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SUGGESTIONS FOR PROCEDURAL REFORM IN SECURITIES MARKET REGULATION

Lanny A. Schwartz*

I. INTRODUCTION

The Securities and Exchange Commission must consider many complex market structure issues in the months and years to come, including overseeing the consolidation of self-regulators,¹ regulating cross-border activities of exchange markets,² creating a new paradigm for short sale regulation,³ establishing clear guidelines for exchange ownership and governance,⁴ and acting on perennial calls for reforming market data revenue distribution.⁵ Whatever the SEC does in these areas, it will affect investor protection, the national economy, and the international position of markets and market participants. For each issue, the SEC will have to decide how much to intervene to promote specific policy goals, and how much to let the forces of competition dictate the shape of the solution.

The SEC's calculus concerning the role of competition is, to a significant degree, dictated by the Securities Exchange Act of 1934 (Exchange Act).⁶ In designing the statutory framework for a national market system in the United States, Congress recognized that free and fair competition is essential to the achievement of preserving our securities

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1. See, e.g., Press Release, NASD Member Firms Embrace Streamlined, More Efficient Regulation (Jan. 21, 2007), available at http://www.nasd.com/PressRoom/NewsReleases/2007NewsReleases/NASDW_018334.

2. See, e.g., Christopher Cox, Chairman, SEC, Speech at Harvard Business School Global Leadership Forum: Cross-Border Exchange Mergers in the Context of Global Trade (June 22, 2006), available at <http://www.sec.gov/news/speech/2006/spch062206cc.htm>; Roel C. Campos, Comm'r, SEC, Remarks at NYU Stern: New Challenges in Regulating Financial Markets (Mar. 24, 2006), available at <http://www.sec.gov/news/speech/spch032406rcc.htm>.

3. See Exchange Act Release No. 54,891, 71 Fed. Reg. 75,068 (Dec. 13, 2006).

4. See Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 50,699, 84 SEC Docket 444 (proposed Dec. 8, 2004). Since the time of this proposal, not only has the New York Stock Exchange combined with Archipelago and the former Pacific Exchange, but many "regional exchanges" have formed alliances, including equity participation, with member organizations and other investors. See, e.g., Aaron Lucchetti, *Wall Street Plays the Market*, WALL ST. J., Aug. 30, 2006, at C1.

5. See, e.g., *Regulation NMS and Recent Market Developments: Hearing before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2005) (testimony of Mark E. Lackritz, President, Sec. Indus. Ass'n); Annette L. Nazareth, Dir., Div. of Mkt. Regulation, SEC, Opening Statement before the Open Meeting regarding Regulation NMS (Apr. 6, 2005), available at <http://www.sec.gov/news/speech/spch040605aln.htm>.

6. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2000 & Supp. IV 2004).

markets as a precious national resource.⁷ When crafting the 1975 Amendments to the federal securities laws, Congress extensively debated the role of competition in shaping market structure.⁸ There was concern that there might be areas in which competition would not act to create essential infrastructure for the markets and that regulation was therefore necessary to achieve Congress's goals.⁹ However, the legislators were equally mindful that unnecessary regulation not impede market forces in shaping market structure,¹⁰ and that the markets and their broker-dealer participants "not be forced into a single mold."¹¹ In the end, the amendments to the Exchange Act that flowed from those debates established a system that both promotes and significantly constrains competition between and among markets and market participants.¹²

The statute vests the SEC with extensive authority to influence market structure. Indeed, in certain respects, under the Exchange Act it is not enough for the SEC to merely fill in gaps left by competitive forces or correct the course of natural market development. Rather, the statute commands the SEC to be an activist regulator and to take affirmative action to achieve certain specific market structure objectives.¹³ The SEC exercises this authority both in its formal actions, such as rulemaking and review of

7. See, e.g., Exchange Act § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C) (2000) ("It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets . . ."); S. REP. NO. 94-75, at 8 (1975) ("The objective would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations of practices and services.").

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

9. See H.R. REP. NO. 94-229, at 92 (1975).

10. See *id.*

11. See S. REP. NO. 94-75, at 8 (1975). Congress also observed in the Senate Report that:

In 1936, this Committee [on Banking, Housing and Urban Affairs] pointed out that a major responsibility of the SEC in the administration of the securities laws is to "create a fair field of competition." This responsibility continues today. . . . The objective would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services. It would obviously be contrary to this purpose to compel elimination of differences between types of markets or types of firms that might be competition enhancing.

Id. For a detailed analysis of the legislative history of section 11A, see Dale Oesterle, *Regulation NMS: Has the SEC Exceeded its Congressional Mandate to Facilitate a National Market System in Securities Trading*, 1 N.Y.U. J. L. & BUS. 613 (2005).

12. As discussed in Part II.C., *infra*, to the extent that Congress and SEC actions under the securities laws have not operated to explicitly displace them, other areas of law, including antitrust law and state law, also affect competitive activity in the securities markets and, therefore, market structure.

13. See, e.g., Exchange Act §§ 11A(a)(2), (c)(1)(A)–(F), 15 U.S.C. § 78k-1(a)(2), (c)(1)(A)–(F).

self-regulatory organization (SRO) rules,¹⁴ and also in its inspection, examination, enforcement, and other actions.¹⁵ Indeed, in many instances, the SEC's power, even its *inaction*, significantly affects and shapes market structure and the landscape for competition.

In general, the Exchange Act's delegation of authority to a highly empowered expert body, such as the SEC, and the directions given to the SEC in the statute to weigh competitive effects against investor protection, maintenance of fair and orderly markets, capital formation and other policy considerations when shaping market structure, were choices and have worked reasonably well.¹⁶ In the last decade alone, the SEC has implemented many successful market structure initiatives, which have proven the SEC's ability to advance the Exchange Act's policy objectives without squelching competition.¹⁷

Nonetheless, certain procedures outlined in the Exchange Act, as administered by the SEC, operate to impose effective restraints on innovation and other potentially salutary attributes of competition that may not be fully justified by countervailing policies. The present structure results in slow, conservative and opaque decision making. This paper examines certain procedural aspects of the SEC's role in shaping market structure and regulating competition under the Exchange Act—and, in particular, the SEC's regulation of securities exchanges, the National Association of Securities Dealers, Inc. (NASD), and other self-regulatory organizations.

Why does the *procedure* matter? First, securities markets compete with each other and establish the modalities by which their members can compete by establishing trading rules, introducing systems, and charging fees or otherwise affecting the cost of doing business. Each of these must be filed as a proposed rule change. Therefore, the SRO rule change process is the “critical path” of much new competition and in many instances the source of developments in market structure. Second, the clearer the Commission's processes for establishing and enforcing legal standards that impact the market are, the more possible it is for market participants to plan

14. See, e.g., SEC, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 25, 2007) [hereinafter *The Investor's Advocate*].

15. See *id.*

16. See, e.g., Exchange Act § 3(f), 15 U.S.C.S. § 78c(f) (LexisNexis 2006); Exchange Act § 23(a)(2), 15 U.S.C.S. § 78w(a)(2) (LexisNexis 2006); Exchange Act § 11A.

17. Naturally, each of these undertakings has had its detractors. In each major initiative, many commentators have argued that the SEC has either (a) gone too far in seeking to achieve through regulation what the forces of free competition would have handled just fine without government intervention, or (b) exceeded its statutory mandate. The SEC's proposal to adopt Regulation NMS alone attracted over 1500 comment letters—many addressing these precise issues. See Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,498 (June 29, 2005).

new initiatives and to attract capital for them. Thus, if the procedure does not work well, is too plodding, lacks transparency, or stifles innovation, then investors are denied freedom of choice with respect to many possible products, international competitiveness of U.S. financial institutions is hampered, and an appetite for “regulatory risk” becomes a key determinant of competitive advantage.¹⁸

This paper suggests a number of possible procedural reforms that might, if adopted, alleviate to some degree these concerns. Specifically, the SEC should:

- Establish new standards of conduct for market participants through the rulemaking process, rather than through informal staff policy determinations, examinations and inspections, and enforcement actions;
- Update the procedures for approval of SRO rule proposals in order to make more types of proposals eligible for “effective on filing” or other expedited processing in order to preserve valuable staff resources for proposals that truly raise competitive and investor protection issues;
- Establish by regulation (or request that Congress, through an amendment to section 19 of the Exchange Act, impose) a time limit for publishing SRO rule filings for public comment;

18. Of course, there is no blinding new insight here. The SEC and others have long been cognizant of this connection between procedure and competitive burden. Moreover, the Commission has successively (and often very productively) endeavored to address unnecessary procedural burdens. *See, e.g.*, Filings by Self-Regulatory Organizations of Proposed Rule Changes and Other Materials with the Commission, Exchange Act Release No. 15,838, 44 Fed. Reg. 30,924 (May 29, 1979); Filings by Self-Regulatory Organizations of Proposed Rule Changes and Other Materials with the Commission, Exchange Act Release No. 17,258, 45 Fed. Reg. 73,906 (Nov. 7, 1980); Proposed Rule Changes of Self-Regulatory Organizations: Annual Filing of Amendments to Registration Statements of National Securities Exchanges, Securities Associations, and Reports of the Municipal Securities Rulemaking Board, Exchange Act Release No. 34,140, 59 Fed. Reg. 29,393 (proposed June 1, 1994); Proposed Rule Changes of Self-Regulatory Organizations: Annual Filing of Amendments to Registration Statements of National Securities Exchanges, Securities Associations, and Reports of the Municipal Securities Rulemaking Board, Exchange Act Release No. 35,123, 59 Fed. Reg. 66,692 (Dec. 20, 1994); Proposed Amendment to Rule 19b-4, Under the Securities Exchange Act of 1934, Exchange Act Release No. 39,885, 63 Fed. Reg. 23,584 (proposed Apr. 29, 1998); Amendment to Rule Filing Requirements for Self-Regulatory Organizations Regarding New Derivative Securities Products, Exchange Act Release No. 40,761, 63 Fed. Reg. 70,952 (Dec. 22, 1998); Proposed Rule Changes of Self-Regulatory Organizations, Exchange Act Release No. 43,860, 66 Fed. Reg. 8912 (proposed Feb. 5, 2001); DIV. OF MKT. REGULATION, SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS, Study I, at 10 (Jan. 1994), available at <http://www.sec.gov/divisions/marketreg/market2000.pdf> [hereinafter *Market 2000*]. *See also* U.S. GEN ACCOUNTING OFFICE, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES, REP. NO. GAO-02-302, at 10–11 (Mar. 2002), available at <http://www.gao.gov/new.items/d02302.pdf> [hereinafter SEC OPERATIONS].

- Liberalize the use of no-action letters and exemptive relief in areas with a competitive impact, including new products and proposals—perhaps using more readily “generic” no-action letters, which can be relied upon by many industry participants, rather than just the applicant, and using temporary or pilot approvals to enable the Commission staff to study the impact of the approvals; and
- Explicitly seek to permit cross-border products and services where access to such products and services is not prohibited by law. In this regard, the SEC (or Congress) should develop a framework for weighing international competition and cross-border access in rulemaking and other official action.

In order to give context to these suggestions, Part II of this article describes the overall framework for market structure regulation utilized by the Exchange Act. The operation of the regulatory regime is evaluated in Part III of the article, which examines the strengths and weaknesses of the regulatory scheme. Part IV of the article contains a detailed discussion of the author’s proposals for procedural reform.

II. THE CURRENT FRAMEWORK FOR MARKET STRUCTURE REGULATION

A. THE CONUNDRUM OF COMPETITION

The Exchange Act creates a dual system of securities market regulation. National securities exchanges, national securities associations, and other entities that function as SROs regulate their members and (if they operate markets) act as market regulators.¹⁹ The SEC acts as an oversight regulator of the SROs, and it also promulgates its own rules and regulations and exercises enforcement authority over markets and market participants.²⁰ In addition, the SEC has extensive rulemaking authority to implement the Exchange Act’s directives.²¹

Among the key areas that the Exchange Act directs the SEC and (somewhat indirectly) the SROs to consider when establishing rules is competition. Under the statute, the SEC is obliged (a) not to unnecessarily burden competition (or permit SROs subject to its purview to do so)²² and (b) to promote fair and orderly markets by assuring, among other things,

19. See generally Concept Release: Regulation of Exchanges, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485 (June 4, 1997) (discussing the system of self-regulation).

20. See generally The Investor’s Advocate, *supra* note 14.

21. See *infra* notes 60-67 and accompanying text.

22. See, e.g., Exchange Act § 6(b)(8), 15 U.S.C. § 78f (2000); Exchange Act § 19(b)(5)(ii), 15 U.S.C. § 78s (2000); Exchange Act § 3(f), 15 U.S.C.S. § 78c (LexisNexis 2006); Exchange Act § 23(a)(2), 15 U.S.C. § 78w (2000).

“fair competition” among and between market participants.²³ To understand the framework established by the Exchange Act in this area, and how it is administered in practice, it is helpful to observe that in designing a template for competition regulation, Congress essentially needed to reconcile several propositions that might appear on the surface to be mutually inconsistent:

Vigorous competition can be good. Competition can be an engine for innovation, which often benefits investors, such as when it spurs new technologies and trading methodologies.²⁴ Moreover, in the context of securities trading, competition, when coupled with price transparency and accessibility of trading interest, can result in economically efficient pricing mechanisms for investors and traders.²⁵

Collaboration among competitors can be good and even necessary. Collaboration among competitors is a cardinal element of U.S. securities markets. Brokers and dealers participate jointly in the governance of securities exchanges, band together to form underwriting syndicates, agree upon the parameters for establishing opening prices for a market and respond collectively to a floor broker’s request for a single price execution or resolving trading disputes. Securities markets also collaborate extensively to collect and disseminate consolidated quotation and last sale information,²⁶ develop and govern inter-market linkages,²⁷ allocate regulatory responsibilities for common members,²⁸ and coordinate

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

24. See, e.g., *Reviewing U.S. Capital Market Structure—The New York Stock Exchange and Related Issues: Hearing before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003) (testimony of Meyer “Sandy” Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange), available at <http://financialservices.house.gov/media/pdf/101603ml.pdf> [hereinafter *Reviewing U.S. Capital Market Structure*].

25. See, e.g., Cynthia A. Glassman & Paul S. Atkins, Comm’rs, SEC, Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS 29 (June 9, 2005), available at <http://www.sec.gov/rules/final/34-51808-dissent.pdf> [hereinafter *Regulation NMS Dissent*].

26. See OPRA, PLAN FOR REPORTING OF CONSOLIDATED OPTIONS LAST SALE REPORTS AND QUOTATION INFORMATION (Jan. 9, 2007), available at http://www.opradata.com/pdf/opra_plan.pdf; NYSE, Inc., Consolidated Tape Association Plan (Second Restatement) (June 16, 2006) (CTA Plan); NYSE, Inc., Consolidated Quotation Plan (Restatement) (June 16, 2006) (CQ Plan). Both the CTA Plan and the CQ Plan are available at <http://www.nysedata.com/cta>.

27. See PLAN FOR THE PURPOSE OF CREATING AND OPERATING AN INTERMARKET COMMUNICATIONS LINKAGE PURSUANT TO § 11A(3)(B) OF THE SECURITIES EXCHANGE ACT OF 1934 (2006), available at <http://www.itsplan.com> (follow “ITS Plan (pdf)” link); Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and International Securities Exchange LLC, Exchange Act Release No. 43,086, 65 Fed. Reg. 48,023 (Aug. 4, 2000).

28. See Exchange Act § 19(d), 15 U.S.C. § 78s(d) (2000); Exchange Act § 17(d), 15 U.S.C.S. § 78q(d) (LexisNexis 2006). For a discussion of allocation of regulatory responsibilities by SROs, see Program for Allocation of Regulatory Responsibilities Pursuant to Rule 17d-2, Exchange Act Release No. 54,136, 71 Fed. Reg. 40,759 (July 18, 2006).

surveillance efforts.²⁹ Without these numerous forms of collaboration among competitors that are directed by the Exchange Act or sanctioned by administrative action, we would not have many of the structures that we take for granted such as: firm quotes by dealers in the equities and options markets; a system of transparent consolidated quotations and last sale information; required display of most limit orders in equities and options; inter-market linkages (and inter-market order protection) in the equities and options markets; and orderly processes for clearance and settlement. Rather, we would have fragmented markets and trading, and non-uniform, non-fungible products without true transparency or inter-market competition. Thus, collaboration in some areas has created ground rules for fair competition that operate in the public interest.

Defining competition in the context of the securities markets is maddeningly complex. Even the definition of competition in the securities business is tricky because exchanges can compete with broker-dealers (and vice-versa)³⁰ and investors can compete with broker-dealers.³¹ Apparently, many at the SEC believe that the proper type of competition to promote is not competition between market participants, so much as competition among orders.³² In addition, the competing interests of “short-term” and “long-term” investors were a significant element in the policy debate concerning the adoption of Regulation NMS.³³ Exchange markets in

29. See Amendment to Rule Filing Requirements for Self-Regulatory Organizations Regarding New Derivative Securities Products, Exchange Act Release No. 40,761, 63 Fed. Reg. 70,952, 70,959 (Dec. 22, 1998), for a discussion of Intermarket Surveillance Group. See also Request for Comment on Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities, Exchange Act Release No. 47,849, 68 Fed. Reg. 27,722, 27,723 (May 20, 2003).

30. See, e.g., Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844, 70,910 (Dec. 22, 1998); see also *Domestic Sec., Inc. v. SEC*, 333 F.3d 239, 243–44 (D.C. Cir. 2003); Aaron Lucchetti, *Wall Street Firms Plan New Service for Block Trades*, WALL ST. J., Sept. 27, 2006, at C4.

31. See, e.g., Notice of Filing of Amendments No. 2, 3, and 4 to Proposed Rule Change to Modify the Information Contained in a Directed Order on the Boston Options Exchange, Exchange Act Release No. 53,357, 71 Fed. Reg. 10,730, 10,730–32 (Mar. 2, 2006); Letter from Adam C. Cooper, Senior Managing Dir. & Gen. Counsel, Citadel Inv. Group, LLC, to Nancy Morris, Sec’y, SEC (Mar. 17, 2006), available at <http://www.sec.gov/rules/sro/bse/bse200552.shtml>; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change to Establish a Fee Per Contract Traded for Improvement Orders Submitted Into a Price Improvement Period by a Public Customer That Are not Submitted as Customer PIP Orders, Exchange Act Release No. 54,328, 71 Fed. Reg. 49,493 (Aug. 23, 2006); Letter from Adam C. Cooper, Senior Managing Dir. & Gen. Counsel, Citadel Inv. Group, LLC, to Nancy Morris, Sec’y, SEC (June 17, 2006), available at <http://www.sec.gov/comments/sr-bse-2006-10/bse200610-1.pdf>; see also Proposed Rule Change by International Securities Exchange, Concerning Professional Account Holders, SR-ISE-2006-26 (May 5, 2006), available at [http://www.iseoptions.com/legal/pdf/proposed_rule_changes/SR-ISE-2006-26\\$Professional_AccountHolders\\$20060505.pdf](http://www.iseoptions.com/legal/pdf/proposed_rule_changes/SR-ISE-2006-26$Professional_AccountHolders$20060505.pdf).

32. See, e.g., Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,498 (June 29, 2005).

33. See *Regulation NMS Dissent*, *supra* note 25, at 24–27.

equities, options, and derivatives compete with over-the-counter markets.³⁴ The extent to which international and cross-border issues should be considered by the SEC in evaluating competitive impacts of various initiatives is a question that has been raised repeatedly, but has not been fully developed in Exchange Act jurisprudence.³⁵ Therefore, the regulation of competition cannot be limited to focusing on specified “categories” of market participants and their competitive relations with one another.

Empowering competitors to establish standards, systems and rules is risky. Self-regulation has its benefits—particularly placing front line regulation in the hands of the people who best understand the business and also requiring industry participants to bear a large part of the cost of regulating themselves.³⁶ However, Congress well understood that, absent a proper system of oversight, the SRO structure would not be sound (though it took some years for an effective statutory oversight structure to be established).³⁷ For example, without oversight there would be continuous concerns that SROs would use their power to levy fees and impose discipline on members to benefit some members but not others, exchange systems would be designed to promote the interests of certain traders but not others (and certainly not investors), and standards would be developed (such as fixed commission schedules) that would discourage competition.³⁸ To ensure that the SROs do not use their statutory authority to the detriment of investors and the marketplace, and to ensure a proper balance of competition-related concerns and other policy objectives, the Exchange Act imposes several key controls, including: prescribing certain minimum standards for the content of SRO rules;³⁹ requiring significant policies and procedures of SROs (including systems and fees) to be filed with and (in

34. See, e.g., Amendment to Rule Filing Requirements for Self-Regulatory Organizations Regarding New Derivative Securities Products, 63 Fed. Reg. at 70,965 (adopting Exchange Act Rule 19b-4(e)); *Examining the Commodity Futures Modernization Act of 2000 and Recent Market Developments: Hearing before the S. Comm. on Banking Housing and Urban Affairs*, 109th Cong. 2 (2005) (testimony of the Sec. Indus. Ass’n), available at <http://www.sia.com/testimony/2005/mlackritz09-08-05.html> [hereinafter *Commodity Futures Modernization Act of 2000 Hearing, SIA Testimony*].

35. See, e.g., Letter from Jayda Dagdelen & Mara Tchalakov, Senior Task Force Comm’rs, Princeton University, Woodrow Wilson School of Public Policy, to Jonathan G. Katz, Sec’y, SEC (Jan. 14, 2005), available at <http://www.sec.gov/rules/proposed/s71004/s71004-587.pdf>.

36. See generally Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. REV. 475 (1984).

37. See generally *id.* at 480–87, for a history of self-regulation in the securities industry.

38. See, e.g., Proposal to Adopt Securities Exchange Act Rule 19g2-1 to Relieve National Securities Exchanges and Registered Securities Associations from Certain Obligations, Exchange Act Release No. 12,483, 9 SEC Docket 731 (May 26, 1976); Enforcement Obligations of Exchanges and Associations, Exchange Act Release No. 12,994, 10 SEC Docket 998 (Nov. 18, 1976).

39. See Exchange Act § 6, 15 U.S.C. § 78f (2000); Exchange Act § 15A, 15 U.S.C. § 78o-3 (2000); Exchange Act § 17A, 15 U.S.C. § 78q-1 (Supp. II 2002).

most cases) approved by the SEC,⁴⁰ specifying procedures and standards for SEC review and approval of SRO rules and proposed rule changes;⁴¹ imposing upon SROs a general legal obligation to enforce their rules and the federal securities laws;⁴² conferring upon the SEC oversight and enforcement authority respecting SROs;⁴³ providing for a mechanism of appeal from certain SRO actions;⁴⁴ and establishing a mechanism for the SEC to amend SRO rules directly on its own initiative.⁴⁵

Promotion of competition is but one policy objective. In order to be effective, a system of market regulation must take into account various alternative policy objectives—such as protecting investors and ensuring that there is adequate infrastructure for market operations and securities trading—that, in some cases, might point away from free competition.⁴⁶

The operation of the Exchange Act in balancing these various considerations is briefly described in Section II.B, which follows immediately below. There are several points to note, however, in assessing the operations of this structure. First, the system is set up to ensure that certain *formal* actions of the SEC are required to be informed by particular policy objective, but not necessarily other actions. Second, in some cases, but not others, the marketplace is informed of the SEC's analysis and has an opportunity to comment upon it. Third, because of the procedures associated with SRO rule approval, the SEC can effectively exercise a “pocket veto” over potentially innovative and pro-competitive rule proposals. This allows the SEC to substantively influence rule proposals without subjecting the proposals to notice and public comment or explaining its rationale for doing so. Fourth, when the SEC does make rules and take other official actions, it is, to some extent, constrained by the policy guidance explicitly stated in the Exchange Act. Thus, the SEC is compelled to weigh certain policy objectives above others, which may be equally valid, or even more compelling, under the circumstances. The implications of these four points in evaluating the effectiveness of the system and determining if it strikes the proper balance in terms of allowing competitive forces—not regulatory mandates—shape market structure are discussed in Section IV, below.

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

41. See *id.*

42. See Exchange Act § 19(g).

43. See Exchange Act § 19(h).

44. See Exchange Act § 19(d), (f).

45. See Exchange Act § 19(c).

46. See SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, pt. 4, at 502–05, 576–79 (1963).

B. STATUTORY DIRECTIVES

1. Content of SRO Rules

In determining whether to allow an organization to register as a national securities exchange or a registered securities association, the SEC must determine whether the organization's rules meet certain specified standards. Among these are the criteria contained in sections 6(b)(8) (dealing with national securities exchanges) and 15A(b)(9) (dealing with registered securities associations) of the Exchange Act, which direct the SEC to ensure that the rules of the exchange or association "do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act. The Exchange Act also provides that the rules of the exchange or association must provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities, and be:

[D]esigned to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange.⁴⁷

2. SEC Consideration and Approval of SRO Rules

Section 19(b)(1) of the Exchange Act requires each SRO to file with the SEC any proposed rule or rule change, accompanied with a statement of the basis and purpose of the proposal. Such rules and rule proposals must be approved by the SEC in order to take effect,⁴⁸ unless the proposal falls within a list of prescribed categories that are "effective upon filing."⁴⁹ The SEC must publish notice of the proposal and give the public an opportunity to comment on it. Generally the comment period for a proposed rule change is twenty-one days, and comments often focus on competition issues.

47. Exchange Act § 6(b)(4), (5), 15 U.S.C. § 78f(b)(4), (5) (2000); *see also* Exchange Act § 15(a)(b)(5), (6), 15 U.S.C. § 78o(a)(b)(5), (6) (Supp. II 2002).

48. *See* Exchange Act § 19(b)(2).

49. *See* Exchange Act § 19(b)(3)(A), which provides that proposed SRO rules constituting a stated policy, practice, or interpretation regarding the meaning, administration, or enforcement of an existing rule, establishing or changing a due, fee, or other charge, or concerned solely with the administration of the self-regulatory organization are not the subject to SEC approval order, but are "effective on filing." *See also* Exchange Act Rule 19b-4(f), 17 C.F.R. § 240.19b-4(f) (2004).

According to section 19(b)(2), the SEC may only approve a proposed rule or rule change if it finds that the proposal is consistent with requirements of the Exchange Act.⁵⁰ For example, the SEC must determine whether the rule would impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The SEC must also consider the protection of investors and “whether the action will promote efficiency, competition, and capital formation.”⁵¹ Thus, the SEC is required to engage in a balancing of various factors along with competition.

In analyzing the effects of SRO proposals on competition, the SEC has observed that it “is not required to achieve its objectives in the least anticompetitive manner and is at most required to decide that any anticompetitive effects of its actions are necessary or appropriate to the achievement of its objectives.”⁵² In a matter involving the rules of a registered clearing organization (a type of SRO) the SEC stated that in assessing the anticompetitive effects of the proposed rules, the SEC “is required to balance the maintenance of fair competition with a number of other equally important express purposes of the Act such as the protection of investors and the safeguarding of securities and funds.”⁵³ For example, in acting upon the application of the clearing organization to largely withdraw from the clearance and settlement of equity securities, the SEC effectively approved a monopoly on clearing of equity securities in the United States. The SEC observed that, despite the dominant market position of certain clearing organizations, the regulatory structure and nature of the depository industries were sufficient to avoid the negative effects of a monopoly, and therefore the proposed rules were not “an inappropriate or unnecessary burden upon competition.”⁵⁴

Although the Exchange Act contains many directives to the SEC concerning consideration of the implications of its actions on competition, it gives little guidance concerning how to analyze competition issues. As a result, the Commissioners and the staff are left to consider, with respect to each action, which type or measure of competition is the most significant. In rulemaking, the Commission generally explains its competitive impact analysis in detail and backs up that analysis with empirical data. Often, the Commission is flooded with adverse comment on its rulemaking proposals

50. See Exchange Act § 19(b)(2).

51. See Exchange Act § 3(f), 15 U.S.C. § 78c(f) (2000).

52. Order Granting Partial Permanent Approval and Partial Temporary Approval of Proposed Rule Changes Relating to a Decision by the Philadelphia Stock Exchange, Inc., Exchange Act Release No. 39,444, 62 Fed. Reg. 66,703, 66,705 (Dec. 19, 1997); *Bradford Nat'l Clearing Corp. v. SEC*, 590 F.2d 1085, 1105 (D.C. Cir. 1978).

53. Order Granting Partial Permanent Approval, 62 Fed. Reg. at 66,705.

54. *Id.*

urging it to adopt different approaches to its competition analysis.⁵⁵ However, by contrast, approvals of SRO rule changes generally do not contain extensive analysis of competitive impacts. Generally, statements regarding competition are conclusory and are rarely backed by extensive data.

Where the SEC is uncertain regarding the possible effects of a particular SRO rule, it frequently approves the rule on a temporary or “pilot” basis. In such cases, the SEC often requires the SRO to submit data regarding the effects of the rule so that it can evaluate whether the rule complies with statutory standards and should be approved on a permanent basis.⁵⁶

Many SRO rules become effective by an SEC-issued order. Like other final orders of the Commission, aggrieved persons may request that such orders be reviewed by a federal court of appeals.⁵⁷

In regard to filings that are “effective upon filing,” there is no Commission approval order issued. However, the SEC may “abrogate” the filing, cause it to be refiled in the “ordinary way” (i.e., under section 19(b)(2)), and subject it to full notice and public comment and SEC review if the Commission believes that such action is necessary to protect investors or to further the purposes of the Exchange Act. In practice, the SEC abrogates “effective upon filing” SRO rule changes where the SEC considers that the proposal raises significant policy issues that should be

55. See, e.g., *Reviewing U.S. Capital Market Structure*, *supra* note 24. Interestingly, a former SEC Chairman and a former Secretary of the Commission have both recently called for greater economist involvement in policy setting at the SEC. See Harvey Pitt, *Over-Lawyered at the SEC*, WALL ST. J., July 26, 2006, at A15; Jonathan G. Katz, *Rules Are Not Sacred, Principles Are*, WALL ST. J., Aug. 8, 2006, at A11.

56. See, e.g., Order Granting Accelerated Approval to Amendment No. 1 by the International Securities Exchange LLC Relating to Market Maker Allocations, Exchange Act Release No. 42,808, 65 Fed. Reg. 34,515, 34,517 (May 30, 2000) (“The Commission . . . intends to use the one-year pilot period to monitor the rule’s impact on competition.”); Order Granting Accelerated Approval to the Proposed Rule Change on a Temporary Basis Relating to Bond Mutual Fund Volatility Ratings, Exchange Act Release No. 42,476, 71 SEC Docket 1852 (Mar. 8, 2000) (“The proposed rule change would permit, for an 18-month trial period, the use of the mutual fund volatility ratings subject to certain limitations, and provided certain disclosures are made.”); Order Granting Accelerated Approval of a Proposed Rule Change to Initiate a Pilot Program that Allows the Listing of Strike Prices at One-Point Intervals for Certain Stocks Trading under \$20, Exchange Act Release No. 48,013, 68 Fed. Reg. 35,933, 35,936 (June 11, 2003) (“The Commission expects the Exchange to monitor the applicable equity options activity closely In addition, the Commission requests that the PHLX monitor the trading volume associated with the additional options series listed as a result of the Pilot Program”); Press Release, SEC Chairman Cox Urges Options Exchanges to Start Limited Penny Quoting (June 7, 2006), *available at* <http://www.sec.gov/news/press/2006/2006-91.htm>. For a discussion of pilot programs concerning the practice of “preferencing,” see SEC, REPORT ON THE PRACTICE OF PREFERENCING, <http://www.sec.gov/news/studies/prefrep.htm> (last visited Feb. 21, 2007).

57. See Exchange Act § 25(a), 15 U.S.C. § 78y (2000).

commented upon by interested persons before the rule change becomes “permanently effective.”

3. SEC Oversight

Section 19(g) of the Exchange Act requires every SRO to comply with (and, in general to cause its members to comply with) its own rules, the Exchange Act, and the rules and regulations promulgated thereunder. The SEC, under section 21 of the Exchange Act, may make investigations to determine whether any person has violated, is violating, or is about to violate any provision of the Act or any SRO rule. The SEC also has authority to institute cease and desist proceedings in the case of actual or prospective violations of the Exchange Act.⁵⁸ Within this context, the SEC may investigate those individuals participating in anticompetitive practices and take appropriate actions to eliminate such anticompetitive behavior.⁵⁹

Finally, section 19(d) of the Exchange Act permits appeals by affected persons of certain SRO disciplinary sanctions, denials of access, and certain other (but not all) SRO actions.

4. SEC Rulemaking

An important source of SEC rulemaking authority and policy direction affecting market structure is section 11A of the Exchange Act, in which Congress directed the SEC to “facilitate the establishment of a national market system for securities.”⁶⁰ In this regard, section 11A makes an important policy choice regarding the role of government in market structure development: it commands the SEC to take an activist role in rulemaking to promote those attributes that Congress determined were essential to the national market system which it envisioned.

58. Exchange Act § 21C, 15 U.S.C. § 78u-3 (Supp. II 2002).

59. For example, in August 1996, as a result of a widely publicized economic study suggesting that NASD market makers colluded to maintain artificially wide inside spreads on Nasdaq by avoiding odd-eighth quotations in many stocks, the SEC issued a report in accordance with section 21(a) of the Exchange Act. *See* REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND NASDAQ MARKET, Exchange Act Release No. 37,542, 62 SEC Docket 1385 (Aug. 8, 1996). Other enforcement proceedings against securities markets have involved competition issues and have been directed, at least in part, at remedying anticompetitive practices. *See, e.g.*, In the Matter of Certain Activities of Options Exchanges, Exchange Act Release No. 43,268, 2000 SEC LEXIS 1881 (Sept. 11, 2000) (proceeding against The American Stock Exchange, The Chicago Board Options Exchange, The Pacific Exchange, and The Philadelphia Stock Exchange for engaging in anticompetitive activities and for failing to adequately enforce compliance with their own rules).

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

Congress stated that the following interests should be assured in regard to the national market system:

- Economically efficient execution of securities transactions;
- Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
- The availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;⁶¹
- The practicability of brokers executing investors' orders in the best market; and
- An opportunity for investors' orders to be executed without the participation of a dealer.

In terms of its specific rulemaking authority in section 11A, the SEC is authorized to compel joint action by competitors in regard to the national market system.⁶² Also, it is important to note that section 23 of the Exchange Act confers general rulemaking authority on the SEC.

When making rules pursuant to the Exchange Act, the SEC is required to consider, among other matters, the impact that rule or regulation would have on competition. The SEC is not permitted to adopt any rule or regulation "which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act. When the SEC adopts a rule, it must express in writing "the reasons for [its] determination that any burden on competition imposed by such rule or regulation is necessary or appropriate in furtherance of the purposes of" the Exchange Act.⁶³

61. See Exchange Act § 11A(1)(d) ("[An additional goal is] the linking of all markets for qualified securities through communication and data processing facilities, [which] will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.").

62. The SEC may "by rule or order, . . . authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under this title in planning, developing, operating, or regulating a national market system . . ." Exchange Act § 11A(a)(3)(B). In addition to issuing orders directing SRO collaboration under section 11A, the SEC also approves "plans" submitted to the Commission by SROs to effectuate matters described in section 11A, such as inter-market linkages. See, e.g., Regulation NMS, 70 Fed. Reg. 37,496, 37,624–30 (June 29, 2005) (defining rules 601(a)(3) and 608); see generally Oesterle, *supra* note 11, at 12–25 (discussing the history, operation, and procedural aspects of these plans). For a recent instance of such a plan proposal, see Notice of Filing of the NMS Linkage Plan by the American Stock Exchange LLC, Boston Stock Exchange, Inc., Chicago Board Options Exchange, Inc., Chicago Stock Exchange, Inc., The Nasdaq Stock Market LLC, National Stock Exchange, New York Stock Exchange LLC, and NYSE Arca, Inc., Exchange Act Release No. 54,239, 71 Fed. Reg. 44,328 (Aug. 4, 2006).

63. It is interesting to note that the other federal securities statute that is of most direct application to most securities markets and trading firms, the Securities Act of 1933 (Securities Act), which concerns the registration of securities offerings, deals somewhat differently with

Where the Commission is studying the effects of a rule, from time to time it adopts the rule (or a partial exemption from a rule) on a temporary or pilot basis. As with pilot approvals of SRO rules noted above, this permits the SEC to study the effects of the rule on competition and on market behavior. For example, there is currently a pilot program in effect which exempts certain “short sales” of equity securities from the SEC’s and SRO restrictions.⁶⁴

Commission rulemaking under certain sections of the Exchange Act are appealable to the federal circuit courts.⁶⁵ Although such appeals to Exchange Act rules are not common,⁶⁶ there has recently been a spate of successful challenges to SEC rulemakings under other statutory authority,⁶⁷ including the Administrative Procedure Act.⁶⁸

5. Exemptive Authority and No-Action Letters

a. Exemptive Authority

Section 36 of the Exchange Act allows the SEC to conditionally or unconditionally exempt from the requirements of the Exchange Act “by rule, regulation, or order . . . any person, security, or transaction, or any class or classes of persons, securities, or transactions” so long as the exemption “is necessary or appropriate in the public interest, and is consistent with the protection of investors.” Section 36 further gives the SEC authority to determine the procedures under which to grant exemptive authority. The SEC may exercise discretion and decline any application for an exemption. Various other provisions of the Exchange Act contain grants of exemptive authority and/or the authority to define terms used in the

competition. Specifically, the provisions of the Securities Act that authorize the SEC to promulgate rules and regulations do not require the SEC to consider the effects on competition. *See* Securities Act § 19(a), 15 U.S.C. § 77s (Supp. II 2002).

64. On July 28, 2004, the Commission issued an order creating a one year pilot suspending the provisions of Rule 10a-1(a) under the Act and any short sale price test of any exchange or national securities association for short sales of certain securities. The pilot was created pursuant to Rule 202T of Regulation SHO, which established procedures to allow the Commission to temporarily suspend short sale price tests so that the Commission could study the effectiveness of short sale price tests.

Order Extending Term of Short Sale Pilot, Exchange Act Release No. 53,684, 71 Fed. Reg. 24,765, 24,765 (Apr. 26, 2006) (citations omitted). The pilot approval has since been extended.

65. Exchange Act § 25(b), 15 U.S.C. § 78y(b)(1) (2000).

66. *See, e.g.,* Ass’n of Inv. Brokers v. SEC, 676 F.2d 857 (D.C. Cir. 1982).

67. *See, e.g.,* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006); U.S. Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005); Chamber of Commerce of the U.S. v. SEC, 443 F.3d 890 (D.C. Cir. 2006).

68. 5 U.S.C. § 551 (2000).

Exchange Act.⁶⁹ Frequently, when the SEC promulgates rules under the Exchange Act, it gives itself exemptive authority in respect of its own rule.⁷⁰

b. No-Action Letters

The SEC also issues informal guidance, which takes the form (among others) of no-action letters. The SEC defines no-action letters as letters “in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated.”⁷¹ Although most no-action letters are addressed to a single applicant and are not intended to be relied upon by others, the staff sometimes issues “generic” no-action letters that, by their terms, permit reliance by all persons who meet the criteria specified in the letter.⁷² No-action letters are not legally binding on the SEC and are not issued by the full authority of the Commission, but instead represent the views of the staff of the Division from which they are issued.⁷³ The SEC takes the position that the staff’s responses to letters “are not rulings . . . on questions of law or fact” and that “such letters are not intended to affect the rights of private persons.”⁷⁴ However, as a practical matter, despite the formal lack of precedential significance of no-action letters, market participants widely rely upon no-action letters as if they did represent an official legal position.

In some respects, no-action letters are an ideal tool for the SEC to test the waters by permitting new activities, which, while consistent with the

69. See, e.g., Exchange Act § 3(b), 15 U.S.C. § 78c (Supp. IV 2004) (defining terms); Exchange Act § 5(2), 15 U.S.C. § 78e(2) (2000) (limited volume exchanges); Exchange Act § 6(h)(4), 15 U.S.C. § 78h(4) (2000) (security futures); Exchange Act § 11(c), 15 U.S.C. § 78k(c) (2000) (certain exchange rules); Exchange Act § 15(a)(2), 15 U.S.C. § 78o(2) (Supp. II 2002) (registration of brokers and dealers); Exchange Act § 15B(a)(4), 15 U.S.C. § 78o-4(a)(4) (Supp. II 2002); Exchange Act § 17(h)(4), 15 U.S.C. § 78q(h)(4) (Supp. IV 2004); Exchange Act § 17B(c), 15 U.S.C. § 78q-2(c) (2000) (penny stock automated quotation systems); Exchange Act § 31(f), 15 U.S.C. § 78ee(f) (Supp. II 2002) (transaction fees). By contrast, section 28 of the Securities Act gives the SEC similar exemptive authority, but the SEC can only make exemptions by rule or regulation. See 15 U.S.C. § 77z-3 (2000). This means that the SEC has less flexibility to grant exemptive relief from the registration requirements of the Securities Act than it is from the requirements of the Exchange Act.

70. See, e.g., 17 C.F.R. §§ 242.203(d), 242.301(a)(5), 240.3b-16 (2007).

71. Procedures Utilized by the Division of Corporation Finance for Rendering Informal Advice, Securities Act Release No. 6253, 45 Fed. Reg. 72,644, 72,644 (Nov. 3, 1980).

72. See, e.g., Giovanni P. Prezioso, Cleary, Gottlieb, Steen & Hamilton, 1997 SEC No-Act. LEXIS 525 (Apr. 9, 1997) (concerning Exchange Act Rule 15a-6) [hereinafter *Nine Firm Letter*]; David C. Whitcomb, Jr., Chicago Stock Exchange, 2006 SEC No-Act. LEXIS 545 (July 20, 2006) (concerning Exchange Act Rule 10a-1).

73. 17 C.F.R. § 202.1(d) (2006).

74. Monthly Publication of List of Significant Letters Issued by the Division of Corporation Finance, Securities Act Release No. 5691, 41 Fed. Reg. 13,682 (Mar. 17, 1976).

relevant statutes,⁷⁵ may be novel or represent a step beyond the current state of agency rulemaking. Since the staff is not called upon to (and does not) concur in the applicant's legal analysis, the letter does not formally have precedential effect and cannot be relied upon by third-parties, and the letter can be withdrawn if (among other things) the staff's view of the law or policy changes. No-action letters are a low cost avenue to permit the limited introduction of new business models which enhance competition.

C. LURKING IN THE BACKGROUND: ANTITRUST LAW AND STATE LAW

1. Sherman Act and Doctrine of Implied Repeal

The principal federal statute governing competition in the securities markets is the Sherman Antitrust Act (Sherman Act).⁷⁶ Section 1 of the Sherman Act states that “[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.”⁷⁷ The central concern of this section is concerted action.⁷⁸ Section 2 of the Sherman Act⁷⁹ is mainly concerned with monopolization.⁸⁰ The goals of the Sherman Act are not as comprehensive as those of the SEC under the Exchange Act, which along with being concerned with competitive issues, is concerned with “the viability of sellers, the truthfulness of information, with sharp practices that may injure customers, and with the smooth functioning of trading institutions.”⁸¹ Often the regulatory scheme of the Exchange Act conflicts with the policy of the Sherman Act.⁸² Although Congress did not expressly exempt securities market conduct from the Sherman Act, courts have historically utilized the doctrine of “implied repeal” to reconcile potential or actual conflicts between the securities laws, SEC actions, and SEC-approved SRO rules,⁸³ and the Sherman Act, and to decide whether an activity is immune from a Sherman Act challenge.⁸⁴

75. While no-action letters purport to be a statement of enforcement intention, rather than a statement of the law, the staff requires applicants to submit a legal opinion that the requested action is consistent with applicable legal standards.

76. Sherman Antitrust Act, 15 U.S.C. §§ 1–7 (2004).

77. Sherman Antitrust Act § 1.

78. See IRVING SCHER, ANTITRUST ADVISER § 1.3 (4th ed. 2005).

79. Sherman Antitrust Act § 2.

80. See SCHER, *supra* note 78, § 1.3.

81. Herbert Hovenkamp, *Antitrust Violations in Securities Markets*, 28 J. CORP. L. 607, 609 (2003).

82. See Russell L. Hewitt, *Securities Exchanges and the Antitrust Laws*, 33 WASH. & LEE L. REV. 999, 999–1000 (1976).

83. *Id.* at 1000.

84. *Id.*

Courts utilize the “implied repeal” doctrine in two situations. First, courts will find implied repeal if Congress, via a specific statute, gave clear authority to the SEC to supervise a particular activity and the application of the antitrust laws would unduly interfere with the operation of the statute and subject those who are regulated under the statute to conflicting standards.⁸⁵ Second, courts will find implied repeal if the regulatory scheme established by Congress is so pervasive that applying the antitrust laws in the face of such specific standards and broad regulatory authority would subject the regulated entities to duplicative and inconsistent standards.⁸⁶

Historically, the SEC’s active intervention in market structure has been significant in preventing the application of inconsistent standards that might have prevailed if ordinary antitrust rules were applied.⁸⁷

2. State Law and Preemption

SEC regulation in many instances also, explicitly or implicitly, preempts state law. According to the Supremacy Clause of United States Constitution, the laws of Congress are “the supreme law of the land.”⁸⁸ When Congress chooses to exercise its constitutionally delegated authority, state law must yield to it.⁸⁹ Although Congress, when enacting the Exchange Act, did not generally preempt state law,⁹⁰ state law has been explicitly overridden in certain instances by specific legislation. For example, the National Securities Markets Improvements Act of 1996 (NSMIA)⁹¹ preempts state laws respecting capital, custody, margin, financial responsibility, recordkeeping, and other obligations of broker-dealers.⁹²

In addition, courts imply congressional intent in instances where the legislative scheme is “so pervasive that it raises a reasonable inference that

85. See *Gordon v. N.Y. Stock Exch.*, 422 U.S. 659 (1975).

86. See *United States v. Nat’l Ass’n of Sec. Dealers*, 422 U.S. 694 (1975).

87. See Oesterle, *supra* note 11, at 18.

88. U.S. CONST. art. VI, cl. 2.

89. See *Gibbons v. Ogden*, 22 U.S. 1, 211 (1824). See generally Complaint, *Sec. Indus. Ass’n v. Klein*, No. 2:06 CV 00623 (D. Utah July 28, 2006), available at http://www.sia.com/utah_lawsuit/pdf/complaint.pdf (citing additional cases); Kenneth I. Denos, *Blue and Gray Skies: The National Securities Markets Improvement Act of 1996 Makes the Case for Uniformity in State Securities Law*, 1997 UTAH L. REV. 101, 131 n.202 (1997) (citing additional cases).

90. See Exchange Act § 28(a), 15 U.S.C. § 78bb(a) (2000) (“[T]he rights and remedies provided in this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.”).

91. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416.

92. See Exchange Act § 15(h), 15 U.S.C. § 78o(h) (2006). NSMIA also amended section 18 of the Securities Act, preempting state registration and qualification requirements for certain “covered securities.” See Brief for Plaintiff at 17, *NASD Dispute Resolution, Inc. v. Judicial Council of California*, 232 F. Supp. 2d 1055 (N.D. Cal. 2002) (No. C02 3486), available at <http://www.sec.gov/litigation/briefs/nasddispute.htm>.

Congress left no room for a state to supplant it,” or where “compliance with both federal and state laws is an impossibility.”⁹³ Where the SEC takes action within the scope of its delegated authority and pursuant to the Exchange Act, inconsistent state law must give way.⁹⁴ This is generally thought to extend to SEC orders approving SRO rules.⁹⁵

Other areas of law, including intellectual property law, can also impact competition and even securities market structure.⁹⁶

III. SOME STRENGTHS AND WEAKNESSES OF THE CURRENT STRUCTURE

A. STRENGTHS

The Exchange Act’s statutory scheme has many positive attributes. Principally, it acknowledges that the success of the securities markets rests upon various factors, and that the competition is but one leg of the stool.

93. See *Shulick v. Painewebber, Inc.*, 722 A.2d 148, 150–51 (Pa. 1998) (finding that SEC regulation of broker disclosure requirements impliedly preempted state agency law requirements).

94. *Id.* There are, of course, limits to the SEC’s jurisdictional authority to displace state law through rulemaking. See *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (holding that the SEC exceeded its authority under section 19(c) of the Exchange Act by promulgating certain rules affecting voting rights).

95. See, e.g., *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119 (9th Cir. 2005); see also *Carapico v. Philadelphia Stock Exch.*, 1994 U.S. Dist. LEXIS 1667 (E.D. Pa. Feb. 14, 1994). The full extent to which SRO rules preempt State law has been the subject of considerable debate, but has not yet been resolved fully in litigation.

96. Intellectual property law affects competition in the securities markets in various ways. Specifically, licensing arrangements with respect to “derivative” products that are based on indices or other measures of value have enabled exchanges to have the exclusive right to trade options based on the index—a large and increasing segment of securities products encompassing exchange traded securities products, such as exchange traded funds and options on them and equity index options. In many instances, intellectual property rights in respect of the use of indexes have been used as a basis for claiming exclusive trading rights in overlying securities products in situations where comparable non-derivative products would not have been permitted to trade on an exclusive basis as a matter of securities law. See Exchange Act § 12(f), 15 U.S.C. § 78l (Supp. IV 2004), with respect to unlisted trading privileges regarding exchange-listed securities, and Exchange Act Rule 19c-5, 17 C.F.R. § 240.19c-5 (2006), concerning options products. It has been asserted that exclusive intellectual property rights “directly affects investors.” See Request for Rulemaking to Amend Rule 19c-5 Regarding Certain Options Exchange Licensing Arrangements, SEC Petition 4-469 (Nov. 1, 2002), available at <http://www.sec.gov/rules/petitions/petn4-469.htm>. Although claims of exclusivity and trading rights in specific products have been slowly resolved on a case-by-case basis in the courts, see, e.g., *Dow Jones v. Int’l Sec. Exch., Inc.*, 451 F.3d 295 (2d Cir. 2006), there are still many open questions, including exclusive rights to trade options based upon a security index. The extent to which the SEC can and should intervene in these issues is a fertile and timely one. See generally Annette L. Nazareth, Comm’r, SEC, Remarks before the STA Annual Conference: Competition & Regulation Balancing the National Market System (Oct. 7, 2005), available at <http://www.sec.gov/news/speech/spch100705aln.htm> (discussing current market issues and “broader regulatory challenges” that arise “as the financial landscape gets more sophisticated and multi-dimensional”) [hereinafter *Competition & Regulation Balancing the National Market System*].

Congress's delegation to the SEC of oversight authority with respect to the SROs, as well as independent rulemaking authority, also recognizes an essential point; the economic, legal and technological underpinnings of the securities markets are constantly changing. Formulating policy in promoting the welfare of the securities markets will necessarily involve an assessment of the proper course in light of changing conditions. Thus, it was wise to vest an expert body with the authority and practical ability to balance these factors when formulating and implementing policy.

The doctrines of implied repeal and preemption also operate to the benefit of the markets by giving effect to the sound policy that the ordinary principles of competition law could operate at cross-purposes to the larger scheme of regulation developed by the SEC in aid of the national market system.

In effect, the system permits the SEC to leverage the benefits of cooperative efforts by industry participants, such as broker-dealers acting through national securities exchanges (or pursuant to their rules) and SROs acting through National Market System plans, while keeping a watchful eye on anti-competitive consequences.

In the last decade alone, the SEC has tackled many important market structure issues without crushing competition, including:

- Facilitating the almost total transition of member owned and dominated exchanges to shareholder ownership and control;⁹⁷
- Approving the separation of The NASDAQ Stock Market, Inc. from the NASD, and overseeing many developments in that market;⁹⁸
- Implementing decimalization of all of the securities markets and the inception of penny minimum price variations in the options market;⁹⁹

97. *See, e.g.*, Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3, Exchange Act Release No. 49,098, 69 Fed. Reg. 3974 (Jan. 27, 2004); Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1, Exchange Act Release No. 49,718, 69 Fed. Reg. 29,611 (May 24, 2004); Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 by the Chicago Stock Exchange, Inc., Exchange Act Release No. 51,149, 70 Fed. Reg. 7531 (Feb. 14, 2005); Order Granting Approval of Proposed Rule Change and Amendment Nos. 1, 3, and 5 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 6 and 8, Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251 (Mar. 6, 2006); Order Approving Proposed Rule Change and Amendment Nos. 1 and 2, Exchange Act Release No. 53,963, 71 Fed. Reg. 34,660 (June 15, 2006).

98. *See* In the Matter of the Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550 (Jan. 23, 2006); *see also* Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1, Exchange Act Release No. 54,084, 71 Fed. Reg. 38,935 (July 10, 2006).

- Introducing a very flexible and highly successful method for exchange-like trading platforms to enter operation rapidly and without most of the extensive requirements applicable to registered national securities exchanges;¹⁰⁰
- Fostering multiple trading, creating a linkage system, discouraging competitive practices, and approving new market entrants in listed options markets;¹⁰¹
- Establishing a new framework for intermarket order protection and open intermarket access in the listed equities market;¹⁰²
- Casting a bright light on specialist practices at the NYSE through enforcement action;¹⁰³
- Promulgating important order handling requirements¹⁰⁴ and extensive reporting of equity market execution quality in furtherance of best execution and investor protection goals;¹⁰⁵ and
- Reconsidering the framework for short sale regulation.¹⁰⁶

99. See U.S. GEN. ACCOUNTING OFFICE, *SECURITIES MARKETS: DECIMAL PRICING HAS CONTRIBUTED TO LOWER TRADING COSTS AND A MORE CHALLENGING TRADING ENVIRONMENT*, REP. NO. GAO-05-535 (May 2005) [hereinafter *GAO DECIMALIZATION REPORT*], for a full discussion of decimalization.

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

101. See *generally* *Competitive Developments in the Options Markets*, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124 (Feb. 9, 2004). See also *Order Granting Approval to Proposed Rule Change and Amendment No. 3 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 4 Thereto by the Boston Stock Exchange, Inc.*, Exchange Act Release No. 49,068, 69 Fed. Reg. 2775 (Jan. 20, 2004); *In the Matter of the Application of the International Securities Exchange LLC for Registration as a National Securities Exchange*, Exchange Act Release No. 42,455, 65 Fed. Reg. 11,401 (Mar. 2, 2000).

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

103. See *In the Matter of New York Stock Exchange, Inc.*, Exchange Act Release No. 51,524, 2005 SEC LEXIS 814 (Apr. 12, 2005). See also *In the Matter of Performance Specialist Group LLC*, Exchange Act Release No. 50,075, 2004 SEC LEXIS 1564 (July 26, 2004); *In the Matter of SIG Specialists, Inc.*, Exchange Act Release No. 50,076, 2004 SEC LEXIS 1563 (July 26, 2004); *In the Matter of Bear Wagner Specialists LLC*, Exchange Act Release No. 49,498, 2004 SEC LEXIS 743 (Mar. 30, 2004); *In the Matter of Fleet Specialist, Inc.*, Exchange Act Release No. 49,499, 2004 SEC LEXIS 744 (Mar. 30, 2004); *In the Matter of LaBranche & Co. LLC*, Exchange Act Release No. 49,500, 2004 SEC LEXIS 749 (Mar. 30, 2004); *In the Matter of Spear, Leeds & Kellogg Specialists LLC*, Exchange Act Release No. 49,501, 2004 SEC LEXIS 742 (Mar. 30, 2004); *In the Matter of Van der Moolen Specialists USA, LLC*, Exchange Act Release No. 49,502, 2004 SEC LEXIS 2197 (Mar. 30, 2004).

104. See *Order Execution Obligations*, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48,290 (Sept. 12, 1996) (adopting Exchange Act Rule 11Ac1-4 and amendments to 11Ac1-1).

105. See *Disclosure of Order Execution and Routing Practices*, Exchange Act Release No. 43,590, 65 Fed. Reg. 75,414 (Dec. 1, 2000) (adopting Exchange Act Rules 11Ac1-5 and 11Ac1-6).

106. See *supra* note 3. See also *Short Sales*, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008 (Aug. 6, 2004) (adopting Regulation SHO); *Amendments to Regulation SHO*, Exchange Act Release No. 54,154, 71 Fed. Reg. 41,710 (July 21, 2006) (proposing amendments to Regulation SHO); *Order Granting Accelerated Approval of Proposed Rule Change to Exempt all*

Critics of the SEC's most recent ambitious market structure initiative, Regulation NMS, were particularly concerned about dampening competition.¹⁰⁷ Yet, it is clear that, while some business models may be impacted, others are rising to take their place. It is worth noting that, since the adoption of Regulation NMS, not only have traditional markets, like the "regional" stock exchanges, submitted proposals to introduce new equity trading platforms, in some cases backed by fresh capital,¹⁰⁸ but also new competitors have emerged.¹⁰⁹ A newly reorganized Nasdaq promises to be a potent force in competing for trading volume in NYSE stocks.¹¹⁰ Finally, the NYSE has broadly enhanced its own trading platform with the introduction of the Hybrid system.¹¹¹

To be sure, Regulation NMS and other reforms will affect (sometimes fatally) particular business models.¹¹² And the SEC must be extremely vigilant that certain business models, including those of market makers and other liquidity providers, do not become unviable. Yet, at least in the case of the equities market, if recent signs of intent to compete are an indication, it seems unlikely that competition will perish, even if some business models suffer or even fade.

The options market seems to be extremely vibrant and competition has never been more intense, despite market structure reforms that many predicted would have dire consequences.¹¹³ In addition, the velocity of

Securities in the NASDAQ-100 Index From the Price Test Set Forth in NASDAQ Rule 3350(a), Exchange Act Release No. 54,435, 71 Fed. Reg. 55,042 (Sept. 20, 2006).

107. See Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,498-99 (June 29, 2005). Among other things, Regulation NMS requires trading centers to establish policies and procedures to prevent "trade throughs" and eliminates sub-penny quoting in most listed stocks.

108. See Lucchetti, *supra* note 4; Aaron Lucchetti, *Wall Street Firms to Control NSX*, WALL ST. J. Sept. 5, 2006, at C3 (describing investments by major financial institutions in the National Stock Exchange).

109. See Annette L. Nazareth, Comm'r, SEC, Speech at the Mutual Fund Directors Forum: Lifting The Veil—Investment Industry Trading Practices And Best Execution Workshop (June 7, 2006), available at <http://www.sec.gov/news/speech/2006/spch060706aln.htm>. See, e.g., Order Granting Accelerated Approval to Amendment No. 2 Thereto to Establish Rules for a Screen-Based Trading System for Non-Option Securities, Exchange Act Release No. 54,422, 71 Fed. Reg. 54,537 (Sept. 15, 2006); Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to Establishing ISE Stock Exchange, LLC as a Facility of the International Securities Exchange, Inc., Exchange Act Release No. 54,399, 71 Fed. Reg. 53,728 (Sept. 12, 2006).

110. See NASDAQ Market Share Statistics, <http://www.nasdaqtrader.com/trader/tradingservices/marketshare.stm> (noting that for the month of August 2006, Nasdaq's total market share in NYSE securities was roughly twenty-eight percent). See also *Nasdaq Beats NYSE in August Market Share Grab*, WALL ST. LETTER, Sept. 18, 2006, at 4.

111. See News Release, New York Stock Exch., NYSE Completes Hybrid Market Phase III Activation (Jan. 24, 2007), available at <http://www.nyse.com/marketinfo/hybmarket/1127349068564.html> (follow "NYSE Completes Hybrid Market Phase III Activation" link).

112. See GAO DECIMALIZATION REPORT, *supra* note 99, at 8, 44.

113. See, e.g., *id.* at 64-67. See generally Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and

introduction of significant new systems and modalities of listed options trading is staggering.¹¹⁴

Although the SEC has been less active in directly regulating the corporate bond market, those market structure innovations that the SEC has encouraged, particularly the NASD's TRACE system for transaction reporting,¹¹⁵ have been successful in promoting transparency in that market without compromising competition.¹¹⁶

Thus, although past results cannot guarantee future performance, it is hard to say that the major market structure initiatives have fatally compromised competition overall or hurt the markets.

B. WEAKNESSES

Despite the strengths of the current market structure, the system also has a number of significant flaws. For example, the process for establishing standards lacks transparency and is slow, the SEC's staff is too cautious, and the Commission and its staff lack clear standards for considering the international implications of its actions.

1. The Process for Establishing Standards is Often Opaque

It is something of a paradox that the SEC exerts much of its market structure influence without any transparency. Although rulemaking and SRO rule approvals require a notice and public comment process,¹¹⁷ in practice, much policy setting is not subjected to that discipline. There are several reasons for this lack of transparency.

International Securities Exchange LLC, Exchange Act Release No. 43,086, 65 Fed. Reg. 48,023 (Aug. 4, 2000), for a discussion of comments in opposition to options inter-market linkage.

114. See, e.g., Order Granting Accelerated Approval to Amendments No. 1, 2, and 3 Thereto To Adopt a Simple Auction Liaison System to Auction Qualifying Marketable Orders for Potential Price Improvement, Exchange Act Release No. 54,229, 71 Fed. Reg. 44,058 (Aug. 3, 2006) (approving, on a pilot basis, CBOE's AIM system); Order Approving Proposed Rule Change and Amendments No. 1 and 2 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 Thereto Relating to the Establishment of the OX Trading Platform, Exchange Act Release No. 54,238, 71 Fed. Reg. 44,758 (Aug. 7, 2006) (approving NYSE Arca's OX Trading Platform). Nasdaq has also indicated recently its intention to enter the options market. See Jenny Anderson, *Nasdaq is Planning to Start Options Exchange in 2007*, N.Y. TIMES, Sept. 7, 2006, at C3.

115. See Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 4 to the Proposed Rule Change by the National Association of Securities Dealers, Inc., Exchange Act Release No. 43,873, 66 Fed. Reg. 8131 (Jan. 29, 2001).

116. See, e.g., Annette L. Nazareth, Dir., Div. of Mkt. Regulation, SEC, Testimony before the United States Senate Committee on Banking, Housing and Urban Affairs, (June 17, 2004) available at <http://www.sec.gov/news/testimony/ts061704aln.htm>; Cynthia A. Glassman, Comm'r, SEC, Remarks at The Bond Market Association Legal & Compliance Conference in New York City, N.Y. (Feb. 3, 2004), available at <http://www.bondmarkets.com/story.asp?id=440>.

117. See *supra* notes 48–49 and accompanying text.

a. Rulemaking

Rulemaking is a resource intensive process, which requires the Commission to present elaborate analysis regarding the proposal and its impacts both under the Exchange Act¹¹⁸ and under other legal regimes.¹¹⁹ Thus, it is natural for the staff to seek other, less burdensome means to effect policy and carry out the agency's mission.¹²⁰

Moreover, the Commission has been subjected to various successful challenges to its rulemaking,¹²¹ which, no doubt, will tend to discourage and further deter the use of this avenue.¹²²

Another factor that contributes to the opacity in the establishment of new behavioral norms is the SEC's organizational structure. The SEC is organized in a way that promotes standard setting other than through the rulemaking process. Since the Office of Compliance and Inspections and Examination (OCIE) and the Division of Enforcement (Enforcement) are effectively co-equals with the Division of Market Regulation, their agendas and legal interpretations are not necessarily aligned with those of the Division of Market Regulation. Increasingly, these units are establishing new modalities of behavior through the inspection process or through enforcement settlements that involve behavioral undertakings with industry-wide and market structure impacts.¹²³ OCIE and Enforcement often are tempted to (and do) fill regulatory gaps that should be addressed in formal SEC rules by establishing new standards of conduct through the examination and inspection process and not via rulemaking.¹²⁴ Naturally,

118. See *supra* note 63 and accompanying text.

119. In addition to the requirements of the Exchange Act noted above, SEC rulemaking requires compliance with a variety of other technical requirements, such as the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, 110 Stat. 857 (codified as amended in scattered sections of 5 U.S.C. and 15 U.S.C., and as a note to 5 U.S.C. § 601), Regulatory Flexibility Act, 5 U.S.C. § 603 (1996), and the Paperwork Reduction Act, 44 U.S.C §§ 3501–3520 (1995).

120. See Richard H. Walker, Dir., Div. of Enforcement, SEC, Remarks at The Bond Market Association's 6th Annual Legal and Compliance Seminar: Regulation vs. Enforcement in an On-Line World (Oct. 25, 2000), available at <http://www.sec.gov/news/speech/spch413.htm>.

121. See *supra* note 67 and accompanying text.

122. See *Lawsuits, Regulatory Scrutiny Threaten SEC, Its Mission, Campos Says*, 8 Broker/Dealer Compliance Rep. (BNA) No. 34 (Aug. 23, 2006) (regarding the implications of this litigation on the mission of the SEC).

123. See Paul S. Atkins, Comm'r, SEC, Remarks before the IA Compliance Best Practices Summit 2006 (Feb. 28, 2006), available at <http://www.sec.gov/news/speech/spch022806psa.htm> ("An integrated structure could allow for improved interaction and exchange between the folks who write and interpret rules and those who are on the frontlines interacting with registrants and assessing their compliance with our rules.").

124. See, e.g., Federal Court Approves Global Research Analyst Settlement, SEC Litigation Release No. 18,438, 2003 SEC LEXIS 2601 (Oct. 31, 2003); In the Matter of Certain Activities of Options Exchanges, Exchange Act Release No. 43,268, 73 SEC Docket 530 (Sept. 11, 2000); In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 37,538, 62 SEC Docket 1346 (Aug. 8, 1996); In the Matter of Certain Market Making Activities on

standards of conduct that are imposed in undertakings by regulated entities that are parties to enforcement settlements with “remedial” undertakings do not have the benefit of notice and public comment, nor are they subjected to the careful balancing of the factors, including competition, that the SEC is obliged to weigh in rulemaking and other official actions.¹²⁵ Moreover, settlements may not reflect actual legal standards, but rather the give and take of negotiation between the Enforcement staff and respondents/litigants. In these latter cases, the policy outcome is not structurally guaranteed to be informed by the formal and mandatory consideration and balancing of competitive effects and other factors that the SEC must engage in when promulgating rules. Therefore, the carefully crafted standards for weighing competition in the Exchange Act are effectively subverted.¹²⁶

Perhaps because of the inherent difficulties in rulemaking and the other factors noted above, the SEC’s stance on many significant matters affecting market structure are not clearly stated in final rules, but are the subject of unofficial general statements that the market place must use to read the tea leaves. For example, although the SEC has continuously stated its view that promoting best execution is a key aspect of its policymaking, and indeed, has taken many official actions to support and undergird best execution in the marketplace,¹²⁷ it has refused to give definition to this concept or to

Nasdaq, Exchange Act Release No. 40,900, 68 SEC Docket 2693 (Jan 11, 1999); SEC v. Credit Suisse First Boston Corp., SEC Litigation Release No. 17,327 (Jan. 22, 2002); In the Matter of New York Stock Exchange, Inc., Exchange Act Release No. 41,574, 70 SEC Docket 106 (June 29, 1999). See also In the Matter of Canadian Imperial Holdings Inc. & CIBC World Markets Corp., Securities Act Release No. 8592, Exchange Act Release No. 52,063, Investment Advisors Act Release No. 2407, 2005 SEC LEXIS 1773 (July 20, 2005). A recent enforcement settlement in which the SEC concluded, without detailed analysis, that certain swaps were unlawful under the margin rules, a proposition that has caused much consternation, and possibly divergent practices in the world of equity swaps.

125. These concerns are not, of course, limited to the SEC, but arise in many areas of Administrative Law. See, e.g., 1 C.F.R. § 305.91-5 (2006) (labor law); Phillip J. Kolczynsk, A Dangerous New Precedent in FAA Enforcement Law (Oct. 25, 2000), <http://www.aviationlawcorp.com/content/dangerous.html> (FAA law); Comments of Verizon Wireless, In the Matter of Petition for Rulemaking to Enhance Security and Authentication Standards For Access to Customer Proprietary Network Information, CC Docket No. 96-115, RM 11277 (Fed. Comm’n Oct. 31, 2005), available at http://www.epic.org/privacy/iei/sbc_comments.pdf.

126. See Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation By Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149 (1990), for a full discussion of various pitfalls relating to regulation by enforcement. See also Paul S. Atkins, Comm’r, SEC, Remarks before the National Association for Variable Annuities (June 28, 2005), available at <http://www.sec.gov/news/speech/spch062805psa.htm>.

127. See Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,508 (June 29, 2005) (“[O]ne of the primary benefits of the Order Protection Rule is to backstop a broker’s duty of best execution. . . .”); Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43,590, 65 Fed. Reg. 75,414, 75,420 (Dec. 1, 2000); Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54,165, 71 Fed. Reg. 41,978, 41,978 (July 24, 2006) (“Fiduciary principles require money managers to seek the best execution for client trades . . .”).

articulate a standard regarding the implications of such related practices as payment for order flow and similar order flow routing arrangements, internalization, and (in the case of the options markets) seeking to have orders executed in “mini auctions” in evaluating compliance with best execution obligations.¹²⁸ Therefore, collectively, this inaction leaves market participants to decide for themselves and to be subject to inspections and examinations where unknown standards will apply to their performance. Options markets in particular have been offering arrangements similar to payment for order flow and/or that encourage order flow arrangements (sometimes called “directed orders”) between firms and price improvement auction facilities. Market participants may be at a loss concerning the significance of these practices for evaluating their order flow costing arrangements. Therefore, the SEC’s official silence on how these practices effect best execution analysis in options has itself become a significant market structure issue.

b. SRO Rule Proposals

Much of the SRO rule review process goes on behind the scenes, with the Commission staff commenting on successive drafts of filings that are not published for public comment until that unofficial review process is complete. The SROs have no effective means of causing the publication of their filings in order to trigger the notice and comment process. That is, the SEC must, within 35 days following the publication of a notice of filing of a proposed rule change, either approve a proposed rule change or institute proceedings to disapprove it (subject to the ability to extend this period of up to 90 days in certain circumstances).¹²⁹ However, there is no statutory provision contained in the SEC’s rules that compels the staff to publish such a notice within a set time period.¹³⁰

See also *Market 2000*, *supra* note 18, for a historical overview of the SEC’s involvement in promoting best execution and reluctance to establish definitive global standards.

128. See, e.g., SEC, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS & OFFICE OF ECONOMIC ANALYSIS, SPECIAL STUDY: PAYMENT FOR ORDER FLOW AND INTERNALIZATION IN THE OPTIONS MARKETS, (Dec. 2000), *available at* <http://www.sec.gov/news/studies/ordpay.htm>; Competitive Developments in the Options Markets, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124 (Feb. 9, 2004); Elizabeth K. King, Assoc. Dir., Div. of Mkt. Regulation, SEC, Remarks before the 2006 Options Industry Conference (May 5, 2006), *available at* <http://www.sec.gov/news/speech/2006/spch050506ekk.htm>; Elizabeth K. King, Assoc. Dir., Div. of Mkt. Regulation, SEC, Remarks before the 2003 Options Industry Conference (May 13, 2005), *available at* <http://www.sec.gov/news/speech/spch051305ek.htm>; OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC, REPORT CONCERNING EXAMINATIONS OF ORDER ROUTING AND EXECUTION, *available at* <http://www.sec.gov/news/studies/2007/optionsroutingreport.pdf> (last visited Mar. 8, 2007).

129. Exchange Act § 19(b)(2), 15 U.S.C. § 78s(b)(2) (2000).

130. The SEC has stated at various times in the past that it is mindful of the burdens of delays in publishing SRO rule proposals for public comment and expressed an intent to expedite the process. See Proposed Rule Changes of Self Regulatory Organizations; Annual Filing of

Thus, the staff has considerable power to cause an SRO to bow to the staff's "desk drawer" views of policy, since rule proposals can be held up indefinitely, sometimes for years, in this unpublished state. The Division of Market Regulation often imposes informal standards of conduct not contained in the Exchange Act or its own rules as a condition for publishing and later approving SRO initiatives.¹³¹ As a consequence, despite the fact that SRO rule filings are subject to a notice and public comment process, this will not necessarily reveal the staff's thinking in imposing an unwritten standard upon the SRO. Moreover, even though the SEC's approval orders are subject to judicial review, an informal condition imposed on the SRO by the SEC in this manner would not necessarily be reviewable, since potential litigants would not necessarily be able to claim that they were aggrieved by that aspect of the Commission approval order.

A further defect in the SRO rule proposal process is that often the SEC does not expressly enunciate the basis on which it determined the impact, if any, on competition of the rule proposal, and whether such impact is justified. Rather, its statements are generally conclusory and its analysis is not described. The staff rarely institutes proceedings to disapprove rule filings, even where a proposal does not meet the staff's standards from a competition perspective. Rather, the staff either declines to notice the proposal for public comment or asks an SRO to voluntarily withdraw the proposal. This process makes it difficult for markets and market participants to form a view regarding the staff's analytical approach to competitive impact, which, in turn, makes planning extremely difficult. Moreover, the SEC is effectively not held accountable with regard to the consistency of its analysis and approach to competition as it relates to SRO rule filings.

Amendments to Registration Statements of National Securities Exchanges, Securities Associations, and Reports of the Municipal Securities Rulemaking Board, Exchange Act Release No. 35,123, 59 Fed. Reg. 66,692, 66,699 (proposed Dec. 20, 1994).

131. For example, in various national securities exchange demutualizations, the staff has indicated its policy to require certain limitations on ownership and voting by exchange shareholders. *See, e.g.*, Order Granting Approval of Proposed Rule Change Relating to the NYSE's Business Combination With Archipelago Holdings, Inc., Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251, 11,256-57 (Mar. 6, 2006); Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550, 3552 (Jan. 23, 2006). Although the SEC has proposed rulemaking that would codify these requirements, *see* Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 50,699, 84 SEC Docket 444 (proposed Dec. 8, 2004), they are not embedded in the Exchange Act or regulations. In effect, demutualizing SROs were forced to accept this unwritten policy as a condition to publication of their proposed post-demutualization rules. Similarly, in the options market, the staff has imposed an informal standard regarding the maximum that a specialist or equivalent market maker at parity, or a firm that facilitates an order, may receive on a guaranteed basis when executing an order. *See, e.g.*, Chicago Board Options Exchange Rules 6.45A & 6.74A; Philadelphia Stock Exchange Rules 1014(g) & 1064 [hereinafter PHLX Rules]; International Securities Exchange Rule 713 (regarding enhanced split rules in options trading); NYSE Arca Rule 6.47 (regarding facilitation rules).

c. Summary

In the aggregate, an opaque process is bad because market participants are not uniformly aware of the SEC's true views of the state of the law and the rationale for those views. Market participants often operate in a zone of uncertainty regarding the legality of particular practices. Moreover, they cannot make rational business plans for introducing new products, systems, and methods, without clarity regarding the time frames in which their proposals (or the SEC's own) will be acted upon. All of this affects competition and market structure.

2. The Process is Slow

The Commission staff is very deliberative and careful, and the notice and public comment process extremely important in drawing out well informed views of investors and market professions likely to be affected. Moreover, it is inevitable that proposals (particularly those of SROs) may not be what they seem, and careful review is merited because of the technical complexity of many such proposals and the potential for burdening competition. However, in general, slow is bad. SEC rulemaking proposals and its consideration of SRO filings can take years to be finalized, often dying of their own weight.¹³² First, market participants often do not know with certainty the legality of particular practices.¹³³ Second, they cannot make effective plans for introducing new products, systems and methods, without clarity regarding the time frames in which their proposals (or the SEC's own) will be acted upon.¹³⁴ This burdens competition because players with the greatest appetite for regulatory risk develop a competitive "first mover advantage," disadvantaging the most responsible market participants. Also, bureaucratic delay tends to entrench existing participants because it can be a barrier to entry for would-be entrants with new and innovative business models.

132. The SEC reported that it received 959 SRO rule filings during its 2005 fiscal year, and that 80% (765) had been reviews by the staff and approved or disapproved within 60 days of receipt of the last amendment filed by the SRO. SEC, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 41 Ex.2.8 (Nov. 25, 2005), *available at* <http://www.sec.gov/about/secpar/secpar2005.pdf>. However, this performance statistic must be taken with a grain of salt, since many SRO rule filings are submitted initially in draft form and therefore not "filed" until the staff has advised the SRO that the draft filing is generally satisfactory to the staff. Moreover, the staff often requests multiple non-substantive amendments during the course of their processing a filing. Also, in many instances, filings are withdrawn (sometimes at the staff's request) and subsequently re-filed.

133. *See* Annette L. Nazareth, Comm'r, SEC, Remarks before the ICI Equity Markets Conference (Sept. 22, 2005), *available at* <http://www.sec.gov/news/speech/spch092205aln.htm> ("[M]arket participants need certainty and the rules of the road must be clear for them to function efficiently and compete effectively in a globally competitive marketplace.").

134. *Id.* *See also* *Competition & Regulation Balancing the National Market System*, *supra* note 96, at 2; SEC OPERATIONS, *supra* note 18, at 15-16.

3. The Staff is Cautious

Despite numerous sources of authority to grant exemptive relief, define terms, and issue no-action and similar guidance,¹³⁵ the staff is reluctant to grant such relief.¹³⁶ The process is generally very protracted.¹³⁷ Moreover, rulemaking cannot capture all permutations and scenarios. Where the SEC staff is requested to permit activity that does not raise the concerns addressed by the general rule, or to give clarity and definition to the application of rules, the staff should use its authority more liberally, particularly if the grants promote fair competition that do not threaten to compromise investor protection. Moreover, outside of the context of SRO rule approvals, the Commission's use of pilot programs and temporary rules to permit it to study the impact of specific actions is too infrequent. These would seem to be an ideal way for the Commission to validate whether its assumptions regarding competitive impact are appropriate.

In regard to SRO rule filings, the staff often does not permit filings that technically qualify for effective upon filing or similar treatment in accordance with the Exchange Act¹³⁸ and SEC rules. Instead, the staff often

135. See *supra* Part II.B.5.

136. Between January 1, 2006 and August 31, 2006, the Division of Market Regulation issued only forty-four no-action letters that were thought to be of sufficient significance to publish on the SEC website. See Division of Market Regulation: Exemptive Orders and Exemptive, Interpretive, and No-Action Letters, Chronological List of No-Action Letters, <http://www.sec.gov/divisions/marketreg/mr-noaction.shtml#chron> (last visited Mar. 1, 2007). The SEC website also lists one interpretive statement, see SEC Interpretive Releases, <http://www.sec.gov/rules/interp.shtml> (last visited Mar. 1, 2007), and five section 36 orders, see Exemptive Orders, <http://www.sec.gov/rules/exorders.shtml> (last visited Mar. 1, 2007), involving market regulation issues. Outside of the context of SRO rule approvals, no new pilot programs affecting market regulation issues were introduced during this period.

137. See SEC OPERATIONS, *supra* note 18, at 14; cf. SEC 2005 PERFORMANCE AND ACCOUNTABILITY REPORT, *supra* note 132, at 41 Ex.2.7. The SEC reported that 85% of exemptive, no-action and interpretive requests (across all Divisions) in 2005 were issued within six months. *Id.* This performance statistic must be taken in context. Most requests for this type of relief are submitted and negotiated in draft form, and no formal request is made until the staff is satisfied. If the staff does not indicate that it is prepared to issue the relief requested, the request is often (but not always) withdrawn. Therefore, requests for relief that are ultimately granted are generally formally submitted (following negotiation with the staff) very close in time to when the staff is ready to issue the letter granting the relief. See, e.g., Jeffrey M. Oakes, SEC No-Action Letter, 2007 SEC No-Act. LEXIS 300 (Mar. 2, 2007); William G. Farrar, SEC No-Action Letter, 2007 SEC No-Act. LEXIS 227 (Feb. 8, 2007).

138. The Exchange Act provides that a proposed rule change may take effect upon filing with the Commission if they fall within the following categories:

- (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization,
- (ii) establishing or changing a due, fee, or other charge imposed by the self-regulatory organization, or

prefers to handle SRO filings in the “ordinary way”: subject to notice and public comment prior to effectiveness. The Commission rarely, if ever, relies upon its statutory authority to put a rule filing into effect summarily.¹³⁹ Given the Commission’s ability to abrogate filings that have taken effect upon filing within 60 days and requiring them to be refiled in the ordinary way, this approach seems unnecessarily cautious. It also possibly burdens competition in two respects. First, it denies the SRO the ability to “test the waters” by quickly implementing a system or rule without subjecting it to extensive pre-approval public comment and waiting period.¹⁴⁰ Second, the handling of these proposals consumes valuable staff

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- (iii) concerned solely with the administration of the self-regulatory organization or other matters which the Commission, by rule, consistent with the public interest and the purposes of this subsection, may specify . . . [as being eligible for effective on filing treatment].

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

Section 19(b)(3)(A) is implemented by Exchange Act Rule 19b-4(f), which incorporates verbatim the categories in clauses (i) and (ii) of § 19(b)(3)(A), reprinted above, as well as the category of rules that are concerned only with administration. *See* 17 C.F.R. § 240.19b-4 (2004). It also includes, among other things, that a proposed rule change may take effect upon filing with the Commission pursuant to § 19(b)(3) of the Act, if properly designated by the self-regulatory organization as:

- [(1)] Effecting a change in an existing order-entry or trading system of a self-regulatory organization that:
- (i) Does not significantly affect the protection of investors or the public interest;
 - (ii) Does not impose any significant burden on competition, or have the effect of limiting the access to or availability of the system; or
- [(2)] Effecting a change that:
- (i) Does not significantly affect the protection of investors or the public interest;
 - (ii) Does not impose any significant burden on competition, and
 - (iii) By its terms, does not become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest.

Exchange Act § 19(b)(3). In this latter case, the SRO must give the SEC written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change. *Id.*

In 2001, The Commission proposed Rule 19b-6, which would have expanded the categories of proposed rule changes eligible for effective upon filing treatment. *See* Rule Changes by Self-Regulatory Organizations, Exchange Act Release No. 43,860, 66 Fed. Reg. 8912, 8912 (proposed Feb. 5, 2001). However, it never acted upon this proposal.

139. The authority is derived from Exchange Act § 19(b)(3)(B), 15 U.S.C. § 78s(b)(3)(B) (2000) (“[A] proposed rule change may be put into effect summarily if it appears to the Commission that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds.”).

140. By contrast, “designated contract markets” (i.e., futures exchanges) regulated by the CFTC have the option of filing rules with the CFTC and “self-certif[ying]” that the rule complies with

resources that might be better utilized in processing proposals that have potentially larger policy ramifications.

4. There are No Standards for the SEC's Consideration of International Implications of its Actions Under the Exchange Act

The Commission and the staff are well aware of the implications of their actions on international competition.¹⁴¹ The most well-publicized current ramification of this is the application of U.S. accounting and auditing standards and the provisions of the Sarbanes-Oxley Act of 2002 to foreign issuers.¹⁴² There are, however, other less visible, but highly significant, cross-border issues such as the ability of U.S. residents to trade and purchase securities products traded on foreign securities markets, and the extent to which foreign financial institutions may access U.S. investors. The SEC does not ignore the significance of these issues, and takes cautious, but non-systematic, steps to address them.¹⁴³ By contrast, the

the Commodity Exchange Act or seeking affirmative CFTC approval of such rules. *See* 17 C.F.R. §§ 38.4(b), 40.6 (2002).

141. *See, e.g., Market 2000, supra* note 18, Study VII; Laura S. Unger, Comm'r, SEC, Speech at the Third National Securities Trading on the Internet Conference: The Global Marketplace, Ready or Not Here it Comes (Jan. 24, 2000), *available at* <http://www.sec.gov/news/speech/spch344.htm>. *See also* SEC OPERATIONS, *supra* note 18, at 10. For a discussion of the integral part that financial services plays in the global economy, see U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE CHAIRMAN, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, U.S. SENATE, FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE, REP. NO. GAO 05-61, at 44-46 (Oct. 2004).

142. *See, e.g.,* Paul S. Atkins, Comm'r, SEC, Speech at the University of Cologne, The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation (Feb. 5, 2003), *available at* <http://www.sec.gov/news/speech/spch020503psa.htm>; Aaron Lucchetti & Carrick Mollenkamp, *New York to Study Lack of IPOs*, WALL ST. J., Sept. 27, 2006, at C3. *See also* Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 55,005, 72 Fed. Reg. 1384 (proposed Dec. 22, 2006).

143. *See, e.g.,* Cleary, Gottlieb, Steen & Hamilton, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 138 (Jan. 30, 1996) (concerning Exchange Act Rule 15a-6); *Nine Firm Letter, supra* note 72 (concerning Exchange Act Rule 15a-6); Cleary, Gottlieb, Steen & Hamilton, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 662 (July 27, 2005) (concerning the sales of certain foreign options listed on Eurex) [hereinafter *Foreign Options on Eurex No-Action*]; Order Granting Limited Volume Exemption from Registration as an Exchange Under Section 5 of the Securities Exchange Act, Exchange Act Release No. 41,199, 64 Fed. Reg. 14,953 (Mar. 22, 1999); Morgan Stanley & Co., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 975 (Dec. 20, 1996) (granting no-action relief with respect to broker-dealer registration requirements due to Indian law restrictions applicable to transactions executed through local broker-dealers); Futures Industry Association, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 693 (Aug. 20, 2002); Macquarie Media Holdings Limited and Macquarie Media Trust, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 799 (Sept. 27, 2005); Supervised Investment Bank Holding Companies, Exchange Act Release No. 49,831, 69 Fed. Reg. 34,472 (June 21, 2004); Application of the Definition of Narrow-based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, Exchange Act Release No. 54,106, 71 Fed. Reg. 39,534 (July 13, 2006). *See also* Custody of

CFTC has a very liberal regime for permitting access by U.S. persons to foreign futures exchanges and foreign futures products without subjecting the markets, brokers and products to extensive U.S. regulation.¹⁴⁴

One instance of the SEC's caution in balancing international competition and investor access concerns is in the area of exchange-traded derivative products. Although U.S. investors may freely invest in foreign shares and other securities,¹⁴⁵ and do in large quantities,¹⁴⁶ their access to risk management tools, such as options on indexes, single securities, exchange-traded funds (ETFs), security futures, and index futures based upon foreign stocks and foreign stock indexes, are often quite limited. These limitations are generally in the name of investor protection. The offering of these products in the United States is, in some cases, bounded by statute or other rules.¹⁴⁷ Yet, in many cases, where the SEC has discretion, it chooses to limit sales of these products very conservatively. For example, a foreign options exchange may not effectively permit access to its options products without submitting to a laborious no-action process, which to date has narrowly limited sales of such products to "qualified institutional buyers," as defined under Rule 144A under the Securities Act.¹⁴⁸ Also, U.S. options exchanges are effectively limited in their ability to list and trade index options with significant foreign stock components or options on ETFs

Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176, 68 Fed. Reg. 56,692 (Oct. 1, 2003) (concerning foreign custodians); Investment Company Act Rules 17f-5 and 17f-7, 17 C.F.R. §§ 270.17f-5, 270.17f-7 (2000) (permitting certain international banks to act as custodians for certain assets owned by U.S. registered investment companies).

144. Commodity Futures Trading Comm'n, Foreign Futures and Options, <http://www.cftc.gov/dea/deadcioforeignfuturesandoptions.htm?from=home&page=epforeignopscontent.html> (last visited Feb. 4, 2007).

145. See DIV. OF CORP. FIN., SEC, INTERNATIONAL INVESTING: GET THE FACTS 2 (1999), <http://www.sec.gov/pdf/ininvest.pdf>. Even so, the offering of such securities into the United States is clearly subject to limitations under the Securities Act and, in many instances, state securities laws. Moreover, large numbers of U.S. shareholders can subject foreign issuers to registration under section 12(g) of the Exchange Act. See Exchange Act § 12, 15 U.S.C. § 781 (Supp. IV 2004). But the issuer may perfect an exemption under Exchange Act Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2(b) (2005).

146. See, e.g., SEC OPERATIONS, *supra* note 18, at 10.

147. See, e.g., Exchange Act § 6(h)(4)(A), 15 U.S.C. § 78f(h)(4)(A) (2000); *Examining the Commodity Futures Modernization Act of 2000 and Recent Market Developments: Hearing before the S. Comm. on Banking Housing and Urban Affairs*, 109th Cong. 11–12 (2005) (testimony of Robert L.D. Colby, Deputy Dir., Div. of Mkt. Regulation, SEC), available at <http://www.sec.gov/news/testimony/ts090805rlde.htm> [hereinafter *Commodity Futures Modernization Act of 2000 Hearing, Colby Testimony*]; Kevin M. Foley, *Foreign Products: Still Off-limits to U.S. Investors*, FUTURES INDUSTRY MAG. (Dec. 2001), available at <http://www.futuresindustry.org/fimagazi-1929.asp?a=743> (noting that the equity option listing standard requires class of underlying stock to be registered under the Exchange Act). See also PHLX Rule 1009(a)(1).

148. See, e.g., *Foreign Options on Eurex No-Action*, *supra* note 143.

and similar instruments.¹⁴⁹ Narrow-based index futures on foreign equities that are not registered under the Exchange Act are also restricted.¹⁵⁰ As a result, much hedging of foreign securities investments must be done in the over-the-counter markets, which lack transparency, have relatively high transaction costs and are limited to non-retail investors.¹⁵¹

The SEC has taken steps to address access and competition issues involving these types of products, such as promulgating joint rulemaking with the CFTC to permit narrow-based index options on foreign sovereign bonds¹⁵² and announcing other initiatives.¹⁵³ However, there is no overarching policy guidance directing the SEC's actions in this arena.

The SEC is also taking pains to balance investor protection concerns with respect to the ability of foreign broker-dealers, including those affiliated with U.S. financial institutions, to do business in the United States. The current framework, which has been in place since 1989, is awkward and in need of reconsideration.¹⁵⁴ Likewise, although there have been calls for greater access of U.S. investors and intermediaries to "screens" of foreign securities markets, direct access to foreign markets by U.S. investors has not been comprehensively revisited for almost a decade.¹⁵⁵

The fault here, if there is one, does not rest principally with the agency. The SEC's formal actions, and institutional direction, must be guided by the

149. See, e.g., PHLX Rule 1009A(b)(9), (d)(10); PHLX Rule 1009 cmts. .03, .06(b), .07(b); Amendment to Rule Filing Requirements for Self-Regulatory Organizations Regarding New Derivative Securities Products, Exchange Act Release No. 40,761, 63 Fed. Reg. 70,952 (Dec. 22, 1998) (limiting percentage of underlying securities that may be of issuers in jurisdictions with which there is no surveillance agreement, and requiring absence of blocking statute and real time reporting).

150. See *Commodity Futures Modernization Act of 2000 Hearing, Colby Testimony*, supra note 147, at 11–12; *Commodity Futures Modernization Act of 2000 Hearing, SLA Testimony*, supra note 34, at 6.

151. See Commodity Exchange Act, 7 U.S.C. § 1a(12) (2000) (defining "eligible contract participant").

152. Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, Exchange Act Release No. 54,106, 71 Fed. Reg. 39,534 (July 13, 2006) (adopting CFTC Rule 41.15 and adding Exchange Act Rule 3a55-4).

153. See *Commodity Futures Modernization Act of 2000 Hearing, Colby Testimony*, supra note 147, at 11–12.

154. Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 27,017, 54 Fed. Reg. 30,013 (July 18, 1989) (adopting Exchange Act Rule 15a-6). Based upon a recent speech by SEC Director of Market Regulation, Eric R. Sirri, it seems possible that the SEC staff may currently support incremental liberalization of the limited safe harbor for foreign broker-dealers contained in Exchange Act Rule 15a-6. Eric R. Sirri, Dir., Div. of Mkt. Regulation, SEC, Speech in Boston, Massachusetts: Trading in Foreign Shares (Mar. 1, 2007), available at <http://www.sec.gov/news/speech/2007/spch030107ers.htm> [hereinafter *Trading in Foreign Shares*].

155. See Concept Release: Regulation of Exchanges, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485 (June 4, 1997). This issue does not seem likely to be resolved in the foreseeable future. See *Trading in Foreign Shares*, supra note 154, at 24, 27–28.

law. The SEC lacks a clear Congressional or other policy direction with respect to the roles of international cooperation, competitiveness of U.S. and non-U.S. financial institutions, and U.S. investor access in the calculus that it must make when making rules, issuing orders and taking other actions under the Exchange Act. Therefore, there may be no specific legal basis for according these factors much weight, and it is difficult for the staff to counterbalance these factors against other concerns that they are charged with, such as investor protection.

As our principal exchanges combine and affiliate with foreign markets,¹⁵⁶ there is likely to be accelerating pressure on the SEC to develop a more effective framework for U.S. investor access to foreign securities products and services, including access to foreign securities exchanges. Perhaps it is time for a larger reconsideration of whether the Commission should have more specific policy direction in regard to the role of international competition and investor access to foreign products and markets.¹⁵⁷

IV. RECOMMENDATIONS FOR REFORM

A. ESTABLISH NEW STANDARDS OF CONDUCT FOR MARKET PARTICIPANTS THROUGH THE RULEMAKING PROCESS AND NOT IN THE CONTEXT OF INFORMAL STAFF POLICY DETERMINATIONS, EXAMINATIONS AND INSPECTIONS AND ENFORCEMENT ACTIONS

As outlined above, the Exchange Act carefully crafts administrative procedures for rulemaking, issuing orders, and approving SRO rule filings. These procedures (a) direct that certain factors, including competitive effects, be considered, (b) provide for notice and public comment, and (c) provide for an appeal process. All of this is subverted when the SEC effectively establishes new rules through industry enforcement settlements, offhand comments in settlements, remedial “recommendations” in OCIE inspection or examination reports, or unofficial statements in Commissioner or senior staff speeches. None of these processes require the same degree of balanced consideration and transparency as rulemaking does. These

156. See, e.g., Press Release, New York Stock Exch., NYSE Euronext to Commence Offer for Euronext Shares (Feb. 15, 2007), available at <http://www.nyse.com/press/1149157439121.html>; Press Release, New York Stock Exch., NYSE Group to Purchase 5% Equity Interest in National Stock Exchange, India’s Largest Financial Marketplace (Jan. 10, 2007), available at <http://www.nyse.com/press/1168342114215.html>; Press Release, N. Y. Stock Exch., NYSE Group and Tokyo Stock Exchange Enter Strategic Alliance (Jan. 31, 2007), available at <http://www.nyse.com/press/1170156819950.html>; Press Release, Nasdaq, Acquisition of Shares in LSE Group PLC (Feb. 10, 2007), available at http://www.nasdaq.com/newsroom/news/pr2007/ne_section07_014.stm.

157. See *Trading in Foreign Shares*, supra note 154.

informal standard setting processes also deny affected parties the possibility to voice their positions or present relevant data. Therefore, establishing industry standards by means other than rulemaking certainly burdens competition, and does not take into account the full scope of policy considerations which Congress intended.

Thus, despite the difficulties inherent in the process of rulemaking, the SEC should not give in to the temptation to “take the easy road” in establishing industry-wide standards of conduct through these other means. In addition, the Commission should seek to ensure that the legal positions of the Divisions of Market Regulation and Enforcement and OCIE are closely aligned, and that their inspection and examination process and rulemaking priorities are in synch.

**B. REFORM THE PROCEDURES FOR APPROVALS OF SRO RULE
PROPOSALS IN ORDER TO MAKE MORE TYPES OF PROPOSALS
ELIGIBLE FOR “EFFECTIVE ON FILING” OR OTHER EXPEDITED
PROCESSING**

The staff of the Division of Market Regulation diligently and intelligently scrutinize SRO rule filings with a cautious eye for anti-competitive and discriminatory concerns. However, in many cases the benefits of such scrutiny do not outweigh the burdens on competition implied by delay. In some instances, the concerns raised in staff reviews are hypothetical or nonsubstantive. SROs, when functioning in their capacity as market operators, compete vigorously with each other for issuer and product listings, trading volume in multiple listed securities, market data revenues, and new member organizations (among other things). Delays in introducing new rules or trading systems directly burden that competition. Moreover, Commission review of all SRO filings, even those that are truly non-controversial, is an enormous drain on staff resources that could be better deployed in processing more significant filings and doing the leg work necessary for rulemaking.¹⁵⁸

The SEC should take several actions. First, it should dust off and extend, its former proposed Rule 19b-6¹⁵⁹ so that fewer SRO rule filings would get full pre-effective reviews. The Exchange Act invites this in section 19(b)(3)(A), and the Commission should use this statutory authority to reduce procedural barriers to competition. Many elements of the 19b-6 proposal were sound, including the elimination of pre-filing submissions and pre-effective periods for “non-controversial” filings, and permitting

158. See generally SEC OPERATIONS, *supra* note 18, at 14–16.

159. See Rule Changes by Self-Regulatory Organizations, Exchange Act Release No. 43,860, 66 Fed. Reg. 8912 (proposed Feb. 5, 2001). See also *supra* note 138 and accompanying text.

certain trading rule changes to be effective on filing.¹⁶⁰ Beyond this, the SEC should give more definition and be liberal about which rule filings are eligible for the “systems change” category.¹⁶¹ Moreover, now that most exchanges are demutualized and members are less involved in exchange governance than in the past, a more expansive view of which changes to an exchange’s governance structure and governing documents should be eligible for effective on filing treatment (or should be excluded from the definition of “rule” and “proposed rule change” under the Exchange Act and Rule 19b-4 altogether). There is little risk that anticompetitive or discriminatory rule proposals will find their way into the permanent structure of the markets, since the Commission retains the power to summarily abrogate rule filings that are effective upon filing.¹⁶² If necessary, the SEC could recommend that Congress extend the period during which it could summarily abrogate rule filings as a trade-off for expansion of effective upon filing treatment.¹⁶³

160. *Id.*

161. *See* Exchange Act Rule 19b-4(f)(5), 17 C.F.R. § 240.19b-4(f)(5) (2006).

162. *See* Exchange Act § 19(b)(3)(C), 15 U.S.C. § 78s(b)(3)(C) (2000).

163. One concern that is latent in the expansion of “effective upon filing” treatment is the extent to which SROs may assume that proposed rule changes which become effective under section 19(b)(3)(A) enjoy the benefits of preemption from state law and immunity from antitrust challenge under the doctrine of implied repeal, since there is no Commission order approving such rule changes. This uncertainty stems in part from the language of the statute, which provides that a rule change filed pursuant to section 19(b)(3)(A) becomes effective immediately and may be enforced by the SRO “to the extent it is not inconsistent with the provisions of this chapter, the rules and regulations thereunder, and applicable Federal and State law.” *See* Exchange Act § 19(b)(3)(C). With regard to antitrust immunity, in its proposing release for Rule 19b-6, the SEC stated:

Subsection (h) of Rule 19b-6 clarifies that where a proposed rule change becomes effective upon filing pursuant to section 19(b)(3)(A) of the Act, no inference may be made regarding whether the proposed rule change is in the public interest, including whether it has an impact on competition. Although the Commission intends to conduct a review of proposed rule changes that are effective on filing in order to determine whether they raise significant issues requiring abrogation of the filing, the Commission will not be taking final action unless it chooses to abrogate the proposed rule change and subsequently issues an order approving or disapproving the proposal pursuant to section 19(b)(2) of the Act. Therefore, the Commission will not necessarily have made a final determination on whether the proposed rule change is in the public interest, including whether it has an impact on competition, where the proposal has become effective upon filing pursuant to section 19(b)(3)(A) of the Exchange Act. Absent a Commission order approving the proposed SRO rule change pursuant to section 19(b)(2), a person may not necessarily draw conclusions about whether the proposed rule change is in the public interest, including whether it has an impact on competition.

Rule Changes by Self-Regulatory Organizations, Exchange Act Release No. 43,860, 66 Fed. Reg. 8912, 8917 (proposed Feb. 5, 2001). Because many SRO rules directly or indirectly authorize joint action among members, the absence of clear antitrust immunity could be a significant stumbling block. *See* Letter from Meyer S. Frucher, Chairman and CEO, Philadelphia Stock Exch., to Jonathan G. Katz, Sec’y, SEC (Apr. 6, 2001), *available at* <http://www.sec.gov/rules/proposed/s70301/frucher1.htm> (concerning proposed Rule 19b-6).

Second, the staff should curtail its current practice of reviewing each filing that is made pursuant to section 19(b)(3)(A) and holding over the SROs the threat of rejecting filings as incomplete or defective if the SRO implements the rule change.¹⁶⁴ The staff should allow the filings to become effective and use their power to abrogate more liberally. In that way, the true effects of the filing can be observed, and any required amendments can be made on a post-effective basis.

Third, with respect to those rule filings that truly raise competitive implications, the staff should include in the approval orders a detailed analysis of competitive effects and policy justification for competitive impacts that are determined to exist. It is doubtful that any one model of competition analysis is “the right one.” However, it is certain that if the SEC adopts a different standard and approach to competition analysis in each of its official actions (or merely, as it does in the case of most SRO rule filing approvals, recites that it does not view the filing as having an adverse impact on competition), virtually any result can be justified.¹⁶⁵ A more detailed analysis would permit market participants to analyze prospectively how the Commission is likely to view the competitive impact of a given proposal while it is in the formulation stage. It would also, where appropriate, facilitate appeals.

There is a similar concern with preemptive effects on state law. *See* Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119, 1132 n.18 (9th Cir. 2005) (leaving open the question of whether SRO rules that have become effective upon filing under section 19(b)(3)(A) of the Exchange Act pre-empt inconsistent state law); Brief for the SEC, NASD Dispute Resolution v. Judicial Counsel of Cal., 232 F. Supp. 2d 1055, 1055 n.11 (N.D. Cal. 2002) (No. C 02 3486 SBA), available at <http://www.sec.gov/litigation/briefs/nasddispute.htm>.

However, to the extent that SROs are concerned about preemption and antitrust issues, they always have the option to submit a filing under section 19(b)(1), (2) and obtain a Commission order approving the filing. *See* Exchange Act § 19(b)(1), (2), 15 U.S.C. § 78s(b)(1), (2) (2000).

164. Naturally, there is some risk that an SRO rule change actually is technically or substantively defective. *See, e.g.*, Filings by Self-Regulatory Organizations of Proposed Rule Changes and Other Materials with the Commission, Exchange Act Release 15,838, 44 Fed. Reg. 30,924 (May 29, 1979) (containing a discussion of defective filings). However, a fatally defective filing that was inconsistent with the Act and the SEC’s rules presumably could not be enforced by the SRO in any event.

165. This suggestion is not meant to suggest that a more coherent and explicit approach to competition analysis in its SRO rule filing approval order would make them more susceptible to court challenge. The standards that the SEC is charged with implementing are very general, and courts are extremely deferential to expert regulatory bodies, such as the SEC, in their analysis of the types of complex and technical issues that arise in such contexts as securities market competition. *See, e.g.*, Domestic Sec., Inc. v. SEC, 333 F.3d 239 (D.C. Cir. 2003); *see also* Oesterle, *supra* note 11, at 3.

C. ESTABLISH BY REGULATION (OR REQUEST THAT CONGRESS, THROUGH AN AMENDMENT TO SECTION 19 OF THE EXCHANGE ACT) A TIME LIMIT FOR PUBLISHING SRO RULE FILINGS FOR PUBLIC COMMENT

Although this will no doubt result in more actions to disapprove filings (which would be a regrettable burden on staff resources), there is no better way to improve the pace and transparency of the process overall. This proposal would eliminate the possibility of significant SRO actions which could promote competition from being stalled at the staff level, thereby acting as a barrier to new entrants to challenge the status quo, while the staff considers the filing. It would also force out earlier in the process the full range of comment by interested parties.

D. LIBERALIZE THE USE OF NO-ACTION AND EXEMPTIVE RELIEF IN AREAS WITH A COMPETITIVE IMPACT, INCLUDING NEW PRODUCTS AND PROPOSALS—PERHAPS USING MORE READILY “GENERIC” NO-ACTION LETTERS AND TEMPORARY OR PILOT APPROVALS TO ENABLE THE COMMISSION STAFF TO STUDY THE IMPACT OF THE APPROVALS

The rulemaking process is too blunt an instrument to capture all of the permutations and variations in businesses being regulated, and to adapt to unforeseen changes in technology and business methods. No-action letters, temporary rules and pilot programs are “escape valves” to permit legitimate activities that do not contravene the law or the spirit of regulation and are meant to be used. They do not commit the SEC to being stuck indefinitely with bad decisions.¹⁶⁶ If the principal constraint on these procedural vehicles is staffing, then the Commission should make it a priority to increase staffing for this purpose.¹⁶⁷ Perhaps a statement of policy by the Commission, giving direction to the Division Directors and the staff, would encourage the staff to be bolder in recommending or granting relief.

166. No-action letters also can be granted on a temporary basis. *See, e.g.*, REDI System, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 444 (Mar. 29, 2002). They may also be withdrawn if facts or Commission policies change. *See, e.g.*, Domestic Securities, Inc., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 756 (Oct. 21, 2005); Dominion Resources, Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (Mar. 7, 2000).

167. *See* SEC OPERATIONS, *supra* note 18, at 14–16.

E. RECOGNIZING THAT MARKETS ARE INCREASINGLY INTERNATIONAL, EXPLICITLY SEEK TO PERMIT CROSS-BORDER PRODUCTS AND SERVICES (OR CONSIDER REQUESTING CONGRESS TO ADD TO THE STATUTORY FACTORS THAT THE SEC SHOULD CONSIDER IN RULEMAKING AND OTHER OFFICIAL ACTION)

The SEC lacks a comprehensive framework for balancing international issues, including the competitive position of U.S. financial institutions and U.S. investor access to foreign markets and products, against other policy issues. As a result, such issues are given relatively little weight. International competitiveness and freedom of access should be considered as a matter of course when developing rulemaking and taking other official actions. Perhaps this can only be effected on a systematic basis by amending the Exchange Act.

V. CONCLUSION

Although the Exchange Act provides an appropriate mechanism for balancing the roles of the SEC and competitive forces in developing market structure in the context of *formal* SEC actions, such as rulemaking, there are several respects in which the system of regulation established under the Exchange Act operates in practice to burden competition unnecessarily. If the modest procedural reforms described in this article are adopted they should promote the general goals of the Exchange Act to alleviate a number of constraints on competition and innovation without compromising the Exchange Act's other policy objectives.