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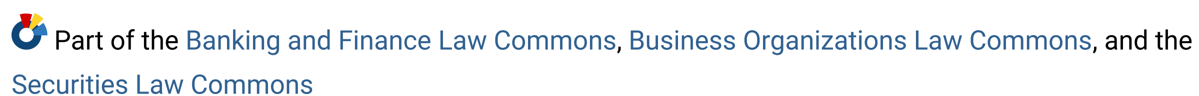
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LOOKING FORWARD: PROFESSOR ROBERTA KARMEL'S PRESCIENT VIEWS ON THE TRANSFORMATION OF SELF-REGULATORY ORGANIZATIONS AND OF THE SECURITIES MARKET STRUCTURE AT THE TURN OF THE LAST CENTURY

James A. Fanto[*]

ABSTRACT

This essay examines Professor Roberta Karmel's scholarship on the transformation of self-regulatory organizations (SROs) and the securities market structure, a transformation that occurred at the turn of the last century. It explains how she examined the events from the perspective of a lawyer who had a rich knowledge of the history of the SROs, the securities markets, and their regulation and how she provided a practical understanding of the way these markets worked. It points out that, rather than offering an overarching theory that would explain all of these developments and that would guide regulators and legislators in SRO and securities market structure reforms, she pointed out problems and contradictions in the developments that, in her view, would have to be faced and addressed by both Congress and the SEC. The essay first sets out briefly the background to and a timeline for the SRO and securities market transformation and describes how that transformation closely intersects with Roberta's career as a legal practitioner, a regulator, and a legal academic. It then looks at her scholarly discussion on how the self-regulatory functions of the stock exchanges became the Financial Industry Regulatory Authority (FINRA), where she raised the important question whether self-regulation by broker-dealers continued to exist post-FINRA. The essay explores a possible answer to this question, which Roberta has acknowledged, in a new form of self-regulation—the collaboration between FINRA and those officers in broker-dealers who are responsible for ensuring that they and their employees follow law and regulation, the compliance officers. It next looks at Roberta's insights on the related subject of the transformation of the stock exchanges and its overall effects upon securities market structure, explaining how she identified for the legal academic audience the forces, including the regulatory ones, that were pushing the exchanges to become public

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* Gerald Baylin Professor of Law, Brooklyn Law School. All rights reserved © For comments on a talk that was the basis for this essay, I thank the participants in the symposium in honor of Professor Roberta Karmel, "A Life Navigating the Securities Markets: A Celebration of Professor Karmel's Work, Teaching, and Mentorship," particularly my fellow panelists on Panel IV: Securities Market Structure, W. Hardy Callcott, Annette L. Nazareth and Eric D. Roiter. And I owe special thanks to Roberta, who offered me her thoughts on my talk.

companies and the market fragmentation that resulted from the proliferation of trading venues. It then explains that Roberta took a "wait and see" approach to problems in securities market structure, recommending that securities markets be allowed to develop with their new forms and technology before Congress and the SEC apply to them a major new regulatory framework and that the SEC regulate with a light hand, correcting market problems where necessary, while the outline of a new market structure emerged. The essay concludes by briefly looking at the current securities market from Roberta's perspective.

INTRODUCTION

The subject of self-regulatory organizations (SROs)[1] and securities market structure drew Professor Karmel's scholarly attention throughout the years.[2] She particularly focused on these subjects in the early 2000s when the stock exchanges were being transformed from member-run organizations into public companies and when their self-regulatory arms were being spun off from them.[3] This was also a time when the self-regulatory structure of exchanges came into question as a result of this transformation. The period saw the creation of the Financial Industry Regulatory Authority (FINRA), which absorbed the member regulatory functions of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE). FINRA then began to look less and less like an SRO of broker-dealers and more like a part of the Securities and Exchange Commission (SEC).[4] Moreover, U.S. regulators and market participants were faced with securities

1. Federal securities law was built upon the existing self-regulation of participants, broker-dealers, in the securities exchanges, which meant that the broker-dealer members of the securities exchanges and other securities marketplaces regulated themselves. The reasoning was that the marketplaces, i.e., self-regulatory organizations, were more competent than outsiders to conduct this regulation. *See* JOHN C. COFFEE, JR. ET AL., SECURITIES REGULATION: CASES AND MATERIALS 722–23 (14th ed. 2021). The marketplaces were mostly securities exchanges. There was also the "over-the-counter" (OTC) market where broker-dealers traded among themselves and for customers securities that were not exchange listed. This market (i.e., a securities association) also had a self-regulatory organization, the National Association of Securities Dealers (NASD). Both kinds of marketplaces were covered by the Securities Exchange Act of 1934 (the Exchange Act), which regulated securities market structure and market participants. *See generally* 15 U.S.C. § 78f (securities exchanges); 15 U.S.C. § 78*o*-3 (securities associations).

2. The articles consulted for this paper, which are her major works on this subject, are the following: Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of the Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367 (2002); Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355 (2007); Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L., BUS. & FIN. 151 (2008); Roberta S. Karmel, *The Future of the Securities and Exchange Commission as a Market Regulator*, 78 U. CIN. L. REV. 501 (2009).

3. *See infra* Part II.

4. *See infra* note 25.

and derivatives markets that were increasingly interconnected and thus in need of a unified regulation.[5]

Roberta was interested in all these events and transformations and, in her articles, brought them to the attention of U.S. securities law scholars. She talked about them from the perspective of a lawyer who had a rich knowledge of the history of the SROs, the securities markets, and their regulation, thereby providing a practical understanding of how these markets worked.[6] She did not offer an overarching theory that would explain all these developments and that would guide regulators and legislators in SRO and market structure reforms. Rather, she pointed out problems and contradictions in the SRO and market structure developments that, in her view, would have to be faced and addressed by both Congress and the SEC if the statutory goals of the Securities Exchange Act of 1934 (Exchange Act) were to be achieved.[7] She wanted them to deal with the problems that arose from the transformations in a careful manner with an appreciation for the market complexities and necessary evolution involved.[8]

In her writing on the transformations, Roberta offered a model and lessons for securities law scholars who explored securities market issues. She made us realize that we needed to approach this subject with an appreciation for the history of these markets and their regulation, and with a willingness to understand the technical details of securities market structure and the role and goals of market participants. Through her work, she conveyed that this appreciation and understanding might enable us to offer solutions to market issues that would likely survive contact with the reality of securities markets and that would thus usefully guide Congress and the SEC. In sum, she pushed us both to explore securities market structure issues and to deal with them with as full a knowledge of their complexities as we could obtain, which would put us in the best position to do valuable scholarship on these issues.

The discussion below explains the identification of the problems and the general guidance that emerge from Roberta's writings on the transformation of SROs and developments in securities market structure. Part II first sets out briefly the background to and a timeline for the SRO and securities market transformation. It also describes how that transformation closely intersects

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5. *See* COFFEE ET AL., *supra* note 1, at 19–32, 38–41, 50–52 (highlighting these issues).

6. *See infra* Part II (on her background).

7. The purposes for the regulation of securities exchanges, other marketplaces, and market participants, which regulation is the subject of the Exchange Act, are set out in Section 2 of the Act. *See* 15 U.S.C. §§ 78b(3)–(4) (citing such reasons as maintaining "fair and honest markets" and preventing excessive speculation that could lead to national emergencies that disrupt commerce and the economy).

8. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 429 ("It would be a mistake, however, for the SEC or CFTC to force a new system of self-regulation on evolving exchange markets . . . The form of tomorrow's trading markets should be permitted to evolve before the existing SRO structure is endorsed, dismantled or otherwise adjusted to compliment a new market structure.").

with Roberta's career as a legal practitioner, a regulator, and a legal academic. Part III then looks at her scholarly discussion on how the self-regulatory functions of the stock exchanges became FINRA. This part explains how Roberta had the foresight to point out that, in the emergence of FINRA, self-regulation was being transformed from broker-dealer self-governance into a very different SRO model, chiefly a quasi-government organization that regulated firms in a way similar to the SEC's. She observed that this transformation raised the question whether self-regulation by broker-dealers continued to exist post-FINRA. This part then explores a possible answer to this question, which Roberta has acknowledged, in the collaboration between FINRA and compliance officers: i.e., those officers in broker-dealers who are responsible for ensuring that they and their employees follow law and regulation. It also explains how this new form of self-regulation was likely inevitable with the enhanced regulation of broker-dealers.

Part IV looks at Roberta's insights on the related subject of the transformation of the stock exchanges and its overall effects upon the securities market structure. It explains how she identified for the securities law academic audience the forces, including the regulatory ones, that were pushing the exchanges to become public companies and the market fragmentation that resulted from the proliferation of trading venues, which came from, among other things, broker-dealer members competing in various ways with the exchanges of which they were members. This part discusses how Roberta thought that Congress and the SEC should not be hasty to offer a wide-ranging solution to this developing situation, although she chastised them and other regulators for not removing impediments to and closing the gaps in effective regulation of the interlocking securities markets and their participants. This part also observes that, while she was dismayed by the enhanced focus on speculative trading that came at the expense of capital raising and investing, she took a "wait and see" approach to problems in securities market structure, recommending that securities markets be allowed to develop with their new forms and technological advances before Congress and the SEC apply to them a major new regulatory framework. She wanted the SEC to regulate with a light hand, correcting market problems where necessary, while the outline of a new market structure emerged. The part then briefly looks at the current securities market from Roberta's perspective. Part V concludes.

I. THE TRANSFORMATION OF THE SROS AND SECURITIES MARKET STRUCTURE AND ITS INTERSECTION WITH ROBERTA'S CAREER

To situate Roberta's writings on the transformation of the SROs and securities market structure, it is useful to set forth the general background and a basic timeline for the regulatory and securities market developments that

she discussed. It is also helpful to point out that Roberta's career as a legal practitioner, a regulator, and a legal academic closely overlapped with these developments.

The major event that serves as the beginning of this transformation was the Securities Act Amendments of 1975 (the 1975 Act).[9] Among other things, this Act was a response to anti-competitive practices and customer harm in the brokerage industry, particularly the widespread breakdown in broker-dealer back offices where customer securities and funds were held.[10] This legislation greatly enhanced and harmonized the power of the SEC over the SROs, particularly stock exchanges. It did this by allowing the SEC to review and approve SRO rules, to amend them, and to review SRO disciplinary actions and denials of membership,[11] and by changing the governance of the SROs to lessen the influence of their broker-dealer members.[12] It thus authorized the SEC to limit the "self" in self-regulation (i.e., restrict the self-governance of the securities marketplaces solely by broker-dealers). Moreover, the 1975 Act set forth the regulatory goal of the creation of a national market system for trading in equity securities, as opposed to the then-existing system where trading for a listed stock was limited to the exchange on which the security was listed.[13]

A discussion of all the regulatory developments that followed the 1975 Act and that dealt with SRO reform and the national market system is beyond the scope of this essay.[14] Many of these changes were designed to provide better pricing information for retail investors and to ensure that they had execution at the best price for traded equity securities. But a major

9. *See generally* Pub. L. No. 94-29, 89 Stat. 97 (amending Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*).

10. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 388 (discussing this background for the 1975 Act).

11. *See* 15 U.S.C. § 78s (Section 19 of the Exchange Act, which deals with the SEC's power over the SROs).

12. *See* 15 U.S.C. §§ 78f(b)(3), 78o-3(b)(4) (setting forth the representation of non-broker-dealers in the governance of exchanges and securities associations). Roberta discussed this enhancement of the SEC's oversight of exchanges by the 1975 Act. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 407.

13. *See* 15 U.S.C. § 78k-1(a) (this is Section 11A(a)(1) of the Exchange Act). Section 11A(a)(1)(D) states the Congressional finding that "[t]he linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders."

14. A good, accessible review of many of these developments is in one of the "Galleries" of the SEC Historical Society. *See Transformation & Regulation: Equities Market Structure, 1934 to 2018*, SEC. EXCH. COMM'N. HIST. SOC'Y, http://www.sechistorical.org/museum/galleries/msr/ (last visited Aug. 4, 2021). Among the developments were (i) the creation of a consolidated tape, which reported transactions in equity securities whether on an exchange or off of it (i.e., between broker-dealers in the OTC market), (ii) a quotation rule requiring exchanges and market makers to give their best bid and offer throughout the trading day and (iii) off-exchange trading of listed securities. Roberta discussed these post-1975 regulatory developments in market structure in *Turning Seats Into Shares*, *supra* note 2, at 389–92.

development that was referred to in the 1975 Act and that altered securities markets and influenced regulation in these years was the advances in electronic trading technology.[15] These advances meant that equity trading did not have to be done in person at centralized locations, which were the floor of stock exchanges where buy and sell orders came together with a specialist who conducted the auction market process to determine securities prices. Rather, the technology allowed rapid electronic trading and order-based matching systems, where investors could enter an order that could be matched with a counterparty's order if each satisfied its respective execution criteria. Regional exchanges began to offer electronic displays of prices and electronic submission of orders, and the NASD provided its "automated quote" system for market maker quotations (i.e., Nasdaq), which eventually had electronic execution.[16] Electronic order matching and execution systems began to appear and were particularly attractive to institutional investors, who had large trades to execute, who did not want their order size to influence negatively the pricing of the order, and who often traded among themselves.[17] These systems, however, drew trading away from the stock exchanges and began to produce a fragmented, albeit more competitive, trading market.[18] Moreover, the exchanges (particularly the NYSE) responded to the competition by enhancing their own capabilities in electronic communication and order execution.[19] These enhancements required significant capital, beyond what the members of the exchanges, the broker-dealers, could provide themselves. In addition, broker-dealers were using electronic systems within their own firms where customer orders could be "internalized" (i.e., executed by the broker-dealer and not sent out to the securities markets for execution).[20]

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15. Indeed, Section 11A(a)(1)(B) of the Exchange Act, i.e., 15 U.S.C. § 78k-1(a)(1)(B), states that Congress finds that "[n]ew data processing and communications techniques create the opportunity for more efficient and effective market operations." As noted earlier, Section 11A(a)(1)(D) of the Exchange Act, i.e., 15 U.S.C. § 78k-1(a)(1)(D), refers to "[t]he linking of all markets for qualified securities through communication and data processing facilities."

16. On the development of the Nasdaq, see Karmel, *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 161. A market maker is a registered broker-dealer that stands ready to buy and sell certain securities as a principal to "make a market" in these securities. The NASD was initially based upon a number of market makers offering quotations in a given security.

17. The early such matching system was Instinet, which allowed institutional investors to trade with one another. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 370–71, 375.

18. The SEC recognized the fragmentation problem in Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577 (Feb. 23, 2000). For a discussion of this fragmentation issue and industry comments on it at the time, see Karmel, *Turning Seats Into Shares*, *supra* note 2, at 392–95.

19. For a discussion of these developments, see Karmel, *Turning Seats Into Shares*, *supra* note 2, at 381–84.

20. *See id.* at 371.

All of this set the stage for the regulatory and market developments in the transformation of the SROs and securities market structure around the turn of the last century, a transformation that Roberta followed closely. Several of the major regulatory developments were the following. First, the SEC adopted Regulation ATS (i.e., alternative trading system) in 1998,[21] which allowed an electronic trading system to be exempt from registration as a stock exchange so long as it is registered as a broker-dealer and otherwise complies with the Regulation, which, among other things, makes the system's orders generally available if it has five percent or more of the trading volume in a national market stock. Second, in 2005, the SEC adopted Regulation NMS (i.e., national market system), which was an effort to link the stock exchanges and the developing non-exchange markets and trading systems. The regulation made it easier for investors to access the markets and market data about pricing and executions and enabled investors to obtain the best price available in most displayed markets (the national best bid and offer (NBBO)).[22] Third, during this period, the major stock exchanges "demutualized," i.e., ceased to be owned by the broker-dealers who were their members and exclusive trading intermediaries, and became public companies (the Nasdaq in 2001; the NYSE in 2005-2006), generally to access more capital.[23] When this transformation in the organizational status of the stock exchanges happened, the SEC required that the part of the stock exchanges that regulated the conduct of their broker-dealer members become a separate entity. In the past, having broker-dealers who were the exchange members establish their own standards of conduct was the essence of self-regulation. This movement of broker-dealer self-regulation away from the exchanges made sense because the broker-dealers were no longer the "owners" of these trading venues; that status had been ceded to public

21. *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844 (Dec. 22, 1998). *See also* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 376–81 (discussing the history of this Regulation).

22. *See* Exchange Act Release No. 52,355, 70 Fed. Reg. 52,014 (Sept. 1, 2005). This regulation has a rule requiring broker-dealers to execute customer orders at the best displayed price available. *See* COFFEE ET AL., *supra* note 1, at 662. A "bid" is an offer to buy a security; an "offer" is an offer to sell a security. Thus, the NBBO is the highest displayed bid and the lowest displayed offer.

23. On the Nasdaq's demutualization, see Karmel, *Turning Seats Into Shares*, *supra* note 2, at 410–13; *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 164. On the NYSE's demutualization, see Karmel, *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 164–67.

investors.[24] Fourth, in 2007, the regulatory arms of the NASD and the NYSE combined into the new SRO, FINRA.[25]

Roberta's legal practice and regulatory and legal academic career completely intersect with these developments.[26] She was on the SEC staff from 1962-69 and then began private law practice in 1969—one that would continue for the next 30 some years when she was not on the SEC—working on securities law matters for major broker-dealers and other market participants. She was an SEC Commissioner in the years soon after the passage of the 1975 Act (1977-80).[27] She was on the board of the NYSE during the important years (1983-89) when that exchange was experiencing competition from the new trading systems and developing its own electronic capabilities.[28] Between 1998 and 2001, she was a member of the National Adjudicatory Council of the NASD Regulation (NASDR),[29] the regulatory arm of the NASD, a council that reviewed disciplinary actions against NASD member firms and their associated persons.[30] From 1986 onwards, she was on the faculty of Brooklyn Law School and there followed these SRO and securities market developments in her teaching and writing.[31] Indeed, her major writings on the transformation were published right when the demutualization was finished and the new self-regulator (FINRA) appeared.[32] Her insights on the transformation are thus almost contemporaneous with its accompanying events.[33]

24. The story of this stock exchange transformation is a bit more complicated. As a result of previous scandals, in 1996 the SEC had compelled the regulatory arm of the NASD to be placed into a separate NASD subsidiary apart from its securities market, the Nasdaq. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 411; *see also* Karmel, *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 163–64. Roberta noted that, even before the demutualization, broker-dealer members of the NASD and the NYSE were already losing their "self" regulatory power. Broker-dealer members of stock exchanges became shareholders with the demutualization, but were not the majority or controlling ones. *Id.*

25. *See* Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change Relating to the Restated Certificate of Incorporation of National Association of Securities Dealers, Inc., Exchange Act Release No. 56146, 72 Fed. Reg. 42,190 (Aug. 1, 2007) (approving the creation of FINRA); *see also* Karmel, *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 151–52 (discussing this creation).

26. Roberta's biographical facts are taken from her conference biography and from her publicly available resume. *See Roberta Karmel*, BROOK. L. SCH., https://www.brooklaw.edu/Contact-Us/Karmel-Roberta (last visited August 27, 2021).

27. *Id.*

28. *Id.*

29. *Id.*

30. Associated persons are employees who are registered with an SRO and qualified, generally through an examination, to conduct a general, or certain kind of, securities business.

31. *See Roberta Karmel*, BROOK. L. SCH., *supra* note 26.

32. *See* sources cited *supra* note 2.

33. During this time, Roberta also wrote a regular column in the NEW YORK LAW JOURNAL on corporate and securities law matters and covered these developments there. *Roberta Karmel*, BROOK. L. SCH., *supra* note 26.

II. TRANSFORMATION IN BROKER-DEALER SELF-REGULATION FROM TRADITIONAL SROS TO FINRA

Roberta particularly focused on the transformation of SROs in the 1990s and the first decade of the 2000s from the "classic" form of self-regulation to what we have today, i.e., FINRA. In her writings (as in her conversations), Roberta was always balanced on this transformation: she was neither a cheerleader for the SROs nor a skeptic who just assumed that their only purpose was to enrich their broker-dealer members at customers' expense. She knew their history well, with all of the scandals that arose from their "clubby" nature and closed, quasi-monopolistic trading practices.[34] Roberta acknowledged that reform of the self-governance of the SROs was one of the main reasons for the amendments to the Exchange Act made by the 1975 Act, which, as discussed above, gave the SEC more direct oversight of the SROs, their rulemaking, and their governance.[35] She recognized this Act as the first step in the transformation, and the weakening, of traditional broker-dealer self-regulation as the broker-dealer firms began to share their governance power in the securities marketplaces with others—listed companies, public investors, and, indirectly, the SEC. She understood that the SROs were very much to blame for their loss of self-regulatory independence because they had repeatedly failed to deal themselves with abusive and anti-competitive practices in their industry, which spurred Congressional and SEC opposition and action.[36]

Roberta indirectly noted that at least some member firms were also becoming less interested in their self-regulatory role at this time as they competed with the stock exchanges for order flow by owning and operating ATSs and by internalizing customer trades.[37] I would add that other reasons were making firms less interested in self-regulation. From being partnerships in their origins with the internal self-policing that this organizational form entailed (i.e., because each partner was responsible for other partners' actions), they became large corporations that listed their stock to raise the necessary funds for their transformation and that allowed their executives to obtain enormous wealth from share ownership in a public company.[38] With the demise of the separation of commercial from investment banking in the

34. *See* Karmel, *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 163–65 (discussing abusive market practices in the Nasdaq and the scandal over NYSE President Grasso's compensation).

35. *See supra* text accompanying notes 11–12.

36. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 411 (discussing the SEC's concerns about the NASD's self-regulation).

37. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 370–71 (discussing the broker-dealer activity of owning and operating ATSs and internalizing customer trades).

38. *See* PHILIP AUGAR, THE GREED MERCHANTS: HOW THE INVESTMENT BANKS PLAYED THE FREE MARKET GAME 36–37 (2005) (discussing the large broker-dealers' change in organizational form).

Gramm-Leach Bliley Act[39] and pushed by the financial crisis, the bulge-bracket firms became parts of financial conglomerates, regulated today as financial holding companies.[40] This development encouraged the large broker-dealers to focus on the synergies and the well-being of the financial group of which they were a part. In other words, the large firms were not just concentrating on their own industry and were less concerned if their role in it weakened with the increased SEC regulation and the rise of a quasi-governmental, bureaucratic organization like FINRA to oversee it. Moreover, the financial groups of which they were a part were dealing with many regulators because of their involvement in numerous and different financial activities so that, as Roberta suggested, one of their goals was to take advantage of gaps in regulation.[41]

An SRO like FINRA was likely inevitable with the SEC's decreasing the role of broker-dealers in their own governance, with the larger broker-dealers becoming less interested in it, and with the ever-increasing regulation of the brokerage industry and financial services in general. As noted above, the ultimate event that led to FINRA's creation was that the exchanges became public companies.[42] As Roberta observed, the SEC used the conflict of interest in stock exchanges that would be focusing on the profits for their shareholders, in a situation where their largest and most profitable member firms were competing with them for stock trading volume, as a reason for the creation of a new kind of SRO to engage in self-regulation of broker-dealers.[43] This specialized organization, which would assist the underfunded SEC, continued to have special ties to the broker-dealers. Today, FINRA has ten industry governors, representatives from broker-dealer members on its national adjudicatory council, and five regional committees entirely composed of representatives from industry firms in the region.[44] However,

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39. Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, 16, 18 U.S.C.). Before this Act, commercial banking was generally separated from investment banking and insurance, although this separation had been eroding for 20 years predating it. When the separation ended, financial conglomerates offering all kinds of banking and other financial services were formed.

40. *See* 12 U.S.C. § 1843(k) (statute governing financial holding companies). As a result of the threat of collapse in the financial crisis of 2007-2008, major investment banks (like Goldman Sachs, Merrill Lynch, and Morgan Stanley) either combined with commercial banks or became bank holding companies and then financial holding companies. For an explanation of the timeline of this transformation, see Viral V. Acharya et al., *The Financial Crisis of 2007-2009: Causes and Remedies, in* VIRAL V. ACHARYA & MATTHEW RICHARDSON, RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 51–56 (2009).

41. *See* Karmel, *Securities and Exchange Commission as a Market Regulator*, *supra* note 2, at 521 (discussing the competition among regulators that financial conglomerates could exploit).

42. *See supra* text accompanying notes 24–25.

43. *See* Karmel, *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 169–70 (discussing this point).

44. *See Governance*, FINRA, https://www.finra.org/about/governance (last visited Aug. 4, 2021). Some have pointed out that broker-dealers no longer care about participation in their governance committees because they feel that, with the quasi-governmental nature of FINRA, firms

there is no question that FINRA, with its main office in Rockville, Maryland next to Washington, D.C., and with its detailed rulebook[45] and enforcement capacity, looks more like a federal securities regulator than, as was formerly the case, a collection of broker-dealer officers who would meet periodically to decide upon an SRO's standards of conduct and rules and to judge rule violators.[46]

Roberta thus asked the logical questions about FINRA right at its creation: was there any broker-dealer self-regulation left after FINRA? If there was not, was FINRA in fact an independent government agency, or just part of the SEC?[47] She did not find easy answers to these questions. On the one hand, she found that, although the SEC did not appoint the members of FINRA's board, FINRA's very existence and governance structure came from the SEC rule-making.[48] Moreover, as she noted, the SEC exercised considerable oversight over FINRA's rule-making and discipline of broker-dealers.[49] On the other hand, FINRA did exercise a degree of independence from the SEC and had funding independent of the government (i.e., it was funded by assessments on its members). Writing in 2008, Roberta favored one of the traditional justifications for SROs: their closeness and responsiveness to the securities industry, which produced more "realistic" and flexible regulations.[50] She thus argued that FINRA should be given the chance to operate independently from the SEC to see whether its new model of self-regulation could work. As she observed,

> Nevertheless, to subject SROs to all of the constraints to which the SEC is subject with regard to their operations would reduce their utility in the scheme of securities regulation. If FINRA is going to be regulated like the SEC, it may as well become part of the SEC. If the SEC becomes too controlling of FINRA's governance and operations, FINRA will no longer be an SRO. While criticism of SROs as being insufficiently responsive to the public interest has been leveled over the years by Congress, there is a danger that FINRA will be insufficiently responsive to the needs and concerns of the securities industry, and will become merely an arm of the

have little influence on them. *See* Alan Wolper, *The Demise of FINRA's District Committees… And Self Regulation, Too?*, BROKER-DEALER L. CORNER (May 22, 2018), https://www.bdlawcorner.com/2018/05/the-demise-of-finras-district-committeesand-self-regulation-too.

45. *See generally FINRA Manual*, FINRA, https://www.finra.org/rules-guidance/rulebooks (last visited Sept. 9, 2021).

46. *See* Karmel, *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 196–97 (describing this classic broker-dealer self-regulation).

47. *See id.* at 154 ("Is FINRA, now organized and recognized, and functioning only as a regulator under the aegis of the SEC, a government regulator? And if so, what are the implications of such a determination?").

48. *Id.* at 169 ("FINRA could not come into existence until it was approved by the SEC. FINRA was created in large part to further the SEC's objectives regarding self-regulation, and the SEC structured its board. So FINRA comes very close to being an organization that would qualify as a government agency.").

49. *See id.* at 186.

50. *See id.* at 197.

> SEC. Should this occur, the duplicative nature of SEC and SRO regulation of broker-dealers will make such regulation inefficient and ineffective. FINRA should be given the opportunity to operate as an independent, non-political expert body engaged in the regulation of broker-dealers, without undue interference from the SEC or Congress, but it will have to prove that it can be sensitive and responsive both to the securities industry and the public interest.[51]

In the years since Roberta wrote about FINRA's creation, there has been a kind of self-regulation that has continued and even strengthened in the brokerage industry, even if the industry is no longer establishing itself the rules governing its members' conduct. This self-regulation is an old concept, as Roberta herself reminded me in a recent conversation, that emphasizes how broker-dealers traditionally enforced compliance with law and regulation within their firms. While firms that were members of a stock exchange established the rules for their members' conduct, in the classic self-regulatory system, the firms had to follow the rules internally and had to set up an internal control system within themselves to ensure that they did so. In other words, the firms were acting as their own regulator or, put another way, embracing the regulator as part of themselves.[52] Roberta recounted a story to me that is an exaggeration of this kind of self-regulation: in her telling, Stanley Sporkin, one of the famous directors of the SEC Division of Enforcement,[53] wanted to have an SEC representative in every broker-dealer, preferably within the general counsel's office. In this example, the external (i.e., laws, regulations, and the public agencies that administer them) clearly becomes internal.

Of course, this internal broker-dealer person who helps ensure that the firm and its employees are following the laws and regulations and who thus makes self-regulation work is the compliance officer. Indeed, Sporkin's choice of a member of the general counsel's office as an internal SEC deputy makes complete sense because, in his day, compliance activities generally took place in the legal department in broker-dealers.[54] In other words, just as self-regulation outside the broker-dealer became embodied in FINRA, so also did it find its place within the firm in a specialized department, group, or

51. *Id.*

52. *See* DAVID P. MCCAFFREY & DAVID W. HART, WALL STREET POLICES ITSELF: HOW SECURITIES FIRMS MANAGE THE LEGAL HAZARDS OF COMPETITIVE PRESSURES 7 (1998) ("Self-regulatory organizations and firms have room to design regulatory systems rather than having to implement rules designed largely by government, and the right to largely control themselves is theirs to lose.").

53. Stanley Sporkin was the Director of the Division of Enforcement while Roberta was an SEC Commissioner. She is reputed often to have resisted his aggressive use of the SEC's enforcement powers. Roberta's views on SEC enforcement were the subject of the "Regulation Through Prosecution" panel in the conference in her honor.

54. *See* COMPLIANCE & LEGAL DIV., SEC. INDUS. ASS'N, WHITE PAPER ON THE ROLE OF COMPLIANCE 1 (2005) (recounting how, prior to the early 1960s, legal departments generally had responsibility for compliance in the brokerage industry).

individual in the field of compliance. This outcome is understandable because the well-accepted definition of compliance is that it is part of internal control: it is the firm function to ensure that the organization and its employees are conducting their activities in accordance with the law, rules, and other agreed-upon standards of conduct.[55] Compliance as an occupation and a field has grown in importance over the last thirty years, both within the brokerage industry and more generally in all organizations.[56] As I have argued elsewhere, its growth in broker-dealers can be explained by firms needing help for them and their supervisors so that they could satisfy the express supervisory obligation imposed upon them by the Securities Act Amendments of 1964.[57] Compliance has become even more significant over the years as a key way for firms to ensure that broker-dealers are complying with their increasing number of legal obligations.[58]

Thus, in this model of self-regulation within firms, compliance officers help the broker-dealers to regulate themselves. In this role, they are representative of the external authorities, in particular, FINRA and the SEC, and understandably have reporting responsibilities to them.[59] But this relationship with the authorities is not as extensive as the one that, according to Roberta, Stanley Sporkin wanted, which was to have an SEC deputy in each firm. To be effective, compliance officers cannot just be quasi-government employees. Nor can they simply be representatives of their firms and in constant opposition to the regulators. Rather, they should work closely with FINRA and the SEC to implement the appropriate regulation in their firms while passing along firm and industry concerns to the regulators, and they should help shape the regulation so that it is not burdensome and can be tailored to firm circumstances.[60] This vision of cooperative regulation where

55. *See* GEOFFREY P. MILLER, THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE 157 (2d ed. 2016) ("The compliance function is a form of internalized norm enforcement within organizations.").

56. *See generally* James A. Fanto, *The Professionalization of Compliance: Its Progress, Impediments, and Outcomes,* 35 NOTRE DAME J. L., ETHICS & PUB. POL'Y 183, 190–204 (2021) (discussing the triumph of compliance).

57. *See generally* James A. Fanto, *The Vanishing Supervisor,* 41 J. CORP. L. 117, 138–40 (2015) (discussing the history of this statutory duty and its relationship to the growth of compliance).

58. *See* James A. Fanto, *Surveillant and Counselor: A Reorientation in Compliance for Broker-Dealers*, 2014 B.Y.U. L. REV. 1121, 1123 (2014) (discussing the growth in and role of compliance in broker-dealers).

59. One example of compliance officer reporting in the brokerage industry is FINRA Rule 4530, where a broker-dealer, generally through a compliance officer, must report rule violations, other misconduct, and customer complaints occurring in the firm to FINRA. FINRA, RULE 4530(a)-(d) (2020).

60. For a recent SEC statement on the importance of compliance in communication with the SEC, see DIVISION OF EXAMINATIONS, 2021 EXAMINATION PRIORITIES 5 ("We continue to believe it is important to emphasize that compliance programs, CCOs and other compliance staff play critically important roles at firms.").

the regulated firms influence the regulation finds support in a well-accepted theory of efficient regulation.[61]

In a similar way, FINRA's self-regulatory role is different from the former self-regulation by the stock exchanges, but it is not synonymous with being part of the SEC. In other words, FINRA is not, and should not be, the government's "fifth branch."[62] In the highly specialized domain of the securities industry, FINRA extends the reach of the SEC, which has neither the resources nor all the necessary expertise to regulate adequately broker-dealers. It thus administers the SEC's regulations of broker-dealers and supplements them with its own tailored rules, given that it is more knowledgeable about the industry and the firms, which it examines, and with which it is in regular communication.[63] By the same token, it can pass on firms' concerns to the SEC. This outcome should meet Roberta's wish, for it is not a story about the SEC's or the industry's control of FINRA, but one of the growth of an independent organization for reasons of necessary expertise and organizational logic (i.e., self-regulation should be situated in a firm that follows industry developments). As noted earlier, Roberta appreciated the flexibility that the former SROs were able to bring to the circumstances of the transformation of the markets.[64] I would contend that FINRA, in collaboration with firm compliance officers, continues this flexible approach to self-regulation, albeit in the current circumstances of "hyper" regulation of broker-dealers and of financial institutions generally.

As Roberta also pointed out, there remains the problematic "government actor" status of FINRA, which status in itself presents contradictions.[65] Under established law, as she explained, FINRA is a government actor when it is engaging in functions delegated to it pursuant to the Exchange Act but not in

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61. This theory is called "new governance." *See generally* Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation,* 45 AM. BUS. L. J. 1 (2008) (under this theory, regulators are viewed as closely working with regulated firms so that the resulting regulations are better tailored than those that are imposed from the "top-down" by regulators who may not be entirely knowledgeable about the circumstances in the industry that they regulate). New governance emerged out of academic and practical efforts to discover ways of achieving more widespread organizational compliance with law and regulation. *See* Christine Parker, *Compliance Professionalism and Regulatory Community: The Australian Trade Practices Regime,* 26 J.L. & SOC'Y 215, 223–25 (1999) (describing this origin).

62. *See* William A. Birdthistle & M. Todd Henderson, *Becoming A Fifth Branch*, 99 CORNELL L. REV. 1 (2013) (arguing that SROs like FINRA are increasingly becoming a part of government agencies).

63. While the SEC has the power to examine broker-dealers, it generally does so only if there is a particularly significant issue in a firm or if it wishes to look over numerous firms for a given matter (known as a "sweep" examination). The regular examiner of broker-dealers is FINRA. On broker-dealer examinations generally, see JAMES A. FANTO ET AL., BROKER-DEALER LAW AND REGULATION § 9.05, at 9-70 to -73 (5th ed. 2019).

64. *See supra* note 50 and accompanying text.

65. *See* Karmel, *Securities Industry Self-Regulatory Organizations*, *supra* note 2, at 154–55 (identifying this issue).

its commercial activities.[66] Importantly, and always of concern to Roberta, regulated parties do not generally have constitutional protections when prosecuted by FINRA enforcement.[67] For Roberta, this outcome was not theoretically or practically satisfying, as jurisprudentially the government actor status shifted with the circumstances.[68] The above presentation and justification of FINRA as a specialized self-regulator does not resolve its status for the government actor issue, which cannot be adequately treated in this essay. What can be said is that, while it conducts tasks on behalf of the government (i.e., the SEC) as part of its very mission, certainly FINRA's activities today suggest that it has been moving closer to the government, rather than the industry, side of the spectrum. It can thus seriously be asked whether FINRA can remain, in Roberta's words, the "independent, non-political expert body" as it takes on more government-related tasks from the SEC, which oversees it closely.[69]

A final point on self-regulation: if it is compelling to have this kind of self-regulator that, in the best case, is institutionally distinct from the industry and the SEC and has special ties to the compliance function in the broker-dealers, there is a point that Roberta herself raised long ago: why doesn't the other main securities market financial professional, the investment adviser, have an SRO like FINRA?[70] I would argue—and Roberta agrees—that this financial professional, whose fiduciary duty has been held up as the "gold standard," is seriously underregulated precisely because of the inadequate capabilities and resources of its current regulators.[71] An investment adviser SRO would help address this problem of inadequate oversight, but would also run into the same issues discussed above as to how independently an SRO can function when it is so closely tied to the SEC.[72]

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66. *See id.* at 171–77.

67. *See id.* at 177–81.

68. *See id.* at 177–81 (discussing the lack of Fifth Amendment privilege for a target of SRO investigations).

69. *Supra* text accompanying note 51.

70. *See* Karmel, *The Future of the SEC*, *supra* note 2, at 532 (noting, in that article, that "Rather, the Investment Advisors Act has long been a skimpy and inadequate statute, and the SEC staff available for inspections of investment advisors is too small and not sufficiently sophisticated."). She also observed that this financial professional was not under the jurisdiction of an SRO, although she thought that it should be. *See id.* at 533.

71. To simplify a complex issue, investment advisers with assets under management of $25 million or more are regulated by the SEC, with the others regulated by state securities authorities. *See General Information on the Regulation of Investment Advisers*, SEC. EXCH. COMM'N (Mar. 11, 2011), https://www.sec.gov/divisions/investment/iaregulation/memoia.htm (last visited Sept. 9, 2021).

72. The investment adviser SRO issue was raised in the debate over whether to adopt a uniform fiduciary duty for investment advisers and broker-dealers, which was triggered by a provision in the Dodd-Frank Act, *see* Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 913, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.), requesting that the SEC consider this. For a good discussion of this debate and its Dodd-Frank background, *see* Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries,* 87 WASH. L. REV. 707 (2012). At that time, FINRA offered to become the

III. THE TRANSFORMATION OF THE STOCK EXCHANGES

While the above account about FINRA deals with the transformation of the SRO governing the regulation of broker-dealers, the story of the transformation of stock exchanges focuses on the structure of the securities markets.[73] In my view, Roberta is a traditionalist about securities markets: that is, she believes that they exist for capital formation in a classic sense, which is to allow deserving companies to tap pools of investor funds and to permit ordinary people to invest in these companies, whether in the primary or secondary market.[74] I once co-wrote an article with Roberta on foreign companies listing on U.S. markets in the heyday of such listings in the 1990s.[75] I remember that she emphasized the capital-raising purposes of this listing for the companies and on the advantages of it for both the companies and for U.S. investors, who would gain by diversifying their portfolios into foreign securities.

Roberta argued that the primary capital-raising and investing purposes of the securities markets had been relegated to a secondary position and replaced by a focus on speculative trading that primarily benefitted financial firms and the stock exchanges.[76] In her articles, she spent considerable time explaining two related reasons for this change: (i) Congressional and regulatory failure and (ii) the capture of Congress and regulators by financial interests. In her view, federal financial regulators were supposed to keep stock speculation, and thus stock trading, in check, but they did much to encourage it—this was her regulatory failure story.[77] In particular, she argued that the Board of Governors of the Federal Reserve System (Federal Reserve) and the SEC, among others, did not enforce existing margin regulations well and declined to revise them after the 1987 crash that was fueled by speculation in securities.[78] She particularly blamed the pre-financial crisis Federal Reserve for repeated bouts of speculative market activity because of its resistance to consolidating the Commodity Futures Trading Commission (CFTC), which regulated most derivatives like stock index futures that had

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SRO of investment advisers, partly because it examines firms that are dually registered as broker-dealers and investment advisers. For various reasons, that path was not taken, nor was the investment adviser SRO concept pursued further. On the investment adviser SRO issue, see generally U.S. GOV'T ACCOUNT. OFF., PRIVATE FUND ADVISERS: ALTHOUGH A SELF-REGULATORY ORGANIZATION COULD SUPPLEMENT SEC OVERSIGHT, IT WOULD PRESENT CHALLENGES AND TRADE-OFFS, GAO-11-623 (July 2011).

73. Because the other speakers on my panel dealt with the question of market structure, my essay mainly focuses on the transformation of the SROs regulating broker-dealers.

74. *See* Karmel, *The Future of the SEC*, *supra* note 2, at 507 ("Further, the SEC of the future, whatever its amended organization, statutory authority, and mandates, should refocus on capital formation in the stock and bond markets and protecting investors' retirement savings.").

75. *See* James A. Fanto & Roberta Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing,* 3 STAN. J.L. BUS. & FIN. 51–83 (Summer 1997).

76. *See* Karmel, *The Future of the SEC*, *supra* note 2, at 507 (discussing this change).

77. *See id.* at 515.

78. *See id.* at 515–18 (discussing this history).

an effect upon the stock market, and the SEC, its opposition to the regulation of over-the-counter (OTC) derivatives like swaps (which also affect the stock market), its belief in market rationality, and its easy money policies that fueled speculation.[79]

In Roberta's account, the SEC and the CFTC fought over their respective missions, with their oversight Congressional committees defending the agency under their jurisdiction, even though the trading in products under the CFTC's control (e.g., index futures and options on the same) had significant effects on the trading in those under the SEC's jurisdiction (e.g., securities and exchange indices).[80] Roberta attributed the divided regulation of related financial instruments to members of Congress seeking campaign contributions from the respective industries that they regulated, i.e., commodities or securities, as the case might be—this was her capture story.[81] But, as she perceptively observed, the financial firms making these contributions to different Congressional committeepersons and thus encouraging bifurcated regulation of related markets were generally part of the same financial conglomerates. She thus understood that the financial conglomerates exploited the lack of or gaps in regulation in a particular financial area or product, such as OTC swaps that were not regulated before the Dodd-Frank Act,[82] and that it was in their interest to continue the existing state of affairs.[83] She also realized that financial institutions could threaten to move their activity offshore to play non-U.S. regulation against U.S. regulation.[84] For Roberta, the Dodd-Frank Act was an effort to remedy this situation of disjointed regulation, and she hoped that it would encourage regulators to rein in speculation.[85]

79. *See id.* at 518–20. This situation of easy money fostered by the Federal Reserve is similar now, although today it is justified by the need to support a post-pandemic economy and to address unemployment.

80. *See id.* at 510–11 (discussing this connection).

81. *See id.* at 514 ("Why has this rivalry between two similar agencies persisted for so long, and who has benefited? The simple answer is that congressmen seeking campaign finance funds from the securities and commodities industries have benefited from the constant warfare between these agencies, along with the periodic fights over CFTC reauthorization.").

82. Title VII of the Dodd-Frank Act brought swaps within regulation but maintained separate regulation: CFTC for non-security-based swaps and the SEC for security-based swaps. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.).

83. *See* Karmel, *The Future of the SEC*, *supra* note 2, at 515 ("But bifurcated regulation of the trading markets was necessarily weaker regulation, especially when the financial industry could claim that there was also regulatory competition with foreign regulators.").

84. *See id.* at 535 ("For about the past decade, regulators have been too willing to credit claims by financial firms that their businesses will move offshore if U.S. regulation is too tough.").

85. *See id.* at 523 (discussing the then Obama Administration's plans for the Dodd-Frank Act, in particular, the creation of the Financial Stability Oversight Council that might be more "activist" in dampening speculation). The articles by Roberta consulted for this essay all predate the passage of the Dodd-Frank Act.

The above was her "macro" account of the reasons for what was, in her view, excessive trading that occurred on and off securities and derivative exchanges. For the transformation of the securities market structure, which resulted in market fragmentation, she gave an explanation related to the one discussed above about the creation of FINRA. That is, the exchanges' longstanding anti-competitive practices—for example, the NYSE's resistance to off-exchange trading of exchange-listed securities, the exchanges' insistence upon quoting securities prices in specific, and unnecessarily large, increments and floor brokers' front-running customers' trades—angered Congress and the SEC, which made them want to control the exchanges' power, but without at the same time undermining their competitive position.[86] As she explained, the Exchange Act, as amended by the 1975 Act, did not help the SEC resolve what it saw as its conflicting missions: to promote competition in securities trading markets, which could undermine the dominance of the stock exchanges, and to have stable and well-linked markets, which favored large market centers like the exchanges.[87] She described how the SEC's reforms pursuant to these goals, such as the encouragement of off-exchange trading and the compromise in Regulation ATS that allowed non-exchange trading systems not to have to register as exchanges, facilitated competition but contributed to the fragmentation of the securities markets.[88] As Roberta also explained, in Regulation NMS, the SEC attempted to address the ill effects of this fragmentation for ordinary investors by allowing them to benefit from the best available prices, wherever available, and to offer price improvement through their limit orders.[89] In her view, the SEC also maintained the dominance of the established exchanges to reduce market fragmentation.[90]

In sum, Roberta observed that the SEC was unable to resolve the market fragmentation issue because it both wanted to foster competition in the securities markets and did not trust it:

> What should the role of the SEC be in this struggle [i.e., between traditional exchanges and other market centers]? On the one hand, the SEC is concerned about encouraging competition and lowering transaction costs . . . . On the other hand, the SEC also is concerned about maintaining orderly and liquid markets, which is accomplished by a single trading market.

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86. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 407 (discussing these points).

87. *See id.* at 399–400.

88. *See id.* at 371–81.

89. *See id.* at 387–95. An investor improves the NBBO by entering a limit order, which is an order to be executed at a set price, that improves upon the NBBO. For example, if the best buy order is at $20, a limit order for $20.50 improves upon the best buy price.

90. *See id.* at 384 ("Further, the SEC is too concerned about fragmentation of the pricing mechanism for equities to permit unregulated competition between market centers. This may well be appropriate as a matter of policy, but the model that is emerging is that of two dominant market centers with ATSs gaining just enough market share to keep the NYSE and Nasdaq innovative and honest.").

> Although the SEC endeavors to foster competition with the dominant markets—the NYSE and Nasdaq—the SEC also worries about fragmentation. Unfortunately, these goals tend to be conflicting and the Exchange Act does not provide the SEC with clear guidelines for reconciling these conflicts. The SEC has never fully trusted competition as a market regulator, but rather, has preferred regulation to ensure that the markets are transparent and fair, but not limited to a single monopoly marketplace.[91]

But this left fragmented markets as a reality, with the accompanying issue as to whether they gave retail investors the best securities' prices and the best information about those prices. As noted earlier, this is especially problematic when broker-dealers internalized or routed their retail customer order flow to particular market centers and when certain sophisticated investors obtained better trading data than these customers.[92] In other words, the SEC worried about the potential harm to retail investors without the existence of centralized marketplaces like the NYSE.

When she was writing about securities market structure issues in the early 2000s, in addition to showing an awareness of the above industry, legislative, and regulatory reasons for why the securities markets had developed as they did, Roberta understood that the securities market transformation owed much to technological innovations of longstanding stock trading practices.[93] For example, she understood how the "upstairs" block trading by institutional investors had moved into the "dark" ATSs to hide this trading's impact upon the market price of the securities being traded and to take advantage of the rapidity and anonymity of the electronic trading.[94] She knew that technology lay behind the speed of execution on all the securities markets and enabled

91. *Id.* at 399–400.

92. As Roberta perceptively asked:

> The real issue is whether regulatory solutions to these issues [i.e., have a single exchange or multiple ones] are needed or their resolution should be left to the market. This depends, in part, on whether the price discovery mechanism for equities is a natural monopoly in the sense that however many orders and intermediaries are formed into pools of liquidity, there is a public interest need to consolidate orders in a transparent system. Alternatively, can the trading markets be fragmented and still function in a fair and efficient manner?

Id. at 424. High-speed traders often purchase more extensive data from exchanges and use special communications technology to obtain exchange data faster than others. *See* HEALTHY MARKETS, THE DARK SIDE OF THE POOLS: WHAT INVESTORS SHOULD LEARN FROM REGULATORS' ACTIONS, at 3 (2015) (referring to this fact).

93. *See* Karmel, *Turning Seats Into Shares*, *supra* note 2, at 375 (discussing the growth of alternative markets from new technologies).

94. *See id.* at 372–73 (discussing the advantages of ATSs). Institutional investors often trade in large amounts, thus the name "block trading" (amounts of 10,000 shares). They have always been concerned that their amounts would affect the price of their trades. Firms on the exchanges traditionally handled blocks by trading in the OTC market or by having certain firms on the exchange divide up a block order for exchange execution. Today, institutional investors can use ATSs to conduct, and to hide, their trades.

broker-dealers to rout orders (or to internalize them) in compliance with Regulation NMS. She also realized that new advances in communications technology made possible the provision of market data by exchanges at different levels, amounts, and timing, understanding why the newly public company exchanges would seek to profit from this data.[95]

Her sensitivity to the history of and the forces affecting stock markets made Roberta careful about proposing a "grand solution" to securities market structure issues. In her pragmatic way, she asked whether a regulatory solution to this market structure was necessary or whether market evolution, with SEC guidance, would resolve fragmentation problems.[96] It was not that Roberta was afraid to advocate a major reform, if she thought that it was the necessary solution to market structure issues. But, at the time of her writing, she was more comfortable if there was continued experimentation and development in the securities markets, with the SEC making adjustments to deal with specific issues, before she would ask Congress or the SEC to impose an entirely new regulatory structure upon markets and market participants.[97]

The question for Roberta and for us today is whether her approach to securities market structure is the right one for the present or whether Congress or the SEC should engage in a wide-ranging reform. Certainly, there are now disturbing problems in the securities markets akin to those that Roberta noticed. For example, in the recent Archegos scandal, numerous financial firms were found to have allowed a lightly regulated family office to engage in highly-leveraged total return swaps.[98] This case encapsulated many of the issues that Roberta wanted financial regulators to address: an unregulated firm (Archegos), an OTC swap (total return equity swap), and, above all, excessive leverage given by financial firms.[99] With respect to

95. *See id.* at 395–99 (discussing the industry and regulatory struggles over market data fees charged by the major stock exchanges).

96. *See id.* at 424 ("The real issue is whether regulatory solutions to these issues are needed or their resolution should be left to the market. This depends, in part, on whether the price discovery mechanism for equities is a natural monopoly in the sense that however many orders and intermediaries are formed into pools of liquidity, there is a public interest need to consolidate orders in a transparent system. Alternatively, can the trading markets be fragmented and still function in a fair and efficient manner?").

97. *See id.* at 429 ("The form of tomorrow's trading markets should be permitted to evolve before the existing SRO structure is endorsed, dismantled or otherwise adjusted to compliment a new market structure.").

98. *See* Quentin Webb et al., *What Is a Total Return Swap and How Did Archegos Use It?*, WALL ST. J. (Mar. 30, 2021), https://www.wsj.com/articles/what-is-a-total-return-swap-and-how-did-archegos-capital-use-it-11617125839.

99. Investment advisors for family offices are not subject to registration, nor are the offices themselves. OTC total return swaps are not traded in any central marketplace. And banks lent money to the family office in this case to engage in the equity swaps. For a recent report on the failings in the firm (Credit Suisse) whose investment bank chiefly funded Archegos and lost $5.5 billion as a result, *see* SPECIAL COMM. OF BD. OF DIR., CREDIT SUISSE GROUP, REPORT ON ARCHEGOS

market structure issues, most of the problems have not drawn great regulatory attention, because they involve sophisticated market players. There have been actions against dark pools,[100] where broker-dealers operating them have been disciplined or settled charges. However, these pools generally involve institutional or wealthy investors who use them to hide their trades and who were misled into believing that their trading was entirely "dark" or "hidden," when in fact it was seen by high-frequency traders who could profit from it.[101] The fights between the stock exchanges who want to profit from their data and the firms who want cheaper access to it have been an intra-industry squabble that does not receive much publicity.[102] The SEC has continued to monitor the overall securities market structure and to enhance its tools to protect the markets and their integrity.[103]

Recently, the SEC did make a preliminary effort to address a market structure issue in its pilot program over rebates offered to makers or takers of liquidity on exchanges.[104] This effort involved an SEC pilot program designed to study the effect on the securities markets and market participants of fees and rebates that exchanges charge or give back, as the case may be.[105] Behind the program was clearly an SEC concern that these fees and rebates were distorting the market by increasing the number of marketplaces and exchange order types, and that they were potentially harming retail investors who usually did not benefit from any of the special deals. While this effort showed a cautious, experimental approach by the SEC to market structure issues, it was struck down by the Court of Appeals for the District of

CAPITAL MANAGEMENT (July 29, 2021), https://www.credit-suisse.com/about-us/en/reports-research/archegos-info-kit.html.

100. A "dark pool" is an alternative trading system that, because of its trading volume, does not have to reveal publicly the identity of trading counterparties and information on orders processed through it. *See* HEALTHY MARKETS, *supra* note 92, at 6.

101. *See, e.g.*, *In re* Barclays Capital Inc., Securities Act Release No. 10010 (Jan. 31, 2016). In this case, Barclays misrepresented to investors that it was screening out predatory traders (which included its own trading desk). If a trader knows that an institution is, say, selling large amounts of a particular security, among other things, the trader could sell short the security to take advantage of its drop in price from the institution's trading. *See also* HEALTHY MARKETS, *supra* note 92, at 26 (discussing enforcement actions on the dark pools).

102. *See, e.g.*, *In re* Sec. Indus. and Fin. Mkt. Ass'n, Exchange Act Release No. 84432 (Oct. 16, 2018) (finding that stock exchanges had not shown that challenged data fees were consistent with the purposes of the Exchange Act).

103. Several examples of protective regulations come to mind: there are Regulation Systems Compliance and Integrity, 17 C.F.R. §§ 242.1000–1007 (2021), designed to strengthen the technology components of securities markets, and the Consolidated Audit Trail, pursuant to 17 C.F.R. §242.613 (2021), which allows regulators to track an order in the national market system through its execution. *See* 17 C.F.R. §§ 242.613, 242.1000–1007 (2021); 17 C.F.R. § 242.613 (2021).

104. *See* Transaction Fee Pilot for NMS Stocks, Exchange Act Release No. 84875, 84 Fed. Reg. 5202 (Feb. 20, 2019) (promulgating Rule 6110T).

105. To simplify things, securities markets like exchanges charge trading fees for their use. Markets may give rebates on these fees to participants who bring liquidity to the markets (i.e., provide sell orders to it). They may also charge higher fees to participants who take liquidity from the market (i.e., send buy orders to it).

Columbia Circuit for precisely this reason.[106] The Court concluded that the pilot program had no purpose other than to collect data on the effect of the fees and rebates.[107] Because the SEC did not justify the pilot program as addressing a specific market problem in the area over which the SEC had jurisdiction—and the SEC did not articulate that this was the purpose of the rule—the Court found that, in promulgating the pilot program, the SEC went beyond its statutory authority.[108]

There is the possibility of new regulatory attention to market structure. This attention and accompanying concerns about the protection of retail investors in securities trading recently came to the foreground with respect to retail trading during the pandemic, much of which went through Robinhood, the online broker-dealer that appealed to retail investors with its commission-free trading and its attractive app.[109] It came to light that Robinhood was able to allow investors to trade without charge because certain broker-dealers, such as Citadel, were paying for its retail order flow. While the harm to retail investors was not immediately apparent—indeed they seemed to benefit from the arrangement by not paying commissions for their stock trades, there were complaints that the investors were not getting best execution, even if Robinhood and the other broker-dealers made sure that the investors got at least the legally required NBBO.[110] The House Committee on Financial Services held hearings on the subject, but its members struggled to understand the mechanics of trading and to try to articulate the harm that was done to retail investors by the payment-for-order flow arrangement.[111] More importantly, the new SEC Chair, Gary Gensler, promised to have the SEC

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106. *See* New York Stock Exch. LLC v. Sec. & Exch. Comm'n, 962 F.3d 541, 544 (D.C. Cir. 2020).

107. *See id.* at 545.

108. *See id.* at 546.

109. *See* Peter Rudegeair & Corrie Driebusch, *Robinhood IPO Filing Shows Power of the Meme-Stock Boom,* WALL ST. J. (July 1, 2021), https://www.wsj.com/articles/robinhood-ipo-144iling-shows-power-of-the-meme-stock-boom-11625163113 (describing the firm's success and initial public offering).

110. *See In re* Robinhood Fin., Securities Act Release No. 10906 (Dec. 17, 2020), at 4. Among other things, the SEC found that Robinhood had misleading communications on its website that did not disclose the extent of the payment for order flow that it received and its inferior execution quality in price improvement in comparison to other retail broker-dealers. *See also In re* Robinhood Financial LLC, FINRA Letter of Acceptance, Waiver, and Consent No. 2020066971201 (June 30, 2020). In this latter settlement, among other things, Robinhood is found to have made misleading disclosures to its clients and improperly supervised option trading by them. As a result, ordinary investors incurred large losses when they entered into options strategies but themselves neglected to perform a necessary part of the strategy, believing that Robinhood would perform it. FINRA found that Robinhood had not properly supervised its advertising, its account records, options trading, and particularly its technology, which was critical to its business as an online brokerage. *Id.*

111. *See Virtual Hearing - Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide*, U.S. HOUSE COMM. ON FIN. SERV. (Feb. 18, 2021), *available at* https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=407107 (first of three hearings).

look again at order routing practices, like payment-for-order flow, in the retail investor context.[112] This examination could once again open the door for the SEC's reconsideration of fragmented markets. Indeed, Chair Gensler asked if harm arose from the fact that so many orders did *not* get routed to the stock exchanges, which sounds like the SEC's classic theme of favoring centralized marketplaces and which supports the continued dominance of the stock exchanges.[113]

CONCLUSION

An important part of Roberta's scholarly contribution dealt with the related topics of the transformation of the SROs as regulators of broker-dealer conduct and as the building blocks of the securities market structure. She entered this area, where few securities law academics dared (and still dare) to tread, because she was familiar with the issues from her experience as an SEC staff member and Commissioner and as a securities law practitioner. Being on the board of the New York Stock Exchange certainly gave her a useful vantage point on these issues, as did her work with the NASDR. She thus performed a valuable role in explaining the SRO and securities market structure issues to a generation of securities law scholars.

Aware of the competing interests of securities firms and regulators and of the rapidly changing nature of securities markets due to technological advances, and not entirely comfortable with grand theoretical solutions, Roberta took a pragmatic approach to the transformation of SROs. In an important contribution, she noted the contradictions and problems in the SROs that emerged in the early 2000s in, on the one hand, the quasi-governmental FINRA and, on the other, in the public company exchanges competing with the ATSs and with their broker-dealer members. On the SRO as a regulator of broker-dealer conduct, she pointed to the problems of a FINRA that began to look more and more like an arm of the SEC but argued that it be given time to function independently of that agency. She also

112. *See* Gary Gensler, Chairman, U.S. Sec. and Exch. Comm'n, Prepared Remarks at London City Week, Washington, D.C. (June 23, 2021).

113. As Chair Gensler remarked,

> Today, our markets essentially have three different segments. While the public generally thinks of lit markets when they think of buying or selling equities — markets like Nasdaq and the New York Stock Exchange — those big public exchanges only accounted for about 53 percent of trading volume in January.
>
> So where's the other 47 percent — trading interest that's not displayed on the lit markets? It's executed by alternative trading systems, which include dark pools, and by off-exchange wholesalers. Thus, significant trading interest on these platforms is not necessarily being reflected in the commonly cited National Best Bid and Offer quote.
>
> I've asked staff to consider whether this equity market structure, as currently composed, best promotes efficiency and competition.

Id. (footnote omitted).

accepted the outcome of a new kind of self-regulation that is built upon the relationship between FINRA and firm compliance officers, who are now the representatives of self-regulation in their firms. On the SROs as securities markets, she was not entirely satisfied with the current fragmented market structure arising from competing stock exchanges, ATSs, and broker-dealer internalization, but was reluctant to propose a grand theoretical solution to this situation. Acutely aware of the industry and technological forces behind this transformation of market structure, she favored continued market experimentation with the SEC's occasional interventions to address specific problems. In all this work, she taught us securities law scholars the important lesson of trying to understand, and being willing to face, the complexities of the securities markets and their participants, which would make us better scholars and more able to offer our own solutions to securities market issues.