of self-regulation is a return to first principles: as we move away from an exchange-centered securities marketplace, self-regulatory obligations must be publicly allocated to another body representative of the securities industry that has the market power, operational expertise, and financial resources to carry them out.

Rather than the Commission or a single SRO, the appropriate body for many—but not all—regulatory functions may well be an association of "market centers," governed by a subset of the most

\textsuperscript{358} Conversely, it would be difficult for the SEC to cajole SROs to establish market facilities—such as the NASD's ADF—to accommodate SEC regulatory initiatives.

\textsuperscript{359} \textit{ABA Market Structure Study}, supra note 2, at 1490.
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influential. Specifically, a national market system plan (the "Plan") may be envisioned (i) in which all market centers, including exchanges, trading systems, and market makers, must either become direct participants or be associated with a direct participant; (ii) whose governing participants are determined not by regulatory status, but rather by volume of trading or other objective criteria; and (iii) whose governing participants periodically change to reflect changes in trading patterns or migration of volume.

The objective of such a structure would be to give major market centers an "ownership interest" in the infrastructure and ground rules of the securities marketplace, circumscribed by Commission approval and the limited antitrust immunity conferred by the Exchange Act. Under such a structure, the Commission would effectively exchange its pervasive authority over a subset of major markets with more limited authority (through its power to approve, disapprove, or modify national market system plans) over a more representative consortium of market centers. Such a solution would also punt the difficult questions raised by regulation

360. The Commission has long recognized the need to develop a new term to encompass centers of trading activity other than "exchanges" or the "over-the-counter market." In its recent rule making, the Commission has defined the "market center" (including individual market makers, exchange specialists, and alternative trading systems) as the relevant unit for assessing execution quality of markets that are required to display public quotes. See, e.g., 17 C.F.R. §§ 240.11Ac1-5-.11Ac1-6. In Regulation NMS, the Commission took the further step of defining the phrase "order execution facility," for purposes of its proposed trade-through rule, to encompass exchanges, alternative trading systems, exchange specialists and market makers, over-the-counter market makers, and broker-dealers executing orders internally as principal or agent. Proposed Regulation NMS, supra note 5, at 11,135.

361. For example, a national market system might be administered by the ten market centers with the highest trading volume, subject to minimum representation of certain categories of market center—e.g., specialists, market makers, and alternative trading systems. All market centers—exchange, trading systems and market makers—with sufficient trading volume would have the choice to become direct participants or to access the national market system through other direct participants, e.g., NASDAQ. Nonvoting participation might also be extended to other entities, as proposed by the Commission in the Governance Amendments outlined in Regulation NMS—e.g., broker-dealers with a substantial retail investor customer base, broker-dealers with a substantial institutional investor customer base, data vendors, and investors. Proposed Regulation NMS, supra note 5, at 11,199.

362. Without belaboring the analogy, one might view the proposal as replacing the current "League of Nations" approach to regulating markets—in which a few powerful yet nonrepresentative markets dictate market norms—with a "United Nations" model—in which a more representative set of markets might constructively achieve the more modern goal of standardizing protocols for market access and information.
of specialists and market makers—with the expectation that such concerns are better addressed through improved competition rather than regulation.

The "demythologization" of stock exchanges could proceed in roughly three phases: (i) delegation of primary responsibility for audit trails and market oversight to the Plan; (ii) delegation of primary responsibility for adopting and enforcing listing standards relating to corporate governance to the Plan; and (iii) delegation of business conduct supervision to a single or multiple SROs independent of any market center.

A. Centralized Market Infrastructure and Oversight

At a minimum, a central Plan, and not the Commission, should be responsible for sorting through the appropriate infrastructure for order dissemination and access as well as the related oversight of order handling and market surveillance. Such a Plan could assume responsibility for structuring systems for collecting and disseminating market data and developing a uniform audit trail for monitoring of securities market transactions. Plan rules could be implemented by contractual arrangements with existing service providers, e.g., NASDAQ and SIAC, and enforced by an existing self-regulatory organization, such as NASD, or by the Commission directly. As with all national market system plans, the discretion of governing participants would be constrained by the Commission's ultimate authority to approve, disapprove, or promulgate Plan provisions—in particular, the fees charged for market information and access to publicly displayed orders.

Such a structure preserves the influence of today's dominant markets—such as the NYSE and NASDAQ—with respect to market oversight but with equal treatment for, and an opportunity to

participate in governance by, nonexchanges. By eliminating exchange registration as a prerequisite to participation in or governance of national market system mechanisms, market systems would be developed by a set of market participants more representative of securities trading patterns.\footnote{364} Foreign exchanges could also be permitted to participate in national market system mechanisms—e.g., through a registered U.S. entity—with more limited expectations regarding their self-regulatory obligations.\footnote{365}

As is the case today, the natural inclination of governing members to impose their technology or standards on other market participants must be checked by Commission oversight.\footnote{366} Using objective criteria to dictate who participates in the market system, however, rather than the subjective registration of certain systems as exchanges, allows for a more representative body of markets to make the decision about intermarket mechanisms and may increase the incentives for participants to make reasonable accommodation for other market participants.\footnote{367} This should also

\footnote{364. Although the Exchange Act provides that the SROs are to work jointly to develop the mechanisms of a national market system, it is arguable that additional legislation is not necessary to open full participation in national market system plans to market centers other than self-regulatory organizations. Certain trading systems have, historically, participated in national market system plans (Instinet), and the Commission has considered the possibility of allowing some such trading systems not registered as exchanges to participate directly in national market system plans. Request for Comments, supra note 93, at 30,487. Conversely, registered exchanges could choose or be encouraged to deregister to the extent they do not provide self-regulatory services without significantly affecting the benefits they receive.}

\footnote{365. The Commission has previously suggested allowing foreign exchanges to register as "securities information processors" in the United States under section 11A(b) of the Exchange Act, 15 U.S.C. § 78k-1(b) (2000). See Request for Comments, supra note 93, at 30,487.}

\footnote{366. Plan participants have long been able to use their veto power to prevent Plan amendments inimical to their interests. To overcome this problem the Commission could adopt a supermajority voting requirement or subject Plans adopted with less than unanimous approval to heightened review. It is also possible simply to allow dominant markets to opt out of national market plans and establish their own Plans, particularly to the extent that their market information or liquidity is perceived to be more valuable because of the type of order flow they handle. See, e.g., J. Harold Mulherin, Market Transparency: Pros, Cons and Property Rights, in MODERNIZING U.S. SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES 375–81 (Kenneth Lehn & Robert W. Kamphuis, Jr. eds., 1992). In such case, the Commission would scrutinize their proposed data and access standards to ensure consistency with the public interest and the terms of other Plans, to the greatest extent possible.}

\footnote{367. The Commission has recognized the need for an "advisory committee" representing market centers other than exchanges and self-regulatory organizations. Proposed Regulation NMS, supra note 5, at 11,127. Given that the SEC regularly convenes advisory committees, public roundtables, and other for the purpose of soliciting comment on pro-
create competitive incentives for today's SROs to be more responsible to their members to improve their internal governance structures, lest members elect to participate directly in the national market system or through another intermediary.

While the initial mandate of the Plan would be to build the basic oversight infrastructure, such a Plan could resolve some of the problems faced by the Commission in its attempt to integrate alternative trading systems into the public markets. For example, exchanges and other trading venues have more operational familiarity with the minimum protocols feasible for access to their best quote or their published quotes. As a result, it is appropriate that they, and not the Commission, be required to develop such protocols in the first instance. The Commission's role, consistent with the premises of self-regulation, is to wield Justice William O. Douglas's proverbial "shotgun behind the door"—i.e., to threaten market centers with termination of market revenues, standardized regulation, or other undesirable alternatives if markets are unable to agree, and to enforce such standards if the market centers prove unwilling to do so.

B. National Market Standards and Individual Listing Requirements

A central Plan could also exercise the authority to designate the nonquantitative criteria—i.e., corporate governance require-

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368. Such access protocols could be tiered, such as the proposed description of "fast" and "slow" markets in Regulation NMS. See Proposed Regulation NMS, supra note 5, at 11,129–30.

369. While the Commission does not have rate-making authority under the Exchange Act, the Commission is empowered to ensure that fees charged by exchanges and SROs for market data are not so excessive as to "impose[] any burden on competition not necessary or appropriate in furtherance of the purposes" of the Exchange Act. See 15 U.S.C. § 78k-1(b)(5)(B) (2000). The SEC exercised this authority in an order requiring the NASD to provide a cost-based justification for the fee it charged competing data vendors for a data feed containing individual market maker quotes. Order Announcing Commission Findings, Exchange Act Release No. 20,874, 49 Fed. Reg. 17,640, 17,643 (Apr. 24, 1984). The order was upheld in NASD v. SEC, 801 F.2d 1415, 1422 (D.C. Cir. 1986).

370. The Commission has previously considered whether discriminatory denials of access should be appealable to the Commission in the context of Regulation ATS. See Regulation of Exchanges and ATS Proposing Release, supra note 329, at 23,520, 23,539–40; Regulation of Exchanges, supra note 4, at 70,901.
ments—that "qualified securities" must meet to be eligible for trading in the national market system. Any attempt by the Commission to establish national listing standards resembling exchange or NASDAQ listing standards would likely be considered, in light of *Business Roundtable v. SEC*, to exceed the Commission's authority under the Exchange Act.\(^\text{371}\) It has also been preferable to allow exchanges to determine the quantitative thresholds for sustaining liquidity on their systems rather than to establish them by regulation.\(^\text{372}\) Commission rules thus do not define which securities are subject to its "national market system" rules, but rather refer to those securities designated as "national market system" securities by each plan or its participating self-regulatory organizations.\(^\text{373}\)

Allowing the governing participants of a national market system to dictate *in concert* the minimum corporate governance standards for trading on a national market system is another way to address this problem.\(^\text{374}\) Unlike the listing standards promulgated by individual exchanges, listing standards developed jointly by major market participants and enforced would be insulated from competitive pressure.\(^\text{375}\) Issuers would have an incentive, but not an obligation, to comply in order to obtain public dissemination of trade and quote information and public access to major

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\(^{371}\) *Bus. Roundtable v. SEC*, 905 F.2d 406, 416 (D.C. Cir. 1990) ("The power to designate securities as 'qualified' for trading on the national market system is necessarily constrained by Congress's purposes in authorizing the Commission to foster that system."). The United States Court of Appeals for the D.C. Circuit did acknowledge, however, that the Commission might be able to establish "qualifications relevant to inclusion within any particular information database," such as the amount of trading activity or type of security. *Id.*

\(^{372}\) See Poser, *supra* note 72, at 901-12 (discussing failed SEC attempts to establish criteria for national market system securities in the 1970s).

\(^{373}\) Proposed Regulation NMS, *supra* note 5, at 11,192-93.

\(^{374}\) This approach would differ from the SEC's approach to defining qualified securities in the 1970s by (i) focusing on corporate governance standards rather than quantitative criteria, which would be left to individual markets, and (ii) delegating the establishment and maintenance of such standards to market centers themselves, while giving the SEC the power to approve or disapprove.

\(^{375}\) This is not unlike an alternative proposed by the ABA Committee, in which corporate governance standards would be developed by an industry SRO. *See ABA Market Structure Study, supra* note 2, at 1490. Issuer participation in the development of standards for secondary markets by a national market system governing body may be appropriate, although it is difficult to conceive of a mechanism for ensuring representative membership of public issuers that would have the authority to impose collective governance standards for all public issuers.
markets for their securities. Denial of access to the national market system, moreover, would carry with it as significant a reputational loss as exchange listing does today.

Like exchange listing standards, however, minimum qualifications adopted pursuant to a national market system plan would be subject to public notice and comment and Commission approval. As with SRO rule making today, this would allow the Commission to block listing requirements that are perceived as arbitrary or anticompetitive, and preserve the Commission's ability to influence markets to develop heightened corporate governance or other listing standards as the need arises. Initiatives such as Sarbanes-Oxley's corporate governance standards, for example, could be executed by national market system governing participants, rather than individual markets with different enforcement priorities.

Under such a structure, moreover, markets such as the NYSE and NASDAQ would retain their own listing standards—and, if ultimately deemed appropriate, be permitted to modify them without Commission approval, subject to antitrust scrutiny. The listing standards developed by an individual market would relate to individual market's reputational interest and the liquidity of securities and suitability for trading in a particular system—such as specialists, market makers, or unique trading methodologies—provided by that market. Such considerations, however, would be uncoupled from the Commission's broader concerns relating to corporate governance.

Ensuring that Plans adopt corporate governance standards and enforce them, e.g., through the limitation or denial of access to national market system mechanisms, may pose some regulatory challenges for the Commission. One approach might be to allow the Plan to collect a listing fee for national market system securities to fund the maintenance of national market system mechanisms; the Commission would then retain the authority to withhold or prevent increases in the fee. Another may be to require automatic suspension of noncompliant issuers within a certain period of time, absent reinstatement subject to Commission re-

376. Individual markets could, as today, create mechanisms for trading or supplying liquidity to other securities, e.g., the NASDAQ OTC Bulletin Board, subject to mandatory disclosures that such securities do not meet national market system standards.

377. 17 C.F.R. § 240.11Aa3-2(b) (2004).
view. Such provisions, however, would be the subject of negotiation between the Commission and the Plan participants, as adoption and enforcement of corporate governance listing standards are today.

C. Member Regulation

While certain self-regulatory responsibilities are ripe for delegation to a national market system, member regulation, for historical, operational, and reputational reasons, is the one for which a national market system solution might not be ideal. Unlike trading or listing, there does not appear to be direct competition for member regulatory services other than the NYSE and the NASD Regulation, no other existing or prospective exchange or national securities association is equipped or has evidenced a willingness to regulate the public business of its members. Accordingly, the question is whether the Commission or the NYSE's members collectively trust the NYSE to regulate member business conduct.

The basic alternatives are set forth in the academic literature and Commission releases described above. A better answer, however, may simply be to allow the NYSE's member regulation function to live out its usefulness within the modified framework discussed herein. Given the NYSE's reliance on listing, transaction, and market data revenues to fund self-regulation, one could imagine that at some point the NYSE might relinquish member regulation entirely if it finds it cannot compete effectively with other markets that do not provide self-regulatory services. Moreover, as broker-dealers acquire, are acquired by, or otherwise consolidate with other providers of financial services, there will be greater domestic and international pressure to regulate the broker-dealers' financial responsibility and record keeping group-wide; such developments may well reduce the spheres of interest in which NYSE member regulation is thought to have the most advantage.

378. See supra notes 224–63 and accompanying text.
VI. CONCLUSION

The 1975 Amendments embraced two perhaps inconsistent frameworks for market regulation—one rooted in the history of stock exchanges and one rooted in the possibility of technologically advanced markets. As the exchanges that once served as the epicenter of trading activity struggle with the challenges posed by new entrants, legislators and regulators must ensure that the allocation of regulatory responsibilities and privileges does not unreasonably limit the benefits of increased competition or the effectiveness of industry regulation. Reviving confidence in both self-regulation and the competitiveness of the securities markets is a difficult balancing act, but one which is necessary to ensure the continued preeminence of the U.S. securities markets.

(codified at 17 C.F.R. pts. 200, 240) (adopting final rules creating a new framework for supervising an investment bank holding company).