

TURNING SEATS INTO SHARES: IMPLICATIONS OF
DEMUTUALIZATION FOR THE REGULATION OF STOCK AND FUTURES
EXCHANGES

Comments Welcome
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I. Introduction

A dramatic shift in the economic and power structure of the securities industry is currently in progress. Although competition to traditional markets from electronic trading markets may be the precipitating cause of this upheaval, more than technology is driving these changes. The worldwide rise in stock exchange trading volume, global integration of the capital markets and competition for trading profits are leading to disintermediation at a rate that the securities markets have not experienced since the unfixing of commission rates. Decimalization, which is now underway, will further cut the conventional trading increment to a penny or less. Futures exchanges similarly have been buffeted by technological change and global competition.

One important response to these challenges is demutualization. The Chicago Mercantile Exchange (CME) has completed its demutualization. The National Association of Securities Dealers Inc. (NASD) is in the process of demutualizing the Nasdaq Stock Market, Inc. (Nasdaq) and registering it as an exchange. The New York Stock Exchange, Inc. (NYSE) announced it would demutualize in 1999, although thus far it has not taken steps to do so. The Chicago Board of Trade, Inc. (CBOT) is similarly stalled in its demutualization initiative, but it has restructured.

Demutualization by some key foreign exchanges has proceeded at a faster pace, demonstrating some of the challenges that demutualized exchanges face in today's new competitive climate. This trend is recent. The first exchange to demutualize was the Stockholm Stock Exchange in 1993, but by the end of the year 2000 numerous additional stock and futures exchanges had demutualized, including the Amsterdam Stock Exchange, the London Stock Exchange, the Paris Bourse and the CME. So far, only the Stockholm and Australian Stock

Exchanges have gone public and listed on their own boards, but public offerings are planned by other demutualized exchanges.

Traditionally, stock exchanges operated in the form of non-profit mutual or membership organizations. To the extent market power was not curtailed by competition or regulation, mutual governance gave specialist or market maker members of an exchange control of the price, quality and range of services produced by the exchange. Exchange profits were returned to broker and dealer members in the form of lower access fees or trading profits. Further, exchanges have long operated as self-regulatory organizations (SROs) with members contributing their time to governance and self-regulation to make exchanges more effective and more profitable. Self-regulation was enshrined in the federal securities laws with oversight by the Securities and Exchange Commission (SEC). In addition, in 1975 the Securities Exchange Act of 1934 (Exchange Act) was amended to impose certain corporate governance structures on exchanges. The Commodities Exchange Act similarly embraced self-regulation by futures exchanges but required certain corporate governance formats to be followed.

The pressure to reduce trading execution costs, the demands for technological innovation and demutualization are raising many market structure issues. These include regulation of electronic communication networks (ECNs), including alternative market systems (ATSs); market fragmentation; market information fees and other exchange revenues; the fair treatment of customer orders; and perhaps most importantly, the future of self-regulation. New competitive strategies by exchanges and their members, including demutualization, are raising conflicts of interest questions about self-regulation that the SEC and the Commodity Futures Trading Commission (CFTC) have only begun to address.

This article will argue that the SEC is attempting to re-regulate market structure under a command and control model pursuant to the national market system (NMS) provisions injected into the Exchange Act in 1975 at a time when the monopoly trading regime which led to the national market system mandate is breaking down. An interesting and relevant question this article will pose is whether current trading technologies and the competition these technologies have engendered should lead to a reduction of SEC market regulation, rather than the increase in regulation envisioned by current SEC concept and rulemaking releases, so that competition rather than regulation can determine outcomes. The CFTC model of regulation of exchanges is in the process of changing to permit exchanges to engage in a greater degree of self-regulation in order to compete with foreign exchanges.

This article will also inquire about the future of self-regulation and stock exchange governance in a world where stock exchanges are not mutual organizations. As a general matter, judging from developments in other countries, demutualization may lead to a transfer of some regulation from exchanges to government regulators. A countervailing trend could be that national regulators will be unable to engage in effective regulation of trading markets in a trading environment that moves across boundaries with the click of a mouse. Therefore, more self-regulation and less government regulation may be required to assure that global markets are fair and honest. Self-regulatory organizations may have to be restructured, however, because of the conflicts of interest demutualization and changing trading platforms entail.

Part II of this Article will discuss the drivers for demutualization, the trend toward replacing exchange floors with electronic trading markets and the SEC's response in the form of Regulation ATS. Part III of this Article will summarize the antitrust problems inherent in exchange trading practices and then Part IV will describe the national market system (NMS)

mandate given to the SEC in 1975 and current issues the SEC is addressing pursuant to this mandate of relevance to the changing nature of stock exchange trading. The future of self-regulation for both securities and commodities exchanges after demutualization will be discussed in Parts V and VI.

II The Development of ECNs, ATSS, and Their Regulation

A. Drivers for Electronic Exchanges and Demutualization

ATSS are proprietary trading systems, sometimes referred to as the “fourth market.” They are operated by NASD members or NASD-member affiliates and are similar to exchanges because they allow two participants to meet directly on the system and are maintained by a third party who also serves a limited regulatory function by imposing requirements on each subscriber.¹ ECNs are a special class of ATSS used to disseminate firm commitments to trade to participants, or subscribers. ECNs may be linked into the Nasdaq marketplace.² Many broker-dealers have internal systems to automate the firm’s execution of customer orders, particularly firms that internalize or purchase order flow. These systems are not generally considered ATSS because all trades effected on internal systems involve only the operator of the system and not external parties.³

Although some ATSS and ECNs have been in operation for many years, technological advances, trading volume increases and pressures on trading profits have enabled some ECNs to become serious competitors to Nasdaq and exchanges. Similarly, in order to compete with foreign derivatives exchanges ECNs have developed for the trading of financial futures. ECNs

¹ Jeffrey W. Smith et al, *The Nasdaq Stock Market: Historical Background and Current Operation*, NASD WORKING PAPER 98-01, Aug. 24, 1998, at 36, available at < http://www.academic.nasdaq.com/docs/wp98_01.pdf >.

² *Id.*

³ *Id.*

also are being developed for the bond markets, and the trading of bonds may therefore become more efficient. Trading efficiency necessarily means a reduction in trading spreads and so it is inevitably resisted by traditional traders. One of the primary issues to which this Article is addressed is whether government regulators have any public interest justification for either impeding or mandating a reduction of trading spreads pursuant to the statutes under which they operate.

Despite the rhetoric about the superiority of one trading system over another, including the debate about the advantages of floor based over electronic systems that continues in the United States, there are only two basic types of securities trading markets: quote driven and order driven. Many of the market structure debates revolve around the extent to which orders must be disclosed to the marketplace or the degree of dealer intervention required for liquidity. Further, the move from floor trading and screen based market maker systems to electronic trading has occurred for reasons of capacity and efficiency. When floors and market makers can no longer efficiently handle their trading volume, markets have moved to a new technological model, just as the blackboard daily call auction gave way to a continuous auction on many exchanges, and the NYSE specialist developed an electronic book.

Economists argue that electronic trading networks are likely to destroy an exchange's natural monopoly and, therefore, the benefits of mutual governance may no longer be as valuable as previously was the case. Different exchange members are likely to benefit or suffer from ATS competition unevenly. A related argument is that electronic exchanges and their competitors are compelled to become for-profit corporations in order to be efficient and to compete effectively.

Another important driver for demutualization of some exchanges has been the perceived need to shift power within exchanges from one group of members to another and to afford

institutional customers direct access to exchange facilities. Separating exchange membership from ownership may be a politically and economically feasible way to effect such a shift and resolve conflicts of interest between exchange members and between exchanges and their members.

In order for floor trading to operate efficiently and to provide adequate liquidity, specialists, market makers or local traders, as well as floor brokers, need to be physically present. Limited access in the form of exchange memberships provides an economic incentive for their presence. Further, mutual ownership gives those market makers and brokers a return on their specialized skills in the form of lower access fees or higher trading profits. The time they devote to exchange governance and self regulation enhances these profits. Electronic trading demands a different trading constituency in that it links widely dispersed buyers and sellers. It is in the economic interest of an electronic marketplace to have screens in as many locations as possible in order to attract order flow. ATs and some non-U.S. exchanges have found it advantageous to permit remote access and to place screens with institutional investors. Retail investors have also demonstrated an interest in such direct access.

Under the federal securities laws as currently drafted and interpreted by the SEC in Regulation ATS,⁴ no registered exchange may have institutional or individual investor members, but may only have broker-dealer members. However, institutions and retail customers could become shareholders of a demutualized exchange. A separation of membership from ownership could then realign the interests of investors, who are providing trading interest and liquidity to an exchange pricing mechanism, and exchange members. It should be noted, however, that exchange demutualizations in countries outside the United States have thus far not generated the

⁴ Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40760, 63 Fed. Reg. 70844, 70852 (Dec. 22, 1998) [hereinafter Adopting ATS Release].

institutional investor shareholding interest that was hoped for by some exchange officials. Rather, the primary shareowners are former members.

In the late 1970s some believed that the trading markets would and should become an electronic “black box,” but this did not happen. Buyers and sellers of securities want efficiency and liquidity and, if they are intermediaries, they need to obtain best execution. They also are concerned about market impact so they want anonymity. Further, they are concerned about the financial ability of counterparties to settle trades. Exchanges have historically provided these functions with the exception of anonymity. But the pressure on intermediary profits is undermining the acquiescence of those who provide liquidity to support a continuation of past practices. Commodities exchanges have been experiencing similar pressures. The CBOT is no longer the world’s biggest futures exchange, but has been eclipsed by an electronic derivatives marketplace in Europe.⁵ Further, the CBOT’s largest customers are going into competition with the exchange. Accordingly, the CBOT is in the process of splitting in two and offering its customers side by side electronic trading and open outcry floor trading and at the same time, demutualizing.⁶ The CME has become an entirely electronic, demutualized for-profit exchange.⁷

Whatever new governance structure or trading system replaces the current trading systems, there is a danger that demutualization of exchanges will cause order flow to move away from exchanges to competitive ATSS. Member firms will no longer have the same stake in an exchange’s viability and success, and there will be competition between exchanges and their members. As for-profit exchanges expand, they may also begin to compete with their listed

⁵ See Peter A. McKay, *CBOT, Eurex Want Asian Partner, Internet Link*, WALL ST. J., Nov. 5, 1999, at C17.

⁶ See David Barboza, *Chicago Faces the Future, Reluctantly*, N.Y. TIMES, Nov. 23, 1999, at C1.

companies. These developments have significant implications for exchange governance and exchange self-regulation.

B. Decimalization

Traditionally, there was a one-eighth increment in the trading of stocks in the United States. Not only was both exchange and over-the-counter trading conducted in eighths, but transactions were reported in eighths. This trading convention was destroyed by an antitrust investigation of Nasdaq, which will be discussed further below. The destruction of the one-eighth trading convention can be compared to the unfixing of stock exchange minimum commission rates in its effect on the profitability of certain segments of the securities industry, as well as in the market structure issues it has triggered.

At the same time as trading spreads were being deregulated, there was a government prompted move to change trading conventions to decimals. While Congressional and SEC pressures to effect such a change were frequently justified as modernizing trading, they were resisted by the securities industry for two reasons. First, it is anticipated that the move to decimalization will greatly increase stock market volume. This was one effect of the unfixing of commission rates, and it had disastrous results. Second, the real threat of decimalization for the trading community is that trading increments will drop to a penny or less. As the unfixing of commission rates also demonstrated, once charges for the trading of stocks are deregulated it is difficult to predict how low such charges will descend.

C. Regulation ATS

SEC concern about ATSs dates back to the 1960s when the NASD developed Nasdaq and Instinet Corp. (Instinet) developed a computer-based facility for trading equities that allowed

⁷ See Peter A. McKay, *New CEO Devises Five-Year Strategy To Restructure For-Profit Chicago Merc*, WALL ST. J., Feb. 24, 2000, at C17.

institutional investors to trade directly with one another. In response, the SEC proposed Rule 15c2-10 under the Exchange Act in order effectively to create a new non-statutory classification for the regulation of automated trading systems.⁸ However, this rule was subsequently withdrawn,⁹ and the SEC permitted Instinet and other ATSS to do business as registered broker-dealers.¹⁰ As a result, the SEC defined the term “exchange” very narrowly as a system that utilizes the capital of specialists to buffer price swings and add liquidity to a marketplace “generally understood” to be an exchange.¹¹ This interpretation was upheld by the Seventh Circuit.¹²

In its Market 2000 Study the SEC examined the development of alternative markets and services for equity trading in the context of market fragmentation and competition. The staff noted that alternative markets had been developing for 20 years, that they produced improved trading services and enhancements and had put pressure on the primary markets to operate more efficiently.¹³ However, the staff also recognized that markets can fragment to the point where price discovery is impaired and maintenance of fair and orderly markets is difficult.¹⁴ The Report noted that almost all ATSS were regulated as broker-dealers, but the proliferation of such

⁸ Proposal to Adopt Rule 15c2-10 Under the Securities and Exchange Act of 1934, Exchange Act Rel. No. 8661, 34 Fed. Reg. 12952 (Aug. 4, 1969).

⁹ Notice of Withdrawal of Proposed Rule 15c2-10, Exchange Act Rel. No. 11673, 40 Fed. Reg. 45422 (Sept. 23, 1975).

¹⁰ Instinet, SEC No-Action Letter from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to Daniel Brooks, Cadwalader, Wickersham & Taft, FED. SEC. L. REP. CCH ¶ 78,997, 1986 WL 67657 (SEC) (Sept. 8, 1986).

¹¹ Self-Regulatory Organizations; Delta Government Options Corporation; Order Granting Temporary Registration as a Clearing Agency, Exchange Act Rel. No. 27611, 55 Fed. Reg. 1890 (Jan. 12, 1990).

¹² Board of Trade of the City of Chicago v. SEC, 923 F.2d 1270, 1272 (7th Cir. 1991).

¹³ Division of Market Regulation, MARKET 2000, AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS (Jan. 1994) at III-2.

¹⁴ *Id.*

systems could have effects on the NMS that should be closely monitored to determine whether additional regulation was warranted.¹⁵ Therefore more enhanced recordkeeping and reporting was required.¹⁶

The rulemaking proceeding resulting in Regulation ATS began with a concept release.¹⁷ In its Concept Release, the SEC abandoned its use of prior acronyms and adopted the term ATS, which it defined as “automated systems that centralize, display, match, cross or otherwise execute trading interest, but that are not currently registered with the Commission as national securities exchanges or operated by a registered securities association.”¹⁸ The Concept Release proposed a new regulatory regime that would either require ATSs to register with the SEC as exchanges or would impose new obligations that would permit ATSs to continue to be regulated as broker-dealers but would require them to comply with rules designed to improve their transparency and surveillance, as well as their systems capacity, integrity and security.¹⁹

The SEC asserted that ATSs were handling almost twenty percent of orders in OTC stocks and four percent of orders in NYSE listed securities and, therefore, they needed to be better integrated into the national market system.²⁰ The particular concerns highlighted by the Concept Release as a justification for increased regulation of ATSs were market access and

¹⁵ *Id.* at III-11.

¹⁶ *Id.* at III-13. The SEC then promulgated Rule 17a-23 under the Exchange Act. Recordkeeping and Reporting Requirements for Trading Systems Operated by Broker Dealers, Exchange Act Release No. 35124 (Dec. 20, 1994), 59 Fed. Reg. 66702 (Dec. 28, 1994). In connection with adopting Regulation ATS, the SEC moved these requirements into rules 17a-3 and 17a-4, 17 C.F.R. § 240.17a-3 and 17a-4. Adopting ATS Release, *supra* note 4, at 70891.

¹⁷ Regulation of Exchanges, Exchange Act Release No. 38672 (May 23, 1997), 62 Fed. Reg. 30485 (June 4, 1997).

¹⁸ *Id.* at 30486 n.1.

¹⁹ *Id.* at 30487.

²⁰ *Id.* at 30486.

fairness, market transparency and coordination, market surveillance and market stability and systemic risks.²¹ In general, commenters opposed the “exchange-lite” concept and suggested that ATSS be permitted to remain registered as broker-dealers.

The SEC then proposed rules and requested comment on a framework that would allow ATSS to choose whether to be a market participant and register as a broker-dealer, or to be a separate market and register as an exchange.²² The thrust of these proposals was to integrate ATSS into the NMS.²³ Although the proposals were controversial and generated a fair amount of negative comment, the SEC adopted its proposed framework with only minor modifications on December 2, 1998. The purpose of the new regulation was to level the playing field for ATSS, Nasdaq, and the registered exchanges.²⁴ SEC Chairman Levitt commented that he was “committed to promoting the competitiveness and viability of the traditional exchanges.”²⁵ Thus, the rule was designed to create “flexibility” for the existing exchanges.²⁶

The SEC’s objective of bringing ATSS into the NMS was accomplished by a new and expanded definition of the term “exchange” that captured most ATSS and a rule exempting ATSS from exchange registration if they chose to register pursuant to Regulation ATS and undertake certain new obligations as to the transparency of their quotes and trades, fair access and systems capacity. Although the SEC extolled the benefits of exchange registration for an ATS, it refused

²¹ *Id.*

²² Regulation ATS, Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 39884, 63 Fed. Reg. 23504 (April 29, 1998), [hereinafter Proposing Release].

²³ *Id.* at 23504.

²⁴ *Id.* See also, Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release 40706, 63 Fed. Reg. 66618 (Dec. 8, 1998).

²⁵ Neil Hare, *Levitt Reminds NYSE, NASDAQ of SRO Rule as Exchanges Consider Demutualization Plans*, 31 SEC. REG. & L. REP. (BNA), July 30, 1999, at 1002.

²⁶ *Id.*

to adjust any obligations of an exchange, and it therefore discouraged most ATSS from choosing exchange registration. The impact of the regulation on smaller ATSS was minimal. It merely required a filing with the SEC regarding the ATSS's operations methods, quarterly filings and maintenance of an audit trail.²⁷ It also mandated oversight by an SRO, presumably NASD Regulation, Inc. (NASDR).²⁸ Larger ATSS became more heavily regulated under the new regulation.²⁹

Exchange Act Rule 3b-16 reinterpreted the term "exchange" to include "any organization, association or group of persons that: (1) Brings together the orders of multiple buyers and sellers; and (2) uses 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."³⁰ The SEC justified its revised interpretation on various grounds, particularly the broad statutory grant of exemptive authority the SEC obtained in 1996,³¹ permitting the SEC to craft a flexible regulatory framework for markets.³² More fundamentally, the SEC asserted that although traditional exchanges still provide liquidity through two-sided quotations and raise an expectation of liquidity at the quoted price, this is no longer the essential characteristic of a securities market.

²⁷ See *Alternate Trading Systems; SEC Will Allow ATSS to Choose Registration as Brokerage or Exchange*, 30 SEC. REG. & L. REP. (BNA), Dec. 4, 1998, at 1686.

²⁸ *Id.*

²⁹ *Id.*

³⁰ Adopting ATS Release, *supra* note 4, at 70847.

³¹ National Securities Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3438 codified in Exchange Act § 36, 15 U.S.C. § 78 mm (1999).

³² Adopting ATS Release, *supra* note 4, at 70899.

Today's technology enables markets participants to tap simultaneous and multiple sources of liquidity from remote locations.³³

Using its exemptive authority under Section 36 of the Exchange Act, the SEC adopted Exchange Act Rule 3a1-1 exempting from the definition of an "exchange" any ATS that registers as a broker-dealer and complies with Regulation ATS.³⁴ The term "alternative trading system" was defined as any system that "constitutes, maintains, or provides a marketplace 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" and that does not "set rules governing the conduct of subscribers other than the conduct of such subscribers' trading" on such system or "discipline subscribers other than by exclusion from trading."³⁵ This definition was intended to preclude any SRO from opting to register as a broker-dealer rather than an exchange or association unless it decides to give up its self-regulatory functions and complies with Regulation ATS.³⁶ An ATS subject to Regulation ATS must be a member of an SRO.³⁷

Various requirements as to quote and trade transparency and access are imposed upon any ATS that has five percent or more of the trading volume of any exchange listed, Nasdaq NMS or Nasdaq SmallCap Security.³⁸ Any such ATS must publicly disseminate its best priced orders in such securities for inclusion in the quotation data made available to quotation vendors

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Id.

³⁴

Id. at 70859.

³⁵

Rule 300(a), 17 C.F.R. § 242.300(a).

³⁶

Adopting ATS Release, *supra* note 4, at 70859. Any ATS that trades only government securities is excluded from the scope of Regulation ATS, but other ATSs that trade other debt securities are subject to the Regulation. The SEC expressed its view that its concerns about trading equity securities on ATSS, especially as to capacity, integrity and fair access, apply to trading of fixed income securities in ATSS. *Id.* at 70861-62, 70902.

³⁷

Id. at 70863.

³⁸

Id. at 70870. *See also id.* at 70866 n. 191-92.

by exchanges and the NASD. Any ATS required to publicly display its best priced orders must also provide to members of the SRO with which it is linked the ability to effect a transaction with those orders. Further, fees cannot be set that are inconsistent with the principle of equivalent access.³⁹ If an ATS accounts for more than twenty percent of trading volume in any equity security, or twenty percent or more of the volume in any category of corporate debt or municipal security, during four of the preceding six months, under new Exchange Act Rule 301(b)(5) it must establish standards for access to its system and apply those standards fairly to all prospective subscribers.⁴⁰ The Proposing Release included a right of appeal to the SEC of any denial of limitation of access. This appeal right was not included in the final rules.⁴¹

Exchange Act Rule 301(b)(6) applies to any ATS that trades twenty percent or more of the volume in any equity security or any category of corporate debt or municipal securities during four of the preceding six months. Any such ATS, among other things, is required to: (1) establish reasonable current and future capacity estimates; (2) conduct periodic capacity stress tests of critical systems; (3) develop and implement reasonable procedures to monitor systems development and testing methodology; (4) review the vulnerability of systems and data center computer operations to internal and external threats, physical hazards and natural disasters; and (5) establish adequate contingency and disaster recovery plans.⁴²

Any ATS that falls within the registration rule, Rule 3b-16, can choose to register as a national securities exchange. But the SEC declined to give any relief from the obligations of an

³⁹ *Id.* at 70870.

⁴⁰ *Id.* at 70923.

⁴¹ *Id.* at 70874.

⁴² *Id.* at 70924.

exchange under the Exchange Act.⁴³ Therefore, any ATS choosing to register as an exchange must be able to enforce compliance by its members and associated persons with the federal securities laws and rules of the exchange.⁴⁴ Further, such an ATS must comply with corporate governance requirements. At least one director must be representative of issuers and investors and not associated with any member or broker-dealer. There must be fair representation of an exchange's members.⁴⁵

The customers of many ATSs are institutions. This is one reason the SEC previously declined to extend the definition of an exchange to include them.⁴⁶ Nevertheless, in its rulemaking package, the SEC determined not to grant any relief from the requirement that all exchange members be registered broker-dealers.⁴⁷

In addition, any ATS choosing to register as an exchange, must provide fair access for members, sufficient systems capacity to handle foreseeable trading volume, participate in NMS quotation and reporting systems and establish trading halt and circuit breaker rules.⁴⁸ For example, a newly registered exchange would be required to halt trading when neither quotation nor transaction information could be disseminated. Any securities traded on a registered exchange must be registered with the SEC and approved for listing on the exchange. Therefore systems that trade privately placed or unregistered foreign securities could not register as exchanges.⁴⁹

⁴³ *Id.* at 70880.

⁴⁴ *Id.* at 70881.

⁴⁵ *Id.* at 70882-84.

⁴⁶ *See Board of Trade of City of Chicago v. SEC*, 923 F.2d 1270, 1273 (7th Cir. 1991).

⁴⁷ Adopting ATS Release, *supra* note 4, at 70884.

⁴⁸ *Id.* at 70885-88.

⁴⁹ *Id.* at 70886.

In order to level the playing field between registered ATSS and registered exchanges, and to further innovation, Exchange Act Rule 19b-5 permits pilot systems to operate for two years before filing with and approval by the SEC.⁵⁰ A pilot trading system is, essentially, a low volume system operated independently of any other SRO system.

Regulation ATS is a significant NMS initiative, but like many of the SEC's past programs in this area, it is unclear what will really be accomplished. Although the SEC expanded the definition of an exchange from its prior narrow interpretations, it did so to force ATSS with substantial volume into NMS quotation and transaction reporting rules, not to change the way in which exchanges operate or are governed. Although the SEC has long believed that market transparency is a keystone of the NMS, the argument can be made that transparency has costs, especially for efficiency and liquidity and that it may benefit the retail investor, but burden the institutional investor.⁵¹ In fact, the SEC has not integrated broker-dealer block trading desks or single market maker or dealer systems into the ATS-NMS framework, thus permitting institutional investors some leeway in keeping their strategies and orders from the marketplace.⁵²

III. Antitrust Issues

There have long been serious conflicts between competition and regulation in the securities field. The seminal case attempting to reconcile these conflicts, *Silver v. New York Stock Exchange*,⁵³ set forth a test for reconciling antitrust laws with securities regulation as follows: "Repeal [of the antitrust laws] is to be regarded as implied only if necessary to make the

⁵⁰ *Id.* at 70892-93.

⁵¹ Ruben Lee, Comment Letter to Jonathan Katz, Secretary, SEC on Proposing Release, *supra* note 22, July 28, 1998.

⁵² Adopting ATS Release, *supra* note 4, at 70851. The reason is that the customers of a broker-dealer generally keep control over their own orders so the broker-dealer is unlikely to be viewed as using discretionary methods in handling the order. *Id.* at 70850-51.

Securities Exchange Act work, and even then only to the minimum extent necessary.”⁵⁴ In this case a nonmember broker sued the New York Stock Exchange, Inc. (NYSE) under the Sherman Act after the NYSE ordered the discontinuance of his wire connections with the offices of NYSE members without notice, explanation or a hearing. The Court held that no policy of the Exchange Act was served by this conduct and therefore the NYSE had acted in violation of the Sherman Act. In the context of the unfixing of commission rates and a restructuring of the securities industry over a decade later the Supreme Court broadened the area in which the antitrust laws may be impliedly repealed by the securities laws.

In *Gordon v. New York Stock Exchange, Inc.*⁵⁵ the Court held that the antitrust laws did not apply to the system of fixed commission rates then utilized by the stock exchanges because the SEC had authority to do away with fixed commissions had it found them inconsistent with the regulatory structure. Direct and active supervision by the SEC over rate-fixing by securities exchanges negated the possibility of antitrust liability for fixed commissions. In a second case of the same year the Court found that the SEC had not exercised the same degree of supervisions with regard to the secondary trading of mutual funds, but read the applicable legislative history as granting to the SEC the informed administrative judgement to do so.⁵⁶ The 1975 Act amendments, passed in the same year as these cases, made clear that the SEC’s role in passing on exchange or other SRO rules must include an evaluation of the anti-competitive aspect of such rules. Several new powers for and limitations on the SEC were added to the Exchange Act with respect to the consideration of competitive questions.

⁵³ 373 U.S. 341 (1963).

⁵⁴ *Id.* at 357.

⁵⁵ 422 U.S. 659 (1975).

⁵⁶ *United States v. NASD*, 422 U.S. 694 (1975).

Within one year after the effective date of the statute, the SEC was required to determine whether the rules of any national securities exchange or registered securities association complied with the Exchange Act. Thereafter, proposed rule changes of exchanges and associations were required to be subjected to prior rulemaking procedures by the SEC and could not take effect without an SEC finding that such rule was consistent with the Exchange Act.⁵⁷ These provisions effectively required the SEC to take competition into consideration in reviewing all existing and any new exchange or association rules. In addition, fixed commission rates were effectively outlawed although the SEC was given the authority to allow “reasonable” fixed rates prior to November 1, 1976 if found to be in the public interest.⁵⁸ The SEC was also instructed to review and presumably eliminate off board trading bans of the exchanges, but as will be explained below, these rules were not finally eliminated until May 2000.

Although the SEC pushed for multiple trading of equities for many years, and believed multiple trading was endorsed by the 1975 Act amendments, in the mid-1970s, the SEC nevertheless discouraged multiple trading of options on more than one exchange because of concerns over manipulative activity.⁵⁹ However, in 1989 the SEC permitted multiple options

⁵⁷ Exchange Act § 19 (b), 15 U.S.C. § 78s. Notice of Rulemaking Proceeding to Consider Amendment or Abrogation of Rules of Nat'l Securities Exchanges which Limit or Condition the Ability of Members to Effect Transactions Otherwise than on such Exchanges, Exchange Act Release No. 11628, 40 Fed. Reg. 41808 (Sept. 2, 1975).

⁵⁸ Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 11203, 40 Fed. Reg. 7394 (Jan. 23, 1975). *See also* Announcement of the Adoption of Rule 17a-20 and Related Form X-17A-20 Under the Securities Exchange Act of 1934, The Approval of Two Plans Submitted Pursuant to Paragraph (a)(3) of Rule 17a-20, and the Implementation of Other Aspects of the Program to Monitor the Impact of Rule 19b-3 Which Provides for the Elimination of Fixed Commission Rates, Exchange Act Release No. 11395, 40 Fed. Reg. 20073 (May 2, 1975).

⁵⁹ *See SEC Proposal Would End Prohibition on Multiple Exchange Trading of Options*, 19 SEC. REG. & L. REP. (BNA), June 19, 1987, at 906.

trading.⁶⁰ Some years later the Department of Justice investigated and brought a class action charging price-fixing in the options markets. This case was against exchanges that had exclusive options and certain of the specialists, market makers and floor brokers which allegedly entered into an unlawful conspiracy to refrain from the multiple trading of options and to refuse to integrate the options markets leading to spreads at excessive levels.⁶¹ This case and a companion SEC case have since been settled.⁶²

Of much greater importance to the future shape of the securities markets was a Department of Justice and SEC investigation into market maker spreads on Nasdaq. A pricing convention by which most Nasdaq stocks were quoted in even eights was declared illegal.⁶³ As a result, stocks began to be quoted and traded on stock exchanges and Nasdaq in smaller increments. Furthermore, this proved but a prelude to decimalization in which stocks could be traded in much smaller increments.⁶⁴ Just as prodding by the Department of Justice was necessary to unfix commission rates, action by the Department of Justice was necessary to narrow trading spreads. This process of unfixing trading spreads is ongoing. Furthermore, ECNs are generating an onslaught of competitive threats to the former monopoly type powers of exchanges.

⁶⁰ 17 C.F.R. § 240 (1999). *See* Multiple Trading of Standardized Options, Exchange Act Release No. 26870, 54 Fed. Reg. 26870 (May 26, 1986).

⁶¹ Press Release, Dept. of Justice, Justice Dept. Files Suit Challenging Anticompetitive Agreement Among Options Exchanges, at < <http://www.usdoj.gov/atr/public/press-release/2000/6452.htm> > (Sept. 11, 2000).

⁶² *See Options Market: Four U.S. Options Exchanges Settle Charges by SEC, Justice of Anticompetitive Conduct*, 32 FED. SEC. L. REP. (BNA), Sept. 18, 2000, at 1226.

⁶³ *See* In the Matter of NASD, Inc., Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Exchange Act Release No. 37542, 62 S.E.C. Doc. 1385 (Aug. 8, 1996).

⁶⁴ *See* E. S. Browning, *Journal Goes "Decimal" With Nasdaq Tables NYSE List Will Follow In Break With Fractions*, WALL ST. J., Aug. 2, 2000, at C1; Greg Ip & Patrick McGeehan, *Big Board Votes Trades In Decimals*, WALL ST. J., June 6, 1997, at C1.

Among these monopoly type powers was the trading of securities in issuers that determined to list on the exchange. Although as far back as the Multiple Trading Case in 1941⁶⁵ the SEC attempted to prevent exchanges from exercising a monopoly in the trading of an issuer's securities, the NYSE's off-board trading rule, Rules 390,⁶⁶ effectively prevented serious competition among exchanges in dually listed stocks. The first significant attack on the monopolization of trading in the stock of a listed issuer was Exchange Act Rule 19c-3 which permitted exchange members to trade off-board as agent for customers, except in agency crosses, and abolished off-board trading restrictions as to stocks listed after April 26, 1979.⁶⁷ In recent years, competition to exchange trading monopolies has come from ECNs or ATSS. The proliferation of these electronic marketplaces has forced the SEC to confront numerous market structure issues.

IV. The NMS Mandate

A. The Securities Acts Amendments of 1975

The 1975 Act amendments imposed much more oversight of exchanges by the SEC and laid the foundation for the establishment of a national market system (NMS). Without mandating specific components of the NMS or even defining the term, Congress vested the SEC with broad flexible authority to design, implement and regulate the trading markets. The purposes and goals of this legislation are set forth in Section 11A(a)(1) of the Exchange Act as follows:

⁶⁵ In the Matter of the Rules of the New York Stock Exchange, Exchange Act Release No. 3033, 10 S.E.C. Doc. 270 (Oct. 4, 1941).

⁶⁶ See Order Approving Proposed Rule Change to Rescind Exchange Rule 390, Exchange Act Release No. 42758, 65 Fed. Reg. 36222 (May 5, 2000).

⁶⁷ Off-Board Trading Restrictions, Exchange Act Release No. 16888, 45 Fed. Reg. 41125 (June 11, 1980); Off-Board Trading Restrictions, Exchange Act Release No. 16889, 45 Fed. Reg. 41156 (June 11, 1980).

(a)(1) The Congress finds that-

- (A) The securities markets are an important national asset which must be preserved and strengthened.
- (B) New data processing and communications techniques create the opportunity for more efficient and effective market operations.
- (C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure-
 - (i) economically efficient execution of securities transactions;
 - (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
 - (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
 - (iv.) the practicability of brokers executing investors' orders in the best market; and
 - (v) an opportunity, consistent with the provisions of clauses (i) and (v) of this subparagraph, for investors' orders to be executed without the participation of a dealer.
- (D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers and investors, facilitate the offsetting of investors' orders and contribute to best execution of such orders.⁶⁸

The 1975 Act amendments were precipitated by the unfixing of commission rates and the back office paperwork crisis and disintermediation that resulted from the onset of freely negotiated rates. Competitive challenges to the hegemony of the NYSE were fragmenting the markets and so there were concerns about the integrity of the pricing mechanism for equities and

⁶⁸ 15 U.S.C. § 78k-i (a). *See generally* Donald Calvin, *The National Market System: A Successful Adventure in Industry Self-Improvement*, 70 VA. L. REV. 785 (1984); Milton Cohen, *The National Market System - A Modest Proposal*, 46 GEO. WASH. L. REV. 743 (1978); Norman Poser, *Restructuring the Stock Market: A Critical Look at the SEC 's National Market System*, 56 N.Y.U. L. REV. 884 (1981); George Simon & Robert Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17 (1986).

the best execution of customers' orders. This background is important to an understanding of current market structure issues because current issues also are arising from a similar disintermediation.

B. NMS Policy Statements

A recent book advocates that governments withdraw from the task of mandatory securities market structure and let market forces shape trading platforms.⁶⁹ While the SEC is unlikely to accede to this advice, and probably could not do so given the NMS provisions of the Exchange Act, the SEC's record of accomplishments is skimpy in realizing its vision of a NMS articulated in 1978.

In a 1978 Policy Statement, the SEC asserted that Congress supported three major principles when directing the SEC to facilitate the development of the NMS. These were: (1) creating an ideal auction type market by implementing a nationwide system according to price and time priority for all limit orders of public investors over all professional orders; (2) the types of securities qualified to be included in a national market system should depend primarily on their characteristics rather than where they were traded; and (3) a refusal to achieve a nationwide centralized auction-type market for qualified securities involving abolition of over-the-counter trading in listed securities.⁷⁰ Competitive forces, to the extent feasible, were to shape the markets.⁷¹ The major problems to which the ideas of the NMS were addressed were those

⁶⁹ Ruben Lee, WHAT IS AN EXCHANGE-THE AUTOMATION, MANAGEMENT, AND REGULATION OF FINANCIAL MARKETS 260-61, 264-65, 308-09 (1998).

⁷⁰ Development of a National Market System, Exchange Act Rel. No. 14416, 43 Fed Reg. 4354, at 13-16 (Jan. 26, 1978).

⁷¹ *Id.* at 17.

arising from market fragmentation or “the existence of multiple, geographically separated forums in which trading in the same security occurs and from institutionalization of the markets.”⁷²

In a Notice of Intent to engage in rulemaking, the SEC expressed views as to those initiatives which it believed had to be taken over the next year (that is, before January 1979) to facilitate the establishment of a national market system. The first initiative was taken simultaneously with the SEC’s National Market System Release, namely the adoption of Rule 11Ac-1-1, designed to facilitate the prompt development of a composite quotation system by improving the quality and reliability of quotation information made available to securities information vendors by exchanges and third market makers.⁷³

The second initiative was the development of comprehensive market linkage and order routing systems. This linkage was created by the Intermarket Trading System (ITS), which initially was a quotation link between all national securities exchanges, and was then linked to the NASD’s Computer Assisted Execution System (CAES).⁷⁴ In the SEC’s view, it is now critical that quotes of electronic communications networks (ECNs) be included in a consolidated quote.⁷⁵

⁷² *Id.* at 18.

⁷³ *See* Dissemination of Quotations for Reported Securities, Exchange Act Release No. 14415, 43 Fed. Reg. 4342 (Jan. 26, 1978).

⁷⁴ *See* Intermarket Trading System, Exchange Act Release No. 18713, 47 Fed. Reg. 20413 (May 6, 1982); American Stock Exchange, Inc., et. al.; Intermarket Trading System, Exchange Act Release No. 19456, 48 Fed. Reg. 4938 (Jan. 27, 1983).

⁷⁵ Disclosure of Order Routing and Execution Practices, Exchange Act Release No. 43,084, (July 28, 2000) [hereinafter Disclosure Rules Release], 65 Fed Reg. 48 406, at pt. IV(A)(2).

ATNs and ECNs that are not exchanges do not have access to the ITS.⁷⁶ This raises a concern about price discovery efficiency and an argument that every exchange, ATN and ECN should be playing by the same rules.⁷⁷ Frustrated critics of the current system note that the U.S. is the only major country without an electronic stock exchange.⁷⁸ Instinet’s CEO, recommends following Europe’s lead and opening access to prevent fragmentation.⁷⁹

A White Paper issued by several large NYSE member firms in February 2000 asserted that in order to make the ITS a “super national market system (NMS), much must be done, including: opening access to all qualified market participants; making governance more democratic and streamlined; updating technology, ensuring efficient order-routing; and providing an effective dispute resolution mechanism.⁸⁰ Then, mandatory price-time priority to ensure automatic execution must be built into the system.⁸¹

The third basic principle upon which the 1978 SEC believed an NMS must be based was the assurance that all agency orders in NMS securities, regardless of location, receive the benefit of auction-type trading protections. To that end, the SEC recommended that concerned self-regulatory organizations develop and implement a central limit order book (CLOB) for public

⁷⁶ Rachel Witmer, *SEC Seeks to Foster Innovation Unger Says, Responding to Criticism of Market Regulation*, 32 SEC. REG. & L. REP. (BNA), February 14, 2000, at 178.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Responding to Chairman Levitt’s Call: A Plan for Achieving a True National Market System*. (Feb. 29, 2000), at < <http://interactive.wsj.com/articles/SB951781063229264679.htm> > [hereinafter Large Firm White Paper]; see Michael Schroeder & Randall Smith, *Sweeping Change in Market Structure Sought*, WALL ST. J., Feb. 29, 2000, at C1; *Five Wall Street Firms’ Vision Of A Centralized Market*, 32 SEC. REG. & L. REP. (BNA), March 6, 2000, at 277.

⁸¹ *Id.*

agency orders. To this day, no such CLOB has been developed and it remains a controversial idea. Some, including SEC Chairman Levitt, have advocated a CLOB for all customer orders.⁸² A CLOB is a “central repository” that allows *all* market participants to see prices for a security simultaneously. This proposal thwarts price fragmentation and promotes price transparency.⁸³ There is a vigorous debate as to whether a CLOB is the answer to this issue, however. Many oppose the CLOB although it would improve broker dealer and ATSS market positions.⁸⁴ The SEC has not taken an official current position on whether the CLOB would better serve the interest of investor protection.⁸⁵

In 1979, the SEC next proposed that a decision was required concerning off-board trading prohibitions. Thereafter, in 1980, the SEC amended Exchange Act Rule 19c-1 and adopted Rule 19c-3, which permitted exchange members to trade off-board as agent for customers, except in agency crosses, and abolished off-board trading restrictions as to stocks listed after April 26, 1979.⁸⁶ However, remaining off-board trading restrictions were not removed until May 2000.

The fifth pillar of the SEC’s vision of a national market system in 1979 was a consolidated transaction reporting system. This pillar was then constructed pursuant to a variety of national market system plans pursuant to Exchange Act Rules 11A3-1, 11Ac1-1, 11Ac1-2 and 11A3-2 by the Consolidated Tape Association (CTA) and related committees.⁸⁷

⁸² See Rachel Witmer, *SEC Proposes Rescission of NYSE Rule 390, Seeks Input on Market Fragmentation Issues*, 32 SEC. REG. & L. REP. (BNA), Feb. 28, 2000, at 241.

⁸³ *Id.*

⁸⁴ See 32 SEC. REG. & L. REP., *supra* note 80.

⁸⁵ *Id.*

⁸⁶ See *supra* note 67.

⁸⁷ Dissemination and Display of Transaction Reports, Last Sale Data and Quotation Information, 19 S.E.C. Doc. 659 (Feb. 19, 1980); Dissemination of Quotations for Reported Securities, Exchange Act Release No. 14415, 43 Fed. Reg. 4342 (Jan. 26,

Finally, the SEC explained that it was necessary to define securities qualified to trade in the national market system and it then proceeded to do so.⁸⁸ A variety of other matters were also briefly addressed in the 1979 National Market System Release including institutional trading prohibitions, self-regulatory organization (SRO) governance and surveillance of national market system facilities, and clearance and settlement issues. Of overriding policy concern, however, was the problem of fostering competition without fragmentation of the market due to internalization by member firms.

C. Fragmentation

The most significant of the many complex market issues currently under consideration is resolution of the tension between trading competition and centrality of the price setting mechanism for equities. The SEC set forth this issue and the many sub-issues involved in its Request for Comment on Issues Relating to Market Fragmentation (SEC Request for Comments).⁸⁹ After reviewing the comments submitted in response to this release, the SEC recently proposed two new rules to improve public disclosure of order routing and execution practices.⁹⁰ Another important market structure issue is resolution of the tension between

1978). *See* Regulation of Market Information Fees and Revenues, Exchange Act Release No. 42208, 64 Fed. Reg. 70613 (Dec. 17, 1999) [hereinafter SEC Concept Release on Fees].

⁸⁸ Designation of National Market System, Exchange Act Release No. 17,549, 46 Fed. Reg. 13,992 (Feb. 17, 1981). The potential this gave the SEC to impose governance standard on listed issues, *see* Roberta S. Karmel, *Qualitative Standards for "Qualified Securities: SEC Regulation of Voting Rights*, 36 CATH. UNIV. L. REV. 809 (1987), did not pan out. *See* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1980).

⁸⁹ *See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577 (Feb. 23, 2000) [hereinafter SEC Request for Comment on Fragmentation].

⁹⁰ Disclosure Rules Release *supra* note 75.

liquidity and transparency. This issue, among others, was addressed in the Report of the Special Committee on Market Structure, Governance and Ownership of the New York Stock Exchange, Inc. (NYSE Report).⁹¹ To some extent, this NYSE Report was a response to the Large Firm White Paper concerning the issue of market fragmentation.⁹² The NYSE Report also was prompted by the SEC's Concept Release on Market Information Fees and Revenues.⁹³ In a further effort to come to grips with the issues of price transparency and consolidated market information and determining how market information fees should be determined, the SEC established an Advisory Committee on Market Information on July 25, 2000.⁹⁴

Fragmentation occurs when investor order flow is directed to different markets that are not connected or are ineffectively connected.⁹⁵ Internalization and payment for order flow are among the causes of fragmentation. These questionable practices have been under SEC scrutiny for some time, but the SEC has been reluctant to outlaw them because they have exerted pressure on the NYSE and Nasdaq to reduce trading costs. Whether fragmentation is a serious current problem in the securities markets is a subject of some debate. The Large Firm White Paper asserted that fragmentation is a reality and that it will worsen when ENC's register as exchanges and when NYSE off-board trading restrictions are removed.⁹⁶ The NYSE also claimed that the

⁹¹ MARKET STRUCTURE REPORT (March 23, 2000) *available at* < http://www.nyse.com/pdfs/market_structure.pdf > (Aug. 4, 2000) [hereinafter NYSE Report].

⁹² *See supra* note 80.

⁹³ SEC Concept Release on Fees, *supra* note 87.

⁹⁴ *See Law School Dean to Chair Advisory Panel on Market Information*, 32 SEC. REG. & L. REP. (BNA), Oct. 2, 2000, at 1331.

⁹⁵ *See Large Firm White Paper*, *supra* note 80 at 3.

⁹⁶ *Id* at 3-4.

rescission of Rule 390 would exacerbate fragmentation to the detriment of investors.⁹⁷ Both the Large Firm White Paper and the NYSE Report blamed inadequacies in the ITS for some market structure problems, but their solutions were quite different.

The Large Firm White Paper urged a completely reformed market linkage system, which would include all qualifying ECNs and would have a new governance structure including representatives from all industry participants so that the NYSE and Nasdaq would no longer be in a position to regulate their ECN competitors.⁹⁸ The Large Firm White Paper also recommended the adoption of a CLOB, that is an automatic price/time priority rule.⁹⁹ These reforms would help to connect fragmented liquidity pools while preserving the ability of the large firms to internalize retail executions.

The NYSE Report asserted that developments in communications technology have eliminated the need for an intermarket order-routing system such as ITS and suggested that ITS be abolished.¹⁰⁰ Recognizing, however, that the SEC was unlikely to agree, the NYSE Report argued that the ITS should continue to require that participants be SROs.¹⁰¹ This would compel broker-dealers, including ECNs that do not register as exchanges pursuant to Regulation ATS, to link to ITS only through an SRO participating in the ITS plan. Further, the NYSE Report opposed the adoption of a CLOB, which it defined as a “single, national, order-driven

⁹⁷ See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577 (Feb. 23, 2000) [hereinafter SEC Request for Comment], at pt. II.

⁹⁸ Large Firm White Paper *supra* note 80, at 11-15.

⁹⁹ *Id.* at 15-25.

¹⁰⁰ See NYSE Report, *supra* note 91, at 42.

¹⁰¹ *Id.* at 43.

intermarket linkage requiring submission of all customer limit orders for automatic matching based upon price-time priority.”¹⁰² The NYSE Report argued that a CLOB eliminates, without replacing, the price discovery that occurs in the crowd on the NYSE floor and questioned whether a CLOB would attract meaningful institutional order flow. The NYSE Report also recommended that the NYSE not facilitate internationalization of customer orders in the absence of opportunities for price improvement.¹⁰³ Recently, the SEC reiterated its concern about the potential for internalization and payment for order flow arrangements to interfere with order interaction and the display of aggressively priced quotations.¹⁰⁴

ECNs and their defenders argue that the equity markets are not fragmented and that competition between market centers – ECNs and exchanges – should make the pricing mechanisms efficient and fair.¹⁰⁵ Both ECNs and the regional stock exchanges (which may have the most to lose in the competition for order flow and executions) oppose a CLOB as anticompetitive.¹⁰⁶ This debate has pitted the interests of the large wire houses wishing to internalize order flow against the interests of exchanges and other markets. The effect decimalization will have on execution costs and profits as well as the continued popularity of limit orders is now unknown. Accordingly, the timing has not been propitious for the SEC to

¹⁰² *Id.* at 27.

¹⁰³ *Id.* at 36-40.

¹⁰⁴ Disclosure Rules Release, *supra* note 75, at pt. I.

¹⁰⁵ See Matthew Andresen, *Manager’s Journal: Don’t CLOBber ECNs*, WALL ST. J., Mar. 27, 2000, at A48; Holman W. Jenkins, Jr., *Business World: Wall Street Fuddy Duddies CLOBber the Future*, WALL ST. J., Mar. 8, 2000, at A23. See also Mark Klock, *The SEC’s New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753 (1999).

¹⁰⁶ See *Market Fragmentation Issue Reduced to CLOB Comments*, 3 SECURITIES REGULATORY UPDATE (CCH), June 12, 2000, at 1.

mandate a CLOB that is opposed by large segments of the securities industry, and the SEC has so concluded.¹⁰⁷

The adoption of a CLOB was not the only idea put forth by the SEC in its Request for Comment on market fragmentation. Other options suggested by the SEC were greater disclosure by market centers and brokers concerning trade execution and order routing; restrictions on internalization and payment for order flow; requirements for exposure of market orders to price competition; and intermarket prohibitions against market makers trading ahead of previously displayed and accessible investor limit orders.¹⁰⁸ The SEC is now following up on all of these ideas.

Rule 11Ac1-5, adopted at the end of 2000, requires market centers that trade national market system securities to make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis.¹⁰⁹ Rule 11Ac1-6 requires broker-dealers that route orders on behalf of customers to make publicly available quarterly reports that describe their order routing practices and disclose the venues to which customer orders are routed for execution.¹¹⁰ There is an ongoing staff study on order execution quality which could serve as a basis for restricting internalization and payment for order flow arrangements.¹¹¹

Industry focus on the merits of a CLOB rather than the SEC's other suggestions for reducing fragmentation is understandable since currently two-thirds of all orders on Nasdaq and

¹⁰⁷ Disclosure Rules Release, *supra* note 75, at pt. I.

¹⁰⁸ SEC Request for Comment on Fragmentation, *supra* note 120, at pt. IV(C)(2).

¹⁰⁹ 17 C.F.R. § 240.11Ac1-5.

¹¹⁰ 17 C.F.R. § 240.11Ac1-6.

¹¹¹ Disclosure Rules Release, *supra* note 75, at pt. I.

system orders on the NYSE are limit orders.¹¹² The SEC believes that limit orders narrow spreads, increase liquidity and promote the ability of investors to trade without the intervention of a dealer.¹¹³ However, the increased chances of missing limit order executions after decimalization may change investor behavior and make the debate over a CLOB irrelevant. The SEC has suggested that after decimalization it may prevent market makers from stepping ahead of customer limit orders at a penny in order to continue to encourage limit orders.¹¹⁴ However, the already complicated regulations for limit order display and handling perhaps defy compliance.¹¹⁵

D. Market Data

Current and contemplated changes in market structure also have thrown into question arrangements for disseminating and charging for market information. The SEC's Concept Release on Market Information Fees and Revenues indicates that the SEC is considering effecting serious changes in the way in which exchanges and other markets will be able to charge for market information. The SEC seems to envision cost-based accounting with respect to the production of market information in order to determine whether the fees for the provision of such information are reasonable.

Although the SEC Concept Release on Fees set forth the SEC's belief that market information fees are an appropriate part of SRO funding, it questioned whether the cost of member regulation should be included in the computation of what market information costs.¹¹⁶

¹¹² SEC SPECIAL STUDY: REPORT CONCERNING DISPLAY OF CUSTOMER LIMIT ORDERS, [Current] FED. SEC. L. REP. (CCH) ¶ 86,306, at 83,401 (May 4, 2000).

¹¹³ *Id.*

¹¹⁴ Disclosure Rules Release, *supra* note 75, at pt. IV(A)(1).

¹¹⁵ *See* Special Study, *supra* note 112.

¹¹⁶ SEC Concept Release on Fees, *supra* note 87, at pt. IV(C)(1).

Further, the SEC suggested that conversion of exchanges to for-profit companies and the proliferation of alternative trading markets may require greater government interference in the way in which SRO information processors are governed as well as how they charge for market information.

It seems curious that at a time when there are more, rather than fewer, competing markets for equity trading the SEC is considering the imposition of utility rate regulation for market information. In response to the SEC Concept Release, the NYSE has threatened to withdraw from the CTA and has lambasted the idea of cost-based rate regulation for market data fees.¹¹⁷ Further, the NYSE has expressed the view that if it charged more for its data, it could charge less for listings and transactions.¹¹⁸ The SEC has now set up an Advisory Committee to deal with this issue.¹¹⁹

The fissures within the securities industry with regard to market structure are longstanding. Further, it is questionable whether the problems of adjusting to changes in the trading environment for equities due to technological and competitive pressures should be addressed by more market regulation by the SEC at this time. Perhaps consideration should be given to dismantling the NMS, or at least seriously deregulating an administrative structure designed in the 1970s to solve the problems of adjustment by a quasi-monopoly to the unfixing of commission rates in the context of a securities industry in serious financial and operational difficulty.

¹¹⁷ *NYSE Proposes Competitive Model for Market-Data Dissemination*, THE EXCHANGE (NYSE), June 2000, at 5.

¹¹⁸ *See The Battle for Efficient Markets*, *ECONOMIST*, June 17, 2000, at 70.

¹¹⁹ *See supra* note 94.

Prior to the 1975 Act amendments, the unfixing of commission rates was forced by numerous rebative practices and the formation of broker-dealers solely for the purpose of recapturing commissions. Similarly, in recent years, pressure to reduce trading spreads has been forced by payment for order flow and internationalization. In 1975 and again today competitive threats to traditional stock exchanges have been attacked for fragmenting the price discovery mechanism for equities. What should the role of the SEC be in this struggle? On the one hand, the SEC is concerned about encouraging competition and lowering transaction costs, which is accomplished by having rival market places. On the other hand, the SEC also is concerned about maintaining orderly and liquid markets, which is accomplished by a single trading market. Although the SEC endeavors to foster competition to the dominant markets – the NYSE and Nasdaq – the SEC also worries about fragmentation. Unfortunately, these goals tend to be conflicting and the Exchange Act does not provide the SEC with clear guidelines for reconciling these conflicts. The SEC has never fully trusted competition as a market regulator, but rather, has preferred regulation to ensure that the markets are transparent and fair, and not limited to a single monopoly marketplace.

In the past, the SEC has been able to slough off some of the more difficult NMS decisions on the securities industry by allowing SROs to come up with such solutions as the ITS and CTA. New competitors such as ECNs and shifting alignments on market structure issues are raising serious questions, however, about the future of SRO structures and decision making for these industry plans and even long standing self-regulation by the stock and commodity exchanges.

V. Background and History of Self-Regulation

A. Stock Exchanges

A major market structure issue currently confronting the SEC is the future of self-regulation, which has been addressed by a special committee of the Securities Industry Association (SIA).¹²⁰ Prior to the enactment of the Exchange Act stock exchanges were private membership organizations under state law. When the federal securities laws were passed, stock exchanges were required to register with the SEC.¹²¹ The SEC thus obtained oversight authority over stock exchanges, but the stock exchanges continued to have rulemaking and regulatory authority with respect to their members, their trading markets and their listed companies.

Before 1934 no analogue to stock exchanges for the over-the-counter (OTC) market existed, but in 1938 Congress passed the Maloney Act to establish a framework for an OTC self-regulatory organization (SRO).¹²² Only one such association, the NASD exists for OTC brokers and dealers. Although the NASD is for all intents and purposes a stock exchange,¹²³ it continues to be called and regulated as an “association” under the securities laws. All broker-dealers registered with the SEC, except those doing business exclusively on a securities exchange, are required to join the NASD.¹²⁴

¹²⁰ SIA, REINVENTING SELF-REGULATION: WHITE PAPER FOR THE SECURITIES INDUSTRY ASSOCIATION’S AD HOC COMMITTEE ON REGULATORY IMPLICATIONS OF DEMUTUALIZATION, Jan. 5, 2000, at 5 (SIA White Paper).

¹²¹ Exchange Act, § 6, 15 U.S.C. § 78f.

¹²² *Id.* § 15A.

¹²³ *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40760, 63 Fed. Reg. 70844 (Dec. 22, 1998), at 70852 [hereinafter Adopting ATS Release]. Nasdaq, the subsidiary of the NASD that functions as an exchange marketplace, is registered as a securities information processor. *Id.* It intends to register as a stock exchange in the future. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Amending the Nasdaq By-laws and Restated Certificate of Incorporation, Exchange Act Release No. 42983, 65 Fed. Reg. 41116 (June 26, 2000) [hereinafter Approval of Nasdaq By-Laws].

¹²⁴ Exchange Act, § 15(b)(8), 15 U.S.C. § 78o(b)(8) (1994). Before 1983, the NASD did not have this kind of an SRO monopoly. Pub. L. 98-38, *See* § 3, 97 Stat. 206 (1983).

Although the efficacy of self-regulation was called into question by stock market abuses reported in the 1963 SEC Special Study,¹²⁵ that Study concluded that self-regulation should be maintained and strengthened.¹²⁶ Nevertheless, in 1964 the SEC obtained greater direct authority over the continuous disclosures made by public companies.¹²⁷ Previously, the SEC was given power to regulate financial disclosure by issuers making initial public offerings,¹²⁸ but after 1964 the SEC also was given responsibility for regulating annual and periodic reports.¹²⁹ Stock exchange listing requirements maintained their importance as to certain shareholder rights issues, however, because the SEC does not have the statutory authority to dictate the corporate governance of listed companies.¹³⁰

The Securities Acts Amendments of 1975¹³¹ further strengthened the SEC's oversight role over the stock exchanges and the NASD by, among other things, giving the SEC the power to initiate as well as approve SRO rulemaking,¹³² expanding the SEC's role in SRO enforcement and discipline,¹³³ and by allowing the SEC to play an active role in structuring the market.¹³⁴ Also, formulation and enforcement of the net capital rule became a direct SEC responsibility instead of a regulation of the SROs.¹³⁵ For the first time, the statute set forth requirements with

¹²⁵ SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKET, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 4, at 502 (1963) [hereinafter Special Study].

¹²⁶ *Id.* pt. 5, at 201-02.

¹²⁷ Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964).

¹²⁸ Securities Act of 1933, § 5, 15 U.S.C. § 77e.

¹²⁹ Exchange Act, §§ 12(g), 14(a), 15 U.S.C. §§ 78l(g), 78n(a).

¹³⁰ *See Business Roundtable v. SEC*, 905 F.2d 406, 407 (D.C. Cir. 1990).

¹³¹ Pub. L. No. 94-29, 89 Stat. 97 (1975).

¹³² Exchange Act, § 19(c), 15 U.S.C. § 78s(c).

¹³³ *Id.* §§ 19(c)(d), (g).

¹³⁴ *Id.* § 11A.

¹³⁵ *Id.* § 15(c)(3).

respect to the composition of exchange and association boards of directors.¹³⁶ Additionally, the 1975 Act gave new SROs, such as clearing and transfer agents and information processors, a statutory foundation.¹³⁷

The 1975 Act sought to preserve and reinforce the concept of industry self-regulation with SEC oversight. However, by directing the SEC to facilitate the creation of a national market system, injecting competition as a statutory goal and giving the SEC greater authority over SRO rulemaking, disciplinary activities and other matters, the SEC became able to exert more leverage over exchange corporate governance than in the past.

B. Commodities Exchanges

CTFC has had to address the problems of conflicts of interest in SRO functions in connection with approving the demutualization of the CME.¹³⁸ Prior to 1974 commodity futures trading was regulated by the Commodity Exchange Authority within the Department of Agriculture.¹³⁹ Then Congress created the CFTC as an independent agency and gave it exclusive jurisdiction over future and commodity options trading pursuant to the Commodity Futures Trading Commission Act of 1974 (Commodity Futures Act).¹⁴⁰ The next year, on October 20,

¹³⁶ *Id.* § 6(a)(3), 15A (b)(4).

¹³⁷ *Id.* § 17A.

¹³⁸ CFTC, Memorandum to the Commission from the Division of Trading and Markets, *Re: The Chicago Mercantile Exchange's Proposed Demutualization Plan*, <http://www.cftc.gov/tm/cme_demu._memo.htm> (visited Nov. 14, 2000).

¹³⁹ Jerry W. Markham, *The Commodity Exchange Monopoly--Reform Is Needed*, 48 WASH. & LEE L. REV. 977, 982 (1991).

¹⁴⁰ Pub. L. No. 93-463, 88 Stat. 1389 (1974).

1975, the CBOT introduced the first futures contract on a security.¹⁴¹ Since then, jurisdictional battles regarding regulation of financial futures have raged between the SEC and the CFTC.¹⁴²

To a large extent the CFTC is an analogue to the SEC with respect to the regulation of futures exchanges. The CFTC has deferred to rulemaking and self-regulation by commodities exchanges.¹⁴³ Such self-regulation by commodities exchanges has a long history.¹⁴⁴ Initially, the organizational and governing structure of a commodity exchange was not subject to CFTC regulation.¹⁴⁵

In addition to self-regulation by commodities exchanges, the National Futures Association (NFA) is a free standing self-regulator that was granted registration by the CFTC in 1982 as a futures association.¹⁴⁶ The NFA works with the CFTC to set standards for ethics training of industry professionals, the review of disclosure documents and issues concerning statutory disqualification of registered persons and entities.¹⁴⁷ Also, the NFA audits any commodities firms not a member of any commodities exchange.¹⁴⁸

C. Federal Involvement in Exchange Governance

1. General

¹⁴¹ Dan Glickman & Thomas A. Russo, *Business Forum; Look Beyond the "Pits" for Directors*, N.Y. TIMES, Oct. 28, 1984 § 3, at p.3.

¹⁴² See Markham, *supra* note 139 at 985-87.

¹⁴³ *Id.* at 1004-05.

¹⁴⁴ See Stephen Craig Pirrong, *The Self-Regulation of Commodities Exchanges: The Case of Market Manipulation*, 38 J.L. & ECON. 141, 142 (1995).

¹⁴⁵ Thomas A. Russo, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS § 1.03, at 1-9 (1983).

¹⁴⁶ See U.S. Gen. Accounting Office, *Securities Arbitration How Investors Fare*, Rep. To Cong. Requesters, GAO/GGD-92-74, May 1992.

¹⁴⁷ Dana A. Lukens, *Regulation for the Securities Markets?*, 10 ANN. REV. BANKING L. 379, 395 n. 135 (1991).

Stock and futures exchanges in the United States traditionally have been organized under not-for-profit incorporation laws of a particular state. Unlike charities or educational institutions, they pay taxes. For example, the NYSE is incorporated under a New York law that existed prior to the exchange's incorporation.¹⁴⁹ The State of Illinois passed a special law to facilitate incorporation by the CBOT.¹⁵⁰ Further, exchanges have been mutual organizations, owned by their members, and profits have been returned to members in the form of lower access fees or other benefits. The members vote for the exchange boards of directors (sometimes called governors).

Recently, however, electronic exchanges have posed the question of whether non-member, for-profit entities may operate as exchanges. The SEC has determined that a for-profit corporation may register as a stock exchange.¹⁵¹ But the Exchange Act limits exchange membership to registered broker-dealers.¹⁵² The SEC has stated that it will not grant relief from this requirement to alternative trading systems (ATSs) wishing to register as exchanges which include institutions among their members.¹⁵³

Floor based exchanges, such as the NYSE and the CBOT have a limited number of members or seat holders. Traditionally, this gave the members monopoly powers with respect to the stocks or futures contracts traded on the exchanges. Concern about the abuse of such power

¹⁴⁸ See *Regulation of Investment Companies and Investment Advisers*, in THE SEC SPEAKS in 1995 (880 PLI Corp. L. & Practice Course Handbook Series No. B4-7080, at 119 (1995)).

¹⁴⁹ N.Y. BUS. CORP. L. § 402.

¹⁵⁰ See *infra* Part VI(B) and accompanying notes.

¹⁵¹ Adopting ATS Release, *supra* note 4 at 70848, 70883. One big electronic network, Island ECN Inc. is moving to raise capital and register as a stock exchange. See Rebecca Buckman, *Island ECN Raises Capital to Become a Stock Exchange*, WALL ST. J., May 11, 1999 at C20.

¹⁵² Exchange Act, § 6(c)(1), 15 U.S.C. § 78f(c)(1).

¹⁵³ Adopting ATS Release, *supra* note 4 at 70884-85.

gave rise to government interest in exchange governance. Examinations of governance issues have tended to focus on power struggles between seatholders, professional exchange managers and upstairs firms. More recently, conflicts have emerged between seatholders and clearing members. In the view of Congress, exchanges are affected with a national public interest, requiring their regulation to insure the maintenance of fair and honest markets.¹⁵⁴

2. Stock Exchanges

When the Exchange Act was passed, Congress expressed concern about the rules of exchanges concerning the classification of members, method of election of officers and committees, and disciplining of members. Congress therefore directed the SEC to study and report on these matters.¹⁵⁵ Before the NYSE's governance could be changed in accordance with SEC recommendations, the Conway Committee was appointed by the NYSE to study its reorganization. This committee recommended a more representative composition of the board, limits on consecutive service and the creation of a full time paid president and professional staff.¹⁵⁶ A scandal involving Richard Whitney, a former NYSE president, interrupted these reforms but did lead to the appointment of the NYSE's first full-time president, William McChesney Martin.¹⁵⁷ In 1949-50 further governance changes were made in response to proposals by a group of floor members to try to eliminate self-perpetuation by a control group. The board was expanded and consecutive service was limited.¹⁵⁸

¹⁵⁴ See Exchange Act § 2, 15 U.S.C. § 78b.

¹⁵⁵ *Id.* § 19(c), *deleted by Securities Act Amendments of 1975*, Pub. L. No. 94-29, 89 Stat. 97 (1975).

¹⁵⁶ Special Study Pt. 4, *supra* note 125 at 507-08.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 571.

In the SEC's 1963 Special Study, exchange governance was again focused upon. The Study noted that self-perpetuation had not been eliminated and recommended making the board "more sensitive to the public character of the exchange and more cognizant of the needs of public investors"¹⁵⁹ by separating voting rights from the concept of seats, and by giving firms doing business with the public increased representation.¹⁶⁰ No changes resulted from these recommendations, however.

From that time and until 1972, the NYSE Constitution consisted of 33 members, composed of the chairman, the president, 3 representatives of the public and 28 members' representatives.¹⁶¹ Specialist firms dominated the governance structure. Of the 29 members' representatives (including the chairman), 17 were required to be seatholders and to spend a substantial part of their time on the floor. Members of the board could not serve more than 2 consecutive terms, except after an interval of 2 years. Nominations to the board were made by an elected committee of 8 members, 5 of whom were required to be seatholders; at least 4 of whom were required to spend substantial time on the floor.¹⁶²

Significant changes were made to the NYSE Constitution in 1972 as a result of the Martin Report released in 1971 and its implementation by the Owens Committee. These changes occurred in the context of uncertainty about the immunity of stock exchanges from the antitrust laws,¹⁶³ pressures to unfix commission rates¹⁶⁴ and the financial and operational back office

¹⁵⁹ *Id.* at 572.

¹⁶⁰ *Id.* at 576.

¹⁶¹ *Id.* at 510.

¹⁶² *Id.*

¹⁶³ SECURITIES INDUSTRY STUDY, REPORT OF THE HOUSE SUBCOMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, 92nd Cong., 1st Sess. (1972), Fed. Sec. L. Rep. (CCH) Spec. Rep. 438 (Aug. 25, 1972), at 155-68 [hereinafter Securities Industry Study].

¹⁶⁴ *Id.* at 131-46.

crisis of the securities industry.¹⁶⁵ These developments ultimately led to the enactment of the 1975 Act that restructured the regulatory relationship between the SEC and SROs and stripped stock exchanges of some of their former autonomy.

The Martin Report was intended to compel the NYSE to discard what vestiges of a private club atmosphere then remained and to become a quasi-public organization. The principal objectives of a recommended reorganization were as follows:

1. To give proper recognition in the governing board of the Exchange to its quasi-public nature and the respective interests of the public, the companies listed on the Exchange and the members of the securities industry involved.
2. To provide broad access to the public auction market for all brokerage firms which meet necessary standards and will be subject to equal regulation.
3. To create an organization which, through the public representation on its governing board and the authority and independence of its management, will strengthen self-regulation and answer the prevalent criticism that member firms of the New York Stock Exchange cannot be expected to discipline themselves.
4. To permit and encourage the principal officers and partners within the member firms to serve on the governing board without respect to business background, e.g., the floor, the back office or the New York metropolitan area.
5. To transfer voting power from the individual members to the member firms and to provide a means for its redistribution so that each member firm could have voting power more closely related to its investment and its share of exchange transactions.
6. To change the present seats into shares, without destroying their market value.¹⁶⁶

More specific steps recommended were that the NYSE board should be reduced from 33 to 21 -- 10 directors from member firms, 10 from the public and a full-time, paid chairman;

¹⁶⁵ *Id.* at 3-13.

¹⁶⁶ *Id.* at 103.

public directors should include representatives of listed companies and all segments of the investing public, including institutional investors; the 10 member firm directors should be principal officers, partners and proprietors; public directors should have staggered 3-year terms and member firm directors 1-year terms; member firm directors should nominate themselves, but nominations from the floor should be allowed and cumulative voting would prevail; public directors should elect their successors; the board should have power comparable to the board of a business organization, with authority to amend its constitution and rules, subject to member override; all directors should be reimbursed for their expenses and public directors should be compensated for their time and responsibility; existing seats should be converted into 1 share, with one vote per share, but 10 shares would be required to enable a firm to place a representative on the board or be a clearing member and share ownership for voting purposes limited in proportion to the amount of business done with the public.¹⁶⁷

In 1971, the NYSE was incorporated and it adopted a new constitution. Its new governance structure, which essentially has been maintained, was adopted in response to the Martin Report, but it did not adopt all of the Martin Report's recommendations. It fell short of doing so in that votes remained tied to seats; public directors were nominated by a joint-industry-public committee and there was not a requirement that the board include representatives of all segments of the investing public; continuous service was not limited; and the board was not given the power to amend the constitution.¹⁶⁸ When the NYSE was incorporated in 1971, the SEC expressed some doubts as to whether this step would impair the effectiveness of the

¹⁶⁷ *Id.* at 103-05.

¹⁶⁸ *Id.* at 105-06.

exchange as a self-regulator.¹⁶⁹ In 1972, the House Subcommittee on Commerce and Finance recommended that the NYSE and the American Stock Exchange (Amex) and the NASD reorganize their boards in conformity with the principles laid down in the Martin Report.¹⁷⁰

By the time the 1975 Act was passed Congress was not inclined to put rigorous corporate governance standards into the Exchange Act. In part, this was not necessary because the term “member” of an exchange was defined in such a way as to divorce it from the concept of a “seat”¹⁷¹ and the SEC was given plenary control over specialists’ activities.¹⁷² In addition, the SEC was given the power to abrogate, amend or add to the rules of any SRO.¹⁷³ Although self-regulation was preserved, and in some ways strengthened, a new emphasis on competition, investor protection and fair procedures changed the manner in which exchanges and associations could operate. Access to the market was opened up¹⁷⁴ and standards were put in place for the design of exchange and NASD rules and disciplinary proceedings.¹⁷⁵

With specific reference to exchange boards of directors, the Exchange Act was amended in 1975 to provide that the rules of an exchange must “assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer.”¹⁷⁶ A corresponding provision was inserted for associations.¹⁷⁷

¹⁶⁹ See SEC Comments on NYSE Incorporation, Exchange Act Rel. No. 9112 (Mar. 17, 1971).

¹⁷⁰ Securities Industry Study, *supra* note 163 at 107.

¹⁷¹ Exchange Act, §§ 3(a)(3), 3(a)(9), 3(a)(19), 15 U.S.C. §§ 78c(a)(3), (a)(9), (a)(19).

¹⁷² *Id.* § 11(b). Previously exempt specialists, floor traders and floor brokers were required to register with the SEC.

¹⁷³ *Id.* § 19(c).

¹⁷⁴ *Id.* §§ 11A(b)(5)(A), 19(f).

¹⁷⁵ *Id.* §§ 6(b)(7), 15A(b)(8), 19(b).

¹⁷⁶ *Id.* § 6(a)(3).

The House bill had required that exchanges and associations include public representatives and further required that these SROs appropriate sums for use of public directors to employ staff independent of the exchange or association, but such provisions were dropped in the conference committee.¹⁷⁸

3. Futures Exchanges

Scrutiny of and debates concerning the governance of futures exchanges occurred in connection with amendments to the Commodity Futures Act.¹⁷⁹ Because the Commodity Futures Act gives commodity exchanges a monopoly over the trading of futures, the perception of conflicts of interest on the part of exchanges was examined in the early 1990s. Commodity exchanges were traditionally governed by their floor members, consisting of “locals” and “independent” floor brokers, who used their leverage to control exchange appointments and policy.¹⁸⁰

Futures exchanges have had no ban on institutional membership. Banks and large agricultural interests traditionally have owned memberships. Because of the enforced monopoly futures exchanges have on the trading of particular contracts, the fear of disintermediation that led to the ban on stock exchange institutional membership in the 1975 Act was not relevant to futures exchanges.

The public had only token representation on futures exchanges in the form of outside public directors.¹⁸¹ Candidates for the board generally were selected by their predecessors.¹⁸²

¹⁷⁷ *Id.* § 15A(b)(4).

¹⁷⁸ Report of the Senate-House Conference Committee, H.R. No. 94-229 (1975).

¹⁷⁹ Pub. L. No. 93-463, 88 Stat. 1389 (1974).

¹⁸⁰ Markham, *supra* note 139, at 1009.

¹⁸¹ *Id.* at 1010.

¹⁸² *Id.* at 1009.

Floor members could select their own candidates by petition and could circulate petitions on the floor demanding that proposals be adopted by the exchange boards.¹⁸³ Although exchanges had professional staffs, they were governed by exchange committees composed of exchange members.¹⁸⁴ The House of Representatives approved a bill in 1989 that would have required at least 20% of the members of the board of a futures exchange to be public representatives with no exchange affiliations, but this proposed law failed to pass.¹⁸⁵

In 1989 there were undercover FBI sting operations at the CME and CBOT that resulted in the indictment of 48 individuals for various trading practice violations on commodity exchange floors.¹⁸⁶ These criminal indictments were upheld, although the trials had mixed results.¹⁸⁷ In response to the sting operation Congress passed legislation to strengthen regulation of the trading pits. Among other things, audit trails were strengthened, there was increased regulation of floor broker associations, and more outsiders were required to be included on exchange boards and disciplinary committees.¹⁸⁸

These 1992 amendments to the Commodity Futures Act to require diversity of membership on exchange boards and disciplinary committees required exchange boards to :

(A) provide for meaningful representation . . . of a diversity of interests, including - -

(i) futures commission merchants;

¹⁸³ *Id.* at 1011.

¹⁸⁴ *Id.*

¹⁸⁵ H.R. Rep. No. 236, 101st Cong., 1st Sess. 6 (1989); *see also* Markham, *supra* note 139, at 1013.

¹⁸⁶ JERRY W. MARKHAM, *COMMODITIES REGULATION: FRAUD, MANIPULATION AND OTHER CLAIMS* § 14.10 (1998).

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

(ii) producers of, and consumers, processors, distributors, or merchandisers of, principal commodities traded on the board of trade;

(iii) floor brokers and traders; and

(iv) participants in a variety of pits or principal groups of commodities traded on the exchange.

(B) provide that no less than 20 percent of the regular voting members of such board be comprised of nonmembers of such contract market's board of trade with –

(i) expertise in futures trading, or the regulation thereof, or in commodities traded through contracts on the board of trade; or

(ii) other eminent qualifications making such person capable of participating in and contributing to board deliberations.

(C) provide that no less than 10 percent of the regular voting members of such board be comprised where applicable of farmers, producers, merchants, or exporters of principal commodities traded on the exchange;¹⁸⁹

Furthermore, such exchanges were required to provide on all major disciplinary committees a diversity of membership sufficient to ensure fairness and to prevent special treatment or preference for any person in the conduct of disciplinary proceedings and the assessment of penalties.¹⁹⁰

VI. Current Governance Structures and the Future of Self-Regulation

A. Stock Exchanges

The NYSE has gone considerably beyond the requirements of the Exchange Act. Half its board is composed of public directors not associated with the securities industry, while the half

¹⁸⁹ 7 U.S.C. § 7a(14), *added by* Pub. L. 102-546, title II, § 206(a)(1), 106 Stat. 3590, 3601 (1992).

that is so associated is a constituency board. There are requirements for industry directors from firms that have substantial direct contact with securities customers, for specialist members and non-specialist floor members and geographical specifications.¹⁹¹ The NYSE has 1,366 members who have physical access to the trading floor and who are the owners of the exchange.¹⁹² However, the NYSE also has up to 24 physical access members, electronic access members and lessee members.¹⁹³ The lessee members are a significant factor in governance issues because they can contract for the right to vote.¹⁹⁴ Moreover, at the end of 1999, 863 of the NYSE's 1,366 regular seats were leased.¹⁹⁵

The NASD does not have "seats" since it has never had a floor. Rather, its membership is composed of broker-dealers. The NASD's job of self-regulation has always been difficult because its membership is nationwide, large and diverse and not pre-selected.¹⁹⁶ Further, its emphasis in the past was on members regulating and disciplining themselves, as distinguished from regulation by a hired staff, and in promoting voluntary compliance with ethical

¹⁹⁰ *Id.* § 7a(15).

¹⁹¹ *See* NYSE Constitution, art. IV, § 2(a)-(b), NYSE Guide (CCH), ¶ 1151.

¹⁹² *See id.*, art. 13; NYSE Constitution, Art. II, § 1(a), 2 NYSE GUIDE (CCH), at 1053.

¹⁹³ *See id.*, §§ 1(b)-(c), 2.

¹⁹⁴ *Id.* Electronic access members (who have access to the DOT system) initially had ½ the vote, but new electronic access members after 1986 do not vote. *See* Order Approving Proposed Rule Change, Exchange Act Release No. 22959, 51 Fed. Reg. 8060 (Mar. 7, 1986).

¹⁹⁵ *See* Richard A. Grasso, CEO, NYSE, *Public Ownership of the U.S. Stock Markets*, Testimony Before the Sen. Comm. on Banking, Housing and Urban Affairs, Sept. 28, 1999, at 10. In addition to voting for members of the board of directors of the NYSE and its chairman, regular members are entitled to one vote on "any sale, lease or exchange or other disposition of all, or substantially all of the assets of the exchange; any merger or consolidation in which the exchange is a constituent corporation; or any dissolution or final liquidation of the Exchange." *See* NYSE Constitution, art. 3, § 9(a), 2 NYSE Guide (CCH), ¶ 1109.

¹⁹⁶ *See* Special Study, Pt. 4 *supra* note 125, at 679.

standards.¹⁹⁷ Principles emanating from the Maloney Act and guiding the NASD were democratic organization, business person's judgment and local autonomy.¹⁹⁸

The NASD was completely reorganized in 1996 in the aftermath of a Department of Justice and SEC investigation into anticompetitive practices by OTC market makers.¹⁹⁹ The SEC criticized the NASD for its regulatory deficiencies in failing to uncover these practices or discipline its members, and found that the NASD was unduly influenced by Nasdaq market making firms with respect to rulemaking, the disciplinary process and the admission of new members.²⁰⁰ In a settlement of these matters, the NASD agreed, among other things, to achieve greater diversity of representation on its board and its policy making committees, to provide for the autonomy and independence of its staff with respect to disciplinary and regulatory matters, to create an enhanced audit trail, and to improve its surveillance and examination of order handling and the reliability of trade reporting.²⁰¹

The 1996 NASD reorganization resulted in the creation of a parent holding company and two operating subsidiaries—Nasdaq and NASD Regulation, Inc. (NASDR). All three boards are constituency boards that are required to have a majority of non-industry members.²⁰² NASD governance is again in a state of flux because of a restructuring that will result in the sale of 78%

197

Id.

198

See id. at 606-07.

199

See Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Exchange Act Release No. 37542 (Aug. 8, 1996) available in 1996 WL 452691.

200

See id. at *2.

201

See id. at *2-3.

202

See By-Laws of the NASD, art. VII, § 4(a), Nasdaq By-Laws, art. IV, § 4.1, NASDR By-Laws, art. IV, §§ 4.2, 4.3, NASD GUIDE (CCH), 1315, 1503, 1703-3.

of Nasdaq to issuers and NASD members and lead to the registration of Nasdaq as a stock exchange with the SEC.²⁰³

On April 14, 2000 the membership of the NASD voted overwhelmingly to turn Nasdaq into a for-profit company and alter its ownership structure.²⁰⁴ This transformation will be accomplished in two stages. In the first stage, up to 49% of Nasdaq's common stock was offered in a private placement to NASD members, Nasdaq issuers, institutional investors, and strategic partners. After a further sale of Nasdaq stock in the second phase, the NASD will own only a minority stake of approximately 22% of Nasdaq.²⁰⁵ A future public offering is a possibility.

Among the purposes of the demutualization of Nasdaq are to permit the NASD to focus more intently on its original mission of being a membership-focused organization; to streamline corporate governance; and to create a financially stronger Nasdaq better able to address competitive challenges and invest in new technology.²⁰⁶ The Nasdaq board will be restructured prior to its registration as an exchange. Currently, all 10 members of the Nasdaq board sit on the NASD board. It is contemplated that the Nasdaq board will be increased by four members who will not serve on the NASD board, two of whom will be industry members and two of whom will be non-industry members.²⁰⁷

²⁰³ See Nasdaq, *Fact Sheet on the Proposed NASD Restructuring* (visited Apr. 1, 2000) <<http://www.nasdaqnews.com/news/per2000/fact313.html>>. Today, Nasdaq is registered as an exclusive information processor. See Adopting ATS Release, *supra* note 4, at 70852.

²⁰⁴ See *Nasdaq Firms Solidly Favor Sale of Market*, N.Y. TIMES, Apr. 15, 2000, at C3.

²⁰⁵ See NASD, Press Release, *NASD Restructuring Wins in landslide Vote of the Members* (last modified Apr. 14, 2000) <<http://www.nasd.com>>; see also Terzah Ewing, *Deals & Deal Makers NASD Members Vote to Sell Nasdaq, Paving the Way for Private Ownership*, WALL STREET J., Apr. 17, 2000, at C21. The NASD will continue to control Nasdaq until Nasdaq's registration as a stock exchange becomes effective.

²⁰⁶ See *id.*

²⁰⁷ See *id.*

B. Futures Exchanges

1. CBOT

The CBOT was established in 1848 and is the oldest derivatives exchange.²⁰⁸ It was the world's largest futures Exchange, until its volume was eclipsed by Eurex in 1999.²⁰⁹ At its inception, the CBOT traded only agricultural futures contracts, but in 1975 it expanded to include financial futures, including the U.S. Treasury Bond futures contract and in 1997 it launched futures and futures-options contracts based on the Dow Jones Industrial Average.²¹⁰ For decades, the primary method of trading at the CBOT was open outcry during which traders meet face to face in trading pits.²¹¹ The CBOT inaugurated a new \$175 million financial trading floor, the largest trading floor in the world, in 1997, to accommodate expanding business in open outcry trading.²¹² In 1994, the CBOT then launched an electronic trading system called Project A, and in August 2000 replaced Project A with a/c/e electronic trading platform (alliance/CBOT/Eurex).²¹³

The CBOT is a membership Association which has over 3,600 members, of which 1,402 are full members who have trading access to all of the exchange's agricultural and financial products. All memberships are owned by individuals. In order to expand and increase liquidity

²⁰⁸ *About CBOT, CBOT Today,* > *Organizational Profile*, <<http://www.cbot.com/cbot/www/page/0,1398,10+10+83,00.html>> (visited Nov. 2, 2000) [hereinafter *Organizational Profile*].

²⁰⁹ See Silvia Ascarelli & Peter A. McKay, *CBOT Directors Agree to a Eurex Partnership*, WALL ST. J., May 19, 1999 at C19.

²¹⁰ *Organizational Profile*, *supra* note 208.

²¹¹ *Id.*

²¹² *About CBOT, History,* > *Chronological*, <<http://www.cbot.com/cbot/www/page/0,1398,10+12+87,00.html>> (visited Nov. 2, 2000) [hereinafter *Chronological*].

²¹³ *Id.*

and participation on the trading floor, the CBOT also created associate memberships.²¹⁴ While there is an elected Associate Members Committee of 15 members, an associate member only has a vote equal to 1/6 of the vote of a full member.²¹⁵

The 18 director Board is divided into 15 elected directors who are full members of the CBOT, of whom 3 are non-residents of the Chicago area; 5 are non-member directors nominated by the President and approved by the Board; and 3 are associate members.²¹⁶ Former public officials, corporate leaders and academics are considered independent directors. There traditionally is a public director from the University of Chicago, and at least one director who represents agricultural interests.

In recent years there have been some severe governance upheavals at the CBOT as a reaction to competition and technological changes. The precipitating cause of these upheavals is competition to the CBOT's floor based, open outcry trading system coming from electronic exchanges, including new trading systems designed by CBOT's members. In 1998 there were merger talks between the CBOT and the CME, but the CBOT pulled out.²¹⁷ Then in early 1998, Eurex, the all-electronic German/Swiss derivatives exchange, began talks with the CBOT regarding a joint venture creating a single global electronic trading system to replace Project A

²¹⁴ *Id.* at 211.00

²¹⁵ *Id.* at 216.00. Each futures or options contract on the CBOT is listed in one of 4 market categories: Agricultural and Associated Market (AAM); Government Instruments Market (GIM); Index, Debt and Energy Market (IDEM); and Commodity Options Market (COM). *Id.* at 290.00-.04. In 1982, 1,402 one-quarter participation each in GIM, IDEM and COM memberships interests were created, which gave such members trading rights, but not the right to vote on matters of general membership. *Id.* at 291.00-294.

²¹⁶ *Id.* at 120.00

²¹⁷ See Terzah Ewing, *Idea of Merging CBOT, CME Gains Support*, WALL ST. J., July 13, 1998, at C1; Jim Kharouf, *Merger Talks For Real This Time?* FUTURES (Oster), Sept. 1, 1998; *Board of CBOT Calls Off CME Back Office Alliance*, WALL ST. J., Sept. 3, 1998, at C17.

(the CBOT's then interactive computerized trading system).²¹⁸ Two years later, CBOT members voted to discontinue the proposed alliance only to reconsider it six months later. Finally, on August 28, 2000, the CBOT Eurex Alliance was launched.²¹⁹ The alliance provides investors with the "opportunity to trade the most active futures and options products in the world from a single screen."²²⁰ While the exchanges will share technology and operating costs, the CBOT and Eurex will remain completely separate entities and each will receive all profits generated by its products.²²¹ In connection with the close vote on the initial rejection of a joint venture between the CBOT and Eurex (450 to 390),²²² there was a contested election for the CBOT chairmanship. David Brennan, a soybean trader who wanted to retain open outcry trading in the pits won this election.²²³ Then, there was an effort by Mr. Brennan to oust the President, Thomas Donovan, a career employee, which was not immediately successful, but Mr. Donovan retired thereafter.²²⁴ At the end of 2000, Mr. Brennan lost the CBOT chairmanship in a contested election.²²⁵

²¹⁸ *About CBOT Annual Report > The 1999 Annual Message from the Chicago Board of Trade Chairman and President*, < <http://www.cbot.com/annual/main.html> > (visited Nov. 2, 2000) [hereinafter 1999 Annual Message].

²¹⁹ Chronological, *supra* note 212.

²²⁰ 1999 Annual Message, *supra* note 218.

²²¹ *Id.*

²²² *CBOT/Eurex Vote 2: Represents Break With Old Regime*, DOW JONES INT'L NEWS SERVICE, Jan. 27, 1999. See Silvia Ascarelli, *German Exchange Still Seeks Entry Into U.S. Market*, WALL ST. J., Mar. 31, 1999, at B2; Michael Dabaie, *CBOT Eyes Links After Spurning Eurex*, SEC INDUSTRY NEWS, Feb. 1, 1999, Vol. 11, No. 5, at 1.

²²³ See Nikki Tait, *Ouster of CBOT Chief Leaves Cloud over Reform Efforts*, FIN. TIMES, Dec. 11, 1998.

²²⁴ See Greg Burns, *CBOT Reins in its Chairman for Attempt to Oust Donovan Rocks the CBOT*, CHI. TRIB., Apr. 15, 1999, at 1; Peter A. McKay, *Donovan Resigns His CBOT Positions Following Period of Strained Relations*, WALL ST. J., Apr. 17, 2000, at C19.

²²⁵ [cite].

Competitive threats from Eurex and other electronic futures exchanges led to proposals for restructuring the CBOT with a view toward its demutualization. A smooth transition to a demutualized, for-profit entity has not been made, however, in part because of a dispute with the Chicago Board Options Exchange, Inc. (CBOE) over trading rights of CBOE members.²²⁶

2. CME

The CME is an outgrowth of the Chicago Produce Exchange which was established in 1874 to provide an organized market for butter, eggs, poultry and other farm products.²²⁷ In 1898 a division of the Produce Exchange formed The Chicago Butter and Egg Board, and in 1919 the name of this Board was changed to the Chicago Mercantile Exchange.²²⁸ In 1969 the Chicago Mercantile Exchange Trust was established to provide discretionary financial assistance to customers of any clearing firm which should become insolvent.²²⁹ In 1972 the International Monetary Market (IMM) was created with the trading of seven foreign currencies.²³⁰ This trading followed the demise of the Bretton Woods Agreement fixing international exchange rates, and transformed the CME into the first major futures exchange to apply to financial instruments the principles of futures markets.²³¹ A decade later, in 1981, cash settlement of futures contracts, instead of physical delivery, was inaugurated.²³² In 1982 the Index and Option

²²⁶ See Futures Exchanges: *CBOT Sues CBOE Over Restructuring, Seeks Declaration of members Rights*, 32 SEC. REG. & L. REP. (BNA), July 10, 2000, at 922.

²²⁷ *CME, About the Exchange, History: A Timeline Highlighting Major Events in CME History*, < <http://www.cme.com/exchange/history.html> > (visited Nov. 2, 2000).

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *CME, About the Exchange, Background on CME, its Membership and its Products*, < <http://www.cme.com/exchange/back2000.html> > (visited Nov. 26, 2000).

²³² *Id.*

Market (IOM) division was formed for the purpose of listing index and options contracts.²³³ The first contract traded on the IOM was the Standard & Poor's 500 (S&P 500) futures contract.²³⁴

In 1984, the CME and Singapore Monetary Exchange (SIMEX) instituted their mutual offset system, the first international linkage between exchanges.²³⁵ In 1987, in conjunction with Reuters Holdings PLC, the CME pioneered GLOBEX, the first world-wide after hours electronic trading system.²³⁶ In 1995, the CME launched the Growth and Emerging Markets (GEM) division to provide access to investment in emerging market countries.²³⁷ In 1998, the CME launched GLOBEX2 based on a technology swap with the Paris Bourse and MATIF.

Until its recent demutualization, the CME was an Illinois Corporation, incorporated as a not-for-profit company, and owned by its members who had purchased exchange seats.²³⁸ There were four categories of memberships: full CME seats; IMM seats; IOM seats and GEM seats. Board membership was required by the CME's Rules to be composed of 12 CME members elected by CME members; 8 IMM members elected by IMM members; 4 IOM members elected by IOM members and up to 10 persons appointed by the Chairman and approved by the Board.²³⁹

Further, the CME Board was required to have a meaningful diversity of interests, including: floor brokers; floor traders; futures commission merchants; producers, consumers, processors, distributors, and merchandisers of commodities traded on the CME; participants in a

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Id.

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Id.

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Id.

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Id.

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Id.

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Amended and Restated Articles of Incorporation of the CME under the Illinois General-Not-For-Profit Corporation Act of 1986, 805 ILL. COMP. STAT. 105/101-01 (West 1996).

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CME Rule 210.

variety of pits or principal groups of commodities traded on the CME; and other market users or participants. To the extent that no elected director represented one of the interests listed above, a person representing such interest was required to be appointed to the Board. At least ten percent of the regular voting members of the Board were required to be comprised where applicable of persons representing farmers, producers, merchants or exporters of principal commodities underlying contracts traded on the CME. In addition, at least twenty percent of the regular voting members of the Board were required to be comprised of persons who were not: members of the CME; currently salaried employees of the CME; primarily performing services for the CME in a capacity other than a member of the Board; or officers, principals or employees of a firm which holds a membership at the CME either in its own name or through an employee on behalf of the firm.²⁴⁰

On November 13, 2000 the CME became the first U.S. futures exchanges to demutualize, in a restructuring designed to streamline its decision-making processes and change its financial model by converting memberships into shares with trading rights in CME products, as well as into shares representing pure equity.²⁴¹ CME's restructuring consisted of a two-step plan: first, the Illinois not-for-profit corporation was merged into a Delaware for-profit non-stock corporation and then subsequently converted into a Delaware stock corporation. Although immediately following demutualization shares will be held only by exchange members, the exchange contemplates a possible future initial public offering. Although the CME's demutualization did not involve a public offering of its shares, the transaction was registered with the SEC and the CME now is a registered and reporting company under the Exchange Act.

²⁴⁰ *Id.*

²⁴¹ Press Release, CME, *CME Becomes a For-Profit Corporation*, CME Press Release, Nov. 13, 2000, < http://www.cme.com/news/00_149corp.html > (visited Nov. 20, 2000).

The restructuring plan created two classes of shares: Class A shares representing equity rights to CME members, IMM members, IOM members and several series of Class B shares giving trading rights as well as equity interest to current all CME members, including GEM members. Any person or entity can become a Class B shareholder, although those who exercise trading privileges must satisfy CME membership and eligibility requirements.²⁴²

The new exchange will be run by a chief executive officer hired by the board, who must report to the Board of Directors. Also in accordance with the restructuring, the existing 39-member board of directors will be reduced to 19 members over a two-year phased reduction period. Following the 2002 election, the Board will be composed of 19 directors: 13 directors known as “equity directors” and 6 directors known as “Class B directors”. The 13 equity directors (consisting of one non-member and six members or non-members, all serving two year terms) will be elected by the Class A and Class B shareholders from a slate proposed by the Board Nominating Committee. The six divisional directors (three CME, two IMM, and one IOM) will be voted by the Class B divisional shareholders from a slate proposed by the Divisional Nominating Committees.²⁴³ Class B shareholders will have rights to change certain “core rights”, rights associated with trading privileges conferred by those shares, while Class A will not have this right. Therefore, although Class B shareholders will represent only

²⁴² Press Release, CME CME Votes to ‘Demutualize’ As Members Overwhelmingly Endorse For-Profit Transformation Into ‘Chicago Mercantile Exchange, Inc.’ June 6, 2000, < http://www.cme.com/news/00_86vote.html > (visited Nov. 14, 2000). Class A shares were allocated to CME, IMM, and IOM members on a 3-2-1 basis and are subject to restrictions that will be lifted gradually over a 15 month period. Class B shares, however, would not be subject to any trading restrictions.

²⁴³ CME Memorandum to All Members from Anne M. Cresce, Corporate Secretary, Oct. 10, 2000 < <http://www.cme.com/news/2000101ELECTION.pdf> > (visited Nov. 14, 2000). The GEM division will not elect any Class B director. Finally, after the 2002 election, there will be no “appointed directors.”

approximately 10 percent of the overall equity interest, such voting rights offer Class B shareholders some ability to block changes.²⁴⁴

The CME has thus been transformed from a membership mutual organization to a for-profit business corporation. Yet, it continues to act as an SRO for its members and markets and, at this time, does not plan to out source its regulatory responsibilities.

C. Models for Self-Regulation

One of the more contentious questions under discussion concerning exchange demutualization is the future of self-regulation. There are several issues that have been raised. First, some have argued that there would be conflicts of interests between shareholders and members in a demutualized exchange environment that would diminish the ability of exchanges to engage in effective self-regulation. A potentially more serious conflict is the regulation of an ATS market by the NYSE or NASD. Second, securities firms are concerned about the costs of multiple SROs, especially if several ATSs become exchanges and begin to engage in self-regulation. Therefore, some industry members argue in favor of a single SRO for exchanges and member firms. Third, there are ongoing power struggles between the SROs and between the SROs and the SEC.

The NYSE and NASD engage in self-regulation in four areas: listed company governance and disclosure; surveillance and discipline of their markets and specialists, floor brokers and market makers; member firm financial and operational compliance; and fair and equitable treatment of customers. Also, both the NYSE and NASD run arbitration facilities for disputes between members and disputes between members and customers. The NASD membership has

²⁴⁴ CFTC, Memorandum to the Commission from the Division of Trading and Markets, *Re: The Chicago Mercantile Exchange's Proposed Demutualization Plan*, <http://www.cftc.gov/tm/cme_demu_memo.htm> (visited Nov. 14, 2000).

always been more diverse than the NYSE and is not pre-selected. Further, it has a nationwide organization with some local autonomy. The NYSE's New York location, more exclusive membership and domination by the industry's largest firms has given its inspection and regulatory operations a different cast than that of the NASD. Further, in a financial crisis, the NYSE's ties to the New York Federal Reserve Bank have been important.²⁴⁵

NYSE listing requirements go back to the nineteenth century and stem from a concern about the quality of the securities sold on the exchange. These requirements were intended to facilitate an efficient, continuous auction market by setting minimum numerical standards for capitalization, number of shares and shareholders, by establishing disclosure requirements and by specifying certain shareholder protection or corporate governance mechanisms.²⁴⁶ The NYSE developed these requirements because it recognized that standards were good for its business and could give the exchange a competitive advantage.²⁴⁷ When Nasdaq was organized as an electronic market, it also established listing qualifications in order to preserve and improve the quality of and public confidence in its market.²⁴⁸

If the NYSE and Nasdaq become public companies it will perhaps be anomalous for them to negotiate listing agreements with themselves and then supervise continuing compliance with such agreements. For this reason, when the Stockholm and Australian Stock Exchanges went public, government regulators were assigned the task of overseeing exchange disclosure to

²⁴⁵ See TIM METZ, BLACK MONDAY 160-61, 195, 212-14, 234 (1988).

²⁴⁶ See Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 Bus. Law 1461 (1992).

²⁴⁷ *Id.*

²⁴⁸ See NASD Rules 4300, 4310, NASD Manual (CCH) at 5271-79.

shareholders.²⁴⁹ On the other hand, the NYSE and Nasdaq will continue to have a motivation to market their exchanges as lists of quality issuers. At least one commentator has argued that the benefits of increased capital mobility would be better realized through regulatory decentralization than greater centralization. Under a decentralized model, exchanges should be the primary writers and enforcers of rules relating to disclosure by listed companies, standards of conduct for member broker-dealers and for market structure.²⁵⁰

Broker-dealer regulation by exchanges has its roots in efforts to assure the credit worthiness of exchange members. This continues to be a significant issue and an important aspect of NYSE and NASD regulation. In that regard, the NYSE has developed a competence in examining and assuring the financial viability of its large member firms that would not easily be duplicated by a single SRO, located in Washington, D.C., and indirectly run by the SEC. Moreover, now that securities firms, banks and insurance companies can operate in a single holding company, the Federal Reserve Board, as an umbrella regulator, will be weighing in heavily on securities industry capital adequacy questions.²⁵¹ If the NYSE or NASD go public, it is likely that clearing member firms will be large stockholders. This will give them an incentive to maintain high standards of financial and operational capabilities for member firms. It may create some new conflicts of interest, but the creation of a single SRO would not solve these conflicts.

The incentive of the NYSE and Nasdaq to police their markets for manipulation, and their effectiveness in doing so, would probably be greater following a public offering than it is

²⁴⁹ See Roberta S. Karmel, *Stock Exchange Demutualization in Sweden and Australia*, N.Y.L.J., Aug. 19, 1999, at 3. In the United States, however, the SEC already has this authority.

²⁵⁰ See Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

today. There should be fewer conflicts of interest in policing the markets if ownership of these SROs is spread beyond those concerned with making markets. Since Nasdaq is a dealer market and the NYSE is a specialist system, the creation of a single SRO to oversee these two markets is unlikely to create any economies of scale and could well be counterproductive. Even if the SEC succeeds in mandating or fostering the creation of new mechanisms for linking exchange and OTC markets,²⁵² it is unlikely that these markets will lose their particular characteristics.

Self-regulation of the broker-customer relationship is a different and difficult issue. Although just and equitable principles of trade have long been a basis for SRO policing of sales practices, many SRO enforcement actions are based on securities fraud under the federal securities laws. Further, aggressive SEC oversight and the threat of civil liability in actions by customers are necessary prods to SRO effectiveness. It is unclear how consolidation of self-regulation would improve enforcement of high standards of broker-dealer customer practices. On the other hand, a for-profit marketplace might not be interested in devoting its resources to funding a rigorous enforcement program in this area.

The Securities Industry Association's (SIA) Ad Hoc Committee on the Regulatory Implications of De-Mutualization has determined guiding principles for analyzing an appropriate SRO structure and has suggested six different models for future regulation of the securities industry.²⁵³ The SIA's Ad Hoc Committee's guidelines for evaluating regulatory options state that any regulatory structure should foster investor protection; preserve fair competition; eliminate inefficiencies; encourage expert regulation; promote reasonable and fair regulatory

²⁵¹ See Gramm-Leach-Bliley, Financial Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

²⁵² See Arthur Levitt, Chairman, SEC, *Dynamic Markets, Timeless Principles*, Address at Columbia Law School (last modified Sept. 23, 1999) <<http://www.sec.gov/news/speeches/spch295.htm>>.

costs; foster due process; and encourage industry participation and self-regulation.²⁵⁴ The five models the Committee put forward are: (1) Status Quo; (2) Multiple Exchanges with Separate Boards and Information Barriers for Their Regulatory Arms (NASDR Model); (3) Multiple SROs with Firms Designated to a Single SRO for Examination Purposes (DEA Model); (4) One SRO for Member Firms; Markets Regulate Their Own Trading (Hybrid Model); (5) All Purpose Single SRO (Single SRO Model); and (6) Single Regulatory Organization (SEC-Only Model).²⁵⁵

The SIA's Ad Hoc Committee endorsed the Hybrid Model in which there would be a central SRO responsible for firm oversight and cross market issues, including rules generally applicable to all markets.²⁵⁶ Individual market SROs would then be responsible for market-specific rules, including rules regarding trading and listing.²⁵⁷ Cross-market rules would include front running, manipulation, free-riding and withholding rules, sales practice regulation, industry admission standards, financial responsibility requirements, training and supervision and recordkeeping.²⁵⁸ Arguments in favor of the Hybrid Model are that this model would improve regulation, decrease regulatory costs, preserve the synergy between markets and market-specific oversight, foster competition and continue self-regulation.²⁵⁹ On March 22, 2000 the SIA board of directors endorsed the Hybrid Model.²⁶⁰ One reason for this endorsement is that the securities

²⁵³ SIA White Paper, *supra* note 120.

²⁵⁴ *See id.* at 1.

²⁵⁵ *See id.* at 5.

²⁵⁶ SIA, REINVENTING SELF-REGULATION-RECOMMENDATIONS REGARDING SELF-REGULATORY STRUCTURE (last modified Mar. 8, 2000) <<http://www.sia.com>>.

²⁵⁷ *See id.* at 2.

²⁵⁸ *See id.* at 3.

²⁵⁹ *See id.* at 5.

²⁶⁰ *See* SIA Press Release, *Securities Industry Board Endorses "Hybrid" Model to Enhance Benefits of Self-Regulation for Investors*, (last modified Mar. 22, 2000) <<http://www.sia.com/html/pr993.html>>.

industry would like to avoid duplication of examinations and inconsistent regulation. In that connection, the White Paper advocates a single, independent arbitration forum.

The NASD has been pushing for a Single SRO model and the Chairman of the SEC briefly embraced this model.²⁶¹ One of the problems with this model is that the NYSE opposes it.²⁶² Another problem is that the SEC does not have the statutory authority to impose corporate governance requirements on listed companies and neither would a free standing Single SRO.²⁶³ Further, although the SEC might find it convenient to oversee a sole self-regulator, the SEC might be tempted to make it an arm of the government, rather than a true self regulator. Yet, SROs do not afford those they discipline the protections of persons who are investigated or prosecuted by government officials.²⁶⁴

One of the goals of the Exchange Act is “fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets.”²⁶⁵ For the SEC to suppress or eliminate competition among SROs could be contrary to this goal because an important function of an exchange is self-regulation.²⁶⁶ On the other hand, an ATS regulated as a member of an exchange could complain of unfair competition, and yet find it uneconomical to become a full service SRO. Further, although the benefits of regulatory competition are often touted, regulatory competition can be unseemly and destructive of public

²⁶¹ See Jeffrey E. Garten, *Manager’s Journal: How to Keep NYSE’s Stock High*, WALL ST. J., Sept. 13, 1999, at A44; Michael Schroeder, *Levitt Studies Plan for Single Market Regulator*, WALL ST. J., Sept. 21, 1999, at C1. See also NASD Press Release, *NASD’s Frank Zarb Asks Securities Industry to Embrace Change* (last modified June 23, 1999) <<http://www.nasd.com>>.

²⁶² See Lisa L. Fried, *Plans Debated for Stock Markets’ For-Profit Conversion*, N.Y.L.J., Sept. 30, 1999, at 5; Grasso, *supra* note 42.

²⁶³ See *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

²⁶⁴ See, e.g., In Re Stephen J. Gluckman, Exchange Act Release No. 41628 (July 20, 1999).

²⁶⁵ Exchange Act, § 11A(a)(1)(C)(ii), 15 U.S.C. § 78k-1(C)(ii).

²⁶⁶ See *id.*, § 6(b).

confidence in the regulators. Given the serious fissures within the securities industry at the present time, the Hybrid Model seems the most likely solution to self-regulation after demutualization if the NYSE can be persuaded to endorse some version of this model.

One of the many difficulties with any new SRO structure is adequate funding. Currently, SROs rely on four primary sources for their funding: (1) regulatory fees and assessments paid by SRO members; (2) transaction services fees; (3) listing fees; and (4) market information fees.²⁶⁷ The continued viability of all of these fees in rapidly changing market conditions is unclear. The SEC has issued a complex and provocative release on some of these fees, and however uncomfortable the SEC may be with establishing fees for market users, this is an issue that will not disappear.²⁶⁸ Clearly, rigorous, expert and fair regulation is not possible unless SRO regulation is adequately funded. But after demutualization, subsidizing general broker-dealer enforcement activities through fees other than regulatory assessments of members may prove difficult. This suggests that the securities industry is likely to focus on the costs of duplicative self-regulation.

The futures industry could perhaps move more easily to a sole self-regulator than the securities industry because the NFA already exists and has statutory recognition. Demutualization of futures exchanges and their need to face competition from electronic exchanges has highlighted another problem — the need to level the playing field between traditional exchanges and ATSs by decreasing government regulation of exchanges.²⁶⁹ The SEC has recognized this challenge in fashioning Regulation ATS,²⁷⁰ but it has not dealt with the need

²⁶⁷ See SIA White Paper, *supra* note 120, at 35.

²⁶⁸ See Exchange Act Release No. 42208, 64 Fed. Reg. 70613 (Dec. 9, 1999).

²⁶⁹ See *Oversight Function for CFTC Emerging as Congress Seeks to Renew Mandate*, 32 SEC. REG. & L. REP., Jan. 24, 2000, at 92.

²⁷⁰ See Adopting ATS Release, *supra* note 4, at 70846.

to significantly change its regulation of traditional exchanges. Yet, if exchanges no longer enjoy a monopoly (or near monopoly) of trading the stocks of their listed issuers, or trading other financial products, much less government regulation is needed because competition can substitute for government regulation.

VII. Conclusion

Today's markets are changing so rapidly that it is impossible to predict tomorrow's market structure or its regulation. New exchange governance and regulatory structures generally have been precipitated by scandals or a financial crisis, so reform of existing exchange models is likely to be shaped by political and economic problems as much as by strategic business planning. Although the diversification of exchange boards has strengthened them, those who make markets still have the greatest interest in maintaining efficient, fair and liquid pricing mechanisms. Much of the competition to the NYSE and Nasdaq in recent years has come from new electronic marketplaces that have taken advantage of uneconomical spreads by the primary markets. When trading costs decline due to decimalization, some of these competitors will not survive. A similar dynamic is at play concerning the trading of financial futures. In time it is likely that the NYSE and CBOT will move to electronic trading systems and their floors will disappear. But this is not a decision that should be made or forced by government regulators. Further, it does not follow that the NYSE and CBOT will cease to be primary markets.

There seems to be a general assumption that the market structure changes rocking the security industry are harbingers of an inevitable cataclysm that will swallow up the NYSE floor-based specialist system and the NASD market maker system. Further, demutualization seems to be, at least in part, a cover for shifting the power structure of the NYSE and Nasdaq further away from the specialists and market makers to the large securities firms. This does not mean that the

markets of the future will be a “black box” that does not require dealer intervention or that demutualization will solve the economic and power struggles taking place in the securities industry.

The ATS electronic systems have not yet become primary markets and therefore their successful operation as price setting mechanisms is uncertain. In that connection, the SEC is unlikely to allow the market for U.S. equities to seriously fragment to the detriment of retail investors²⁷¹ Also, the success of ATSS in the OTC market is due in part to a shift in the ratio of dealer to agency transactions, and this shift may not be necessary to achieve optimal efficiency in the NYSE market.²⁷² In addition, the viability of ATS electronic markets have not yet been tested by a market break followed by a serious bear market. In volatile markets, the need for the negative and affirmative obligations imposed upon specialists is significant, and it is unclear how markets will be held to a fair and orderly standard in the absence of such dealer intervention. If traders can no longer make money on spreads they will make money by exploiting time and place advantages, and such unfair and inequitable conduct will sooner or later attract the attention of regulators.²⁷³

For all of these reasons it is hard to predict the future structure of the securities markets and the future governance and regulation of stock exchanges. Issues about exchange governance probably do not have to be fully resolved prior to demutualization because one of the objectives of demutualization is to streamline governance and base it upon stock ownership rather than

²⁷¹ See NYSE Rulemaking: Notice of Filing of Proposed Rule Change To Rescind Exchange Rule 390, Exchange Act Release No. 42450 (Feb. 23, 2000) *available in* 2000 WL 202094.

²⁷² See Guy Moszkowski et al, *Trading Up – The Equity Markets and the New World of Electronic Trading*, Solomon Smith Barney Equity Research: United States, Oct. 5, 1999, at 20-21.

constituency representation of member firms. However, issues concerning the balance between government regulation and self-regulation and the regulatory implications of demutualization are more urgent because the SEC is unlikely to allow the exchanges to demutualize unless it is satisfied with the securities industry's new self-regulatory structure.²⁷⁴

Demutualization of exchanges will shift the power structures within exchanges, but public offerings of exchanges will change them much more. By raising new capital, exchanges will be able to implement new business strategies. But the freedom of public ownership will add burdens to exchange operations. New disclosure and reporting duties will affect cultures of confidentiality and even (from the public's viewpoint) mystery. To the extent that broker-dealer regulation is subsidized by listed companies, these issuers may object to this use of listing fees. Exchange executives will have to learn to deal with security analysts and plaintiff securities lawyers. Stock market corrections may adversely affect the stock of exchanges disproportionately to general indices.

During the 1990s, for political and economic reasons, business has enjoyed the public's respect and entrepreneurship has been fashionable. If there is a prolonged stock market decline and an economic recession, public perceptions might shift. A non-profit organization enjoys a greater aura of acting in the public interest than does a for-profit corporation. There is a risk that turning exchanges into ordinary public companies, likely to have much smaller capitalizations than their listed companies, will undermine public confidence in these symbols of capitalism.

²⁷³ See Greg Ip, *Catbird Seat: Nasdaq Market Maker, Seeing All the Orders, Becomes Canny Trader*, WALL ST. J., Mar. 3, 2000, at A1.

²⁷⁴ The SEC's plenary power over exchanges may not be fully appreciated. Even before the 1975 Act, the SEC believed it had the power to prevent the NYSE from incorporating. See SEC Comments on NYSE Incorporation, Exchange Act Release No. 9112 (Mar. 17, 1971) available in 1997 WL 17117.