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ARTICLES

PROVIDING LIQUIDITY IN A HIGH-FREQUENCY WORLD: TRADING OBLIGATIONS AND PRIVILEGES OF MARKET MAKERS AND A PRIVATE RIGHT OF ACTION

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This Article analyzes the reach of a private right of action under federal securities law for violations of trading obligations and abuses of trading privileges by market makers in today's rapidly evolving securities markets. The development of the applicable case law is traced, and potential approaches to a coherent theory of a private right of action are considered. The Article also discusses the significance of the changing economics and institutional framework of providing liquidity in securities markets and related regulatory debates.

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INTRODUCTION

Market makers, entities that provide liquidity under different names and in various forms, continue to play a key role in today's rapidly evolving securities markets characterized by their automation and decentralization, the pivotal role played by high-frequency traders, and the complexity of trading strategies, execution algorithms, and order types.[1] The balance of

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1. For a selective mix of sources discussing the recent developments in securities markets, with some of them concentrating on high-frequency trading, see *Dark Pools, Flash Orders, High-Frequency Trading, and Other Market Structure Issues: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. (2009) [hereinafter *Senate Hearing on Market Structure Issues*]; Concept Release on Equity Market Structure, Exchange Act Release No. 61,358, 75 Fed. Reg. 3594 (Jan. 14, 2010) [hereinafter SEC's Equity Market Structure Release]; TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, FR09/11, FINAL REPORT, REGULATORY ISSUES RAISED BY THE IMPACT OF TECHNOLOGICAL CHANGES ON MARKET INTEGRITY AND EFFICIENCY (Oct. 2011), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD361.pdf [hereinafter IOSCO'S REPORT ON TECHNOLOGICAL CHANGES]; MICHAEL DURBIN, ALL ABOUT HIGH-FREQUENCY TRADING (2010); James J. Angel et al., *Equity Trading in the 21st Century*, 1 Q.J. FIN. 1 (2011); Bruno Biais & Paul Woolley, High Frequency Trading (Mar. 2011) (unpublished manuscript) (on file with author), *available at* http://idei.fr/doc/conf/pwri/biais_pwri_0311.pdf. For a discussion of the boundaries and overlaps between "high-frequency trading," "electronic trading," "algorithmic trading," and "low-latency

trading obligations and privileges of market makers, an important part of the regulatory framework for securities markets, is established by governmental regulation, such as rules of the U.S. Securities and Exchange Commission (SEC) adopted primarily under the mandate of the Securities Exchange Act of 1934 (Exchange Act), and private regulation by trading venues in their role as self-regulatory organizations (SROs). This balance, the importance of which has been recognized by the federal courts,[2] is a tradeoff between time, information, fee, order flow allocation, and other advantages, on one hand, and compliance with various trading rules, including commitments to enter—or not to enter—into transactions under specific parameters, such as an "affirmative" obligation to maintain a proper market or a "negative" obligation to refrain from certain types of proprietary trading, on the other.[3]

The nature of this balance at least partly lies in the underlying externality: "In general, liquidity provision represents a positive externality in that traders who commit capital to make markets are not fully compensated for their liquidity services. While the usual solution to this inefficiency is a Pigovian subsidy, the form that this payment should take is less clear."[4] In fact, several empirical studies suggest that the imposition of

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trading," see IRENE ALDRIDGE, HIGH-FREQUENCY TRADING: A PRACTICAL GUIDE TO ALGORITHMIC STRATEGIES AND TRADING SYSTEMS 23–24 (2010).

2. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 234 (1980) ("[The U.S.] Congress[] recogni[zed] that specialists contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of buy and sell orders."); Clement v. SEC, 674 F.2d 641, 643 (7th Cir. 1983) ("In return for undertaking . . . special obligations to the market, market makers enjoy advantages not available to others.").

3. *See, e.g.*, Dissemination of Quotations in NMS Securities, 17 C.F.R. § 240.602 (2012) (imposing certain trading obligations on market makers with respect to quoting); Order Approving Proposed Rule Changes by Several Self-Regulatory Organizations To Enhance the Quotation Standards for Market Makers, Exchange Act Release No. 63,255, 75 Fed. Reg. 69,484 (Nov. 5, 2010) [hereinafter SEC's Release on the Quotation Standards for Market Makers] (approving proposed rules by various trading venues on trading obligations of market makers in order to eliminate the practice of "stub" quotes); *Market Maker Categories*, *in* MARKETSMEDIA OPTIONS NETWORK 22, 22 (Natasha Gural ed., 2009) (describing different types of options market makers on various trading venues and their trading obligations); Andreas Charitou & Marios Panayides, *Market Making in International Capital Markets: Challenges and Benefits of Its Implementation in Emerging Markets*, 5 INT'L J. MANAGERIAL FIN. 50, 62–63 tbl.IV (2009) (describing trading obligations and privileges of market makers on several major trading venues); George T. Simon & Kathryn M. Trkla, *The Regulation of Specialists and Implications for the Future*, 61 BUS. LAW. 217, 224–25 (2005) (describing the origins of affirmative and negative obligations of market makers in the context of the specialist system).

4. Kumar Venkataraman & Andrew C. Waisburd, *The Value of the Designated Market Maker*, 42 J. FIN. & QUANT. ANALYSIS 735, 755 (2007). There are different theoretical approaches to the nature of the externality in the process of providing liquidity. For instance, it may emerge because of the impact of liquidity on issuers that do not necessarily participate in secondary trading but cannot be excluded from potential benefits conferred by such liquidity or because the nature of the trading process itself with respect to different types of actual or potential participants in this process. *See* Stanislav Dolgopolov, *Linking the Securities Market Structure and Capital Formation: Incentives for Market Makers?*, U. PA. J. BUS. L. (forthcoming) (manuscript at 4–5 & n.8), *available at* http://ssrn.com/abstract=2169601 .

trading obligations on market makers—coupled with privileges—improves market quality,[5] although there is some skepticism that formal market makers are desirable for very liquid securities.[6] In order to capture certain liquidity-related benefits, issuers themselves sometimes compensate market makers for undertaking trading obligations,[7] and several empirical studies indicate that this mechanism is particularly valuable around such key events as secondary offerings, stock splits, and repurchases.[8] While issuer-to-market maker compensation arrangements are effectively prohibited in the United States, they have been lobbied for by several trading venues for certain types of securities, such as exchange-traded products and smaller-cap stocks, culminating in specific proposals under which trading venues themselves would serve as intermediaries.[9]

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5. *See* Amber Anand et al., *Paying for Market Quality*, 44 J. FIN. & QUANT. ANALYSIS 1427, 1427 (2009) (analyzing transactions in stocks on the Stockholm Stock Exchange and arguing that the existence of designated liquidity providers, entities with affirmative obligations that are compensated by issuers, improves market quality and price discovery); M. Nimalendran & Giovanni Petrella, *Do Thinly-Traded Stocks Benefit from Specialist Intervention?*, 27 J. BANKING & FIN. 1823, 1829–30, 1851–52 (2003) (analyzing transactions in stocks on the Italian Stock Exchange and finding that the existence of specialists, entities with affirmative obligations that pay lower trading fees and may be compensated by issuers, is associated with improved market quality); Marios A. Panayides, *Affirmative Obligations and Market Making with Inventory*, 86 J. FIN. ECON. 513, 513 (2007) (analyzing transactions in stocks on the New York Stock Exchange, finding that affirmative obligations of specialists, entities that enjoyed several important privileges, are associated with better market quality, and arguing that their affiliated costs are covered by profits from discretionary trading); Narayan Y. Naik & Pradeep K. Yadav, *Trading Costs of Public Investors with Obligatory and Voluntary Market-Making: Evidence from Market Reforms* 1, 17, 35 (Eur. Fin. Ass'n, Annual Conference Paper No. 408, 2003), *available at* http://ssrn.com/abstract=424982 (analyzing transactions in stocks on the London Stock Exchange and arguing that the switch from obligatory to voluntary market making together with the abolition of certain informational privileges had an adverse effect on the price stabilization function played by dealers); Albert J. Menkveld & Ting Wang, *How Do Designated Market Makers Create Value for Small-Caps?*, J. FIN. MKTS. (forthcoming) (manuscript at 37), *available at* http://ssrn.com/abstract=890526 (analyzing transactions in stocks on Euronext Amsterdam and arguing that the existence of designated liquidity providers, entities with affirmative obligations that are compensated by issuers, improves market quality).

6. *See* Michael J. Aitken et al., The Role of Market Makers in Electronic Markets: Liquidity Providers on Euronext Paris 1 (Apr. 18, 2007) (unpublished manuscript) (on file with author), *available at* http://69.175.2.130/~finman/Barcelona/Papers/EuronExCost.pdf (analyzing transactions in stocks on Euronext Paris and finding evidence to "suggest that the prohibition of market makers in the most liquid stocks is sound public policy"); *see also Senate Hearing on Market Structure Issues*, *supra* note 1, at 87 (prepared statement of Peter Driscoll, Chairman, Securities Traders Association) ("We believe that there is a need for market making in secondary and tertiary issues, but not necessarily the primary tier stocks where data suggests most high frequency traders concentrate their activity.").

7. *See* Anand et al., *supra* note 5 (evidence from the Stockholm Stock Exchange); Nimalendran & Petrella, *supra* note 5 (evidence from the Italian Stock Exchange); Menkveld & Wang, *supra* note 5 (evidence from Euronext Amsterdam); Johannes A. Skjeltorp & Bernt Arne Ødegaard, Why Do Listed Firms Pay for Market Making in Their Own Stock? (May 2012) (unpublished manuscript) (on file with author), *available at* http://ssrn.com/abstract=1944057 (evidence from the Oslo Stock Exchange).

8. Anand et al., *supra* note 5, at 1429; Skjeltorp & Ødegaard, *supra* note 7, at 3.

9. *See* Dolgopolov, *supra* note 4 (manuscript at 44–46 & nn.129–38).

One key question addresses the reach of a private right of action under federal securities law for violations of trading obligations and abuses of trading privileges by market makers.[10] This issue is a challenge to market makers and an opportunity for private plaintiffs, notably institutional investors and high-frequency traders. The availability of a private right of action may be a powerful enforcement mechanism in addition to SEC and SRO sanctions, but it may also lead to adverse consequences for the market for liquidity. The existing case law on this issue is a thicket of decisions from different contexts, which is complicated by the SEC-SRO regulatory dichotomy. The rapid evolution of securities markets and accompanying regulatory debates also present a number of challenges and concerns.

This Article analyzes the reach of a private right of action under federal securities law for violations of trading obligations and abuses of trading privileges by market makers in today's rapidly evolving securities markets. Part I traces the development of the applicable case law. Part II considers potential approaches to a coherent theory of a private right of action. Part III discusses the significance of the changing economics and institutional framework of providing liquidity in securities markets and related regulatory debates. The Article concludes by evaluating the legal viability of a private right of action for violations of trading obligations and abuses of trading privileges by market makers and its desirability from the standpoint of public policy.

I. THE DEVELOPMENT OF THE CASE LAW ON A PRIVATE RIGHT OF ACTION IN CONNECTION WITH TRADING OBLIGATIONS AND PRIVILEGES OF MARKET MAKERS

Several cases have examined different aspects of liability of market makers in connection with their trading obligations and privileges. While some of them specifically focused on the availability of a private right of action, several others addressed the interrelated issue of securities fraud in the criminal context.

10. The relevant inquiry primarily pertains to the limits of the antifraud prohibition under federal securities law embodied by section 10(b) of the Exchange Act and the SEC's Rule 10b-5 for the purposes of this Article, for which the existence of an *implied* private right of action has been universally recognized. *See, e.g.*, Janus Capital Grp., Inc. v. First Derivative Traders, 131 U.S. 2296, 2301–02 (2011) ("Although neither Rule 10b-5 nor § 10(b) [of the Exchange Act] expressly creates a private right of action, this Court has held that 'a private right of action is implied under § 10(b).' That holding 'remains the law,' but '[c]oncerns with the judicial creation of a private cause of action caution against its expansion.'") (internal citations omitted). However, another aspect is whether an *implied* private right of action exists under other provisions of the federal securities statutes, such as sections 6, 15, 15A, and 19 of the Exchange Act that govern the process of SROs' registration, require them to adopt—under the SEC's supervision—certain rules for their respective members, and impose mandatory membership in such SROs on broker-dealers, or even the very existence of the broad regulatory scheme established by these statues.

A. *SCHONHOLTZ*

In one of the early cases, a short seller brought claims under section 10(b) of the Exchange Act against the American Stock Exchange (Amex) and a specialist firm, as well as its parent company, based on the allegation of losses caused by certain transactions at "artificially high prices created by a limited and inadequate supply of Levitz common stock."[11] The plaintiff maintained that the exchange "failed to supervise [the specialist firm] in the discharge of [its] obligation as a specialist, pursuant to Amex Rules, to 'maintain a fair and orderly market,' and that [the defendants] were under a duty to disclose that the market in Levitz stock was not in fact fair and orderly."[12] Dismissing the complaint for its failure to state a claim, the district court pointed to deficiencies with respect to detailing how the relevant Amex rules were violated and summarized the relevant case law as stating that "violations of exchange rules are not *per se* actionable by private parties."[13] On the other hand, the court noted that a "violation of *some* exchange rules *might* provide the basis for a private cause of action"[14] and "something of a catch-all . . . including merely unethical behavior" is unlikely to meet this standard.[15] In its turn, the court of appeals concluded that, "even if a private right of action otherwise exists for violation of Rule 170 . . . no valid claim [was] asserted."[16] In its dictum, the court also suggested that certain Amex rules may serve as a source of implied representations under the federal antifraud prohibition and stated that "at most [the Amex and the specialist] represented that all relevant statutes and [Amex] rules were complied with; and it is apparent . . . that none of [the plaintiff's] allegations establishes that this representation was false."[17]

B. *SPICER*

Another controversy addressed the events in the aftermath of the "Black Monday" of October 19, 1987, when several market makers in equity index options on the Chicago Board Options Exchange (CBOE) "did not trade but allegedly should have" or allegedly traded at "inflated and grossly

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11. Schonholtz v. Am. Stock Exch. Inc., 376 F. Supp. 1089, 1090 (S.D.N.Y.), *aff'd*, 505 F.2d 699 (2d Cir. 1974).

12. *Schonholtz*, 376 F. Supp. at 1091 (quoting Rule 170 of the Amex).

13. *Id.* at 1091–92. The plaintiff also referred to Rule 177 of the Amex that dealt with the specialist's obligation to report to the exchange "any unusual activity or price change in a security, or material information regarding the issue or the market in it." *Id.* at 1091.

14. *Id.* at 1092 (citing Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir. 1966)). *Colonial Realty* was decided in the context of sections 6(b) and 15A(b)(8) of the Exchange Act that required national securities exchanges and broker-dealer associations to adopt rules mandating their members to follow "just and equitable principles of trade." *Colonial Realty*, 358 F.2d at 180.

15. *Schonholtz*, 376 F. Supp. at 1092 (quoting *Colonial Realty*, 358 F.2d at 182).

16. *Schonholtz*, 505 F.2d at 700.

17. *Id.* at 701.

exaggerated prices" and thus "abrogated their responsibility . . . to enter into transactions designed to contribute to the maintenance of a fair and orderly market."[18] One of the claims was directed at the market makers for alleged violations of several CBOE rules under section 6 of the Exchange Act,[19] and, rather surprisingly, there were no claims under section 10(b) of the Exchange Act and Rule 10b-5 "against any of the market makers."[20] The rules in question established the general obligation of all exchange members not to "engage in acts or practices inconsistent with just and equitable principles of trade" and specifically required all market makers to engage in transactions that "constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market" and to do so continuously.[21] The district court "reluctantly conclude[d] that there is no implied right of action under sections 6 or 19 [of the Exchange Act] for the violation of an exchange rule."[22] Furthermore, the court concluded that, "[w]hether they trade or not, [market makers] do not owe fiduciary duties to investors."[23]

By contrast, the court of appeals analyzed the content of the applicable SRO rules. Rule 4.1 was described as "nearly identical to the 'just and equitable principles of trade' rule *Colonial Realty* held could *not* support an implied private remedy."[24] Rule 8.7(a) was similarly characterized as "a vague, 'catch-all' standard, whose enforcement *Colonial Realty* thought best left to the exchanges,"[25] which still allowed some space for civil liability for violations of more specific rules. With respect to Rule 8.7(b), the court found no relevant precedent "recognizing an implied remedy against an exchange member for anything remotely resembling this conduct" and declined to characterize this situation as warranting "an implied action for the knowing violation of 'important, non-discretionary' exchange rules"[26] because the relevant precedent was said to be based on

18. Spicer v. Chi. Bd. Options Exch., Inc., No. 88 C 2139, 1990 U.S. Dist. LEXIS 14469, at *1–2 (N.D. Ill. Oct. 24, 1990), *aff'd*, 977 F.2d 255 (7th Cir. 1992).

19. *Spicer*, 1990 U.S. Dist. LEXIS 14469, at *9. More specifically, section 6(b)(5) of the Exchange Act required the CBOE to promulgate rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest." *Id.* (alteration in original).

20. *Id.* at *24.

21. *Spicer*, 977 F.2d at 257, 265 (quoting Rules 4.1 and 8.7(a) and referring to Rule 8.7(b) of the CBOE, respectively).

22. *Spicer*, 1990 U.S. Dist. LEXIS 14469, at *23; *see also id.* at *9 ("Enforcement of section 6 is provided for in section 19(g), which states that SROS 'shall comply . . . and . . . enforce compliance' with their own rules, SEC rules, and applicable statutes.") (alterations in original).

23. *Id.* at *45.

24. *Spicer*, 977 F.2d at 265 (citing Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir. 1966)).

25. *Id.* (citing *Colonial Realty*, 358 F.2d at 182–83).

26. *Id.* at 265–66 (quoting Bosco v. Serhant, 836 F.2d 271, 278 (7th Cir. 1987)). *Bosco* addressed the issue of a private right of action under the Commodity Exchange Act rather than the federal securities statutes. *Spicer*, 977 F.2d at 265–66; *Bosco*, 836 F.2d at 274–75.

"an entirely different body of case law."[27] Overall, the court affirmed the dismissal of the claims brought against the market makers and concluded that section 6(b) of the Exchange Act "does not grant an implied private right of action to investors who charge that market-makers, or any exchange member, violated CBOE Rules 4.1, 8.7(a) or 8.7(b)," while reserving the broader issue of whether a private right of action may arise under this statutory provision with respect to a violation of *any* other exchange rule.[28]

C. *MARKET STREET*

Another case involved claims against the Amex and a specialist firm based on an attempt to cancel a sell order for put options on shares of an airline company, which was placed through a third-party broker, while this order was executed for the specialist's account after the release of news on the collapse of a takeover for another major player in the airline industry.[29] One of the claims against the specialist was brought under section 10(b) of the Exchange Act and Rule 10b-5 for alleged violations of the Amex's rules that "reflect[ed] the unique role given the specialist in directing that a member may reject any transaction in which the specialist acted as principal"[30] and required the specialist to abstain from transactions unnecessary for maintaining a "fair and orderly" market.[31] While considering the motion to dismiss this claim, the court concluded that "[t]he facts alleged support the inference that the [specialist] may have violated . . . the terms of AMEX Rules 155 and 170"[32] and sustained the allegation that such violations were a part of the scheme to defraud.[33] The court also argued that "[t]he specialist has fiduciary obligations closely resembling, if not identical to, those of a broker [when he] 'holds and executes orders for the public on a commission basis [and thus is] an agent [with] a fiduciary obligation to his principal, the purchaser or seller of stock.'"[34]

D. THE NYSE SPECIALISTS' CONTROVERSY

The next group of cases, which includes both civil and criminal proceedings, dealt with the high-profile controversy over the conduct of

27. *Spicer*, 977 F.2d at 265.

28. *Id.* at 266.

29. Mkt. St. Ltd. Partners v. Englander Capital Corp., No. 92 Civ. 7434, 1993 U.S. Dist. LEXIS 8065, at *3–8 (S.D.N.Y. June 14, 1993). On the other hand, the specialist "did disclose that he took the trade as a principal." *Id.* at *31.

30. *Id.* at *33 (referring to Rule 155 of the Amex).

31. *Id.* at *33–34 (referring to Rule 170 of the Amex). The court also took note that this rule was based on the corresponding SEC rule and the mandate of the Exchange Act. *Id.* at *9, *34.

32. *Id.* at *31.

33. *Id.* at *35.

34. *Id.* at *32–33 (quoting Note, *The Downstairs Insider: The Specialist and Rule 10b-5*, 42 N.Y.U. L. REV. 695, 697 (1967)).

specialists operating on the New York Stock Exchange (NYSE).[35] One key characteristic of the NYSE's trading architecture at the time was that a specialist played the dual role of a dealer and an agent, effectively serving as an administrator of the trading process:

> Specialists are responsible for maintaining a two-sided auction market by providing an opportunity for public orders to be executed against each other. In order to do so, they serve dual-roles, acting as both "agent" and "principal." Once an order has been received, the specialist, acting as agent, is required to match the open order to buy with an open order to sell within the same price range. Specialists generally receive no compensation for filling orders as agents. When there are no matching orders to sell and orders to buy, specialists are permitted to trade on a "principal" basis by either selling the stock from their own proprietary account to fulfill the investor's order to buy or buying the stock and holding it in their own account to fill an investor's order to sell.[36]

Under the NYSE rules, all specialists were subject to the "affirmative obligation," which required them "to buy or sell stock on a principal or dealer basis when necessary to maintain a 'fair and orderly' market, *i.e.*, to minimize any actual or anticipated short-term imbalance between supply and demand."[37] Furthermore, the NYSE

> place[d] a negative obligation on specialists, prohibiting "purchases or sales of any security in which such specialist, is registered . . . unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market" [and] prohibit[ed] proprietary trading, with limited exceptions, when the specialist "has knowledge of any particular unexecuted customer's order to buy (sell) such security which could be executed at the same price."[38]

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35. For the key facts of this multifaceted controversy, see *In re* NYSE Specialists Sec. Litig., 405 F. Supp. 2d 281 (S.D.N.Y. 2005), *aff'd in part, rev'd in part*, 503 F.3d 89 (2d Cir. 2007), *remanded to* 260 F.R.D. 55 (S.D.N.Y. 2009); Finnerty, Initial Decision Release No. 381, 96 SEC Docket 1098 (ALJ July 13, 2009). For academic commentary, see J. Scott Colesanti, *Not Dead Yet: How New York's* Finnerty *Decision Salvaged the Stock Exchange Specialist*, 23 ST. JOHN J. LEGAL COMM. 1 (2008); Stanislav Dolgopolov, *A Two-Sided Loyalty?: Exploring the Boundaries of Fiduciary Duties of Market Makers*, 12 U.C. DAVIS BUS. L.J. 31 *passim* (2011); Nan S. Ellis et al., *The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation*, 7 BERKELEY BUS. L.J. 102 (2010).

36. *NYSE Specialists*, 260 F.R.D. at 61. The history behind treating exchange specialists as agents or sub-agents of public customers is a long one. *See* Dolgopolov, *supra* note 35, at 37–39. On the other hand, a relationship between an exchange specialist and public customers, which is intermediated by other brokers, is by definition not the same as a "real" broker-customer relationship. An illustration of a market maker owing the duty of best execution in the context of a broker-customer relationship is provided by *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (3d Cir. 1998).

37. United States v. Finnerty, 474 F. Supp. 2d 530, 533 (S.D.N.Y. 2007) (citing Rule 104 of the NYSE).

38. *NYSE Specialists*, 260 F.R.D. at 61–62 (quoting Rules 104 and 92 of the NYSE, respectively). For an additional discussion of other NYSE rules relevant in this controversy that

More specifically, the defendant specialists were accused of the following wrongdoings in connection with their status as market makers:

> (i) "interpositioning" in violation of the Specialist Firms' "negative obligation," in which a Specialist Firm "steps in the way" of matching orders of public sellers and / or buyers of stock to generate riskless profits to the detriment of [other market participants]; (ii) "trading ahead" or "front-running," in which Specialist Firms take advantage of their confidential knowledge of public investors' orders . . . and trade for their own account as principals before completing orders placed by public investors; [and] (iii) "freezing the book," in which a Specialist Firm freezes its Display Book on a stock so it can first engage in trades for its own account prior to entering and then executing public investors' orders . . . .[39]

Of course, concerns about similar practices of exchange specialists have a long history.[40]

One of the initial decisions of the district court concluded that the plaintiffs had stated a "manipulative scheme claim" based on "interpositioning" and "trading ahead" and a claim based on "false and misleading statements" under section 10(b) of the Exchange Act with respect to the defendant specialists and denied the corresponding motions.[41] In the context of the alleged express false and misleading statements made by the defendant specialists "concerning (1) the extent of their efforts to minimize the transaction costs paid by their customers in connection with the purchase or sale of an otherwise efficiently priced security, and (2) the extent to which stocks were bought and sold at market prices, as opposed to artificially high and low prices,"[42] the court also pointed to the potential

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involved technical aspects of order matching by specialists and general principles applicable to all exchange members, see *NYSE Specialists*, 405 F. Supp. 2d at 291–92.

39. *NYSE Specialists*, 260 F.R.D. at 64. Interestingly, one of the defendant specialists made a self-contradicting argument that "the negative obligation sometimes had to give way to the affirmative obligation [and] he believed trading ahead was permissible in order to maintain a fair and orderly market." Brief for Defendant-Appellee David Finnerty at 52, 60, United States v. Finnerty, 533 F.3d 143 (2d Cir. 2008) (No. 07-1104-cr), 2007 U.S. 2nd Cir. Briefs LEXIS 808, at *63, *73. Several other defendant specialists similarly argued that, "when necessary to 'maintain a fair and orderly market,' a specialist has an affirmative legal obligation to trade for its own account even at the expense of public orders." Defendants' Reply Memorandum of Law in Further Support of Their Motion to Dismiss the Indictment at 8, United States v. Bongiorno, No. 05 Cr. 390, 2006 U.S. Dist. LEXIS 24830 (S.D.N.Y. May 1, 2006), 2006 U.S. Dist. Ct. Motions LEXIS 33164, at *8.

40. *See, e.g.*, SEC. & EXCH. COMM'N, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER 33 (1936) ("[W]here limit-price orders are concerned, no restriction exists upon the specialist's power to outbid or undersell his customers."); REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 2, ch. VI, at 92 (1963) ("[T]he injection of the specialist in an active stock may lead to investors' obtaining less favorable prices in order to provide for the specialist's 'jobber's turn.'").

41. *NYSE Specialists*, 405 F. Supp. 2d at 311–17, 321.

42. *Id.* at 318. For specific examples of these express statements, see *id.* App. B, at 325–33.

applicability of the fraud-on-the-market doctrine that addresses the impact of misrepresentations and certain omissions on the market price:

> Just as information about a specific security is reflected in the price of that security, so too is information about the manner in which transactions would be completed reflected in the price of securities generally. Plaintiffs may be presumed to have relied upon information indicating that securities would be matched by specialists, as opposed to bought and sold at artificially high and low prices.[43]

Another important point articulated by the court was that, "under established principles of agency theory, the specialist firms can be held liable for their agents' Section 10(b) violations if such violations were committed within the scope of the agency relationship."[44] In a later proceeding, the district court once again asserted that the fraud-on-the-market doctrine is potentially applicable, as the plaintiffs were presumed to rely "on an efficient and fair market," and extended its analysis to "customer expectation in terms of reliance."[45]

Other group of cases considered criminal liability of the defendant specialists under federal securities law. One of the initial decisions of the district court addressed the practices of "interpositioning" and "trading ahead" in the context of section 10(b) of the Exchange Act and Rule 10b-5.[46] Essentially, the specialists were charged "with intentionally failing to obtain best execution by trading for their proprietary account in a fraudulent and deceptive manner, and failing to tell the public that they were doing so,"[47] and the prosecution denied that "a breach of [the defendants'] fiduciary duty . . . to execute public trades at the best possible prices [was] the sole basis for the charge."[48] Furthermore, the prosecution maintained that

> the defendants made *implied representations* that, among other things, they would adhere to their duties as specialists, *follow the NYSE rules and securities laws*, not cheat customers, and not steal from customers. By failing to inform public customers that they were ripping them off by trading for the specialists' proprietary accounts before the public, the defendants violated section 10(b) [of the Exchange Act].[49]

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43. *Id.* at 319.
44. *Id.* at 314.
45. *In re* NYSE Specialists Sec. Litig., 260 F.R.D. 55, 77–79 (S.D.N.Y. 2009).
46. United States v. Bongiorno, No. 05 Cr. 390, 2006 U.S. Dist. LEXIS 24830, at *5–6, *9 (S.D.N.Y. May 1, 2006).
47. Government's Memorandum of Law in Opposition to Defendants' Motion to Dismiss the Indictment at 17, United States v. Bongiorno, 05 Cr. 390, 2006 U.S. Dist. LEXIS 24830 (S.D.N.Y. May 1, 2006), 2006 U.S. Dist. Ct. Motions LEXIS 4325, at *17.
48. *Id.*
49. *Id.* at 22 n.7, *22 n.7 (emphasis added).

Making a colorful analogy, the prosecution asserted that the practices in question

> constituted fraud because defendants were using their position as specialists—who can uniquely see both buy and sell orders in advance of a trade's consummation—to profit at the expense of their public customers, in the same way that a card dealer would be committing fraud by sneaking a peek at the deck and taking the best cards for himself before dealing a hand.[50]

The defendant specialists advanced the argument that "trading ahead and interpositioning at most constitute violations of NYSE rules and breaches of their fiduciary duties to public customers, but do not amount to violations of the federal securities laws."[51] The defendants further argued that "simply repackaging an exchange rule violation as a fraudulent omission—by alleging that defendants failed to disclose a rules violation—does not transform it into a crime."[52]

In its analysis of the reach of all three subsections of Rule 10b-5[53] to the practices of "interpositioning" and "trading ahead," the court dismissed the defendants' argument that "violations of subsections (a) and (c) that do not involve material misstatements or omissions can sustain a conviction only if they constitute manipulation," which was defined by the defendants as

50. *Bongiorno*, 2006 U.S. Dist. LEXIS 24830, at *15.

51. *Id.* at *10.

52. Defendants' Memorandum of Law in Support of Their Motion to Dismiss the Indictment at 3, United States v. Bongiorno, No. 05 Cr. 390, 2006 U.S. Dist. LEXIS 24830 (S.D.N.Y. May 1, 2006), 2006 U.S. Dist. Ct. Motions LEXIS 4324, at *3. A reiteration of this argument stated that "[i]t is well settled that violations of exchange rules, without more, cannot serve as the basis for liability under Section 10(b) and Rule 10b-5. . . . Accordingly, any notion that defendants committed federal securities fraud simply by violating certain NYSE rules is fundamentally at odds with this Circuit's settled law." *Id.* at 4, *4.

53. Rule 10b-5, which has not been amended by the SEC since its adoption in 1942, provides that

> [i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> > (a) To employ any device, scheme, or artifice to defraud,
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> >
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2012); *see also* Prohibition of Fraud by Any Person in Connection with the Purchase or Sale of Securities, 7 Fed. Reg. 3804 (May 21, 1942).

"artificial" market activities that mislead others.[54] In fact, the court distinguished the terms "manipulative" and "deceptive" and, in turn, partially denied the motion to dismiss because the practices of "interpositioning" and "trading ahead" could be found deceptive at trial.[55] On the other hand, the court granted the defendants' motion to dismiss with respect to subsection (b) of Rule 10b-5, downplaying the prosecution's argument that, "by virtue of their position as specialists, defendants owed a fiduciary duty of 'best execution' to their public customers [and thus had] to disclose that they were improperly trading stocks to and from their own account ahead of executable public orders."[56] While the court reserved its judgment on the general applicability of the fiduciary standard to specialists, the ruling was based on the prosecution's failure to identify "any statements whatsoever made by defendants, let alone any that were rendered misleading by virtue of defendants' omissions."[57] When the prosecution moved for a reconsideration of the dismissal with respect to subsection (b) of Rule 10b-5, the court disagreed that the "shingle" theory, which deals with certain implied representations deemed to be made by broker-dealers, was of relevance, but it also emphasized that the ruling "in no way contradicted the cases supporting the 'shingle theory' of fraud or the fact that implied misrepresentations can constitute violations of the securities laws."[58] Furthermore, the court dismissed the prosecution's argument that the fact that every individual specialist had signed a form kept on record by the NYSE served as "an express statement by that defendant that he would follow the rules of the Exchange and that those statements were 'rendered misleading by [the defendants'] failure to disclose their improper trading activities'" because such actions were not public statements.[59]

Another criminal case against one of the defendant specialists also addressed the practices of "interpositioning" and "trading ahead" in the context of section 10(b) of the Exchange Act and Rule 10b-5.[60] The district court maintained that subsections (a) and (c) of Rule 10b-5 cover both

54. *Bongiorno*, 2006 U.S. Dist. LEXIS 24830, at *15–18.

55. *Id.* at *17–21.

56. *Id.* at *17–21, *26.

57. *Id.* at *22–23.

58. United States v. Hayward, No. 05 Cr. 390, 2006 U.S. Dist. LEXIS 37108, at *3–6 (S.D.N.Y. June 5, 2006).

59. *Id.* at *6–7; *see also* Government's Memorandum of Law in Support of the Motion to Reconsider Dismissal of a Portion of the Indictment at 6, United States v. Hayward, No. 05 Cr. 390, 2006 U.S. Dist. LEXIS 37108 (S.D.N.Y. June 5, 2006), 2006 U.S. Dist. Ct. Motions LEXIS 4327, at *6 ("[T]he implied representations to the public of fair dealing that are recognized in the case law were in fact made expressly by each of the defendants here to the New York Stock Exchange and the NASD. These express representations were made repeatedly and in writing as a condition of their registration as specialists.").

60. United States v. Hunt, No. 05 Cr. 395, 2006 U.S. Dist. LEXIS 64887, at *5, *8–9 (S.D.N.Y. Sept. 6, 2006).

manipulative and deceptive forms of conduct.[61] The corresponding conclusion was as follows:

> Defendant's alleged acts of trading ahead and interpositioning his orders in between executable customer orders, which resulted in a profit to his firm at the expense of the public, constituted fraudulent devices and a course of business that operated as a fraud on the public, in violation of Rule 10b-5(a) and (c).[62]

The court also granted the motion to dismiss with respect to subsection (b) of Rule 10b-5 for the lack of allegations regarding any statements by the defendant specialist.[63] Furthermore, the court rejected the argument that the defendant specialists owed a fiduciary duty to other market participants and, accordingly, had an obligation to disclose their actual trading practices.[64] On the other hand, the court dismissed the relevance of the defendant's argument that "violations of exchange rules, without more, cannot serve as the basis for liability under Section 10(b) and Rule 10b-5," arguing that "more than a violation of NYSE rules has been alleged [because] his acts of trading ahead and interpositioning constituted fraudulent acts perpetrated upon the trading public, not mere violations of quasi-regulatory rules."[65]

In another criminal case against one of the defendant specialists, the district court similarly treated the practices of "interpositioning" and "trading ahead" in the context of section 10(b) of the Exchange Act and Rule 10b-5. The court concluded that subsections (a) and (c) of Rule 10b-5 were applicable, as these practices "worked to deceive the trading public, as investors believed that defendants were working to match orders, first and foremost, and that defendants traded for their own proprietary accounts *only* to maintain a fair and orderly market."[66] Furthermore, the court pointed out that the reach of these subsections goes beyond practices that artificially affect market prices, rejecting the argument that "trading ahead and interpositioning are not deceptive because they were legitimate transactions that took place openly on the NYSE floor."[67] Emphasizing this aspect, the court made the following observation:

> Simply because these securities transactions were being recorded on the books does not remove them from the realm of deception. If the allegations are true, it is apparent that the customers were being misled into believing that their orders were being matched, and that their interests were being placed above defendants' interests. Indeed, contrary to

61. *Id.* at *9–10 (citing *Bongiorno*, 2006 U.S. Dist. LEXIS 24830, at *15–16).
62. *Id.* at *10–11.
63. *Id.* at *11–12.
64. *Id.* at *12–18.
65. *Id.* at *21–22.
66. United States v. Finnerty, No. 05 Cr. 393, 2006 U.S. Dist. LEXIS 72119, at *10–11 (S.D.N.Y. Oct. 2, 2006).
67. *Id.* at *11–14.

> defendants' argument, the fact that the orders were publicly executed and recorded on the books arguably makes these acts even more deceptive, *as the perception was given that defendants were performing their duties as directed by the NYSE and SEC rules*.[68]

Once again, the relevance of subsection (b) of Rule 10b-5 was dismissed because the prosecution had not identified "any statements that were misleading" or "any statements that were made misleading by defendants' omissions."[69] The court also declined to accept the prosecution's approach based on implied representations in the context of the shingle theory: "[S]pecialists do not actively solicit customers, and unlike securities dealers, do not 'hang[] out [their] professional shingle.'"[70]

Given that the prosecution had "proved at [a jury] trial that [the defendant specialist] engaged in interpositioning," the district court later considered whether the defendant "engaged in fraudulent or deceptive conduct within the meaning of the [federal] securities laws" and concluded that it had not been proven at trial that his "[public] customers were misled or defrauded or otherwise deceived."[71] The court agreed with the defendant that the prosecution "could not prove that interpositioning was deceptive without showing what the investing public expected"[72] and made a corresponding conclusion that, "[w]ithout evidence of what the customers expected, no rational juror could conclude that the interpositioning trades had a tendency to deceive or the power to mislead."[73] The court summarized the relevant precedents as stating that "a violation of NYSE rules, without more, is not enough to constitute a deceptive or fraudulent act. Evidence that the conduct is deceptive is still required."[74] More specifically, the court required a showing that public customers "were aware of the rules, expected the specialists to comply with them, and acted in accordance with those expectations."[75] The court once again rejected the applicability of implied representations in the context of the shingle theory because the defendant "did not 'actively solicit customers,' and thus, did not hold himself out as someone representing the best interests of the

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68. *Id.* at *14–15 (emphasis added).

69. *Id.* at *17 (citing United States v. Bongiorno, No. 05 Cr. 390, 2006 U.S. Dist. LEXIS 24830, at *23–24 (S.D.N.Y. May 1, 2006)); *see also id.* at *19 ("[T]he Government's implied representation theory for omission liability would also render the text of subsection (b) meaningless.").

70. *Id.* at *19 (alterations in original) (quoting Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 192 (2d Cir. 1998)).

71. United States v. Finnerty, 474 F. Supp. 2d 530, 532 (S.D.N.Y. 2007). The prosecution had dropped the "trading ahead" charge in its revised indictment. *Id.* at 536 n.3.

72. *Id.* at 539.

73. *Id.* at 540.

74. *Id.* at 541 (citing Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971); Van Alen v. Dominick & Dominick, Inc., 441 F. Supp. 389, 404 (S.D.N.Y. 1976)).

75. *Id.*

customers."[76] The court also considered a possible characterization of "interpositioning" as theft and stressed the pivotal role of a fiduciary relation in order to bring the alleged conduct under the umbrella of securities fraud.[77] The court was quite skeptical with respect to the fiduciary status of the defendant specialists, although it concluded that "the existence of a fiduciary duty was one for the jury, but the jury was never asked to decide the issue."[78]

When the decision of the district court was reviewed on the appellate level, it was observed that "'[c]onduct itself can be deceptive,' and so liability under § 10(b) [of the Exchange Act] or Rule 10b-5 does not require 'a specific oral or written statement,'"[79] but the court qualified this observation with the statement that, "[b]road as the concept of 'deception' may be, it irreducibly entails some act that gives the victim a false impression."[80] The court ultimately held that the prosecution "ha[d] identified no way in which [the defendant specialist] communicated anything to his customers, let alone anything false."[81] The court held that "there is no evidence that [the defendant] conveyed an impression that was misleading, whether or not it could have a bearing on a victim's investment decision,"[82] although it reserved the issue of whether "some form of communication by the defendant is always required to prove deception."[83] The court also took note of the prosecution's argument that "at least some customers were aware of the NYSE rules, would have expected [the defendant] to comply with the rules, and were therefore deceived when [he] violated them" because these transactions were effected through broker-dealers holding the NYSE membership,[84] but it was also rejected:

> Some customers may have understood that the NYSE rules prohibit specialists from interpositioning, and that the rules amount to an assurance (by somebody) that interpositioning will not occur. As a consequence, some customers may have expected that [the defendant] would not engage in the practice. But unless their understanding was based on a statement or conduct by [the defendant], he did not commit a primary violation of § 10(b) – the only offense with which he was charged.[85]

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76. *Id.* at 543.
77. *Id*.
78. *Id.* at 543–44.
79. United States v. Finnerty, 533 F.3d 143, 148 (2d Cir. 2008) (quoting Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008)).
80. *Id.*
81. *Id.* at 148–49.
82. *Id.* at 149.
83. *Id.*
84. *Id.*
85. *Id.* at 150. On the other hand, perhaps the meaning of "statement or conduct" for an individual employee in the context of criminal liability could be distinguished from the meaning of the same phrase for a market making firm in the context of civil liability.

Another attempt by the prosecution to craft a theory of liability linked to securities fraud—by characterizing the defendant specialist's "scheme [as] 'self-evidently deceptive' because he had 'two critical advantages' over his customers: he could see all pending orders to buy and sell a particular stock and he determined the price ultimately paid"[86]—also failed. The court stated that "[i]t may be that [the defendant] unfairly profited from superior information. . . . [But] there must be some proof of manipulation or a false statement, breach of a duty to disclose, or deceptive communicative conduct."[87] The court further observed that "[a] violation of an NYSE rule does not establish securities fraud in the civil, let alone in a criminal prosecution."[88] Addressing a possible application of the fraud-on-the-market doctrine, the court stated that the prosecution "ha[d] attributed to [the defendant] nothing that deceived the public or affected the price of any stock: no material misrepresentation, no omission, no breach of a duty to disclose, and no creation of a false appearance of fact by any means."[89]

E. *GURFEIN*

Another case involved a complaint against an options market maker for its alleged non-compliance with the SEC and SRO rules on firm quotes and preferential treatment of certain orders in violation of section 10(b) of the Exchange Act and Rule 10b-5.[90] The complaint also lumped together the market maker in question with a brokerage firm and an options exchange in connection with more general allegations relating to omissions and affirmative misrepresentations about the execution practices and interference with certain orders.[91] The district court found the complaint to be inadequate, dismissing it without prejudice with respect to the market maker.[92] The subsequent proceedings addressed only the claims against the

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86. *Id.*

87. *Id.*

88. *Id.* at 151 (citation omitted). While the court cited no authorities with respect to the criminal liability aspect of this pronouncement, the only authority cited in support of the civil liability aspect, *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971), appears to have a more limited application. With the claim being brought only under section 10(b) of the Exchange Act and Rule 10b-5, the court clearly stated that the "plaintiffs' claim is nothing more than a garden-variety customer's suit against a broker for breach of contract, which cannot be bootstrapped into an alleged violation of § 10(b) of the Exchange Act, or Rule 10b-5, in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud." *Id.* at 445. The facts and allegations in *Finnerty* do not seem to follow the same pattern.

89. *Finnerty*, 533 F.3d at 151.

90. Gurfein v. Ameritrade, Inc., 411 F. Supp. 2d 416, 418–19, 424–25 (S.D.N.Y. 2006).

91. *Id.* at 426–27.

92. *Id.* at 428.

brokerage firm,[93] which left unresolved the reach of a private right of action to market-making activities.

F. *Last Atlantis*

Another series of decisions under the umbrella of section 10(b) of the Exchange Act and Rule 10b-5 addressed the allegation that specialists operating on several options exchanges engaged in discrimination—including interference with execution and mishandling—of orders placed by direct access customers.[94] The plaintiffs described themselves as engaged in "a variety of trading strategies, including arbitrage trades, to earn profits on short term trades at times they believe that they have information and/or technological capabilities that are superior to that of Specialist Defendants and other traders in the market."[95] Furthermore, the plaintiffs specifically pointed out that, "[b]y electronically submitting limit orders and conducting arbitrage trades, Plaintiffs also act as competitors of the Specialists, competing with their quoted prices for trades with other market participants, thus increasing overall competition for trades in the options market."[96] The pivotal allegation directed against the options exchanges and specialists under the federal antifraud prohibition was pointing at

> a fraudulent scheme and course of conduct pursuant to which each Defendant violated SEC Rules and Exchange Rules enacted to protect the interests of public investors against the conflicting interests inherent in Defendants' positions as either a specialist permitted to buy and sell options as both an agent for public customers and as a principal for its own proprietary account, or as a national securities exchange charged with ensuring that the members who own, operate and/or substantially fund its activities, comply with the SEC Rules and Exchange Rules that, if violated, must be enforced by the exchanges against such members. Each Specialist also violated the fundamental responsibilities of a specialist, which the SEC has held are to, (a) limit their own course of dealings to that "necessary to maintain a fair and orderly market," and (b) fulfill a "basic obligation to serve public customer orders over their own proprietary interests."[97]

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93. Gurfein v. Ameritrade, Inc., No. 04 Civ. 9526, 2006 U.S. Dist. LEXIS 75374 (S.D.N.Y. Oct. 13, 2006), *reh'g granted*, 2007 U.S. Dist. LEXIS 51801 (S.D.N.Y. July 17, 2007), *aff'd*, 312 F. App'x 410 (2d Cir. 2009).

94. Last Atlantis Capital LLC v. AGS Specialist Partners, 819 F. Supp. 2d 708, 711–12 (N.D. Ill. 2010); Last Atlantis Capital LLC v. Chi. Bd. Options Exch., 455 F. Supp. 2d 788, 791–92 (2006).

95. Consolidated Complaint and Demand for Jury Trial at 43, Last Atlantis Capital LLC v. Chi. Bd. Options Exch., Inc., 455 F. Supp. 2d 788 (N.D. Ill. 2006) (No. 04 C 397), 2005 U.S. Dist. Ct. Pleadings LEXIS 10704, at *43.

96. *Id.*

97. *Id.* at 9, *9.

The complaint interpreted the scope of duties of all specialists in the context of applicable trading mechanism as follows:

> Each Specialist Defendant, when it undertakes to act as an agent . . . in connection with the execution of marketable limit orders . . . legally owes its public customers, and thus owed to each Plaintiff, three legal duties: (a) a duty of "best execution" to immediately seek and obtain a prompt execution at the best reasonably available prices; (b) a duty of loyalty to act solely in the interests of its customer in executing the customer's market orders and marketable limit orders; and (c) a duty to fully disclose all information material to its execution of the public customers' (i.e., Plaintiff's) market orders and marketable limit orders, including any conflicts of interest.[98]

Another central element of the complaint focused on the issue of reliance on alleged express and implied representations:

> Each Plaintiff *reasonably relied on the express and/or implied representations made by each and every Defendant* that if Plaintiff sent a marketable limit order to any of the four Exchanges, the particular Specialist(s) responsible for executing the Order would do so *in compliance with applicable laws, SEC Rules and Exchange Rules* . . . .[99]

On the other hand, the plaintiffs also somewhat downplayed the significance of SRO rules applicable to all specialists:

> Plaintiffs do not seek to assert an implied private right of action based on alleged violations of Exchange Rules. Rather, Plaintiffs allege that by engaging in various fraudulent and deceptive acts in violation of the duty of best execution—some of which also violated Exchange Rules—each Specialist violated Section 10(b) and SEC Rule 10b-5.[100]

Another allegation was that,

> pursuant to the 'Shingle Theory,' each Specialist Defendant is legally deemed to have issued a pledge to each Plaintiff, by which the Specialist represents that, if you submit your marketable limit order to the Exchange's [order execution system] that routes it to us, then we will abide by our legal obligations as a specialist.[101]

The plaintiffs also pointed to the alleged abuses of trading privileges enjoyed by the defendant specialists:

98. *Id.* at 41, *41.
99. *Id.* at 21, *21 (emphasis added).
100. Plaintiffs' Memorandum of Law in Opposition to the Specialist Defendants' Motion to Dismiss the Consolidated Complaint Pursuant to Fed. R. Civ. P. 9(b) & 12(b)(6) at 12, Last Atlantis Capital LLC v. Chi. Bd. Options Exch., Inc., 455 F. Supp. 2d 788 (N.D. Ill. 2006) (No. 04 C 397), 2006 U.S. Dist. Ct. Motions LEXIS 35415, at *12.
101. *Id.* at 2 n.3, *2 n.3.

> [E]ach Specialist knows of all the existing orders for [assigned] options, including potential order flow that is not yet publicly disclosed. This information provides the Specialist with a unique, comprehensive and exclusive picture of the overall supply and demand for the market of each option it oversees. Because the Specialists hold such a privileged position, they are required by law and rules (and have impliedly promised) to place their retail customers' interests ahead of their own. However, each Specialist has routinely abused the trust imparted to them by Plaintiffs and has used its inside information and exclusive control over the market in a given option to trade for its own proprietary accounts ahead of, and to the detriment of, the Plaintiffs.[102]

Overall, the plaintiffs maintained that their claims were "based upon acts alleged to have been taken by the Specialists in their capacities as securities brokers designated as exchange specialists, *and are not at all* based upon any acts they may have taken when trading options for their own accounts as ordinary market-makers."[103]

The defendant specialists responded that

> the central theory . . . that the Market Makers impliedly represented that they would follow Exchange rules and failed to disclose violations of these rules, is an impermissible attempt to circumvent the Congressional determination that Exchange rules are to be enforced only by the exchanges and the SEC, not through private actions. Similarly, plaintiffs' reliance on the inapplicable "shingle theory" is an improper attempt to imply a private cause of action where none otherwise exists. Moreover, neither fraud by omission nor the shingle theory is viable here because plaintiffs have not reposed trust and confidence in the Market Makers, who . . . are their competitors, not their trusted advisors.[104]

The argument that mere non-disclosure of violations of SRO rules applicable to all specialists triggers liability under Rule 10b-5 was also attacked:

> If plaintiffs were allowed to state claims merely by alleging that the Market Makers did not disclose violations of the rules, any rule violation could be turned into a securities fraud case. That result, however, would contradict the Congressional judgment that enforcement should be left to the SEC and the Exchanges.[105]

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102. *Id.* at 10–11, *10–11.

103. Plaintiffs' [Corrected] Memorandum of Law in Opposition to the Exchange Defendants' Motion to Dismiss the Consolidated Complaint Pursuant to Fed. R. Civ. P. 9(b) & 12(b)(6) at 6, Last Atlantis Capital LLC v. Chi. Bd. Options Exch., Inc., 455 F. Supp. 2d 788 (N.D. Ill. 2006) (No. 04 C 397), 2006 U.S. Dist. Ct. Motions LEXIS 35414, at *6 (emphasis added).

104. Market Maker Defendants' Motion to Dismiss the Consolidated Complaint at 2–3, Last Atlantis Capital LLC v. Chi. Bd. Options Exch., Inc., 455 F. Supp. 2d 788 (N.D. Ill. 2006) (No. 04 C 397), 2006 U.S. Dist. Ct. Motions LEXIS 35830, at *2–3.

105. *Id.* at 10, *10.

In any instance, the defendant specialists advanced the argument that "the only possible fraud rests on the generalized allegation that the Market Maker Defendants handled certain orders in violation of exchange rules [but the] allegations do not demonstrate rules violations, intentional or negligent, by any Market Maker Defendant."[106]

In one of the initial decisions, the district court stated "the fraud-on-the-market doctrine does not apply to plaintiffs' claims because plaintiffs do not seek recovery for a loss caused by the inflation of the price of an underlying security due to the dissemination of misleading information into the marketplace."[107] The court clarified that "[the alleged] loss is completely independent from, and unrelated to, the underlying value of the option, which may or may not have been inflated due to misleading information."[108]

Another decision of the district court followed a prior precedent, pointing to a similar lack of direct communications between the specialist in question and public customers, and concluded that "implied misrepresentations under the shingle theory are insufficient to prove securities fraud under Rule 10b-5(a) and (c)."[109] The court also adopted the formula that the "plaintiffs must provide evidence of: (1) customer expectations, and (2) a deceptive statement or act on the part of the specialist."[110] The court observed that the plaintiffs had provided evidence that they expected the defendant specialist to "act in accordance with all applicable rules when handling and executing the orders [and] relied on [the defendant specialist] to execute their orders in a fair and proper manner,"[111] but it nevertheless concluded that the plaintiffs had "fail[ed] to provide any proof that the plaintiffs' expectations were *based on* the alleged misrepresentations made by [the defendant specialist]."[112] The court also followed another precedent stating that, "under Rule 10b-5(b), the shingle theory was not applicable to specialists where the plaintiff failed to put forward evidence of misleading statements."[113] Interestingly, the court took note of an earlier holding that "not revealing to investors a failure to comply

106. Market Maker Defendants' Reply at 7–8, Last Atlantis Capital LLC v. Chi. Bd. Options Exch., Inc., 455 F. Supp. 2d 788 (N.D. Ill. 2006) (No. 04 C 397), 2006 U.S. Dist. Ct. Motions LEXIS 35412, at *7–8.

107. *Last Atlantis*, 455 F. Supp. 2d at 800–01. This statement was made with respect to the defendant options exchanges rather than the defendant market makers. *Id.* at 798.

108. *Id.* at 801 n.16.

109. Last Atlantis Capital LLC v. AGS Specialist Partners, 819 F. Supp. 2d 708, 715 (N.D. Ill. 2010) (footnote omitted) (following United States v. Finnerty, 533 F.3d 143 (2d Cir. 2008)).

110. *Id.* at 716 (citing *Finnerty*, 533 F.3d at 150).

111. *Id.*

112. *Id.* The court also stressed that "[t]he key language . . . states that a customer's expectation 'must be based on a statement or conduct' by [the defendant specialist]." *Id.* (quoting *Finnerty*, 533 F.3d at 150).

113. *Id.* at 717 (citing United States v. Finnerty, No. 05 Cr. 393, 2006 U.S. Dist. LEXIS 72119, at *16–18 (S.D.N.Y. Oct. 2, 2006)).

with one's duties about transactions in their securities can lead to liability under the [federal] securities acts,"[114] but it dismissed this analogy—in an artificially restrictive way—by stating that the prior case "did not involve options specialists."[115] Finally, the court stated that the "[p]laintiffs have cited no controlling or persuasive authority suggesting that [the defendant], as a specialist, owed plaintiffs a fiduciary duty."[116]

In a subsequent decision, the district court re-articulated the position that "specialists, such as the defendants here, are not liable under [subsections (a) and (c) of] Rule 10b-5 via the 'shingle theory' for implied misrepresentations concerning 'best execution'"[117] and stated that a showing of express representations is required.[118] In connection with alleged express misrepresentations and misstatements, the court also confirmed the existence of potential liability under subsection (b) of Rule 10b-5.[119] On the other hand, the court rejected the argument that "a promise of 'best execution' is equivalent to the much broader promise of following *all* applicable rules governing each particular defendant."[120] Furthermore, the court dismissed the theory that "the statements at issue [must] be specifically directed to these particular plaintiffs," maintaining that "it is reasonable for members of the public who trade in options to rely on statements made by options specialists on their public websites."[121] Similarly, the court rejected the "defendants' argument that the nature of plaintiffs' arbitrage trading strategy would make it impossible for plaintiffs to have relied on any statements by defendants."[122] Finally, the court

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114. *Id.* at 716 n.6 (citing Kurz v. Fidelity Mgmt. & Research Co., 556 F.3d 639, 642 (7th Cir. 2009)). This decision made a specific reference to potential liability stemming from non-compliance with SRO rules. *Kurz*, 556 F.3d at 641–42.

115. *Id.*

116. *Id.* at 718 (footnote omitted).

117. Last Atlantis Capital LLC v. ASG Specialist Partners, 749 F. Supp. 2d 828, 832 (N.D. Ill. 2010). Another key observation was that, "[u]nlike the terms 'orderly,' 'efficient' and 'liquid,' which . . . are merely puffery and are too vague to be material, the promise of 'best execution' is a defined, specific concept in the securities context." *Id.* at 834. The court also dismissed as non-actionable the following statements by the defendant specialists: "[o]ur efforts are always directed toward market efficiency and price discovery," *id.* at 834–35, "[t]he Specialist also acts as a 'broker's broker' by taking limit orders into his care and executing them on behalf of the broker and customer," *id.* at 835, "a specialist has an obligation to maintain 'a fair and orderly market in the securities he trades,'" *id.*, "the company is dedicated to complying with the 'laws, rules and ethical principles that govern us,'" *id.* at 838, and the specialist keeps markets "liquid, fair, and competitive as possible," *id.* at 840.

118. *Id.* at 832. One administrative adjudication also came to a similar conclusion with respect to a non-specialist market maker. *See* Herzog, Heine, Geduld, LLC, Exchange Act Release No. 54,148, 88 SEC Docket 1300, 1300 (July 14, 2006) ("Herzog, in its capacity as a market maker, assumed the duty of best execution by making written and oral statements to correspondent broker-dealer firms to the effect that it would provide best execution to orders routed to Herzog for execution.").

119. *Last Atlantis*, 749 F. Supp. 2d at 842.

120. *Id.* at 833.

121. *Id.* at 834.

122. *Id.* at 841.

concluded that the "plaintiffs have failed to put forward evidence from which a reasonable jury could conclude that defendant[] [specialists] were fiduciaries."[123]

II. IN SEARCH OF A COHERENT THEORY OF A PRIVATE RIGHT OF ACTION

A theory of a private right of action with respect to trading obligations and privileges of market makers interacts with a host of legal issues, such as the shingle theory, the significance of express and implied representations, the fraud-on-the-market doctrine, and the reach of fiduciary duties. Furthermore, the overarching issue relates to civil liability for violations of rules set by trading venues in their self-regulatory capacity, as such rules play a big role in establishing the balance of trading obligations and privileges of these market participants.

A. VIOLATIONS OF RULES OF SELF-REGULATORY ORGANIZATIONS

The availability of a private right of action for violations of rules of an SRO by its members is a pivotal issue,[124] given the specificity of many of these rules applicable to market makers.[125] One categorical point of view—predominant in more recent cases—is that "[i]t is well established that violation of an exchange rule will not support a private claim."[126] On the

123. *Id.* at 842.

124. For commentary on the availability of a private right in such circumstances, see ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD § 13:62–:71 (2d ed. 2007 & Supp. 2012); NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION § 16.06[A] (4th ed. 2007 & Supp. 2012); Philip J. Hoblin, Jr., *A Stock Broker's Implied Liability to Its Customer for Violation of a Rule of a Registered Stock Exchange*, 39 FORDHAM L. REV. 253 (1970); Lewis D. Lowenfels, *Implied Liabilities Based on Stock Exchange Rules*, 66 COLUM. L. REV. 12 (1966); Nicholas Wolfson & Thomas A. Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules*, 58 CAL. L. REV. 1120 (1970); Amnon Wenger, Note, *See No Evil, Hear No Evil, Don't Get Sued: Should a Private Cause of Action Exist for a Violation of a NASD Conduct Rule 3010?*, 74 FORDHAM L. REV. 303 (2005).

125. In connection with market-making activities, the relevance of SRO rules for a private right of action is not new. In fact, the issue of civil liability of exchange specialists and exchanges themselves in connection with violations of specialists' trading obligations came up during the process of adoption of the SEC's Rule 11b-1 in 1964, which addressed the affirmative and negative obligations of exchange specialists, Regulation of Specialists, Exchange Act Release No. 7465, 29 Fed. Reg. 15,862 (Nov. 20, 1964). Given the concerns shared by the securities exchanges and the regulatory agency, the prevailing view was that the imposition of such trading obligations via SRO rules rather than direct SEC regulation would serve as a shield from civil liability. *See Securities Industry Study: Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing & Urb. Affairs* 93d Cong. pt. 4, 10–15 (1972) (Staff, Subcomm. on Sec., Comm. on Banking, Housing & Urb. Affairs, U.S. Senate, Case Study of the Regulation of Specialists on the New York and American Stock Exchanges (1972)).

126. *In re* VeriFone Sec. Litig., 11 F.3d 865, 870 (9th Cir. 1993); *see also* United States v. Finnerty, 533 F.3d 143, 151 (2d Cir. 2008) ("[A] violation of an NYSE rule does not establish securities fraud in the civil, let alone in a criminal prosecution."); Jablon v. Dean Witter & Co., 614 F.2d 677, 681 (9th Cir. 1980) ("[There is] no Congressional intent to provide a private action

other hand, this complex issue may be approached in a number of ways, and several cases justify the opposite result.[127] The pivotal dividing line in the applicable case law is the choice of claims under the federal antifraud prohibition or under the provisions of the federal securities statutes that govern the process of SROs' registration, require them to adopt—under the SEC's supervision—certain rules for their respective members, and impose mandatory membership in such SROs on broker-dealers, or even under the very existence of the broad regulatory scheme established by such statutes without necessarily resorting to any specific provision.[128]

Characteristic of the early decisions on this matter, one court made the following observation on the required analysis of the *content* of the applicable SRO rule in connection with a claim brought under sections 6 and 15A of the Exchange Act:[129]

> [W]hether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.[130]

Another court similarly contrasted the "housekeeping" and "investor protection" functions of SRO rules in the context of a claim under section 6 and 19 of the Exchange Act[131] and made the following assertion: "The touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design 'for the direct

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for violation of stock exchange rules [and] no implied right of action for an NASD rule violation."). *But see* Lang v. French, 154 F.3d 217, 222 n.26 (5th Cir. 1998) ("[T]he issue of implied rights under stock exchange or dealer association rules is far from settled."); Leist v. Simplot, 638 F.2d 283, 338 (2d Cir. 1980) ("[W]e do not necessarily accept the broad language of the *Jablon* opinion.").

127. For two notable *recent* pronouncements on the appellate level to that effect, see VanCook v. SEC, 653 F.3d 130, 141 n.8 (2d Cir. 2011); Kurz v. Fidelity Mgmt. & Research Co., 556 F.3d 639, 641–42 (7th Cir. 2009).

128. *See supra* note 10.

129. Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 180 (2d Cir. 1966).

130. *Id.* at 182. Choosing an indirect path to the availability of a private right of action, the court did not see "any reference to exchange rules in the grant of federal jurisdiction over 'all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder'" in section 27 of the Exchange Act. *Id.* at 181–82. A similar textual analysis of section 27 by another court, similarly in the context of a claim under sections 6 and 19 of the Exchange Act, maintained that, while "the Stock Exchange rules themselves are not encompassed by the 'rules and regulations thereunder' . . . a violation by a member of the Exchange of its rules, filed pursuant to the statute may be actionable as a violation of a 'duty created by this chapter.'" Starkman v. Seroussi, 377 F. Supp. 518, 523–24 (S.D.N.Y. 1974).

131. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 141 (7th Cir. 1969).

protection of the investors.'"[132] The court also argued that "one of the functions of [the 'know your customer' SRO rule] is to protect the public, so that permitting a private action for its violation is entirely consistent with the purposes of the [Exchange Act]."[133] Another court offered a detailed description of the distinction between the "housekeeping" and "investor protection" functions in the context of a claim hinging on sections 6, 15A, and 19 of the Exchange Act:[134]

> "[H]ouse-keeping rules" abound—composition and election of the Board of Governors, transfers of memberships, dues and other fees, registration of floor employees, and back-office procedures—and, generally speaking, should not engender private actions by the investing public. Rules promulgated by exchanges and securities dealers associations for the direct protection of the investing public should, on the other hand, give rise to private actions. Under such rules, the investing public is, in a very real sense, a third party beneficiary of the duties imposed upon those required to adhere to those rules. The "house-keeping rules" confer no such status on the investing public.[135]

The content-based analysis also addressed the dichotomy between SEC and SRO rules and difficulties with separating these two categories. For instance, one court stated in the context of a claim brought under sections 6 and 15A of the Exchange Act that an SRO rule may "play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement, and we would not wish to say that such a rule could not provide the basis for implying a private right of action."[136] Another court, which analyzed a private right of action under

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132. *Id.* at 142 (quoting Lowenfels, *supra* note 124, at 29).
133. *Id.*
134. Geyer v. Paine, Webber, Jackson & Curtis, Inc., 389 F. Supp. 678, 680–81 (D. Wyo. 1975).
135. *Id.* at 683. Several courts have endorsed the "investor protection" rationale in the context of claims based on the existence of the broad regulatory scheme without necessarily relying on any specific statutory provision. *See* Sacks v. Reynolds Sec., Inc., 593 F.2d 1234, 1244 (D.C. Cir 1978); Carras v. Burns, 516 F.2d 251, 260 (4th Cir. 1975); Ocrant v. Dean Witter & Co., 502 F.2d 854, 858 (10th Cir. 1974); Cook v. Goldman, Sachs & Co., 726 F. Supp. 151, 156 (S.D. Tex. 1989). The counterargument, which reflects the inherent conflict of interest in self-regulation, is that

> [p]ublic policy concerns militate against implying private rights of action under the NYSE and NASD rules [because] [t]he likely outcome of permitting civil damage actions for violations of such rules would be to discourage the stock exchange and the dealers association from promulgating rules for the protection of the investing public, an undesirable result.

Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 443 (E.D. Mich. 1983). Another court analogously observed that "the self-regulatory bodies must be encouraged to take the initiative in exploring and formulating new rules to govern the conduct of their members. Such action is doubtful if the promulgation of every new rule has the potential of creating massive liability for the members." Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164, 168 (10th Cir. 1977).
136. Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir. 1966).

the existence of the broad regulatory scheme,[137] even suggested that the SRO rule in question may be merely "comparable" to SEC regulation in order to trigger a private right of action.[138] Linking the broad goals of federal securities law and the role of certain SRO rules and pointing to the fungibility of SEC and SRO regulation, another court made the following pronouncement in the context of the existence of the broad regulatory scheme:

> [Certain SRO] rules are promulgated directly for the protection of the investing public and regulate the kind of fraudulent conduct to which the [Exchange] Act is specifically directed. These rules insure the integrity of the securities market, not simply the efficient functioning of exchanges. They often serve as *substitutes* for [SEC] regulations and are vital to effective securities control. Implication of a [private] cause of action from them is not only permissible, but may be necessary to the success of the tripartite system.[139]

The court also put this reasoning within the four-prong framework set by the U.S. Supreme Court, including the inquiry whether it is "consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff."[140] Another court similarly pointed to the broad goals of the federal securities statutes in the context of a claim hinging on sections 6, 15A, and 19 of the Exchange Act: "The protection of the investing public is enhanced, not diminished, by permitting a private action to be based on [certain SRO] rules; and such actions, where based on such explicit rules, further the purposes of these Acts."[141]

Another consideration is the specificity of the applicable SRO rule. As one court stated in the context of a claim hinging on sections 6, 15A, and 19 of the Exchange Act, "A principle with such vague and uncertain contours [as being 'inconsistent with just and equitable principles of trade'] could not have been intended to give rise to a legal claim for what might merely be unethical behavior."[142] Another court similarly contrasted a "broad generalized [rule] with vague or uncertain contours that may lend itself to variant interpretations" with a "precise" rule, such as the prohibition of certain forms of profit-sharing and guarantees against losses,[143] arguing that "[t]he alleged violations of the [applicable] rules are *such an integral part of the transaction* as to constitute a sufficient claim for violation of sections 6 and 19 of the Exchange Act."[144] Yet another court indicated that some

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137. Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1040–43 (S.D.N.Y. 1977).
138. *Id.* at 1041.
139. *Sacks*, 593 F.2d at 1244.
140. *Id.* at 1243 (quoting Cort v. Ash, 422 U.S. 66, 95 (1975)).
141. Geyer v. Paine, Webber, Jackson & Curtis, Inc., 389 F. Supp. 678, 683 (D. Wyo. 1975).
142. *Id.* at 682.
143. Starkman v. Seroussi, 377 F. Supp. 518, 523 (S.D.N.Y. 1974).
144. *Id.* at 524 (emphasis added).

SRO rules, such as those addressing the suitability and supervision standards, are "sufficiently precise to sustain a cause of action" under the existence of the broad regulatory scheme.[145] A close analogy pertains to SRO rules regulating disclosure obligations of issuers,[146] as opposed to SRO members, since information is likely to have a direct and immediate effect on the market price as an essential element of every transaction.[147]

Putting aside specific judicial tests and lists of factors,[148] the content-based analysis favoring a private right of action in connection with violations of SRO rules appears to be relevant for trading obligations and privileges of market makers. Although often expressed in technical terms, SRO rules governing such obligations and privileges may be classified as measures dealing with "investor protection" rather than as "housekeeping" rules. Furthermore, SRO rules relating to market making form, to use one court's observation in a different context, "an integral part of the transaction."[149] After all, such rules directly address, with the appropriate degree of specificity, the transaction protocol for specific counterparties, sometimes involving conflict-of-interest issues. Other considerations include the notions of "honest" transactions and "fair and orderly" markets maintained by market makers, which are relevant for the broad goals of federal securities law, and, more generally, the blurry line between SEC and SRO regulation.

On the other hand, the content-based analysis of SRO rules implying a private right of action under various provisions of the Exchange Act other than section 10(b) or under the mere existence of the broad regulatory

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145. Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977).

146. While considering a claim under sections 6 and 19 of the Exchange Act that a redemption notice for convertible debentures was inadequate with respect to the NYSE's listing agreement, one court refused to "take the position that . . . violation of an exchange rule cannot under any circumstances give rise to civil liability under the federal acts." Van Gemert v. Boeing Co., 520 F.2d 1373, 1379–81 (2d Cir. 1975). A later decision suggested, with some reservations, the continuing validity of *Van Gemert*, but the court declined to recognize a private right for non-compliance with the NYSE's Company Manual requiring "to disclose general corporate news" under the existence of the broad regulatory scheme because of its broader reach compared to "specific notice requirements." State Teachers Ret. Bd. v. Fluor Corp., 654 F.2d 843, 851–53 (2d Cir. 1981). Furthermore, the court observed that, unlike the facts in *Van Gemert*, the relevant rule "touches upon areas of corporate activity already extensively regulated by Congress and the [SEC]." *Id.* at 852. On the other hand, the court noted that "the debate in this circuit over whether a rule of the Exchange can provide the basis for an implied private right of action is far from over" and that the validity of *Van Gemert* "may be subject to question on the ground that it was handed down without benefit of the Supreme Court's decision in *Cort v. Ash* . . . which established criteria for implying a private right of action." *Id.* at 853 (citing Cort v. Ash, 422 U.S. 66 (1975)).

147. *But see* O'Neill v. Maytag, 339 F.2d 764, 770 (2d Cir. 1964) (rejecting the position that "a suit against a listed company or its officers based on violation of an Exchange rule arises under federal law [under the existence of the broad regulatory scheme]").

148. *See, e.g.*, Hoblin, *supra* note 124, at 268 (contrasting the "substitution" and "public benefit" theories); Wolfson & Russo, *supra* note 124, at 1135–45 (proposing another theory and discussing its applicability to a hypothetical NYSE specialist under several scenarios).

149. *Starkman*, 377 F. Supp. at 524.

scheme established by federal securities law is unlikely to meet the muster of the U.S. Supreme Court's approach to implying a private right of action. In one of the most notable examples of this trend, while addressing a claim hinging on sections 6 and 15A of the Exchange Act,[150] one court concluded that "Congress did not intend to create private rights of action for violation of stock exchange rules [and, similarly] there is no implied right of action for an NASD rule violation."[151] The court analogized this general principle to the contemporary decisions of the U.S. Supreme Court that "reflect[ed] a restrictive approach to implying private rights of action"[152] and indicated that the approach based "on the remedial purposes of [Exchange] Act" and the jurisdictional grant is no longer viable.[153] More specifically, the "investor protection" rationale was considered as foreclosed by the same decisions on the grounds that the mere fact that certain provisions of federal statutes had been motivated by the need to protect certain groups, such as securities brokers' customers or investment advisers' clients, does not necessarily create a private right of action under such provisions.[154] In

150. Jablon v. Dean Witter & Co., 614 F.2d 677, 679–81 (9th Cir. 1980). While a later case, *In re VeriFone Securities Litigation*, 11 F.3d 865, 870 (9th Cir. 1993), cited *Jablon* in connection with a broad principle that a "violation of an exchange rule will not support a private claim," stated that "argument that a violation of those rules violates § 10(b) [of the Exchange Act] or Rule 10b-5 amounts to the same thing," and "declin[ed] to hold that a violation of exchange rules governing disclosure may be imported as a surrogate for straight materiality analysis under § 10(b) [of the Exchange Act] and Rule 10b-5," *id.* at 870, *Jablon* was decided under different sections of the Exchange Act in connection with civil liability of SRO members rather than issuers, as in *VeriFone*, *id.*

151. *Jablon*, 614 F.2d at 679, 681. A subsequent case partially relied on *Jablon* to conclude that "[t]he predominant consideration is whether Congress intended to create . . . a private cause of action [for violations of SRO rules]." Colman v. D.H. Blair & Co., 521 F. Supp. 646, 653 (S.D.N.Y. 1981). The court also articulated four factors suggesting the absence of congressional intent:

> (1) the statutory bases for [SRO rules] . . . do not confer any rights or proscribe any conduct by exchange or association members . . . ; (2) there is apparently no mention of this subject in the legislative history . . . ; (3) there are several express provisions in the [Exchange] Act creating private remedies under specified circumstances, suggesting that the failure to provide for private actions for violations of exchange or association rules was not an oversight . . . ; and, (4) the statutory scheme provides for self-regulation and enforcement by exchanges and associations, suggesting that Congress has selected this as the exclusive means of enforcement . . . .

Id. at 653–54 (internal citations omitted).

152. *Jablon*, 614 F.2d at 679 (citing Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979)).

153. *Id* at 680 (citing *Touche Ross*, 442 U.S. 560; J.I. Case v. Borak, 377 U.S. 426 (1964)).

154. *Id.* at 680–81 (discussing *Transamerica*, 444 U.S. 11; *Touche Ross*, 442 U.S. 560). Interestingly, a later case, although citing *Touche Ross* on the issue of congressional intent but probably departing from it, provided the following analysis of a claim under the existence of the broad regulatory scheme:

> [A] private right of action does exist under the NYSE or NASD rules [because the federal securities statutes] were enacted to protect the public from the abuses which led to the Stock Market Crash of 1929 [and] Congress required the exchanges themselves

contrast to the earlier decisions based on the content analysis,[155] *Jablon* declared that section 27 of the Exchange Act "creates no cause of action of its own force and effect; it imposes no liabilities. The source of plaintiffs' rights must be found, if at all, in the substantive provisions of the [Exchange] Act which they seek to enforce, not in the jurisdictional provision."[156] Reliance of some of the content-analysis cases on the "consisten[cy] with the underlying purposes of the legislative scheme"[157] is also restricted by the subsequent decisions of the U.S. Supreme Court.[158]

On the other hand, violations of SRO rules may still trigger a private right of action if appropriately tied with the concept of fraud. More generally, one court argued that a violation of an SRO rule "may be probative in demonstrating a *course of conduct* amounting to fraud,"[159] and another court was even more specific in pointing out that "violations of [SRO] rules may be probative of plaintiff's claims under the *antifraud provisions of the [federal] securities laws*."[160] Indeed, many cases that employed the content-based analysis—without connecting it to section 10(b) of the SEC of 1934 and Rule 10b-5—still stressed the pivotal importance of fraud,[161] which probably makes any similar claim outside the

> to promulgate rules consistent with the [federal securities statutes]. Congress' sole intent in doing so was to protect the public.

Woods v. Piedmonte, 676 F. Supp. 143, 145–46 (E.D. Mich. 1987).

155. *See supra* note 130.

156. *Jablon*, 614 F.2d at 680 (quoting *Touche Ross*, 442 U.S. at 577).

157. Sacks v. Reynolds Sec., Inc., 593 F.2d 1234, 1243 (D.C. Cir 1978) (quoting Cort v. Ash, 422 U.S. 66, 95 (1975)).

158. *See, e.g.*, Thompson v. Thompson, 484 U.S. 174, 179 (1988) ("The intent of Congress remains the ultimate issue . . . and 'unless this congressional intent can be inferred from the language of the statute, the statutory structure, or some other source, the essential predicate for implication of a private remedy simply does not exist.'") (quoting Nw. Airlines, Inc. v. Transp. Workers, 451 U.S. 77, 94 (1981)); *Touche Ross*, 442 U.S. at 575 ("[In *Cort v. Ash*] the Court did not decide that each of these factors is entitled to equal weight. The central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action.").

159. Newman v. L.F. Rothschild, Unterberg, Towbin, 651 F. Supp. 160, 162–63 (S.D.N.Y. 1986) (emphasis added) (citing Mauriber v. Shearson / Am. Express, Inc., 567 F. Supp. 1231, 1238 (S.D.N.Y. 1983)).

160. Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 443 (E.D. Mich. 1983) (emphasis added); *see also* Architectural League of N.Y. v. Bartos, 404 F. Supp. 304, 314 (S.D.N.Y. 1975) ("Absent facts which demonstrate fraud, independently cognizable under the antifraud provisions of the securities laws, violation of NASD rules does not provide an independent basis for liability.").

161. *See* Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 154, 160 (8th Cir. 1977) (concluding that "courts have not usually recognized a private right of action for violations of exchange rules in the absence of a finding of fraud" in the context of a claim under sections 6, 15A, and 19 of the Exchange Act); Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 142–43 (7th Cir. 1969) (holding that "the facts alleged here are tantamount to fraud . . . thus giving rise to a private civil damage action" in the context of a claim under sections 6 and 19 of the Exchange Act); Carroll v. Bear, Stearns & Co., 416 F. Supp. 998, 1002 (S.D.N.Y. 1976) (holding that "a federal private right of action based on an alleged violation of [SRO] rules will be implied only when there are well-pleaded allegations of fraudulent conduct on the part of the

federal antifraud prohibition redundant.[162] As another illustration, the content-based analysis may easily be read in the context of the federal antifraud prohibition: "The argument may be made that the [broker-customer] agreements . . . constituted a misrepresentation to the plaintiff that they were entirely proper and not in violation of any rule of the Stock Exchange and indeed were part of a scheme or device to evade the Stock Exchange rules and thereby defraud plaintiff . . . ."[163] Furthermore, the importance of specificity of SRO rules emphasized by the content-based analysis interacts with the concept of materiality under the federal antifraud prohibition.[164] Overall, not every violation of an SRO rule constitutes fraud under federal securities law—or even a direct economic injury that does not necessarily come under the umbrella of fraud—but some of such violations do rise to that level. Market participants are unlikely to be concerned about occasional or even routine violations of many SRO rules, but they often effectively rely on specific rules governing the trading process and the corresponding conflicts of interest and are injured by opportunistic non-compliance with such rules.

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defendant" in the context of a claim under the existence of the broad regulatory scheme); *see also* Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977) (stating that "each court that has considered the question has concluded that mere negligent violations of the NYSE or NASD rules are not actionable in federal court; rather, to form the basis for liability in damages, the broker's violations of the rules must be 'tantamount to fraud'"); Mercury Inv. Co. v. A.G. Edwards & Sons, 295 F. Supp. 1160, 1162–63 (S.D. Tex. 1969) (quoting Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 430 (N.D. Cal. 1968) (pointing out that the federal securities statutes "are essentially directed at *fraud* – not against mere negligence or errors of judgment" in the context of a claim under the existence of the broad regulatory scheme); *but see* McMillan v. E. F. Hutton & Co., 399 F. Supp. 1153, 1155 (N.D. Cal. 1975) (stating that, "[w]hen the acts challenged rise to the level of fraud *or some other conduct central to the purpose of the [federal] securities acts*, then a private right of action on the rule is to be implied" in the context of a claim hinging on sections 6, 15A, and 19 of the Exchange Act) (emphasis added) (citing *Buttrey*, 410 F.2d 135).

162. Indeed, one court mounted a serious challenge to the approach in *Buttrey*:

> The logic behind [the "tantamount to fraud"] analysis is difficult to comprehend. If the violation of a particular exchange rule is to give rise to a private right of action, then such a private right of action would seem to exist for all violations of the rule and regardless of whether the specific conduct involved appears to be fraudulent.

Zagari v. Dean Witter & Co., No. C-74-2007, 1976 U.S. Dist. LEXIS 13032, at *21 (N.D. Cal. Sept. 27, 1976) (citing Hoblin, *supra* note 124, at 267). This approach also offers some support to the redundancy of claims outside the federal antifraud prohibition.

163. Starkman v. Seroussi, 377 F. Supp. 518, 524 (S.D.N.Y. 1974).

164. *See* BROMBERG & LOWENFELS, *supra* note 124, § 7:25 (discussing the link between specificity and materiality); *see also id.* § 7:432 ("[R]eliance may be presumed from materiality [in the context of a private right of action under the federal antifraud prohibition]. There is some judicial acceptance of this view, and it makes sense; once the latter is shown, the reasonably prudent investor would be expected to rely.") (footnote omitted).

B. THE SHINGLE THEORY

As another potential approach, the shingle theory addresses certain implied representations deemed to be made by broker-dealers. One complication is that the reach of this theory beyond a broker-customer or a similar agency relationship is quite uncertain, as different commentators have given conflicting descriptions of the shingle theory.[165] This theoretical dispersion and the corresponding uncertainty regarding the terms "customer" and "public investor," as opposed to *any* counterparty, are evident from descriptions given by cases and administrative adjudications.[166] The SEC itself recently articulated the position that "[t]he shingle theory 'is not predicated upon the existence of a fiduciary obligation' and applies to all broker-dealer transactions 'including those engaged in as 'dealer' or principal.'"[167] The regulatory agency also maintained that its "formal adjudicatory decisions interpreting the shingle

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165. *Compare* Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 518 (1948) ("This [theory] has nothing to do with any agency obligation. . . . [E]ven a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public."), *with* BROMBERG & LOWENFELS, *supra* note 124, § 13:79 ("The 'shingle theory' is based in part on the theory that a broker-dealer has, as a matter of federal law, a fiduciary relation to the customer."); *and with* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1295–96 (1995) ("The shingle theory . . . embodies the notion that broker-dealers impliedly represent that they will deal fairly, but this implied representation is really a legal fiction. At bottom, the shingle theory rests on the premise that a broker-dealer has fiduciary obligations to its customers.").

166. *Compare* Univ. Hill Found. v. Goldman, Sachs & Co., 422 F. Supp. 879, 898 n.17 (S.D.N.Y. 1976) ("Under [the shingle theory], when a broker-dealer hangs out his shingle he implicitly represents that he will deal fairly with the public.") (citing 3 LOUIS LOSS, SECURITIES REGULATION 1483 (2d ed. 1961)), *and* Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968) ("It is now well established that a securities dealer who does business with the public, even at arm's length, impliedly represents that he will deal fairly with the public.") (citing 3 LOSS, *supra*, at 1483), *and* Blinder, Exchange Act Release No. 34,095, 52 SEC Docket 1145, 1155 (Aug. 26, 1992) ("A broker-dealer, by holding itself out as a securities professional with special knowledge and ability, impliedly represents that it will deal fairly, honestly, and in accordance with industry standards with the public investor."), *with* Bissell v. Merrill Lynch & Co., 937 F. Supp. 237, 247 (S.D.N.Y. 1996), *aff'd*, 157 F.3d 138 (2d Cir. 1998) ("[C]laim[s] [under] the 'shingle' theory [must] arise from affairs entrusted to the broker as a fiduciary, agent, or trustee."), *and* SEC v. Great Lakes Equities Co., No. 89-CV-70601, 1990 U.S. Dist. LEXIS 19819, at *16 (E.D. Mich. Sept. 4, 1990) ("When a broker-dealer hangs out a professional shingle it impliedly represents that it will deal with customers thoroughly, honestly and in accordance with industry standards."), *and* Cea, Admin. Proc. File No. 3-785, 1968 SEC LEXIS 2729, at *77 (Hearing Examiner Mar. 11, 1968) (initial decision) ("The [SEC] has manifested its serious concern with the fiduciary aspect of the dealer's role and this has been illustrated in its 'shingle theory' under which a broker-dealer is held to make an implied representation that when he hangs out his 'shingle,' he will deal with his customer fairly and honestly."). For a discussion of the evolution of the shingle theory and the implications of the key judicial decisions under federal securities law, see 8 LOUIS LOSS ET AL., SECURITIES REGULATION ch. 9(C)(1)(a) (4th ed. 2006 & Supp. 2012).

167. Brief for the Securities and Exchange Commission, Amicus Curiae, on Issues Addressed at 23–24, Capital Mgmt. Select Fund Ltd. v. Bennett, 670 F.3d 194 (2d Cir. 2012) (No. 08-6166-cv), 2009 U.S. 2nd Cir. Briefs LEXIS 56, at *30 (quoting EZRA WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS 171 (1965)).

theory, like the [SEC's] other interpretations of the federal securities laws, are entitled to deference in the courts."[168] Yet, overall, there is some ambiguity whether this open-ended theory of liability covers the function of providing liquidity as such.

The shingle theory has its origins in administrative adjudications of the SEC on excessive markups in the context of a broker-customer relationship,[169] and this theory relies on the broad principle that "[t]he law of fraud knows no difference between express representation on the one hand and implied misrepresentation or concealment on the other."[170] With the focus on broker-dealer practices, the SEC

> applied the shingle theory in a variety of other instances . . . recogniz[ing] that without appropriate disclosure it is a fraudulent practice to sell securities at a market price which is materially affected by artificial restrictions and stimulations caused by the seller's own activities, to sell oil royalties at prices unrelated to the reasonable value of estimated oil recoverable from the underlying tract, to execute transactions not authorized by the customer, to sell securities that are subject to a lien, to fail to execute orders or deliver securities promptly, or to accept customers' funds while insolvent.[171]

Furthermore, from the standpoint of a private right of action in the context of the federal antifraud prohibition, it was observed that,

> [a]s with all allegations of fraud under § 10(b) [of the Exchange Act], a plaintiff alleging a 'shingle theory' . . . must present evidence to satisfy four elements: (1) a misrepresentation or omission of a material fact; (2) made with scienter; (3) upon which the plaintiff justifiably relied; and (4) which proximately caused the plaintiff's damages.[172]

Another consideration is that specific disclosures may counter the assumption of implied representations.[173]

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168. *Id.* at 24, *31.

169. *See* Charles Hughes & Co., Exchange Act Release No. 3464, 13 S.E.C. 676 (July 19, 1943), *aff'd*, Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943); Trost & Co., Exchange Act Release No. 3345, 12 S.E.C. 531 (Dec. 11, 1942); Duker & Duker, Exchange Act Release No. 2350, 6 S.E.C. 386 (Dec. 19, 1939).

170. *Charles Hughes*, 139 F.2d. at 437.

171. Mac Robbins & Co., Exchange Act Release No. 6846, 41 S.E.C. 116, 119 (July 11, 1962) (footnotes omitted); *see also* Starr v. Georgeson S'holder, Inc., 412 F.3d 103, 111 (3d Cir. 2005) ("Although the shingle theory has traditionally been applied to broker-dealers who sell securities at a markup, we see no reason not to apply the theory to exchange agents . . . that convert stock certificates for a fee.") (footnote omitted); Gruntal & Co. v. San Diego Bancorp, 901 F. Supp. 607, 619 n.12 (S.D.N.Y. 1995) ("[T]he shingle theory has been employed as an additional means of ensuring that brokers have a good faith basis for their recommendations to customers.").

172. Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1034 (2d Cir. 1997).

173. *See, e.g.*, Capital Mgmt. Select Fund Ltd. v. Bennett, 670 F.3d 194, 210 (2d Cir. 2012) ("[When specific] disclosures [are] made in conjunction with a bargained-for agreement between sophisticated counter-parties that could be expected to understand the relevant benefits and risks . . . there is no liability under the shingle theory.").

While the SEC has endorsed several variations of the shingle theory in its administrative adjudications—without using the word "shingle" itself—with respect to market-making activities of specialists with both dealer and agent functions,[174] the author is not aware of any case explicitly recognizing such an application. On the contrary, one court specifically stated that "specialists do not actively solicit customers, and unlike securities dealers, do not 'hang[] out [their] professional shingle,'"[175] thus hinting at the necessity of a customer-broker relationship. Also with respect to a specialist, another court based its decision on the precedent interpreted as a "reject[ion] [of] the equivalent of the shingle theory" and a requirement of "a statement or conduct."[176] The court also dismissed the argument advanced by the plaintiffs that "by hanging out its professional shingle as a specialist, [the defendant] *impliedly represented to plaintiffs that it would follow all applicable rules* and that it deceived plaintiffs when it engaged in certain actions which violated those rules,"[177] stating that the plaintiffs' "expectations that [the defendant specialist] would follow all applicable rules [must be] based on statements or conduct by [the defendant]."[178] In the context of the shingle theory, one court also declined to recognize the existence of an inherent duty of best execution owed by a specialist, despite

174. *See* Fleet Specialist, Inc., Exchange Act Release No. 49,499, 82 SEC Docket 1895, 1895 (Mar. 30, 2004) (arguing that NYSE specialists make "implied representations to public customers that they [are] limiting dealer transactions to those reasonably necessary to maintain a fair and orderly market"); Albert Fried & Co., Exchange Act Release No. 15,239, 16 SEC Docket 100, 105 (Nov. 3, 1978) (arguing that "the [NYSE] specialist impliedly represents that he will not take advantage of his unique position and his customers' ignorance of market conditions nor exploit that ignorance to extract unreasonable profits"). On the other hand, the *Fleet* formula might be read as a broader interpretation of implied representations made to potential counterparties in the context of specific trading rules, while the *Albert Fried* formula stresses the nature of the underlying relationship with a reference to the original focus of the shingle theory on "unreasonable" profits.

175. United States v. Finnerty, No. 05 Cr. 393, 2006 U.S. Dist. LEXIS 72119, at *19 (S.D.N.Y. Oct. 2, 2006) (alterations in original) (quoting Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 192 (2d Cir. 1998)).

176. Last Atlantis Capital LLC v. AGS Specialist Partners, 819 F. Supp. 2d 708, 715 (N.D. Ill. 2010) (following United States v. Finnerty, 533 F.3d 143 (2d Cir. 2008)); *see also* Last Atlantis Capital LLC v. ASG Specialist Partners, 749 F. Supp. 2d 828, 831 (N.D. Ill. 2010) (reiterating the position that the "defendants, as specialists, were different than other broker-dealers and did not fall under the 'shingle theory'"). The defendant specialists also asserted that, "to the extent the 'shingle theory' has any validity, it only applies to 'affairs entrusted to the broker as a fiduciary, agent, or trustee of the plaintiff'" and that they "were not acting as fiduciaries, agents or trustees." Market Maker Defendants' Reply at 10, Last Atlantis Capital LLC v. Chi. Bd. Options Exch., Inc., 455 F. Supp. 2d 788 (N.D. Ill. 2006) (No. 04 C 397), 2006 U.S. Dist. Ct. Motions LEXIS 35412, at *10 (quoting Bissell v. Merrill Lynch & Co., 937 F. Supp. 237, 247 (S.D.N.Y. 1996)). However, the court neither relied on *Bissell* nor examined the dual agent-dealer role of specialists in the context of the shingle theory.

177. *Last Atlantis*, 819 F. Supp. 2d at 713 (emphasis added).

178. *Id.* at 717.

its dual agent-dealer role, and stated that an express—rather than implied—representation is required.[179]

C. EXPRESS AND IMPLIED REPRESENTATIONS

Another approach addresses express and implied representations made by market makers with respect to their trading obligations and privileges in the context of the federal antifraud prohibition. This approach complements the shingle theory, given the latter's doctrinal inconsistencies and potential restrictions on the nature of the underlying relationship between counterparties. The logic of implied misrepresentations is equally applicable to "pure" arm's-length transactions, and, furthermore, it may be approached from the standpoint of specific rules and regulations rather than the hazier notion of "fair dealing."

Regarding express representations made by market makers, the relevant inquiry is whether they are actionable in terms of their specificity. One decision characterized the defendant specialist's statement regarding its obligation to maintain "a fair and orderly market" as "non-actionable puffery,"[180] although specific numerical targets and other prior guidance provided by trading venues,[181] perhaps even in the form of SRO case-by-case proceedings,[182] may reverse this conclusion.[183] Similarly, the promise

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179. *Last Atlantis*, 749 F. Supp. 2d at 832. According to the plaintiffs, the duty of best execution existed independently of various SRO rules applicable to the defendant specialists. Plaintiffs' Memorandum of Law in Opposition to the Specialist Defendants' Motion to Dismiss the Consolidated Complaint Pursuant to Fed. R. Civ. P. 9(b) & 12(b)(6) at 12, Last Atlantis Capital LLC v. Chi. Bd. Options Exch., Inc., 455 F. Supp. 2d 788 (N.D. Ill. 2006) (No. 04 C 397), 2006 U.S. Dist. Ct. Motions LEXIS 35415, at *12.

180. *Last Atlantis*, 749 F. Supp. 2d at 835. The SEC has provided the following definition of "fair and orderly": "A 'fair' market is free from manipulative and deceptive practices, and affords no undue advantage to any participant. An 'orderly' market is characterized by regular, reliable operation, with price continuity and depth, in which price movements are accompanied by appropriate volume, and unreasonable price variations between sales are avoided." Fleet Specialist, Inc., Exchange Act Release No. 49,499, 82 SEC Docket 1895, 1895–96 (Mar. 30, 2004).

181. For instance, a recent rule adopted by NASDAQ, which addressed the issue of stub quotes, refers to a market maker's obligation to maintain "fairly and orderly markets" in the context of specific numerical targets. Notice of Filing of a Proposed Rule Change by NASDAQ Stock Market LLC To Enhance Quotation Requirements for Market Makers, Exchange Act Release No. 62,950, 75 Fed. Reg. 59,311, 59,312–13 (Sept. 20, 2010). The SEC's order approving this rule, together with similar rules of other trading venues, similarly pointed out that such measures "should promote fair and orderly markets." SEC's Release on the Quotation Standards for Market Makers, *supra* note 3, at 69,485.

182. As an example, the NYSE has addressed the meaning of "fair and orderly" in the context of specific situations in disciplinary proceedings against its specialists. *See, e.g.*, Veenstra, Exchange Hearing Panel Decision 07-65, 2007 NYSE Disc. Action LEXIS 64 (N.Y. Stock Exch. May 3, 2007); Henderson Bros., Inc., Exchange Hearing Panel Decision 99-148, 1999 NYSE Disc. Action LEXIS 121 (N.Y. Stock Exch. Nov. 3, 1999); Bocklet, Exchange Hearing Panel Decision 99-115, 1999 NYSE Disc. Action LEXIS 92 (N.Y. Stock Exch. Sept. 7, 1999).

183. Interestingly, an early decision suggested that the jury instruction on "the duty of maintaining an orderly market" owed by exchange specialists, which was based of their function

of complying with "laws, rules and ethical principles that govern us" was held to be non-actionable.[184] Broad—and arguably vague—statements about liquidity, efficiency, and competitiveness were also held non-actionable.[185] On the other hand, that same court concluded that "the promise of 'best execution' is a defined, specific concept in the securities context."[186] Given such judicial pronouncements, express representations in the form of cautionary statements made by market makers to potential counterparties perhaps may serve as an additional shield from liability, although such statements are likely to attract the attention of the SEC and trading venues. Yet, overall, from the standpoint of practicality, a lengthy duplication of numbers-heavy trading obligations and privileges of market makers in express representations, including disclosure documents, seems problematic, although there could be an SRO or SEC rule requiring a special disclosure incorporating such terms by reference.

A much broader reach of a private right of action depends on the actionability of implied representations deemed to be made by market makers. One court left some room for this approach in the context of trading rules specifically applicable to market-making activities.[187] Drawing support from a context other than market making and under a different provision of the Exchange Act, another court stated that several broker-customer agreements "constituted a misrepresentation to the plaintiff that they were entirely proper and not in violation of any rule of the Stock Exchange."[188] This language corresponds to the logic of implied representations and might be taken even further to cover arm's-length transactions. Furthermore, one recent decision held—with a specific reference to subsection (b) of Rule 10b-5—that "the implied misrepresentation that [an introducing broker's employee] made by engaging in late trading [contrary to the prohibition on late trading in mutual fund prospectuses, the clearing broker's instruction manual, and SEC regulation] . . . violate[s] Rule 10b-5 and Section 10(b) [of the

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of "'maintain[ing] a fair and orderly market" referenced in section 11(b) of the Exchange Act itself, may be sufficiently specific in the criminal context. United States v. Re, 336 F.2d 306, 314–15 (2d Cir. 1964). By contrast, a recent administrative adjudication stated that section 11(b) of the Exchange Act and the corresponding SEC rule, which employ the "fair and orderly" language, "do[] not place any requirements directly on specialists, and thus cannot be violated by specialists." Finnerty, Initial Decision Release No. 381, 96 SEC Docket 1098, 1034–35 (ALJ July 13, 2009). On the other hand, section 11(b) of the Exchange Act was amended after 1964 in a way that deemphasized direct statutory regulation of exchange specialists. *Compare* Securities Exchange Act of 1934, Pub. L. No. 73-291, § 11(b), 48 Stat. 881, 891, *with* Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 6(2), 89 Stat. 97, 111.

184. *Last Atlantis*, 749 F. Supp. 2d at 838.
185. *See supra* note 117.
186. *Last Atlantis*, 749 F. Supp. 2d at 834.
187. Schonholtz v. Am. Stock Exch. Inc., 505 F.2d 699, 701 (2d Cir. 1974).
188. Starkman v. Seroussi, 377 F. Supp. 518, 524 (S.D.N.Y. 1974).

Exchange Act]."[189] Although *VanCook* distinguished *Finnerty* by stating that the defendant "did not merely violate an NYSE rule that customers might or might not have expected him to follow; he violated the mutual funds' own express wishes, as set out in their prospectuses,"[190] the difference from the perspective of mutual fund *investors* is not as apparent.

D. The Fraud-on-the-Market Doctrine

Another potential theory of liability in the context of the federal antifraud prohibition is the fraud-on-the-market doctrine, which deals with the impact of misrepresentations and certain omissions on the market price.[191] In fact, this doctrine reaches beyond fundamental information about underlying companies: "Just as information about a specific security is reflected in the price of that security, so too is information about the manner in which transactions would be completed reflected in the price of securities generally."[192] The reach of the fraud-on-the-market doctrine was also recognized in a related case, in which the actions of an options exchange, a clearinghouse, and options market makers allegedly led to inflated prices: "A successful scheme to charge excessive prices across the

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189. VanCook v. SEC, 653 F.3d 130, 140–41 (2d Cir. 2011); *see also* SEC v. Pentagon Capital Mgmt. PLC, 844 F. Supp. 2d 377, 419 (S.D.N.Y. 2012) (arguing that the defendants' "submission of late-trade orders constituted a fraudulent device and an implied misrepresentation in violation of Rule 10b-5(b) because it suggested that final orders were received before the funds' 4:00 p.m. pricing time, as reflected in the applicable [mutual fund] prospectus language, when, in fact, the trading decisions were made after 4:00 p.m."). Both *VanCook* and *Pentagon* also found the respective defendants liable on the basis on subsections (a) and (c) of Rule 10b-5. *VanCook*, 653 F.3d at 138; *Pentagon*, 844 F. Supp. 2d at 422. Although one of these cases cautioned against analogizing private and SEC actions under *Janus Capital Group, Inc. v. First Derivative Traders*, 131 U.S. 2296 (2011), in the context of subsection (b), *Pentagon*, 844 F. Supp. 2d at 421–22, *Janus* focused on the distinction between primary and secondary violators and the meaning of the word "make" in connection with express statements. These issues would be largely irrelevant in a hypothetical involving a market maker's implied representations. Furthermore, while drawing any conclusions from SEC-initiated lawsuits for private lawsuits in connection with the federal antifraud prohibition is limited by the fact that the regulatory agency "does not need to prove investor reliance, loss causation, or damages", the SEC still has to show "a material misrepresentation or a material omission as to which [the defendant] had a duty to speak, or . . . a fraudulent device; with scienter." SEC v. BankCorp, Ltd., 195 F. Supp. 2d 475, 490–91 (S.D.N.Y. 2002). This requirement appears to be relevant for private lawsuits. As stated by another court, "Judicial decisions defining the conduct necessary to constitute a Rule 10b-5 *violation* do apply to actions by the SEC as well as private parties." Rana Research, Inc., 8 F.3d 1358, 1364 (9th Cir. 1993); *see also* Aaron v. SEC, 446 U.S. 680, 691 (1980) ("[S]cienter is an element of a violation of § 10(b) [of the Exchange Act] and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought.").

190. *VanCook*, 653 F.3d at 140.

191. For a brief survey of the fraud-on-the-market doctrine by the author, see Stanislav Dolgopolov, *Risks and Hedges of Providing Liquidity in Complex Securities: The Impact of Insider Trading on Options Market Makers*, 15 FORDHAM J. CORP. & FIN. L. 387, 428–31 (2010).

192. *In re* NYSE Specialists Sec. Litig., 405 F. Supp. 2d 281, 318–19 (S.D.N.Y. 2005). In a later proceeding, the same court once again asserted that the fraud-on-the-market doctrine may be applicable, as the plaintiffs were presumed to rely "on an efficient and fair market." *In re* NYSE Specialists Sec. Litig., 260 F.R.D. 55, 77–79 (S.D.N.Y. 2009).

market and not to disclose that fact affects the integrity of market prices as surely as any scheme to spread false information about corporate prospects that affects the price only of a single issuer's stock."[193]

On the other hand, the problem with fitting this doctrine lies in the difficulty of tracing a link to trading obligations and privileges of market makers, as they are more likely to determine terms of transactions around some "fundamental" price rather than that price itself. In the similar context of civil liability of trading venues, one court concluded that "the fraud-on-the-market doctrine does not apply [when] plaintiffs do not seek recovery for a loss caused by the inflation of the price of an underlying security due to the dissemination of misleading information into the marketplace."[194] Another judicial pronouncement also addressed potential complications with demonstrating a causal link necessary for the application of the fraud-on-the-market doctrine to a market maker: "[T]he *Basic Inc.* presumption of reliance arises where a civil plaintiff can point to 'public, material misrepresentations' that impugned the integrity of a stock's market price. Here, the government has attributed to [the defendant specialist] nothing that . . . affected the price of any stock . . . ."[195]

E. THE REACH OF FIDUCIARY DUTIES

Generally, the federal courts have been very skeptical about imposing a broad fiduciary duty on market makers—including specialists, despite their agency-like functions—with respect to other market participants, and this concept is problematic, if not openly impractical, on both doctrinal and public policy levels.[196] A typical statement on the application of the fiduciary standard—in the context of the NYSE's specialist system—maintained that, "[w]hile specialists may have an obligation to maintain the market economy, they do not owe the public a fiduciary duty [and] have no loyalty to buyers or sellers, as they execute orders for both, and further, they often do not know the identity of those for whom they execute buys and sells."[197] On the other hand, one court mentioned in a dictum that the market maker status—the role that the defendant in fact had not played—

193. Spicer v. Chi. Bd. Options Exch., Inc., No. 88 C 2139, 1990 U.S. Dist. LEXIS 14469, at *35 (N.D. Ill. Oct. 24, 1990).

194. Last Atlantis Capital LLC v. Chi. Bd. Options Exch., 455 F. Supp. 2d 788, 800–01 (2006); *see also* Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 175–76 (2d Cir. 2001) (stating that the fraud-on-the-market doctrine does not apply to claims for a broker's breaches of the duty of best execution because they "do not involve an omission or misrepresentation that affected the value of a security in an efficient market").

195. United States v. Finnerty, 533 F.3d 143, 151 (2d Cir. 2008) (internal citation omitted) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988)).

196. *See generally* Dolgopolov, *supra* note 35.

197. United States v. Hunt, No. 05 Cr. 395, 2006 U.S. Dist. LEXIS 64887, at *16–17 (S.D.N.Y. Sept. 6, 2006).

"implicate[s] broader fiduciary duties,"[198] and one recent decision left some room for "a claim for breach of fiduciary duty based on an agency theory" with respect to options specialists with both agent and dealer functions.[199] In any instance, a fiduciary relation, by definition, implies more than just formalistic compliance with various trading rules, although non-compliance with such rules may serve as proof of a violation of one's fiduciary duty in the context of the federal antifraud prohibition.[200]

F. PUTTING THE PIECES OF THE PUZZLE TOGETHER

The most recent strain of the case law directly dealing with a private right of action for violations of trading obligations and abuses of trading privileges of market makers—exemplified by *Finnerty* and *Last Atlantis*—took the path of a very restrictive interpretation of "statement or conduct" that approximates the necessity of demonstrating an explicit statement addressed to other market participants and precludes the applicability of implied representations or, alternatively, many conduct-based approaches in the context of the federal antifraud prohibition. Another characteristic of this line of cases is its near-blanket rejection of civil liability for violations of SRO rules rather than treating such violations as a trigger for further inquiry. Therefore, the fundamental question pertains to the reach of a private right of action *beyond* express representations and disclaimers made by such market participants as a potential means of addressing their opportunistic behavior.

In the author's view, creating an appearance or "false impression"[201]—by the virtue of functioning as a formal market maker—that transactions are to be consummated in accordance with the applicable SRO and other rules that define specific parameters of such transactions, especially if non-compliance with such rules is not disclosed, could be classified as deceptive conduct and/or implied misrepresentations within the reach of the antifraud prohibition under federal securities law, for which a private right of action is readily available.[202] Furthermore, this approach should have a more

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198. Arst v. Stifel, Nicolaus & Co., 86 F.3d 973, 980 (10th Cir. 1996).

199. Last Atlantis Capital LLC v. ASG Specialist Partners, No. 04 C 397, 2011 U.S. Dist. LEXIS 60380, at *10 (N.D. Ill. June 6, 2011).

200. Of course, a mere breach of fiduciary duty without "any deception, misrepresentation, or nondisclosure" does not give rise to liability under section 10(b) of the Exchange Act and Rule 10b-5. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).

201. *Finnerty* used the concept of "false impression," but it was held to be non-applicable to the facts under consideration. United States v. Finnerty, 533 F.3d 143, 148 (2d Cir. 2008)

202. One limitation is that non-consummated transactions in violation of trading obligations of market makers are likely to be outside the purview of the federal antifraud prohibition under *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). A potential avenue for addressing such claims is the state law of contracts—especially if the market maker in question also performs brokerage functions—but there are certain limitations as well. *See* Gurfein v. Ameritrade, Inc., 312 F. App'x 410, 413–14 (2d Cir. 2009) (concluding that a mere acknowledgement that transactions are to be governed by the applicable SRO rules in an agreement between a brokerage

general applicability, given the limitations of the shingle theory, the fraud-on-the-market doctrine, and the reach of fiduciary duties. More generally, putting away the distinction between market makers and other market participants, it is problematic to expect a potential counterparty in an impersonal market to make an express representation as to the adherence to certain or even *all* rules relating to the trading process and determining material characteristics of the transaction in question—especially if such rules are publicly available and adopted or vetted by regulators. As one case insightfully observed, market makers give "the perception [that they are] performing their duties as directed by the [SRO] and SEC rules."[203] The requirement of an express representation may be also impractical if such rules are multilayered and complex. Another consideration is that conscious non-compliance with certain trading rules by market makers often has a wealth redistribution effect vis-à-vis other market participants.

A near-blanket ban on a private right of action in connection with violations of SRO rules, as adopted by several courts, is perhaps misguided. Some of SRO rules applicable to market makers define the nature of the trading process and, accordingly, some of the essential characteristics of individual transactions. In other words, such rules go beyond the self-regulatory maintenance of professional ethical standards. One approach is to re-characterize violations of SRO rules not as harmful acts per se but as a part of deceptive conduct and/or implied misrepresentations within the reach of the federal antifraud prohibition.[204] This approach would neither open the door too wide—for instance, for violations caused by mere negligence or failures of the trading infrastructure itself—nor immunize certain types of securities fraud under the existing regulatory framework. The reach of the federal antifraud prohibition is especially relevant when

firm and its customer "does not incorporate into the contract the rules and regulations of those outside regulatory bodies [or] impose any contractual obligations on [the brokerage firm]"); Appert v. Morgan Stanley Dean Witter, Inc., No. 08-CV-7130, 2009 U.S. Dist. LEXIS 104594, at *10 (N.D. Ill. Nov. 6, 2009) (finding that a similar language in an agreement between a brokerage firm and its customer "does not appear to contractually obligate [the brokerage firm] to abide be [sic] NASD and NASDAQ rules"). An even tighter interpretation adopts the position that "the ability to enforce such [SRO] regulations through a state law contract action . . . would fail even if the plaintiffs could have produced supportive [contractual] language." *Appert*, 2009 U.S. Dist. LEXIS 104594, at *9 (interpreting Kurz v. Fidelity Mgmt. & Research Co., 556 F.3d 639 (7th Cir. 2009)).

203. United States v. Finnerty, No. 05 Cr. 393, 2006 U.S. Dist. LEXIS 72119, at *15 (S.D.N.Y. Oct. 2, 2006)

204. This position has been suggested by several courts in the context of market making activities. *See* United States v. Hunt, No. 05 Cr. 395, 2006 U.S. Dist. LEXIS 64887, at *21–22 (S.D.N.Y. Sept. 6, 2006); Mkt. St. Ltd. Partners v. Englander Capital Corp., No. 92 Civ. 7434, 1993 U.S. Dist. LEXIS 8065, at *35 (S.D.N.Y. June 14, 1993); *see also* Government's Memorandum of Law in Opposition to Defendants' Motion to Dismiss the Indictment at 21–22, United States v. Bongiorno, 05 Cr. 390, 2006 U.S. Dist. LEXIS 24830 (S.D.N.Y. May 1, 2006), 2006 U.S. Dist. Ct. Motions LEXIS 4325, at *21–22 (analyzing the connection between violations of SRO rules and manifestations of fraud and stating that violations of "NYSE trading rules [was] not the sole basis for the charges" in the NYSE specialists' controversy).

such violations remain undetected, illustrated by the alleged misconduct of the NYSE specialists, as opposed to a flat-out refusal to follow a specific rule by not entering into a transaction. While a market maker's transaction is likely to be transparent in terms of its specificity and correspond to economic reality even when certain SRO rules are violated, that transaction's alternative terms may not be transparent.[205] Furthermore, even broadly worded SRO rules applicable to market makers may potentially have teeth in terms of their specificity in some situations.[206]

A recent appellate decision also offers a powerful argument supporting a private right of action in the context of SRO rules:

> NASD's rules themselves are part of the apparatus of federal securities regulation. NASD is a "self-regulatory organization"; its requirements are adopted by notice-and-comment rulemaking (not by the mechanism of contract, which requires consent by all affected persons) and are subject to review and change by the SEC. Some of these rules are the source of legal duties, and not revealing to investors a failure to comply with one's duties about transactions in their securities can lead to liability under the [federal] securities acts.[207]

An even more recent appellate decision specifically reconsidered its own precedent and articulated the position that a market maker's non-compliance with trading rules constitutes "deceptive conduct":

> [A]s the [SEC] notes, we decided *Finnerty* before the SEC had issued any "interpretation to which *Chevron* deference was required regarding the deceptive nature of interpositioning by an NYSE specialist." The Commission has since issued a formal adjudicatory decision on the subject, concluding that, inter alia, by becoming a specialist "Finnerty expressly represented to the NYSE that he would comply with its rules" and that "[b]y engaging in undisclosed interpositioning and trading ahead in contravention of [his] duties and representations . . . Finnerty engaged

205. *See also id.* at 15–16, *15–16 ("The specialist's ability to unilaterally determine the specific price of every executed trade demonstrates that he has discretion – indeed control – over the most important aspect of a securities trade, the price.").

206. Although decided in the context of an SRO disciplinary action against one of its members, some guidance is offered by *Shultz v. SEC*, 614 F.2d 561 (7th Cir. 1980), in which the "charges were based on a series of circular transactions engaged in by [several] market makers [that] left each in exactly the same position he had been in prior to the trades," *id.* at 564. In these circumstances, the SRO rule requiring market makers' transactions to be "reasonably calculated to contribute to the maintenance of a fair and orderly market," *id.* at 571, was deemed to give "sufficiently definite warning as to the proscribed conduct when measured by common understanding and practices," *id.* (quoting United States v. Petrillo, 332 U.S. 1, 8 (1947)). In a later decision, however, the same court characterized the same SRO rule as "a vague, 'catch-all' standard" with respect to a private right of action in the circumstances involving a market crash. Spicer v. Chi. Bd. of Options Exch., Inc., 977 F.2d 255, 265 (7th Cir. 1992).

207. *Kurz*, 556 F.3d at 641–42.

> in deceptive conduct." . . . This later interpretation of Rule 10b-5 "trumps" our prior interpretation in *Finnerty*.[208]

The articulation of this principle specifically in the context of SRO rules was further reinforced by the pronouncement that "'[c]onduct itself can be deceptive,' and liability under Section 10(b) [of the Exchange Act] and Rule 10b-5 does not require 'a specific oral or written statement.'"[209]

Expanding the availability a private right of action even further, a creative argument based on a presumption of the integrity of *the trading process* as compliance with all relevant rules—similar to the presumption of "the integrity of the market price" as the cornerstone of the fraud-on-the-market doctrine[210]—perhaps could resonate with the federal courts in order to address the problem of violations of trading obligations and abuses of trading privileges of market makers and avoid the necessity of proving reliance on specific rules. After all, market participants' reliance on the adherence to applicable trading rules by market makers does not necessarily imply the comprehension of every single rule by a potential plaintiff. In any instance, demonstrating reliance is not an insurmountable obstacle,[211] and trading algorithms themselves may potentially serve as evidence.

III. THE SIGNIFICANCE OF THE CHANGING ECONOMICS AND INSTITUTIONAL FRAMEWORK OF PROVIDING LIQUIDITY IN SECURITIES MARKETS AND RELATED REGULATORY DEBATES

A discussion of a potential private right of action with respect to trading obligations and privileges of market makers also requires analyzing the changing economics and institutional framework of providing liquidity and

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208. VanCook v. SEC, 653 F.3d 130, 140 n.8 (2d Cir. 2011) (quoting Finnerty, Securities Act Release No. 9033, Exchange Act Release No. 59,998, 95 SEC Docket 2534, 2535 (May 28, 2009)). The administrative adjudication specifically based its demonstration of deceptive conduct on the assertion that "absent disclosure to the contrary by [the specialist], those who submitted orders executed by him . . . were entitled to believe that he would execute their orders in a manner consistent with [his] duties [including those set by the applicable NYSE rules]." *Finnerty*, 95 SEC Docket at 2535. Still, this decision of the SEC was a settlement "not binding on any other person or entity." *Id.* at 2534 n.1. The judicial pronouncement in *VanCook* is also relevant for the SEC's endorsement of the related but distinct theory of liability based on implied representations with respect to an exchange specialist, which, however, was also settlement-based. *See, e.g.*, Fleet Specialist, Inc., Exchange Act Release No. 49,499, 82 SEC Docket 1895, 1895 (Mar. 30, 2004). On the other hand, the U.S. Supreme Court has "expressed skepticism over the degree to which the SEC should receive deference regarding the private right of action." Janus Capital Grp., Inc. v. First Derivative Traders, 131 U.S. 2296, 2302 n.8 (2011) (citing Piper v. Chris–Craft Indus., Inc., 430 U.S. 1, 41 n.27 (1977)).

209. *VanCook*, 653 F.3d at 141 (quoting Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008)). Interestingly, the same passage was quoted in *United States v. Finnerty*, 533 F.3d 143, 148 (2d Cir. 2008), but with a different outcome.

210. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).

211. *See, e.g.*, Last Atlantis Capital LLC v. AGS Specialist Partners, 819 F. Supp. 2d. 708, 716 (N.D. Ill. 2010).

related regulatory debates. One factor pertains to the changes that have already taken place, such as adjustments in the status of market makers and the balance of their trading obligations and privileges. Another factor concerns the rise of high-frequency trading and its role in providing liquidity in an informal fashion, as well as conflicts between certain high-frequency traders and formal market makers. Finally, kaleidoscope-like changes in securities markets have produced heated regulatory debates on trading obligations and privileges of market makers.

A. THE PROCESS OF "DEAGENTIZATION" OF MARKET MAKING AND OTHER CHANGES IN THE BALANCE OF TRADING OBLIGATIONS AND PRIVILEGES

The regulatory framework applicable to market makers has already undergone a number of key changes in recent years. One notable development is that some trading venues are abandoning the model in which formal market makers serve as agents or quasi-agents. This development is exemplified by the decision of the NYSE not to charge its "designated market makers," specialists' replacements, with "the specialist's agency responsibilities with respect to orders on the Display Book,"[212] and "supplemental liquidity providers," an additional class of liquidity providers on the NYSE, similarly do not "act on an agency basis."[213] The fact that the specialist, i.e., agent-dealer, model of market making is supplanted by the dealer-only model makes irrelevant certain trading obligations related to agency functions, such as order matching procedures. As some of the cases directed against market makers addressed

212. Order Approving a Proposed Rule Change by New York Stock Exchange LLC To Create a New NYSE Market Model, Exchange Act Release No. 58,845, 73 Fed. Reg. 64,379, 64,389 (Oct. 24, 2008). For similar measures adopted by other trading venues, see Order Approving a Rule Change by American Stock Exchange LLC To Eliminate Options Specialists' Agency Responsibilities and Establish Amex Book Clerks, Exchange Act Release No. 56,804, 72 Fed. Reg. 66,002 (Nov. 16, 2007); Order Approving a Rule Change by Chicago Board Options Exchange, Inc. Relating to the Removal of Agency Responsibilities from Designated Primary Market-Makers and the Establishment of PAR Officials, Exchange Act Release No. 52,798, 70 Fed. Reg. 71,344 (Nov. 18, 2005).

213. Order Approving a Proposed Rule Change by New York Stock Exchange LLC for a Pilot Program To Establish a New Class of NYSE Market Participants That Will Be Referred to as "Supplemental Liquidity Providers," Exchange Act Release No. 58,877, 73 Fed. Reg. 65,904, 65,904 (Oct. 29, 2008). Interestingly, the NYSE has recently added a new subclass of supplemental liquidity providers that are able to transact "in either a proprietary capacity or a principal capacity on behalf of an affiliated or unaffiliated person [including] on behalf of customers." Order Approving a Proposed Rule Change by New York Stock Exchange LLC To Add a Class of Supplemental Liquidity Providers That Are Registered as Market Makers at the Exchange, Exchange Act Release No. 67,154, 77 Fed. Reg. 35,455, 35,456 (June 7, 2012). However, this arrangement is still very different from the old specialist model based on the "broker's broker" paradigm.

their agency functions,[214] among other issues, the disappearance of these functions also narrows the area for a private right of action.

Another key development is that "changes in the business models of many exchanges and advancements in technology have eliminated or reduced the value of the special time and place privileges traditionally enjoyed by specialists and registered market makers."[215] As an illustration, the NYSE recently eliminated the "advance 'look' at incoming orders," which was previously available to specialists, for designated market makers,[216] although the feasibility of trading arrangements without informational advantages of exchange specialists had been articulated a long time before that.[217] The accompanying increase in transparency of the trading process also precludes certain types of questionable conduct by market makers—exemplified by *NYSE Specialists*—that are potentially actionable.

Another notable development is the abolition of the "negative obligation," which is illustrated by the NYSE's decision not to subject its designated market makers to "a specialist's negative obligation not to trade for its own account unless reasonably necessary to the maintenance of a fair and orderly market."[218] This measure similarly narrows the area for a

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214. *See, e.g.*, Last Atlantis Capital LLC v. ASG Specialist Partners, No. 04 C 397, 2011 U.S. Dist. LEXIS 60380, at *10 (N.D. Ill. June 6, 2011); *In re* NYSE Specialists Sec. Litig., 405 F. Supp. 2d 281, 314 (S.D.N.Y. 2005).

215. Letter from Greg Tusar, Managing Dir., Goldman Sachs Execution & Clearing, L.P., & Matthew Lavicka, Managing Dir., Goldman Sachs & Co., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 7 (June 25, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-243.pdf. Market makers also lost some valuable regulatory exemptions, which, however, had only a remote connection to a potential private right of action. For instance, the SEC has declined to provide certain exemptions for market makers in connection with short-selling activities despite the argument made by many representatives of the securities industry that this measure would have an adverse market-wide effect. Amendments to Regulation SHO, Exchange Act Release No. 61,595, 75 Fed. Reg. 11,232, 11,271–75 (Feb. 26, 2010) (to be codified at 17 C.F.R. pt. 242).

216. Order Approving a Proposed Rule Change by New York Stock Exchange LLC To Create a New NYSE Market Model, 73 Fed. Reg. at 64,389. Even under the NYSE's "Hybrid Market," the previous trading system, specialists had "access to certain information before other market participants, and [were] permitted to make a range of specified quoting and trading decisions based on that information." Order Approving a Proposed Rule Change by New York Stock Exchange LLC To Establish the Hybrid Market, Exchange Act Release No. 53,539, 71 Fed. Reg. 16,353, 16,363 (Mar. 22, 2006).

217. *See, e.g.*, Fischer Black, *Toward a Fully Automated Stock Exchange* (pt. 2), FIN. ANALYSTS J., Nov.–Dec. 1971, at 24, 26 ("The book of straight limit orders could be made public (without identifying who placed each order). Thus the specialist would not have this type of information to himself, and the cost of handling such orders could be sharply reduced."); Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 399 n.22 (1970) ("It does not seem technologically impossible to replace the entire [trading] floor . . . with a computer, fed by many remote consoles, that kept all the books now kept by specialist, that could easily make the entire book on any stock available to anybody (so that interested individuals could then compete to 'make a market' in a stock) . . . .").

218. Order Approving a Proposed Rule Change by New York Stock Exchange LLC To Create a New NYSE Market Model, 73 Fed. Reg. at 64,380; *see also* Order Approving a Proposed Rule

private right of action. The justification for this restriction's existence used to be straightforward: "The basic principles of the negative obligation [and] underlying regulatory objectives [are] to curtail the potential for speculative or abusive trading and to mitigate the specialist's information advantages and inherent conflicts of interest when permitted to act as both broker and dealer."[219] Of course, given the disappearance of many key privileges of market makers, it is much harder to rationalize the existence of the negative obligation for many trading venues.[220]

Another key development is the push to abolish "stub" quotes, i.e., placeholder quotes setting up unreasonably wide spreads with deliberately unattractive prices,[221] and this regulatory measure could be seen as a market stabilization tool. Stub quotes were banned by several trading venues as a part of more stringent quotation standards for market makers in the aftermath of the Flash Crash of May 6, 2010.[222] This measure was adopted "in coordination" with the SEC,[223] and, in fact, the regulatory agency started "consider[ing] steps to deter or prohibit the use by market makers of 'stub' quotes" on its own shortly after this market breakdown.[224] On the other hand, the ban on stub quotes is not a panacea from the standpoint of its effectiveness,[225] and, indeed, some evidence suggests that violations of

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Change by NYSE Amex LLC Extending the Operation of Its New Market Model Pilot, Exchange Act Release No. 60,758, 74 Fed. Reg. 51,639, 51,640 (Oct. 1, 2009) (stating that designated market makers "no longer have a negative obligation").

219. Simon & Trkla, *supra* note 3, at 225.

220. *See* Order Approving a Proposed Rule Change by New York Stock Exchange LLC To Create a New NYSE Market Model, 73 Fed. Reg. at 64,382 ("Given the real-time availability of market information and resultant increase in market transparency in today's markets and the [NYSE's] proposed elimination of the advance 'look' at incoming orders by the [designated market makers], the [NYSE] believes that the imposition of a negative obligation . . . is unnecessary."). In addition to the abolition of the negative obligation on the NYSE, designated market makers were also given the right to "receive executions on an equal basis . . . with other interest available at that price." *Id.* at 64,380.

221. *See, e.g.*, REPORT OF THE STAFFS OF THE CFTC AND SEC TO THE JOINT ADVISORY COMMITTEE ON EMERGING REGULATORY ISSUES, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010, at 38 (Sept. 30, 2010), *available at* http://www.sec.gov/news/studies /2010/marketevents-report.pdf ("In order to comply with their obligation to maintain continuous two-sided quotations, market makers utilize stub quotes if they choose to discontinue actively quoting."). *But see* Steve Wunsch, *Straitjacket, Part 2: The Role of Stop-Loss Orders and Stub Quotes on May 6*, TABB FORUM (Jan. 31, 2011), http://tabbforum.com/opinions/straitjacket-part-2-stop-loss-orders-and-stub-quotes (registration required) ("Stub quotes likely arose out of the regulatory conflict between a stubborn SEC insisting on continuous two-sided quoting and the business needs of exchanges and their liquidity suppliers trying to sidestep this non-productive requirement.").

222. SEC's Release on the Quotation Standards for Market Makers, *supra* note 3.

223. *Id.* at 69,484

224. *Examining the Causes and Lessons of the May 6th Market Plunge: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 54 (2010) (prepared statement of Mary L. Shapiro, Chairman, U.S. Securities and Exchange Commission).

225. *See* Michael Shashoua, *Flash Flood*, WATERS, Nov. 2010, at 34, 37 ("You need the protection that the stub quotes did not provide. That protection is really expensive. You're going

the prohibition on stub quotes are common,[226] which could potentially trigger a private right of action. Indeed, from the perspective of civil liability, a Flash Crash-type situation might be very problematic for market makers, although the adopted SRO rules take into account the existence of circuit breakers.[227]

B. THE EMERGENCE OF HIGH-FREQUENCY TRADERS AS LIQUIDITY PROVIDERS

One pivotal feature of today's securities markets is that a good chunk of liquidity—at least in certain markets—is provided by market participants other than formal market makers with corresponding trading obligations and privileges: "Proprietary firms largely have replaced more traditional types of liquidity providers in the equity markets [although such] firms generally are not given special time and place privileges in exchange trading (nor are they subject to the affirmative and negative trading obligations that have accompanied such privileges)."[228] Informal methods of providing liquidity are further reinforced by the "maker-taker" model adopted by many trading venues—in which liquidity rebates are paid for submitting "passive" orders and funded by fees charged for submitting "aggressive" orders—as this model was described as a "structure that rewards any participant that provides liquidity and charges those who consume liquidity."[229] Furthermore, certain trading strategies can be thought of as market making *across* different trading venues in the increasingly fragmented marketplace: "HFT firms tend to have their tentacles spread across multiple trading venues, arbitraging tiny differences in price . . . as a direct response to the fragmentation of trading

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to have to pay someone to do that because it's a lot of risk that they are going to have to take. So I think the circuit breaker is a better method than paying someone to take a huge amount of risk.") (quoting Alison Crosthwait, Director of Global Trading Research, Instinet); *id.* ("Implementing market-maker obligations is an antidote to stopping stub quotes. Market-maker obligations are a positive, but we run the risk of promoting too many stringent obligations.") (quoting Mary McDermott-Holland, Vice President of Transaction Services, Nasdaq OMX).

226. *Stub Quote Rule Violations – Letter to Mary Schapiro*, NANEX (Aug. 11, 2011), http://www.nanex.net/Research/StubRuleViolations/StubViolations.html.

227. *See* SEC's Release on the Quotation Standards for Market Makers, *supra* note 3, at 69,484–85.

228. SEC's Equity Market Structure Release, *supra* note 1, at 3607; *see also* IOSCO'S REPORT ON TECHNOLOGICAL CHANGES, *supra* note 1, at 24 ("By looking at traded volumes, HFT firms have become significant participants in the liquidity and price formation process in many markets and instruments and, even when acting informally in this role, have partly replaced traditional market makers.").

229. Letter from John A. McCarthy, Gen. Counsel, Global Elec. Trading Co., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 5 (June 23, 2010), *available at* http://www.sec.gov/comments/s7-09-10/s70910-25.pdf.

infrastructures."[230] Overall, de facto market making may even be the dominant high-frequency trading strategy.[231]

On the other hand, the nature of providing liquidity may be different in the absence of regulatory requirements: "[T]he high-frequency trader must resort to more innovative, aggressive, and (some would say) predatory strategies than those of traditional market-makers [and such a trader] is also more selective than the pure market-maker when it comes to choosing which securities to trade . . . ."[232] Furthermore, high-frequency traders may mix market making and proprietary trading, such as statistical arbitrage.[233] Not surprisingly, there are concerns about the unconstrained nature of such market making, such as a complaint expressing reservations about "some frictional trades going on out there that clearly look as if they are testing the boundaries of liquidity provision *versus* market manipulation."[234] With respect to at least some strategies employed by high-frequency traders, it is observed that this set of strategies is

> predatory in its aim of stepping ahead of institutional order flows [and] can be characterized as an opportunistic and discriminatory mimic of traditional market making—where HFT uses opaque advantages, including special order types, instead of explicit market making

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230. Andrew G. Haldane, Exec. Dir., Fin. Stability & Member of the Interim Fin. Policy Comm., Bank of Eng., Speech Before the Sixteenth World Congress of the International Economic Association 5 (July 8, 2011), http://www.bankofengland.co.uk/publications/speeches/2011/speech509.pdf [hereinafter Haldane's IEA Speech].

231. *See* Vikas Shah, *The Secrets of High Frequency Trading*, ALLABOUTALPHA.COM (Sept. 6, 2011), http://allaboutalpha.com/blog/2011/09/06/the-secrets-of-high-frequency-trading (registration required) ("The majority of US Equity HFT is employed in the strategy of liquidity provisioning, also known as electronic market making.") (quoting Arzhang Kamarei, Tradeworx).

232. DURBIN, *supra* note 1, at 40. Given thin margins for the bulk of strategies employed by high-frequency traders, they prefer very liquid securities. *See* Peter Gomber et al., High-Frequency Trading 15 (Mar. 2011) (unpublished manuscript) (on file with author), *available at* http://ssrn.com/abstract=1858626.

233. *See* Letter from Manoj Narang, Chief Exec. Officer, Tradeworx, Inc., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n app. at 9 (Apr. 21, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-129.pdf; *see also* DURBIN, *supra* note 1, at 40 (describing "the quintessential high-frequency trader as a hybrid market-maker and predictor with awesome technological capabilities"). The general difficulty of disentangling market making from proprietary trading is also demonstrated by various concerns of the SEC, the Department of the Treasury, the Federal Reserve System, and the Federal Deposit Insurance Corporation over the implementation of the Volcker Rule applicable to certain commercial banks and their affiliates. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, Exchange Act Release No. 65,545, 76 Fed. Reg. 68,846 (proposed Oct. 7, 2011); *see also* Darrell Duffie, Market Making Under the Proposed Volcker Rule 1 (Jan. 16, 2012) (unpublished manuscript) (on file with author), *available at* http://www.sifma.org/issues/item.aspx?id=8589937022 (arguing that the "proposed implementation of the Volcker Rule would reduce the quality and capacity of market making services that banks provide to U.S. investors").

234. *Senate Hearing on Market Structure Issues*, *supra* note 1, at 42 (remarks of Robert C. Gasser, President and Chief Executive Officer, Investment Technology Group). For several examples of market making strategies, some of which might appear questionable, see DURBIN, *supra* note 1, at 56–70.

> privileges—without the market making obligations. It is not a traditional spread-scalping strategy that posts on each side of the spread, relying on speed to jump ahead of the rest of the market. It is not a traditional strategy based on low latency—speed is simply a prerequisite for effective utilization of special order types and market microstructure.[235]

By contrast to informal methods of providing liquidity, some empirical research also favors "the presence of a market maker obligated to maintain a market" even in the context of liquid securities during a period of extreme volatility.[236]

Another perspective on informal methods of providing liquidity is illustrated by a distinction between equity and options markets. More generally, "[o]ptions market makers . . . provide liquidity to a much larger degree than equity market makers [and] there is much less 'natural' customer-to-customer interaction in the options market than in the cash equities market, requiring even more market maker liquidity."[237] There are several reasons—chiefly the preference for very liquid securities—why high-frequency trading has not affected options markets to the same degree as equity markets:

> In relation to organised and transparent derivatives markets, the percentage of market share attributable to High Frequency Trading is low compared to that experienced in the underlying cash markets. Derivative contracts that are attractive to high frequency traders are those contracts with a large number of participants, high volatility and a high level of liquidity. Such contracts are most likely to be Index Future contracts, and will likely have tight spreads, enabling high frequency traders to get in and out of positions frequently, and achieve a flat end of day position. . . . [But] as competition increases in the derivative space and derivative markets become more fragmented, the likely increase in HFT in derivative markets could mean that we face similar issues as the equity markets have raised . . . .[238]

It was also noted that, "as options trading takes on many of the characteristics of the equities market, [high-frequency traders] are dipping their toes in the water [although] progress may be slower and less

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235. Haim Bodek & Mark Shaw, Decimus Capital Mkts., LLC, Introduction to HFT Scalping Strategies 3 (Nov. 2012) (unpublished manuscript) (on file with author).

236. Thomas J. Boulton et al., The Flash Crash: Effects on Shareholder Wealth and Market Quality 12 (Dec. 2011) (unpublished manuscript) (on file with author), *available at* http://ssrn.com/abstract=1917960.

237. Letter from Michael J. Simon, Sec'y, Int'l Sec. Exch., to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 9 (Nov. 23, 2009), *available at* http://www.sec.gov/comments/s7-21-09/s72109-83.pdf.

238. Letter from Anita Collett, Senior Manager, Regulatory Strategy, London Stock Exch., to the Comm. of Eur. Sec. Regulators 4–5 (Apr. 30, 2010), *available at* http://www.esma.europa.eu/system/files/LSEG_response_to_CESR_10_142_FINAL.pdf.

pronounced because of the illiquidity of many issues and the multitude of options series."[239]

The existence of informal liquidity providers without trading obligations or privileges—at least regulatory ones—by definition precludes the existence of a private right of action. On the other hand, some prominent high-frequency trading firms, such as GETCO, have joined the club of formal market makers.[240]

C. CONFLICTS INVOLVING HIGH-FREQUENCY TRADERS AND FORMAL MARKET MAKERS

In addition to providing liquidity themselves, high-frequency traders sometimes employ "predatory" trading strategies adverse to traditional market makers.[241] As one securities industry professional described the situation, which fits the profile of a high-frequency trader, "the market maker [is] up against a better informed trader [such as] a quantitative trader . . . who performs bleeding-edge statistical analysis on screaming-fast computing software [and] can make reasonably confident predictions based on very strong alpha signals."[242] Of course, in that role, high-frequency traders were preceded by "SOES bandits," "RAES bandits," "direct access customers," and other market participants that attempted to exploit various institutional and regulatory frictions, including trading obligations of market makers, in order to get ahead.[243]

Types of information used by high-frequency traders include "order book dynamics, trade dynamics, past stock returns, cross stock correlations, cross asset correlations, and cross exchange information delays [or] illegitimately obtained or created [via] front running, quote stuffing, or

239. Justin Schack & Joe Gawronski, *Convergence of the U.S. Options and Equities Markets: Is the Party Over, or Just Getting Started?*, J. TRADING, Winter 2009, at 56, 57, 67 n.7; *see also* Peter Chapman, *HFTs Shun Options Marts*, TRADERS MAG., Nov. 2010, at 54, 54 (listing more idiosyncratic reasons for a slower spread of high-frequency trading in options markets, such as "less use of maker-taker pricing; inferior access to the markets vis-a-vis market makers; order cancellation fees; an overwhelming amount of message traffic; and an inability to allocate executions to managed accounts" and "[t]he lack of off-exchange trading").

240. *See, e.g.,* Press Release, GETCO & NYSE Euronext, GETCO Expands Market Making Services at NYSE (Nov. 30, 2011), http://www.getcollc.com/uploads/articles/GETCO_DMM_Nov_30_2011.pdf; Ivy Schmerken, *High-Frequency Trading Hits the Floor*, WALL ST. & TECH., June 2010, at 20.

241. Some sources also point to conflicts involving high-frequency traders and institutional investors. *See, e.g.*, Sal Arnuk & Joe Saluzzi, *Playing Fair?*, WELLING & WEEDEN, June 11, 2010, at 1, *passim*, *available at* http://www.themistrading.com/article_files/0000/0576/61110_Welling_Weeden_PlayingFair.pdf; Nadia Papagiannis, *Market Structure Arbitrage*, MORNINGSTAR ALTERNATIVE INVESTMENTS OBSERVER, 4th Q. 2010, at 2, 3–4; Jason Zweig, *The Market War Between Traders and Investors Heats Up*, WSJ.COM (Sept. 25, 2010), http://online.wsj.com/article/SB10001424052748703793804575511990102886132.html.

242. DURBIN, *supra* note 1, at 93–94.

243. *See* Stanislav Dolgopolov, *Insider Trading, Informed Trading, and Market Making: Liquidity of Securities Markets in the Zero-Sum Game*, 3 WM. & MARY BUS. L. REV. 1, 15–19 (2012).

layering,"[244] and these trading strategies also often rely on transaction data feeds provided by individual trading venues.[245] Furthermore, high-frequency traders use "fundamental" company-specific and non-company-specific information via machine-readable news feeds in order to get an edge with processing *public* information.[246] Overall, information asymmetry in securities markets in many ways is defined by speed, and there need not be any inherent inequalities in access to information: "In a high-speed, co-located world, being informed means seeing and acting on market prices sooner than competitors. . . . To be uninformed is to be slow."[247] In fact, the short-term nature of information acted on by predatory traders is particularly damaging to market makers compared to long-lived pieces of information, such as those typically involved in insider trading.[248] Furthermore, the feasibility of various short-term trading activities of high-frequency traders has been aided by decreased bid-ask spreads in many markets: "[W]hen spreads narrow to a penny or less, it's that much easier for a small informational advantage by the well informed trader to become a costly disadvantage to the less-informed market maker."[249] The conflict between market makers and high-frequency traders is particularly acute in options markets:

> Market makers, not so much in stocks as in options, must maintain tens of thousands or hundreds of thousands of quotes at the exchanges, and when some input makes them move those quotes they must move them in a matter of milliseconds. On the opposite side, we have High Frequency Traders who are waiting for just such an input signal to quickly grab those quotes that have not yet been moved. This is not an even playing field. It

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244. Jonathan A. Brogaard, *High Frequency Trading, Information, and Profits* 5 (U.K. Gov't Office for Sci., The Future of Computer Trading in Financial Markets – Foresight, Driver Review No. 10, 2011), *available at* http://www.bis.gov.uk/assets/bispartners/foresight/docs/computer-trading/11-1241-dr10-high-frequency-trading-information-and-profits.pdf.

245. *See id.* at 8.

246. For examples of such feeds, see *Low-Latency News & Event Data for Electronic Trading*, DOW JONES & CO., http://www.dowjones.com/salesandtrading/category-low-latency-feeds.asp (last visited Mar. 21, 2013); *Low Latency Event Data*, SELERITY, INC., http://www.seleritycorp.com/index.php?page=the-selerity-platform (last visited Mar. 21, 2013); *Thomson Reuters Machine Readable News*, THOMSON REUTERS, http://thomsonreuters.com/products_services/financial/financial_products/a-z/machine_readable_news (last visited Mar. 21, 2013).

247. Haldane's IEA Speech, *supra* note 230, at 6.

248. *See* Dolgopolov, *supra* note 243, at 17. One simulation study also concluded that the adverse selection component of bid-ask spreads, which presumably captures the harm inflicted on market makers by informed trading, and the estimate of the probability of informed trading "incorrectly identify adverse selection when, in fact, continuation in transaction prices is due to an arbitrageur picking off stale limit orders, not due to adverse selection." Qin Wang, Simulation Tests of Typical Adverse Selection Measures 5 (Sept. 23, 2008) (unpublished manuscript) (on file with author), *available at* http://www.fma.org/Texas/Papers/simul_test_measures_fma_09.pdf.

249. DURBIN, *supra* note 1, at 94.

> obviously takes much longer for the market maker to move thousands of quotes than for the HFT to hit a handful.[250]

One natural consequence of these developments is that "[low-frequency trading] market-making has been squeezed-out by competitive pressures from [high-frequency trading]."[251] The nature of trading strategies employed by high-frequency traders also explains why formal market makers have to catch on in terms of technology and why some high-frequency traders themselves are joining the ranks of formal market makers.[252]

Some clashes between market makers and high-frequency traders specifically stem from the fact that certain predatory algorithms take advantage of trading obligations of market makers—as, theoretically, any rules known in advance can be taken advantage of—and, in turn, market makers sometimes respond by utilizing "combative" algorithms.[253] As an illustration, certain types of predatory algorithms are triggered by large price changes when market makers have an obligation to stay in the market by continuously providing quotations.[254] Turning to the issue of civil liability, high-frequency traders employing predatory algorithms to take advantage of—and explicitly reply on—trading obligations of market makers may potentially use a private right of action, although they would not be very sympathetic plaintiffs. Furthermore, a natural question is whether the presence of such predatory traders would impose a cost on liquidity of securities markets via trading and litigation-related losses of market makers.

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250. Thomas Peterffy, Chairman & CEO, Interactive Brokers Grp., Comments Before the 2010 General Assembly of the World Federation of Exchanges 6 (Oct. 11, 2010), http://investors.interactivebrokers.com/download/worldFederationOfExchanges.pdf [hereinafter Peterffy's WFE Speech].

251. Haldane's IEA Speech, *supra* note 230, at 13.

252. *See* DURBIN, *supra* note 1, at vi, 92–94; *see also* Interview by Gregory Crawford with Ryan Terpstra, CEO, Selerity, *Getting an Edge with Dividend Info*, TABB FORUM (Mar. 28, 2012), http://www.tabbforum.com/opinions/getting-an-edge-with-dividends (registration required) (describing the development of a machine-readable dividend data feed, pointing out that "options valuations can be impacted by changes relative to market expectations before a trader or trading system has time to react," and stating that "[t]he groups that should be most interested in staying on top of real-time dividend announcements will be option market makers and directional traders that look to capitalize on real-time events").

253. *See* E-mail from securities industry professional "A" to author (Nov. 10, 2011, 8:23 CST) (on file with author); *see also Anti-Gaming for TSX Market Makers*, MARKETS MEDIA ONLINE, No. 2, 2011, *available at* http://cyborgtrading.dreamhosters.com/institutional/app/files/media/brochures/anti_gaming_for_tsx_market%20Makers.pdf (describing "an automated market making program . . . which uses algos equipped with anti-gaming software [and] is designed to prevent [high-frequency traders] from artificially changing the best bid/offer against market makers").

254. Skype Interview with securities industry professional "B" (Apr. 4, 2012).

D. RECENT REGULATORY DEBATES ON TRADING OBLIGATIONS AND PRIVILEGES OF MARKET MAKERS

Turning to recent regulatory debates, the changes in the market for liquidity have raised questions about the existing balance of trading obligations and privileges of market makers:

> The former liquidity provision model of specialists and market makers with central positions in the trading process has shifted to a more electronic form of market making with the ever more sophisticated use of specialized liquidity providing order types. Incentives and obligations for market making arguably have not adapted to, and may not appropriately reflect, this new world of electronic trading.[255]

In fact, several initiatives to impose market making obligations on various types of market participants, such as high-frequency traders or firms internalizing their customers' orders, have been voiced.[256] The SEC itself is deliberating on a proposal to institute "obligations for certain high-frequency traders to provide quotes near the national best bid and offer prices . . . during a certain percentage of the trading day."[257] The opposition

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255. SIFMA, IMPACT OF HIGH FREQUENCY TRADING AND CONSIDERATIONS FOR REGULATORY CHANGE 6 (Dec. 13, 2011), *available at* http://www.sifma.org/issues/item.aspx?id=8589936694.

256. *See, e.g.*, JOINT CFTC-SEC ADVISORY COMM. ON EMERGING REGULATORY ISSUES, SUMMARY REPORT, RECOMMENDATIONS REGARDING REGULATORY RESPONSES TO THE MARKET EVENTS OF MAY 6, 2010, at 12 (2011), *available at* http://www.sec.gov/spotlight/sec-cftcjointcommittee/021811-report.pdf [hereinafter CFTC-SEC REPORT ON EMERGING REGULATORY ISSUES] ("The SEC's review should, at a minimum, consider whether to . . . require firms internalizing customer order flow or executing preferenced order flow to be subject to market maker obligations that requires them to execute some material portion of their order flow during volatile market periods."); Letter from U.S. Sen. Edward E. Kaufman to Mary L. Shapiro, Chairman, U.S. Sec. & Exch. Comm'n att., at 2 (Aug. 5, 2010), *available at* http://www.sec.gov/comments/s7-27-09/s72709-96.pdf ("[T]he SEC should impose some liquidity provision obligations on high frequency traders . . . to encourage [them] to post two-sided markets and supply investors with a consistent source of deep liquidity. In addition to affirmative liquidity provision obligations, the Commission should consider instituting negative obligations as well."); Letter from Karrie McMillan, Gen. Counsel, Inv. Co. Inst., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 5 (Apr. 21, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-138.pdf ("We recommend that the [SEC] . . . consider whether HFT firms should be subjected to quoting obligations similar to that of OTC market makers or any other regulations similar to the affirmative and negative obligations of specialists and market makers."); Letter from Greg Tusar & Matthew Lavicka to Elizabeth M. Murphy, *supra* note 215, at 6 ("[Securities] [e]xchanges should . . . consider expanding the classes of firms to which [market making] obligations apply, such as to firms that choose to utilize 'step-up' order types [such as 'flash orders'] or significant bandwidth.").

257. Scott Patterson & Andrew Ackerman, *SEC May Ticket Speeding Traders*, WALL ST. J., Feb. 23, 2012, at C1. However, there are some hesitations within the SEC. *See, e.g.*, Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at the Security Traders Association 77th Annual Conference and Business Meeting (Sept. 24, 2010), http://www.sec.gov/news/speech/2010/spch092410tap.htm ("[I]t may be difficult to impose market maker obligations on high frequency traders without affording them some form of compensation, such as by granting them privileges, as specialists themselves used to enjoy."). Interestingly, the European Commission has issued the following formal proposal:

to such proposals, often coming from the proprietary trading community, has been voiced as well,[258] and, of course, the issue of trading obligations of market makers cannot be resolved in isolation from the issue of their trading privileges. While there is a great deal of skepticism that trading obligations of market makers serve as an effective stabilizing device during periods of extreme volatility,[259] there is support for a reformed set of such

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> An algorithmic trading strategy shall be in continuous operation during the trading hours of the trading venue to which it sends orders or through the systems of which it executes transactions. The trading parameters or limits of an algorithmic trading strategy shall ensure that the strategy posts firm quotes at competitive prices with the result of providing liquidity on a regular and ongoing basis to these trading venues at all times, regardless of prevailing market conditions.

Commission Proposal for a Directive of the European Parliament and of the Council on Markets in Financial Instruments Repealing Directive 2004/39/EC of the European Parliament and of the Council, at 70, COM (2011) 656 Final (Oct. 20, 2011). For a critical evaluation of this proposal, see Dave Cliff, *Market-Making Obligations and Algorithmic Trading Systems: A Feasibility Assessment of the March 2012 Draft of MiFID2 Article 17(3)* (U.K. Gov't Office for Sci., The Future of Computer Trading in Financial Markets – Foresight, Economic Impact Assessment No. 19, 2012), *available at* http://www.bis.gov.uk/assets/foresight/docs/computer-trading/12-1078-eia19-market-making-obligations-and-algorithmic-trading-systems.pdf.

258. *See, e.g.*, Letter from Stuart J. Kaswell. Exec. Vice President, Managing Dir. & Gen. Counsel, Managed Funds Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 23 (May 7, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-178.pdf ("Imposing affirmative or negative obligations on market participants would likely have the effect of raising barriers to entry, cause market consolidation, and induce some firms to exit the market, all of which would decrease competition and raise costs—to the detriment of investors."); Letter from Andrew S. Margolin, Assoc. Gen. Counsel, Bank of Am. Merrill Lynch, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 4 (Apr. 21, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-134.pdf ("We do not believe that market participants who obtain co-location services should be subject to any affirmative or negative obligations, rather the focus should be on ensuring fair access at the market level.").

259. *See, e.g.*, CFTC-SEC REPORT ON EMERGING REGULATORY ISSUES, *supra* note 256, at 10 ("[E]ven historically, [market making] obligations were of only limited effectiveness during periods of extreme volatility because the risks were simply too great."); Letter from Stuart J. Kaswell, Exec. Vice President, Managing Dir. & Gen. Counsel, Managed Funds Ass'n, to Members of the Joint CFTC-SEC Advisory Comm. on Emerging Regulatory Issues et al. 4 (Sept. 12, 2010), *available at* http://www.sec.gov/comments/265-26/265-26-38.pdf ("We do not believe that more stringent market maker obligations for [additional categories of market participants] will prevent a future market break."); Michael A. Mendelson, AQR Capital Mgmt. LLC, Statement Before the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues 8 (Aug. 11, 2010), http://www.sec.gov/comments/265-26/265-26-34.pdf ("[O]n those rare occasions when markets are severely disrupted, market-maker obligations will accomplish nothing."); *see also* Interview by Mike O'Hara with Natan Tiefenbrun, Commercial Dir., Turquoise, *Market Surveillance, Liquidity Shocks and Regulation*, HFT REV. (Dec. 3, 2010), http://www.hftreview.com/pg/file/mike/read/5337/market-surveillance-liquidity-shocks-and-regulation (registration required) (arguing that the proposal to subject high-frequency traders to the obligation "to post two-sided quotes during times of market stress [is misguided because these market participants] manage their risk the most tightly . . . try and maintain very diversified positions . . . don't hold positions for any great length of time and don't have a huge amount of capital").

obligations as a tool to enhance liquidity of securities markets.[260] Cautious or even intransigent statements that question or attack the desirability of trading obligations of market makers—notably, the affirmative obligation—as such[261] appear to be misguided and perhaps overemphasize extreme scenarios.

Furthermore, there are concerns about the viability of market making in certain segments of the securities industry—partly because of uneven regulatory requirements vis-à-vis de facto liquidity providers.[262] Several regulatory proposals in fact addressed various approaches to additional incentives for market makers.[263] One potential concern, which also includes

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260. *See, e.g.*, Haldane's IEA Speech, *supra* note 230, at 17 ("In principle, a commitment by market-makers to provide liquidity, whatever the state of the market, would go to the heart of potential price discontinuity problems [and] lessen the chances of liquidity droughts and associated fat tails and persistence in prices."); Letter from Edward E. Kaufman to Mary L. Shapiro, *supra* note 256, att., at 2–3 ("While no degree of affirmative or negative obligations will totally prevent another flash crash—as traders will never be willing to stand in front a freight train of sell orders 100 percent of the time—such rules could restore a much-needed sense of stability to the marketplace and serve the trading interests of long-term investors."); Peterffy's WFE Speech, *supra* note 250, at 6 ("[I]f an exchange would like to be assured of the continuous availability of buyers and sellers, it should have registered market makers with serious affirmative obligations.").

261. *See, e.g.*, *Examining the Efficiency, Stability, and Integrity of the U.S. Capital Markets: J. Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs and the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. 41 (2011) (remarks of Manoj Narang, Chief Executive Officer, Tradeworx, Inc.) ("I cannot think of any empirical evidence that market maker obligations actually matter in practice."); Hans R. Stoll, *Reconsidering the Affirmative Obligation of Market Makers*, FIN. ANALYSTS J., Sept. / Oct. 1998, at 72, 80 ("That an affirmative obligation reduces volatility or makes markets more efficient is not evident. . . . Markets will function will without an affirmative obligation. Market makers need no regulatory obligations and should not receive special privileges."); Harold Bradley & Robert E. Litan, Choking the Recovery: Why New Growth Companies Aren't Going Public and Unrecognized Risks of Future Market Disruptions 66 (Nov. 12, 2010) (unpublished manuscript) (on file with author), *available at* http://www.kauffman.org/uploadedFiles/etf_study_11-8-10.pdf ("History shows that affirmative obligations affirm only intermediaries' profits.").

262. *See, e.g.*, *Senate Hearing on Market Structure Issues*, *supra* note 1, at 85 (prepared statement of Peter Driscoll, Chairman, Securities Traders Association) ("[Market makers] retained all of their obligations to the market . . . but the rewards for these obligations were cut dramatically. Traditional market making became unprofitable and most market making firms reduced their market making activity or bowed out of the business altogether."); Jacob Bunge & Brendan Conway, *Options Exchanges Decry Possible Exit of Market Maker*, WSJ.COM (Oct. 5, 2011), http://online.wsj.com/article/SB10001424052748703298504575534101333589296.html (registration required) (describing the concern of one firm that considered "curtail[ing] its role as a registered market maker in options because of tough competition from smaller rivals that operate with fewer requirements"); Larry Tabb, *Restarting the Engines of Growth*, TABB FORUM (Apr. 20, 2011), http://tabbforum.com/opinions/restarting-the-engines-of-growth (registration required) (arguing that "the horrible economics of providing small- and mid-cap liquidity [is] chasing away market makers").

263. *See, e.g.*, CFTC-SEC REPORT ON EMERGING REGULATORY ISSUES, *supra* note 256, at 10 ("[M]easures [to encourage market making] could certainly include differential pricing and might include preferential co-location provisions."); Peterffy's WFE Speech, *supra* note 260, at 6 ("If you want to have market makers you should give them some modest preferential access. Hold every order for a tenth of a second with the exception of market maker quote updates for products

the civil liability perspective, is whether certain trading privileges, such as time and information advantages, might conflict with trading obligations compared to more "transparent" advantages, such as pricing and order flow allocation incentives or subsidies from issuers, because of the blurry line between market making and proprietary trading.[264]

A more general proposal even argues for imposing a degree of uniformity across trading venues with respect to trading obligations and privileges of market makers:

> [T]he definition of market making activity and the establishment of incentives for this activity should not be the left to individual market centers. To permit market centers to drive this critical regulatory issue not only ensures disparate and potentially conflicting rules, but it also encourages competition among exchanges on the basis of regulation—a situation which leads either to a race to the bottom in which market maker obligations are completely eviscerated, or to exclusive market maker designations that increase dependence on single firms.[265]

A similar proposal maintained that "the eligibility requirements and obligations of market makers should be uniform across all exchanges and trading venues."[266] A counterargument is that varying sets of trading obligations and privileges of market makers is an essential tool of competition among trading venues and a vehicle of innovation, although there could be some general harmonized principles.[267]

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in which the market maker is registered and has affirmative obligations."); Larry Tabb, *A New Structure for Smaller Cap Stocks?*, TABB FORUM (Feb. 15, 2012), http://tabbforum.com /opinions/a-new-structure-for-smaller-cap-stocks (registration required) ("[M]arket makers would have very specific advantages to ensure that they had greater flexibility in managing quotes and sitting on the best bid/offer [such as] co-location, minimum time in force for non-market makers, or even quote precedence over non-market makers. . . . These structural shifts would virtually guarantee that an officially sanctioned market maker would take precedence over virtually all other traders/investors."); *see also* SEC. TRADERS ASS'N, THE STA'S PERSPECTIVE ON U.S. MARKET STRUCTURE 6 (May 2008), *available at* http://www.securitytraders.org/news-media/sta-special-report-u.s.-market-structure-2008 ("Market making incentives are no longer valuable enough to incentivize participants to risk their capital.").

264. *See supra* note 233.

265. Letter from Peter Kovac, Chief Operating Officer & Fin. and Operations Principal, EWT, LLC, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 19 (Aug. 27, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-279.pdf; *see also* Letter from John A. McCarthy, Gen. Counsel, GETCO, LLC, Christopher R. Concannon, Partner, Virtu Fin., LLC, & Leonard J. Amoruso, Gen. Counsel, Knight Cap. Grp., Inc., to Robert Cook, Dir., Div. of Trading & Mkts., U.S. Sec. & Exch. Comm'n 1–2 (July 9, 2010), *available at* http://www.sec.gov /comments/s7-02-10/s70210-255.pdf (expressing a concern that "several exchanges impose no true affirmative quoting or trading requirements" and proposing a minimum set of standards applicable to the bulk of market makers in the wake of the Flash Crash of May 6, 2010).

266. Letter from U.S. Sen. Charles E. Schumer to Mary Shapiro, Chairman, U.S. Sec. & Exch. Comm'n (Aug. 11, 2010), http://schumer.senate.gov/record.cfm?id=327160.

267. *See* IOSCO'S REPORT ON TECHNOLOGICAL CHANGES, *supra* note 1, at 59; *see also* Letter from Andrew Bowley, Managing Dir., et al., Nomura Int'l plc, to Werner Bijkerk, Int'l Org. of Sec. Comm'ns 4 (Aug. 12, 2011), *available at* http://www.iosco.org/library/pubdocs/pdf /IOSCOPD361.pdf ("Market making regimes are part of the commercial DNA of competitive

Some regulatory proposals raise red flags in the context of civil liability of market makers. For instance, imposing both affirmative and negative obligations on certain types of traders, as suggested by some regulatory proposals,[268] would effectively confine such traders' activities to market making and invite additional—and potentially very costly—scrutiny of their transactions. The chief complication with this proposal is the difficulty of disentangling market making and proprietary trading.[269] Other controversial regulatory proposals relevant for market makers in the high-speed trading environment pertain to the intertwined issues of imposing a minimum order duration and limiting order cancellation. Such measures have been largely opposed by the trading community,[270] although they have gained support from some institutional investors and brokerage firms[271] and, rather

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venues, and common regulatory imposed standards make it harder to create that differentiation and hence support competition.").

268. *See, e.g.*, Letter from Edward E. Kaufman to Mary L. Shapiro, *supra* note 256, att., at 2; Letter from Karrie McMillan to Elizabeth M. Murphy, *supra* note 256, at 5.

269. *See supra* note 233.

270. SIFMA, *supra* note 255, at 9 ("Although [a minimum quote duration] may seem appropriate for addressing some concerns, such as latency arbitrage, they could be easily gamed. Overall, such requirements would have a negative impact on legitimate trading behavior and thus reduce liquidity and impede legitimate market making activities."); Letter from Stuart J. Kaswell to Elizabeth M. Murphy, *supra* note 258, at 22 ("[The ability to] receive immediate cancellations and just as quickly enter new orders . . . is an essential requirement for market participants engaged in electronic market making strategies to be able to offer tight bid-ask spreads and provide liquidity at low margins. . . . If the [SEC] were to limit cancellations in any way, market participants would be more reluctant to post limit orders, which would likely result in a widening of spreads and a decrease in liquidity."); Letter from Brett F. Mock, Chairman & John C. Giesea, President and CEO, Sec. Traders Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 8 (Apr. 30, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-170.pdf ("Requiring a minimum duration for orders is draconian and inconsistent with the operation of efficient markets. . . . Setting an arbitrary minimum time that an order must be in force will expose the liquidity provider to much greater risk for which they will require greater compensation in the form of wider spreads."); Letter from Greg Tusar & Matthew Lavicka to Elizabeth M. Murphy, *supra* note 215, at 7–8 ("[T]he [SEC] should avoid regulatory measures that would artificially slow down the pace of trading during normal market operations, such as an across-the-board minimum duration for orders."). One industry group specifically argued for "economically rewarding participants that do expose orders for a set duration." Letter from Brett F. Mock & John C. Giesea to Elizabeth M. Murphy, *supra*, at 8.

271. *See, e.g.*, Letter from O. Mason Hawkins, Chairman & CEO, et al., Se. Asset Mgmt., Inc., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 2 (Oct. 19, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-295.pdf ("We strongly encourage the Commission to *institute a minimum order duration of one second to be implemented at the exchange level*."); Christopher Nagy, Managing Dir., Order Strategy and Co-Head of Gov't Relations & John S. Markle, Deputy Gen. Counsel and Co-Head of Gov't Relations, TD Ameritrade, Inc., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 7 (Apr. 21, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-124.pdf ("A requirement should be mandated to make all bid/asks effective for a minimum amount of time."); Letter from Clive Williams, Head of Global Equity Trading, et al., T. Rowe Price Assocs., Inc., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 2 (Aug. 30, 2010), *available at* http://www.sec.gov/comments/s7-02-10/s70210-290.pdf ("One suggestion [in order to address problems created by co-location] might be to impose rules to increase minimum time quotes that must be displayed.").

surprisingly, even some market making firms.[272] One potential consequence of the imposition of a minimum order duration is that "the likelihood that your quotes become stale [would] increase significantly [thus allowing others, such as high-frequency traders] to trade on your outdated quotes and thus pocket an easy profit,"[273] a scenario that could trigger civil litigation over non-compliance. Another warning emphasizes that this regulatory measure would "introduce[e] additional systemic risk to the market as a whole."[274] A critic of cancellation fees also pointed to its potentially anticompetitive effect on liquidity providers operating across trading venues:

> If I'm a market maker and I post my bids and offers in two markets and I trade in one market then I cancel in the other one as well because I only have a certain amount of capital to deploy. Now, if I'm going to be charged for those cancellations I can't afford to be a market maker in multiple venues. So, it would drive further consolidation amongst venues.[275]

On the other hand, the proposal to establish mandatory cancellation fees does have substantial support thrown behind it,[276] and there have been several modest initiatives by individual trading venues to address this issue,[277] but specific exemptions for formal market makers are possible and perhaps desirable.[278] Furthermore, there has been some experimentation

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272. *See, e.g.*, *Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 119 (2013) [hereinafter *House Hearing on Market Structure*] (prepared testimony of Thomas M. Joyce, Chairman and Chief Executive Officer, Knight Capital Group, Inc.) ("Market makers should be required to keep their quotes 'live' for at least one second. . . . In our view, this will restore a good deal of credibility to the posted quotations in the market, and will eliminate a good deal of trading behavior which does not contribute meaningful liquidity to the market.").

273. Thierry Rijper et al., Optiver Holding B.V., High Frequency Trading 15 (Dec. 2010) (unpublished manuscript) (on file with author), *available at* http://optiver.com/corporate/hft.pdf.

274. Interview by Mike O'Hara with Hirander Misra, Managing Dir., Misra Ventures, *The Good and Bad of HFT and the Importance of Consistent, Informed Regulation*, HFT REV. (Sept. 9, 2011), http://www.hftreview.com/pg/blog/mike/read/7249/the-good-and-bad-of-hft-and-the-importance-of-consistent-informed-regulation (registration required).

275. Interview by Mike O'Hara with Natan Tiefenbrun, *supra* note 259.

276. *See, e.g.*, CFTC-SEC REPORT ON EMERGING REGULATORY ISSUES, *supra* note 256, at 11 (recommending to the regulators to "explore ways to fairly allocate the costs imposed by high levels of order cancellations, including perhaps requiring a uniform fee . . . based on the average of order cancellations to actual transactions effected by a market participant"); Patterson & Ackerman, *supra* note 257(describing the SEC's deliberations related to "imposing fees on order cancellations, which constitute 'a vast majority of orders' submitted by high-frequency firms").

277. *See* Joe Saluzzi & Sal Arnuk, *HFT in Detention For Excessive Cancellations! LOL*, TABB FORUM (Mar. 8, 2012), http://tabbforum.com/opinions/hft-in-detention-for-excessivecancellations-lol (registration required) (describing recent initiatives of two trading venues to penalize frequent order cancellation, dismissing them as cosmetic, and noting the existence of exemptions for market makers).

278. *See, e.g.*, *House Hearing on Market Structure*, *supra* note 272, at 73 (prepared testimony of Jeffrey M. Solomon, Chief Executive Officer, Cowen and Company, LLC) ("While order

with the minimum order duration feature on the optional basis by some trading venues.[279] More generally, mandatory market-wide rules addressing these issues with the aim of producing tangible benefits for the trading process, while not in the realm of the impossible, might be difficult to implement, perhaps requiring a redesign of specific trading and order aggregation mechanisms and a synchronization of different trading venues.[280] Of course, from the standpoint of civil liability, measures that mandate a minimum order duration or prolong the exposure of posted orders may encourage opportunistic civil litigation—potentially involving predatory traders.

CONCLUSION

Potential civil liability of market makers for violations of trading obligations and abuses of trading privileges is real and, from a number of perspectives, logical, staying within the boundaries established by the U.S. Supreme Court. While there are doctrinal hurdles to reaching this result under a spectrum of scenarios, several recent decisions on the appellate level suggest a broader availability of a private right of action under the federal antifraud prohibition—even in the context of violations of SRO rules—as an incipient trend. In addition to potential SEC and SRO sanctions, as well as criminal liability under federal securities law, the threat of civil litigation may promote the broad goals of federal securities law and supplement other available remedies—especially if other participants are unable or unwilling to play that role.[281] On the other hand, the existence of a private right of action may have a detrimental effect on

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cancellations related to making markets is one thing, orders sent to the market with no intention of being executed before cancellation is quite another.").

279. For instance, one trading venue recently created a "minimum life order" as a *voluntary* order type with accompanying incentives to submit such orders, with its designation invisible to other market participants, which at least partly addresses a potential concern about being exposed to predatory algorithms. Order Approving a Proposed Rule Change by NASDAQ OMX PHLX LLC To Introduce the Minimum Life Order as a New Order Type, Exchange Act Release No. 65,926, 76 Fed. Reg. 78,057 (Dec. 9, 2011); Notice of Filing of a Proposed Rule Change by NASDAQ OMX PHLX LLC To Introduce the Minimum Life Order as a New Order Type, Exchange Act Release No. 65,610, 76 Fed. Reg. 67,012 (Oct. 24, 2011).

280. For a related discussion, see J. Doyne Farmer & Spyros Skouras, *Minimum Resting Times and Transaction-to-Order Ratios: Review of Amendment 2.3.f and Question 20* (U.K. Gov't Office for Sci., The Future of Computer Trading in Financial Markets – Foresight, Economic Impact Assessment No. 2, 2012), *available at* http://www.bis.gov.uk/assets/foresight/docs/computer-trading/12-1064-eia2-minimum-resting-times-and-transaction-order-ratios.pdf.

281. Some of the relevant controversies indeed resulted in heavy penalties for securities firms in the form of large SEC-brokered settlements and for their individual employees in the form of SEC and SRO bars. *See, e.g.*, Finnerty, Initial Decision Release No. 381, 96 SEC Docket 1098 *passim* (ALJ July 13, 2009). However, while this particular controversy had many "blockbuster" features lucrative to the regulators, the underlying securities class action based on the antifraud provision probably played a role in this outcome. Furthermore, another controversy might not attract the attention of the SEC or the SRO in question because of its small scale or potential conflicts of interest.

securities markets if the balance of trading obligations and privileges of market makers exposes them to opportunistic lawsuits, becoming an additional cost of providing liquidity and even a market-wide externality. Such opportunistic plaintiffs may come from the ranks of high-frequency traders, whose existence perhaps will change the landscape of securities litigation, although some trading strategies employed by these market participants are spotlight-shy.

The availability of a private right of action could be either a reality check on the reasonableness of the balance of trading obligations and privileges of market makers for the SEC and individual trading venues or a magnification of potential problems—especially in light of the recent events that demonstrated the fragility of market making business.[282] Accordingly, the current push in the direction of more stringent trading obligations of market makers and the imposition of such obligations on a variety of market participants—while often ignoring incentives for providing liquidity—should be approached with caution. Furthermore, in some cases, alternative regulatory solutions would be preferable; for instance, properly crafted procedures for breaking up erroneous trades or circuit breakers during periods of extreme volatility appear to be a much better option than protracted civil litigation over the duty of market makers to "catch a falling knife."[283] In any instance, striking a balance in order to discourage opportunistic behavior by both market makers and potential plaintiffs remains an important policy issue on both SEC and SRO levels for the evolving architecture of securities markets.[284]

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282. *See* Jessica Toonkel & John McCrank, *Facebook Market Makers' Losses Total at Least $100 Million*, REUTERS, May 24, 2012, *available at* http://www.reuters.com /article/2012/05/24/net-us-facebook-fidelity-thousands-idUSBRE84N10120120524 (describing the estimated losses of over $100 million in the aftermath of the Facebook IPO suffered by the leading market makers as a result of NASDAQ's malfunctioned trading process); Scott Patterson et al., *SEC Nixed Knight's Plea for A Do-Over*, WALL ST. J., Aug. 6, 2012, at A1 (describing the estimated loss of $440 million of a market maker in the course of approximately 25 minutes as a result of an internal software glitch).

283. *See also* Letter from Brian T. Durkin, Chief Operating Officer and Managing Dir., Products & Servs., CME Grp., to Werner Bijkerk, Int'l Org. of Sec. Comm'ns 11 (Aug. 11, 2011), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD361.pdf ("[E]ffectively calibrated market-wide circuit breakers, coupled with automated volatility mitigation and risk management mechanisms and certainty regarding trade cancellation policies, are straightforward steps that will be much more impactful than mandated affirmative quoting obligations in encouraging liquidity providers to remain in the market during highly volatile periods.").

284. While certain problems relating to recent development in securities markets would be better addressed via governmental regulation, the self-regulatory potential of trading venues cannot be ignored—despite the spread of the for-profit business model and the corresponding conflicts of interest. As an illustration, the NYSE adopted a rule aimed at a variety of trading strategies, and it specifically referenced such tactics as "quote stuffing and layering," which are associated with certain types of high-frequency trading. Order Approving a Proposed Rule Change by New York Stock Exchange LLC Adopting the Text of FINRA Rule 5210, Which Prohibits the Publication of Manipulative or Deceptive Quotations or Transactions, as NYSE Rule 5210, Exchange Act Release No. 65,954, 76 Fed. Reg. 79,260, 79,261 (Dec. 14, 2011). Of course,

whether on the SEC or SRO levels, it is reasonable to expect that, "[while] predation of liquidity suppliers should be discouraged . . . [m]easuring and defining predation would undoubtedly prove challenging, intrusive, and contentious." Carole Camerton-Forde et al., *Time Variation in Liquidity: The Role of Market-Maker Inventories and Revenues*, 65 J. FIN. 295, 326 (2010).